Finance for Europe

Association for Financial Markets in Europe

Briefing note

AFME T+2 Task Force: Recommendations – July 2014

24 July 2014

1. Introduction

In May 2013, the AFME T+2 Task Force published a paper describing the challenges that it foresaw in the run up to a migration to a shortened settlement cycle. Following the finalisation of the CSD Regulation (CSDR), the Task Force reconvened to examine the implications of the final wording. It quickly identified many potential issues throughout the trade lifecycle which had not been previously observed. The focus was on topics outside of the mandatory scope of the CSDR, and where AFME and its members would be impacted.

For a number of potential issues, the Task Force identified measures or recommendations for best practices between market participants, which can alleviate or prevent most impacts. Care was taken to respect the provisions of CSDR and also to avoid duplication with other ongoing work by other market associations and task forces

The Task Force identified the following types of potential issues regarding T+2:

- Potential issues which can be addressed by common market practices and/or improvements in securities processing. Recommendations have been provided below
- Need for detailed information/harmonisation. AFME intends to collate such information on behalf of its members, and intends to work together with other task forces on this where possible
- Transition-related issues, which AFME members need to be aware of
- Bilateral issues which are best addressed between market participants, or internally within individual organisations

Where possible, AFME proposes to leverage the best practice recommendations made by the ECB Task Force on T+2 in the scope of T2S. AFME formally endorse these, not just for T2S markets but for all EU impacted markets. In certain cases, particular nuances or details were deemed critical and these are explained below.

A principal area of concern is the impact of a change in the settlement cycle for transactions executed on a regulated platform or MTF (i.e. in scope of CSDR) on those transactions executed and settled off exchange (often referred to as "OTC", which are out of scope of CSDR).

AFME believe it is of critical importance to provide additional guidance on the default settlement cycle for such OTC transactions, and to ensure that both are aligned where possible, unless there are valid business reasons to deviate from it. We recognise that venues, clients and AFME members are all seeking further clarity in this area.

While these recommendations for market participants provide guidance for a default settlement cycle for different instrument types, they allow the necessary flexibility for market participants to agree between themselves on exceptions with a different settlement date. These recommendations reflect the majority opinion of AFME members who require certainty when they trade, and are in no way intended to contradict the Regulation.

Changing settlement cycles for in-scope instruments also has an impact on other securities which are outside of the scope of transferable securities as defined by the Regulation. Examples are UCITS funds which invest in European equities or bonds, and where subscriptions and redemptions settle on a different lifecycle (T+3 or even T+4). While AFME recognises there will be spill over impacts on such out of scope instruments, it is of the opinion that these issues can best be addressed by other associations, which have a greater competency than AFME to opine on these matters.

Finally, we recognise that investors and intermediaries in other regions, when trading and settling in European securities will be impacted by the reduction of settlement cycles due to a shorter window to manage the post trade process. They will receive a confirmation at the end of trade date, and possibly only be able to process on T+1 for next day settlement. Whilst our colleagues in Asia, ASIFMA, have worked with their members to alleviate some of the problems, T+2 settlement will be a challenge.

Finally, we expect that the process of borrowing securities to cover fails to the venues will be challenging. We foresee a potential decrease in the availability of securities available for loan, which in turn is likely to lead to further settlement fails.

Whilst we have no concrete recommendations for these latter points, it will be important that markets are prepared for an increase in failed trades across the migration weekend and for some time afterwards until the markets adjust to the new settlement cycle. To alleviate the consequences thereof, AFME would encourage market infrastructures to consider a temporary pause of fining regimes, where possible, in the period following the transition to T+2 in October 2014.

2. Recommendations for market participants

T+2 as default rule for most OTC transactions

The AFME Task Force supports the ECB as well as the ICMA best practice proposals, promoting T+2 as the default settlement period for all OTC transactions in transferable securities in scope of art 5.1 CSDR, unless:

- a different lifecycle is bilaterally agreed by individual counterparties (see ECB BP 1), or
- in the case of certain types of instruments which are mostly traded off exchange, there is an overriding business reason to keep the current OTC standard settlement cycle. The move to a shortened settlement cycle would require substantial changes outweighing the potential benefits.

Define standard default OTC settlement cycles per type of instrument

The Task Force encourages a standard default OTC settlement cycle per type of instrument (as opposed to more complex methods, e.g. a mixed approach using broker execution venue + instrument type). This default standard still leaves room for both parties to agree on a different lifecycle.

Based on majority views among AFME members, a matrix has been enclosed for default OTC settlement cycles for most instrument types. AFME proposes to use this matrix (attached) as a basis for discussions between market participants.

Trade affirmation/confirmation (preferably on Trade Date)
Trades need to be allocated, confirmed and affirmed as soon as possible, preferably on Trade Date (T) to ensure timely input and matching of settlement instructions into the CSD ahead of settlement date (S), and where possible on T.

AFME proposes that this confirmation and allocation process takes place on Trade Date where possible, in line with ECB BP nr 13.

Whilst this practice is strongly recommended, it should not be mandatory, nor subject to fines/penalties (as explained in the AFME submission to the ESMA CSDR Discussion paper), to allow for flexibility for specific trade types and for clients in different time-zones.

Whilst the mandatory use of Place of Settlement (PSET) is unlikely to be implemented by all participants by October, AFME continues to believe that the use of this field is beneficial and recommends all participants work towards populating this field in their confirmation and settlement messages.

Input and matching of settlement instructions
To encourage early input and matching of settlement instructions, the Task Force recommends:

- to include the maximum amount of information for matching in the trade confirmation/affirmation process, to optimise the matching of settlement instructions based thereon
- incentivising the early input of settlement instructions into the CSDs. Transactions with a T+2 or longer settlement cycle should match by ISD-1 end of business day, while for transactions with ISD with T+1 or T+0 settlement cycle, the trade should match on ISD
- encouraging the use of tools which facilitate the early input and monitoring of settlement instructions into the CSD, such as the use of Hold and Release functionality, and the provision of allegement and matching reporting.

Optimisation of settlement on S
To maximise the potential for early settlement on S, AFME recommends the following functionalities be available to market participants, which can then opt to use them:

- optimisation of settlement early on S. This can be achieved through a combination of measures including the use of overnight settlement processes and settlement optimisation (netting) tools
- provision of real-time settlement processes and settlement information by CSDs
- partialling of settlement instructions, balancing the pros of increased settlement efficiency against the costs
- the provision of automated securities borrowing facilities, where appropriate.

Impacts on derivatives
Changes in the settlement periods of securities will also have an impact on the settlement of derivatives (e.g. futures, options) based on these securities. The AFME Task Force supports in general the ECB recommendation to align the settlements of derivatives, both listed and OTC derivatives, (when physically settled/exercised) to the underlying instruments, including where that switches to T+2, and refers for further guidance to other associations such as ISDA, which are analysing best practices.

3. Need for market information/harmonisation

To allow market participants to prepare for the migration to T+2, it is key that market infrastructures provide timely, detailed information on the exact scope and timing of the change to T+2.

A large amount of information has been disseminated by different venues, however, AFME observes that such information is not always complete, and sometimes inconsistent across different markets.

In this respect, the AFME Task Force will send a short questionnaire to most of the different trading venues, CCPs and CSDs to gain greater clarity and to establish where different practices emerge in collaboration with the ECB T+2 Task Force.

The key objectives are to:

- Request all trading venues to confirm which products are in scope
- Encourage MTFs to define and publish their settlement cycle
- Obtain information from CCPs about their netting practice over migration
- Obtain information about likely corporate actions over migration period.
- Obtain information about testing that will occur at each CSD

4. Transition to T+2

Most markets have converged on a single migration date around the weekend of 4-5 October 2014.

The AFME Task Force endorses the ECB Best Practice proposals around:

- Avoidance of indices rebalancing (BP nr 6)
- Avoidance of portfolio transfers (BP nr. 7)
- Avoidance of issuance and complex corporate action events (BP 8)
- Publication of changes on corporate action processing as a result of the migration (BP nr. 9)
- Sequencing and changing of ex-date and record-date (BP nr 10)

In addition, the AFME Task Force would like to highlight some potential issues surrounding the migration date, with a view to creating awareness among market participants, allowing them to take the necessary steps. In addition, some suggestions/recommendations are made:

i. CCPs are encouraged to review their trade netting processes, and communicate their netting/aggregation methodology for trades over transition date. AFME encourages the CCPs not to deviate from their usual netting process and to explain the process pre-transition.

ii. AFME anticipates an increase in settlement volume on 8 October, especially on-exchange transactions. Market participants and infrastructures should ensure they have sufficient staff available to manage over this migration date and the subsequent weeks to cope with any transition issues.

iii. AFME recommends that, in markets which have a settlement discipline regime (late settlement fines), this regime is temporarily relaxed until the end of October 2014.

iv. In-scope CSDs are encouraged to be flexible and prepared to support all market participants with regard to their deadlines on 8 October and thereafter given the spike of volumes on this date and expected increase in fails for a period thereafter.

v. In-scope market infrastructures are requested to formally communicate their readiness /'go-live' status to participants for the transition to T+2 over the weekend of 4th / 5th October. Additionally, market infrastructures should make test environments available to their participants in advance of the migration.

vi. Market participants are encouraged to review their central bank settlement liquidity needs across the in-scope markets to support the spike in settlement volumes on 8 October.

During this transition phase and perhaps sometime thereafter, securities inventory management and borrowing activities may be challenging. Throughout that period, there may be a risk of a temporary decrease in available securities on loan, which could lead to further settlement fails.

5. Conclusion

AFME members are aware that there are still outstanding questions in relation to the move to T+2. Some products (e.g. funds, derivatives) are outside of our members' area of core competence, and we call upon other organisations to review the impacts of the move to T+2 and issue recommendations where appropriate.

Nevertheless, we believe that this paper can help guide members and their clients to common ground and ease the transition to T+2 settlement. AFME is amenable to constructive dialogue with other organisations on this topic.

Annex: table for default OTC settlement cycles

The following table summarises the views of the majority of the AFME members on the appropriate default settlement cycle for OTC settlements, for transferable securities in scope of the CSDR. It is only intended to define default standard OTC settlement cycles as basis for further discussion between counterparties.

	Asset Type	In Scope of CSDR (transferable securities)	Rationale for OTC activity settlement cycle	Default OTC settlement cycle (parties can agree bilaterally otherwise)	Comment
Equities	**Equity**	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	Warrants	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	Rights	**Y**	- Align OTC settlement of activity on Trading Venues	**T+2**	
	Preferred Shares	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	Depository Receipts (ADR, GDR) [1]	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	For OTC transactions in European CSDs
	Investment Trusts inc REITs	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	Convertible bonds	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
Fixed Income	**EU Sovereign Government bonds**	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	Corporate bonds	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	Emerging markets bonds	**Y**	- Significant activity on domestic market - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	RMBS/Asset Backed Securities (ABS)	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	Eurobonds [2]	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	Supras & Agencies	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	
	Covered Bonds	**Y**	- Significant activity on Trading Venues - Align OTC settlement with settlement of activity on Trading Venues	**T+2**	

Please see notes overleaf.

Notes to the table

[1] Scope is the not the underlying asset ('ordinary'), but the Receipt or Share itself. This only covers DR's which are traded/listed on a European trading venue

[2] Bonds within this category include bonds that carry an ISIN prefixed with "XS" where settlement is undertaken via EU domiciled ISCDs. They can be issued via a common depository, global notes, and or bearing Regulation S & 144A Selling Restrictions

The following is based on agreement by AFME members and is provided as a guideline. AFME reserves the right to add additional information in the future.

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