

Response: ESMA call for evidence on shortening the settlement cycle in Europe

Background

Established in 1961, the World Federation of Exchanges (WFE) is the global industry association for exchanges and clearing houses (CCPs). Headquartered in London, it represents over 250 market infrastructure providers, including standalone CCPs that are not part of exchange groups. Of our members, 34% are in Asia-Pacific, 45% in EMEA, and 21% in the Americas.

The WFE’s 90 member CCPs and clearing services collectively ensure that risk takers post some $1.3 trillion (equivalent) of resources to back their positions, in the form of initial margin and default fund requirements. WFE exchanges, together with other exchanges feeding into our database, are home to over 50,000 listed companies, and the market capitalisation of these entities is over $100 trillion; around $140 trillion (EOB) in trading annually passes through WFE members (at end 2022).

The WFE is the definitive source for exchange-traded statistics, and publishes over 350 market data indicators. Its free statistics database stretches back more than 40 years and provides information and insight into developments on global exchanges. The WFE works with standard-setters, policy makers, regulators, and government organisations around the world to support and promote the development of fair, transparent, stable and efficient markets. The WFE shares regulatory authorities’ goals of ensuring the safety and soundness of the global financial system.

With extensive experience of developing and enforcing high standards of conduct, the WFE and its members support an orderly, secure, fair, and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise the common good, consumer confidence, and economic growth, and we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in a globally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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Introduction

The WFE appreciates the opportunity to comment on the European Securities and Markets Authority (ESMA) call for evidence on shortening the settlement cycle in Europe, and to share perspectives and feedback on behalf of our members. The WFE and its members share ESMA’s goals of ensuring the safety and soundness of the global financial system, which is critical to enhancing investor and consumer confidence. We therefore remain supportive of the broader effort to ensure that potential developments in securities settlement are analysed properly and appropriately managed by the associated international policy framework.

Response  
 **The current state of play**

On the 15th of February 2023, the US Securities and Exchange Commission (SEC) adopted final requirements for Rule 15c6-1 to formally change the settlement date for trades in cash equities, corporate debt, and unit investment trusts in the US from trade date plus two trade days (T+2) to trade date plus one trade day (T+1).[[1]](#footnote-2) An implementation date has been set for the 28th of May 2024, with the Canadian Capital Markets Association (CCMA)[[2]](#footnote-3) and Contraparte Central de Valores of Mexico (CCV)[[3]](#footnote-4) announcing they will follow suit one day earlier on the 27th of May.

This shift follows the implementation of T+1 in India, which has been phased in by the Indian Securities and Exchange Board (Sebi) based on investor type and the ranking of different stocks by market capitalisation, and China, where Interbank Market government bonds settle at T+0, and stocks traded on-exchange settle at T+0 for securities and T+1 for cash. In other jurisdictions, the United Kingdom (UK) launched the Accelerated Settlement Taskforce (AST) in December 2022 to explore the potential for faster settlement of financial trades, with initial findings due in December 2023, and a full report and recommendations made by December 2024.

When the US migrated from T+3 to T+2 settlement in 2017, a majority of international markets were already on a T+2 settlement cycle. Most securities transactions executed on trading venues in EEA countries, the UK, and Switzerland have followed T+2 settlement cycles for most major asset classes since 2014. Further shortening of settlement cycles will create international dislocation as many jurisdictions are likely to remain at T+2 in the medium term.

**Potential benefits of moving to a T+1 settlement cycle**

There are important implementation challenges to overcome, but the transition to T+1 could potentially provide benefits to market participants and the overall economy.

The first key benefit is that of potential risk reduction in the long run. Risk can be viewed as a function of time – a shorter window for cash and securities to change hands after a trade is agreed results in less time for market conditions to change and cause the mark-to-market value of a position to change, which could coincide with a counterparty defaulting on its obligations. Therefore, T+1 would reduce risk, particularly during periods of high volume and volatility, in addition to getting customers funds or securities quicker than otherwise.

This reduction in risk would feed into another key benefit of a shorter settlement cycle, which is the reduction of costs for market participants. A shorter window of exposure to price volatility and counterparty risk may lower the amounts of margin required by CCPs when clearing participant trades, and fewer price changes would result in fewer margin calls made to clients. The Depository Trust and Clearing Corporation (DTCC) estimates that shortening the settlement cycle to T+1 could reduce the volatility component of the margin collected by its National Securities Clearing Corporation (NSCC) CCP by 41%.[[4]](#footnote-5) This reduced capital burden would free up cash and help market participants during volatile periods, creating more opportunities to use capital efficiently, increasing overall market liquidity, and leaving investors with faster access to funds. However, the WFE encourages ESMA to also consider one-time costs incurred during the T+1 implementation which may outweigh the benefits for many industry participants, as discussed below.

Shortening the settlement cycle is also promoted as a way to ultimately modernise technology and infrastructure, as the shift will require significant investment in new systems and procedures and automation of manual processes to drive further post trade efficiency where automation is not already in place across the broader ecosystem. This includes the adoption of Straight-Through Processing (STP) to enable match-to-instruct capabilities for trade affirmation and confirmation, for example. These upgrades should reduce manual errors and increase productivity in the mid-to-long term. The migration to T+1 settlement may also improve standardisation across processing timelines, and improve transparency and access to shared data (particularly for critical reports or intraday trade allocation data between counterparties).

**Challenges from shorter settlement**

However, upgrading or replacing existing operational and technological infrastructure represents a considerable expense to the industry. Many CCPs would face significant one-time costs for design, implementation, and testing for the adjusted and extended netting and end-of-day processing, and increased running costs such as additional reporting. Impacted processes would include the linking of single trades by Clearing Members; trade Date Netting; the sending of settlement instructions, and the generation and provision of CCP reports. The shift to T+1 will likely result in a number of other significant challenges due to the compressed window for various market players (such as CSDs, CCPs, trading venues, custodians, and brokers) to carry out post-trade processes prior to settlement, such as matching the details of both sides of the transaction, allocation, affirmation and confirmation, netting of positions, funding of treasury and securities flows, and matching the currencies of payments.

While previous compressions of the settlement cycle have removed a business day between trading and settlement, it should be noted that T+1 removes the only business day between trading and settlement, creating significant pressure on post-trade operations. The decreased time available to undertake these processes could heighten a number of risks, such as an increase in failed trades and trade breaks due to the reduced time available for reconciliation and error correction. Some smaller participants may also lack the liquidity to meet quicker settlement obligations.

A shortened settlement cycle also presents challenges for instruments with underlying components that are tradable across multiple markets. ETFs are likely to be particularly impacted by a shorter settlement cycle, due to their global composition with underlying securities across multiple jurisdictions.

Different time zones also create complexities for foreign investors in a T+1 world - investors based in Asia have little overlap with European working hours, while the European overnight settlement process starts midway through the US working day, leaving a relatively short window until market-close to remediate any issues under T+1. This complexity increases when dealing with foreign currency exchange (FX) transactions, as FX markets mainly operate on a T+2 basis, and transactions typically occur after a security purchase has been confirmed. This is of particular concern for markets in the Asia-Pacific region, which currently has one full day to reconcile any FX-related issues. Further compression of the settlement cycle may effectively enforce a T+0 cycle, with any FX issues likely leading to settlement failures unless foreign currency investors provide money up front (assuming they know in advance that they will need to do so), requiring more liquidity. Alternatively, service providers may provide bridge funding to facilitate the FX transactions, creating new exposures, outside the centrally cleared system.

Overall, the WFE expects that settlement fails will increase noticeably. Settlements on the Intended Settlement Date of T+2 often do not happen right at the start of night-time settlement (NTS) but rather later during the day. This suggests that these intraday settlements on T+2 would result in settlement failures following the shift to a settlement cycle of T+1. Instruction deadlines may need to be adjusted, as end-of-day processing will become more significant to enable settlement the next day.

**Shortening the settlement cycle needs to be based on a robust cost-benefit analysis**

Successful adoption of a T+1 settlement cycle would also require an industry-wide effort to update operational processes. The WFE therefore advises that sufficient time should precede the implementation of a shorter settlement cycle in the EU to accommodate these improvements to trading and post-trade processes by market participants. A robust cost benefit analysis should be undertaken, including an impact assessment and feasibility study outlining potential risks, dependencies, and bottlenecks. A schedule should be created, highlighting a transparent decision-making process and decision-point, and if it is decided to shorten the settlement cycle in Europe, this should take place according to an agreed industry roadmap, including continuous assessment of industry preparedness, as well testing under the shortened settlement cycle, issue resolution, and migration management during the period leading up to any migration. We believe that, for CCPs, a minimum of 18 to 24 months is required for T+1 adoption after the respective changes have been published in the Official Journal.

Shifting Europe to a shorter settlement cycle would require a particularly co-ordinated effort, and one should not apply examples from the North American experience to a European context without understanding important structural differences. Europe’s capital markets feature a diverse range of legal, fiscal and regulatory frameworks, with a significant number of market infrastructures for trading, clearing and settlement. Europe is home to 14 currencies, 41 exchanges, 18 central counterparty clearing houses (CCPs) and 31 central securities depositories (CSDs), whereas the US has dealt with one currency, less than half the number of exchanges, one CCP, and two CSDs.

**Moving to atomic settlement or a T+0 settlement cycle before T+1 could create new risks**

When looking beyond T+1, it is important to distinguish between atomic settlement and T+0 (Trade Date plus zero days). Atomic settlement represents the immediate settling of trades after a buy or sell order is placed, which would likely rely on new technology in the early stages of development, such as Distributed Ledger Technology (DLT). Atomic settlement would require post-trade processes to occur before trading, such as provision of allocations and exchange of settlement information, positioning of sufficient securities by the seller, and the pre-funding of the settlement amount by the buyer in the correct currency. This model would require a complete transformation of the trade lifecycle, removing the liquidity-saving convenience of settling to a delay, tying up capital, and losing the efficiencies and risk mitigation gained from multilateral netting when clearing through a CCP, which may no longer be utilised in an atomic settlement environment.

On the other hand, T+0 represents settling the trade on the same day, either throughout the day at certain times, or at the end of the day at close-of-business. An “end of day T+0” model preserves certain benefits such as the cost efficiencies and risk mitigation received from multi-lateral netting when clearing through a CCP. Although not so much of a complete overhaul when compared to atomic settlement, an immediate move to T+0 settlement would still require a considerate transformation of current pre- and post-trade processes, and therefore it is the WFE’s view that moving from T+2 to T+0 could result in the needless creation of new risks, rather than a reduction as desired by ESMA. We would encourage any consideration of T+0 to take place only after the move to T+1 has been successfully completed and with a careful quantification of the benefits.

Conclusion

The WFE appreciates the opportunity to comment on ESMA’s call for evidence on shortening the settlement cycle in Europe, and agrees that the question of settlement cycle duration is of significant importance, as this may bring benefits in terms of technological modernisation, increased capital efficiency, and reduced counterparty exposure, while risking other impacts such as spikes in trade fails, liquidity shortfalls, or market volatility.

However, moving to a shorter settlement cycle presents substantial challenges, particularly within the context of Europe’s complex post-trade ecosystem. Therefore, the WFE encourages ESMA to focus on market readiness and consider the level of technological and operational change required by market infrastructure providers. Furthermore, the WFE highlights that moving beyond T+1 would require a fundamental overhaul of market infrastructure, technology, and regulatory frameworks, and that any further work regarding moving to T+0 or atomic settlement should involve significant additional consideration of these risks and their potential consequences.

Any next steps towards a shorter settlement cycle should involve extensive industry-wide engagement, a robust cost benefit analysis, impact assessment, and feasibility study, with an outline of potential risks, dependencies, and bottlenecks, as well as a transparent decision-making process with a clear migration decision-point. If it is decided to shorten the settlement cycle in Europe, this should take place according to an agreed industry roadmap, including continuous assessment of industry preparedness, testing under the shortened settlement cycle, issue resolution, and migration management during the period leading up to any migration. Any transition should not be rushed, and the WFE recommends that the EU use this time to observe and incorporate the lessons learned following the implementation process of T+1 in the US.

1. Securities and Exchange Commission (SEC), “*Shortening the Securities Transaction Settlement Cycle”,* https://www.sec.gov/investment/settlement-cycle-small-entity-compliance-guide-15c6-1-15c6-2-204-2 [↑](#footnote-ref-2)
2. Canadian Capital Markets Association (CCMA), “*T+1 Portal*”, http://ccma-acmc.ca/en/wp-content/uploads/All-about-the-CCMA-Tour-savoir-sur-lACMC.pdf [↑](#footnote-ref-3)
3. Contraparte Central de Valores of Mexico (CCV), “*Announcement to market participants*”, https://www.contraparte-central.com.mx/wb3/wb/CCV/archivos\_publicos/\_vtp/CCV/118d\_2023/\_rid/151/\_mto/3/CCV\_y\_AMIB\_T1\_Anuncio\_Ingle769s\_Version\_FInal.pdf [↑](#footnote-ref-4)
4. The Depository Trust and Clearing Corporation, *“What are the industry benefits of accelerated settlement?”,* https://www.dtcc.com/ust1/faqs [↑](#footnote-ref-5)