Response to ESMA's Call for Evidence
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I am pleased to respond to ESMA's Call for Evidence regarding the possible compression of settlements in securities trades to T+1.

Specifically, ESMA requests evidence on:

- What would be the impact of the reduction of the securities settlement cycle in the operations of market players;
- What would be the benefits and the costs that a shorter securities settlement cycle would bring;
- If it is concluded that a mandatory shorter settlement cycle should be imposed, how and when a shorter settlement cycle could be achieved;
- What are the impacts on the EU's capital markets resulting from international developments related to securities settlement.

The first thing ESMA points out is something that the proponents of T+1 have not mentioned, the fact that many of the global markets, which are interconnected, do not, and may not in the future, have the same settlement cycles. For example, an asset manager (AM) that sells a European security and buys a US security as a replacement after May of next year faces the clear possibility that it won't have the cash for the US settlement because the European settlement won't have happened yet. Interestingly, this represents a business opportunity for DTCC and the custodian community, since they can lend the AM's customer the funds overnight, generating entirely risk-free interest income. The same effect applies to cross-currency transactions, where the currency trade settles T+2 and the securities trade settles T+1.

ESMA's Call for Evidence also mentions the Central Securities Depositories Regulation, which "introduced … a series of requirements to prevent settlement fails." CSDR itself says "The cash penalties referred to in Article 7(2) of Regulation (EU) No 909/2014 shall be calculated and applied by CSDs for each settlement instruction that fails to settle… CSDs shall charge and collect on at least a monthly basis the net amount of cash penalties to be paid by each failing participant… CSDs shall distribute on at least a monthly basis the net amount of cash penalties referred to in paragraph 1 to receiving participants affected by settlement fails." What that means, surprisingly, is that securities buyers might actually receive a windfall profit from the shortening the settlement cycle.

But do we have any indication of the impact of T+1 settlement on fail volumes? Actually, we do. The US Treasury market has been a T+1 settlement market for decades, and is almost entirely institutional in nature. What is that market's fail volume vis a vis trading volume, as compared to US equities?

It turns out that the US equities markets average about 1.2% of trades failing (by dollar volume), while Treasuries average about 5% of dollar volume. Now, of course, there can be many explanations for higher fail volumes besides the settlement cycle, but the startling fact that Treasury fail volumes are 4 times as high as equities seems to require a deeper analysis of all the differences between these markets.

There is one additional factor that ESMA needs to consider – the growth of ETFs, both in AUM and in trading volume, because the create/redeem process for ETFs is done in kind. What that means is that the authorized participant (AP), the only entity allowed to create or redeem ETF shares, does that in exchange

for a "proxy basket" of securities, instead of cash. Thus the AP must effect two settlements for every creation/redemption, one in the proxy basket, and one in the ETF shares.

How big a problem could that be? For the last year ETFs have accounted for about 80% of the largest daily fail volumes by dollar amount, even though ETFs represent only about 10% of the trading volume. Since this is under the T+2 settlement scenario, nobody knows what that would look like under T+1.

So ESMA is correct to ask for everyone to take a hard look at the implications of shifting to T+1. These two implications – the possible rise in fail rates and the impact on create/redeem events in ETFs – require detailed research and heightened vigilance.