ALFI's response to ESMA discussion paper of 20 March 2014 on draft technical standards for the regulation on improving securities settlement in the European Union and on central securities depositories ('CSD')

Luxembourg, 22nd May 2014

Dear Sirs,

ALFI is the representative body of the 2.7 trillion Euro Luxembourg fund industry. It counts among its members not only investment funds but also a large variety of service providers of the financial sector. There are 3,885 undertakings for collective investment in Luxembourg, of which 2,538 are multiple compartment structures containing 12,343 compartments. With the 1,374 single-compartment UCIs, there are a total of 13,690 active compartments or sub-funds based in Luxembourg. 67% of UCITS that are engaged in cross-border business are domiciled in Luxembourg. As one of the main gateways to the European Union and global markets, Luxembourg is the largest cross-border fund centre in the European Union and, indeed, in the world.

As a general comment the Association of the Luxembourg Fund Industry ('ALFI') welcomes the opportunity to submit its comments on the European Securities and Markets Authority's ('ESMA') discussion paper for technical standards for the regulation on improving securities settlement in the European Union and on central securities depositories (CSD). ALFI would like to underline, however, that it voluntarily refrains from commenting individually each question or issue raised by ESMA, as some of these concern the governance of CSDs and their technical implementation of the new standards, and because of the very different nature of investment funds and issuing procedures in cross-border jurisdictions compared to other financial instruments.

ALFI acknowledges the substantial benefits of T+2 settlement for exchange traded financial instruments held by the portfolios of investment funds, while noting a number of limitations in its application to non-exchange traded instruments held by investment funds and shareholder transactions in investment funds that are not traded on exchange. ALFI would like to use this as an opportunity to highlight the main points ESMA should consider regarding T+2 settlement of Luxembourg investment funds.

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From a risk perspective, ALFI welcomes and supports the application of a harmonised reduced settlement cycle and enhanced settlement discipline for on exchange traded financial instruments across European Member States and trading venues. European capital markets will largely benefit from increased standardisation of settlement cycles, leading inevitably to an increase of market liquidity and investor protection, thus becoming an integral component of the risk management framework for investment managers and depositary banks.

The T+2 settlement cycle that will apply to most of those financial instruments that constitute the majority of assets in the investment portfolios of Luxembourg UCITS, is not equally valid for shares or units issued by the same UCITS to investors. Most trades in Luxembourg UCITS are by design different to many other European securities classes as they are ordinarily transacted directly with the promoter or its agent as primary market trades. The open ended nature of most funds means many shares are created on demand by or through the funds' agents. The act of sending a subscription or redemption order to the fund's agent by the cut-off time published in the fund's prospectus is the action that generates a trade using the price corresponding to next applicable NAV valuation. The settlement risk which is generated by this trade or subscription is entirely monitored by the fund management company, the depositary bank or its agent. The shares or units in the UCITS are only created or liquidated on receipt of the order typically with settlement received from or paid to the investor three or four days after the trade date. ALFI therefore considers that the official "trade date" for subscription and redemption of UCITS shares or units cannot be determined in accordance with the same standards that apply to "on exchange" trades of financial instruments that settle on receipt of matching instructions, on a DVP settlement basis on T+2. As such the primary UCITS investor trades with the funds agent are not comparable with on exchange trades of financial instruments traded on the secondary market, that are entered into with a counterparty that holds the securities. In this case, the market risk exists and vests with the holder. It is valid to state that a reduced settlement cycle reduces market and settlement risk, but this statement needs to be considered against the various aspects described below.

There are a large number of investors in European investment funds domiciled in Luxembourg located in countries in the eastern time zones that manage to settle trades with T+3 terms on a timely basis. However it is unlikely that many investors would be able to manage a T+2 settlement as they would not access trade confirmations until sometime on T+1 which they need to load into their systems and reconcile before instructing the payment. It is likely therefore that a move to T+2 would damage the appeal of European UCITS to Central and Eastern European and Asian investors. The timing of such a move would be damaging particularly at a time when Asian countries are considering local fund passporting regimes of their own.

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As described above, before determining whether a fund could be settled on T+2 settlement terms, the dealing cut-off and valuation model of the fund should be considered. For example if a fund has a dealing cut-off of 16:00 CET (T); a close of US markets valuation point 22:00 CET (T) and the NAV calculation is performed by 10:00 CET (T+1), this leaves limited time to issue trade confirmations to investors and for them to process them and settle by T+2. This becomes even more acute an issue for certain currencies that need to be instructed prior to the value date (settlement date).

Investment Funds with a global, balanced or multi-assets mandate and a geographically diversified investment policy in securities in the underlying fund portfolio offer a range of contractual settlement dates from T+0 to T+3 plus. As such a movement to T+2 settlement may help the investment manager with the liquidity of the fund overall where existing shareholder settlement terms are T+3 or greater, but moving the shareholder terms at the fund level to T+2 will add pressure on the fund's liquidity.

Many alternative investment funds UCI's are designed with a customised liquidity model set at the level of the fund to accommodate the investment in the portfolio's assets type or the nature of the investment proposition. As such if an investment manager is trading in illiquid assets, in a "prepaid model" he may well require subscription proceeds on or before trade date, this is quite common in private equity and hedge funds. Equally the terms for settling redemption orders from investors may often be delayed by several weeks or months. Settling on T+2 would not work for most of these funds.

European UCITS domiciled in Luxembourg are denominated in many different currencies or offer a hedged share class in a currency different to that of the fund denomination. Investors purchasing in these currencies may find it difficult to instruct the settlement of the trade before the relevant currency instruction cut-off (determined with reference to the relevant central bank cut-off time), particularly for smaller currencies or where the investor is located in the eastern time zone.

Given the primary nature of investment fund order processing and the specific role of the fund \ the Transfer Agent as the sole issuing agent, the idea of buy-ins cannot apply to the fund parts which are either created or cancelled on the register. Interest claimed on late settlement is common practice and for extended late payment funds ordinarily have the right to recover market losses and cost incurred on unsettled trades from the subscribing investors. Given the low level of late settlement the working group saw no need for additional penalties to apply to investors who settle late.

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