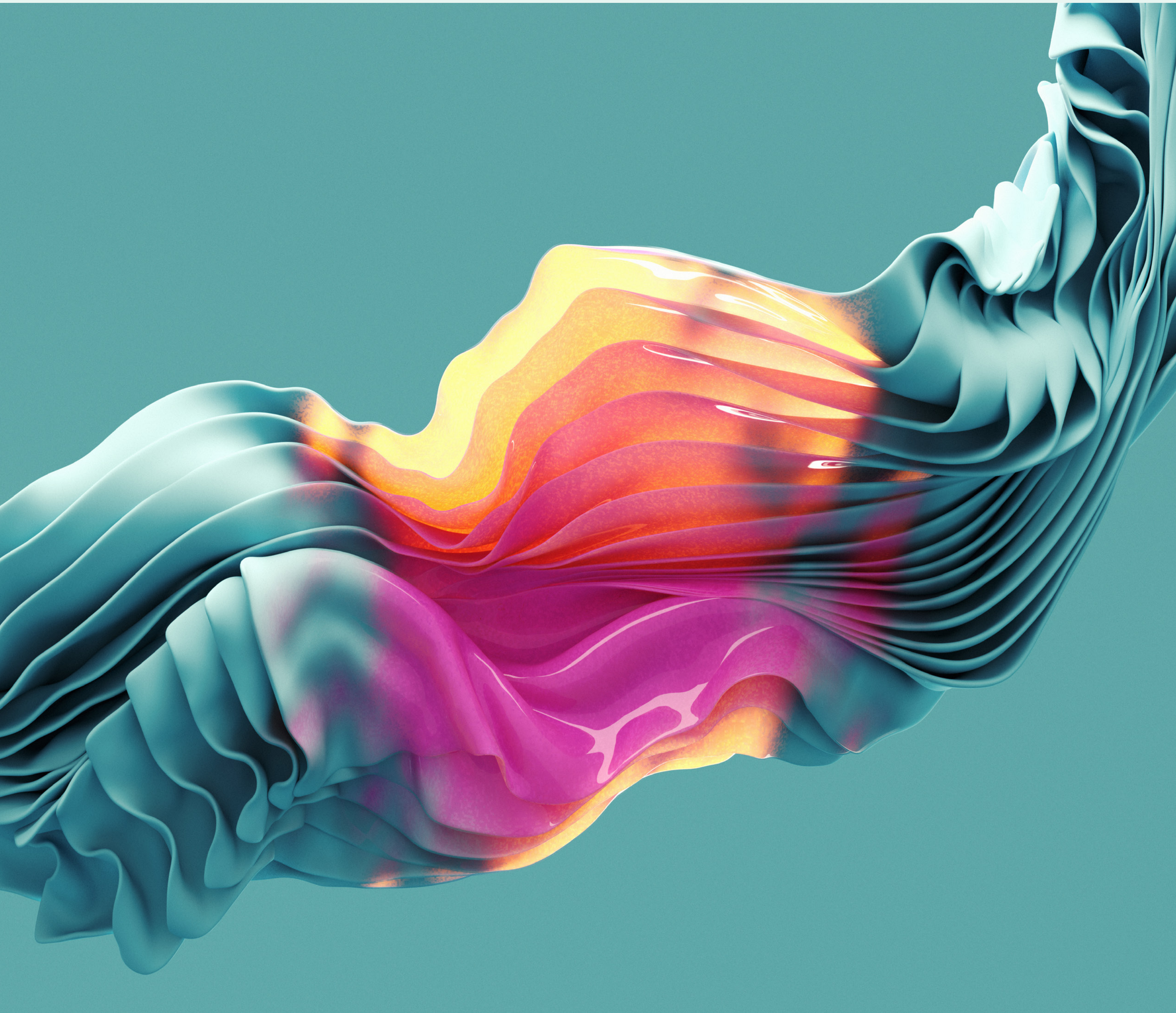
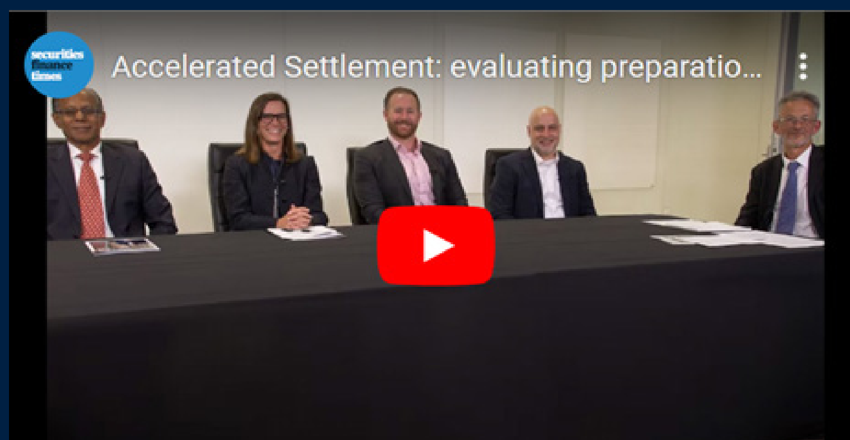
ACCELERATED SETTLEMENT:

Evaluating Preparations for T+1 in Canada

NOVEMBER 2023



As part of a panel discussion on accelerated settlement cycles, Ronald C. Landry, Head of Product and Canadian ETF Services, CIBC Mellon, spoke to the Canadian considerations for T+1 and its expected impact to transaction types and market participants.



For the entire article, read page 16 from Issue 326 in Asset Servicing Times.

RONALD C. LANDRY

Head of Product and Canadian ETF Services

Ronald C. Landry is Head of Product and Canadian ETF Services at CIBC Mellon. He has over ten years of experience in ETF servicing and more than 25 years of experience in the financial services industry. In his role, Ronald is responsible for all aspects of the ETF business in Canada and product development and strategy for CIBC Mellon.

TIME TO SETTLE

The U.S. and Canadian transition to T+1 securities settlement is scheduled for May 2024, with Canada scheduled to begin trading using next-day settlement on May 27 and the U.S. doing so one day later, after the Memorial Day public holiday, on the 28.

In proposing the T+1 project, market authorities indicate that the shorter T+1 settlement cycle will reduce credit risk, market risk and liquidity risks associated with settlement failure.

By shortening credit exposure over the settlement period, this is expected to lower margin costs, improve mobility of liquidity and collateral, and potentially reduce the capital costs of trading. Additionally, this may drive further automation of the transaction lifecycle, encouraging infrastructure modernization and forcing those firms that are still hanging on to manual processing and communication to upgrade their workflow — including wider adoption of electronic trade matching, confirmation, and allocation systems.

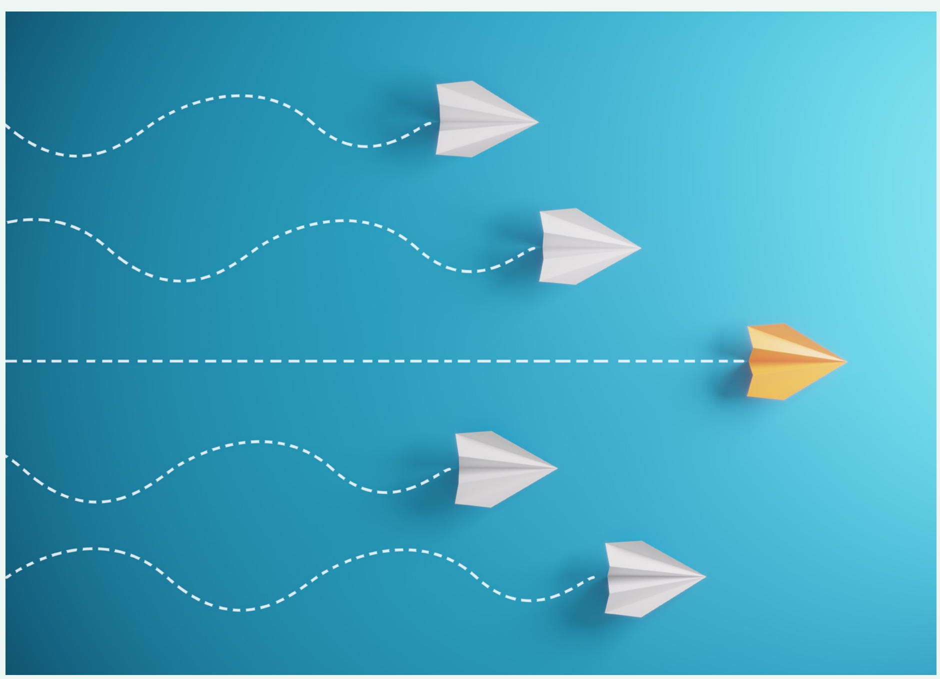
HOW WILL THIS MOST AFFECT YOUR FIRM AND THE CLIENTS YOU SUPPORT?

The challenge is particularly in getting clients ‘technology ready’ for the transition to T+1. As a custodian, we are prepared and largely ready to go. Some firms across the industry are lagging in their preparations and we will be spending the next few months providing education around what is required. Many of the larger asset management and asset owner clients are already supporting electronic settlement communication, via the Swift network, via vendor-based order management and workflow solutions, or using our own internal trade capture tools.

Like other custodians, we still have some clients that prefer to send settlement instructions by email or fax. These clients genuinely need to embrace effective technology solutions to help them to manage this transition. If they do not, they are likely to face some challenges.

EXPLORE WITH US

We would be pleased to discuss these themes further, including exploring them in the context of our ongoing Canadian and global research efforts. Please don’t hesitate to contact your relationship manager to arrange a discussion.



LEARNING FROM THE PAST

This is not the first transition to a shorter settlement cycle that we have witnessed. The European Union migrated to T+2 equities settlement in 2014 in the first tranche of the Central Securities Depositories Regulation. The U.S. migrated to T+2 in 2017. To what extent did those migration efforts create pressure to strip out manual inefficiency?

The transition to T+2 did not have a significant impact in forcing firms to eliminate manual interventions. In transitioning from T+3 to T+2, firms still had a day to work with to ensure that trades settled on time. For this reason, settlement culture did not substantially change, and some firms postponed the need to upgrade processes that should be automated. In transitioning to T+1, firms will need to change their operational practices as well as upgrading their technology. Offices at many buy-side firms have traditionally closed at 17:00, while settlement issues often tend to arise after hours.

> "If investment companies maintain these same working hours in a T+1 environment, their operations teams may not identify potential settlement breaks until the following morning, leaving one working day and no overnight to take remedial action."

In short, with only 6-8 hours to deal with any settlement issues in a T+1 environment, automation will play a prominent part in ensuring that the transition to T+1 is successful.

This is also not the first time that the U.S. has embarked on a transition to next-day securities settlement. In October 2001, the Securities Industry Association pushed back the release date for T+1 implementation because the industry did not feel that it was ready — and it has taken more than two decades to be actioned. Has the industry changed sufficiently to be confident of a successful T+1 migration in 2024?

> "Technology has also advanced a long way since 2001. The industry is better equipped than it was 20 years ago in terms of adoption of technology and electronic messaging standards."

If an asset manager does not have suitable technology to manage its portfolio, and the associated investment operations, then regulators will be taking a close look at that firm's operational and risk management practices. The pandemic also changed things greatly. Trading, operations, and risk management teams were forced, at short notice, to move to remote working and to operate without access to fax machines, to printers and to other mechanisms that sustained manual workflow. This helped to displace outdated practices. However, there are still some that are holding back and think that they can find manual workarounds to manage their settlement commitments in a T+1 environment.

As technology solutions improve, moving settlement gradually closer to real-time and enabling more real-time information and analytics, this will further reduce settlement risk.

A recent ISITC Europe report has highlighted that the challenge around recalls may make some asset owners more reluctant to lend their stock. Is that a concern?

In response, we are encouraging clients to report their trades earlier and more often. Some fund managers in the current T+2 environment tend to sit on their trades until the end of the day, then to run these trades through their systems and to submit their settlement instructions the following morning. In the T+1 settlement environment in Canada, counterparties are required to be matched by 03:59 on T+1. To meet this, we are requiring clients to have trades in by 03:00 on T+1. By association, the sooner that the firm gets its trades in, the easier it is to manage recalls.

We have been doing this for exchange-traded funds (ETFs) for some time. With ETF trading, settlement is typically in-kind against a basket of securities and so, from a lending perspective, you will typically need to maintain a buffer. Firms will increasingly start to set natural buffers in place to manage their settlement risk as they move to T+1. As technology solutions improve, moving settlement gradually closer to real-time and enabling more real-time information and analytics, this will further reduce settlement risk.

PRODUCT SOLUTIONS AND TECHNOLOGY

What solutions are you offering your clients to manage these adjustments?

"CIBC Mellon has developed a trade lifecycle analytics tool that enables clients to see where they are in the trade lifecycle and to monitor the risk that a trade may fail."

This allows them to proactively address these inaccuracies at the earliest point. We also offer an instruction capture tool, enabling firms that cannot send instructions via the SWIFT network or other electronic formats to use this tool to upload instructions.

CIBC Mellon is part of a global organization and is therefore able to take advantage of global centres of excellence. The group is reflecting on how it can change its hours of operation to meet clients' settlement requirements more efficiently. When we need to process trades overnight in the Canadian time zone, for example, we can draw on these global resources to manage the bulk of our settlement volume, such that our staff in Toronto only expect to be dealing with the exceptions in the morning.

END-TO-END INTEGRATION

Is pre-trade analytics becoming increasingly important? The ability to identify risk of settlement failure at an early point and to address this to prevent a trade failing?

This regulatory change will motivate firms, even more than previously, to identify their specialist position in the trade lifecycle and to pinpoint what they are truly good at. They are then likely to be motivated to specialize in these areas of comparative advantage and to outsource functions where they are less effective and add less value.

AGGREGATE COST OF TRADING

Is this forcing firms to look more closely at the aggregate cost of trading, including capital costs, cost of settlement fails and other post-trade costs? How adept are firms at allocating the post-trade costs and balance sheet costs across the organization?

In accordance with National Instrument 24-101, which is the securities regulation that governs institutional trade matching and settlement in Canada, counterparties are required to match transactions before 12 p.m. ET on T+1. We are currently at a 98 per cent success rate in meeting this requirement. One outcome is that this puts considerable pressure on the latter half of the business day to get things done. When it gets past 2 p.m., that is when pressure really builds on the CSD to get those settlements processed. Providing that we receive the settlement instructions early, we are confident in our ability to get the job done.

ETF SETTLEMENT

Some elements did not appear to be fully worked through when the SEC announced the requirement to migrate to T+1 in May 2024. This may generate some unintended consequences for ETF settlement for example.

The Canadian Capital Markets Association (CCMA) has a taskforce around T+1 that is dealing with a lot of these challenges. In moving from T+2 to T+1, settlement practices for collective investment funds and ETFs are governed under the Rule National Instrument 81-102 — NI 81-102, the securities regulation for investment funds in Canada. The legislation for these instruments will not be changing, enabling ETFs to remain at T+2 for primary market settlement if their underlying assets do not settle predominantly on T+1. This will have an impact on Associated Participants (APs) that have sold ETF shares to investors in the secondary market, for example, and do not have the inventory on hand to deliver to the issuer in the primary market to create additional shares.

To address this situation, the CCMA Task Force has proposed to the Canadian Securities Administrators (CSA) to introduce an exemption under NI 81-102 to enable collateral to be used to facilitate settlement in the primary market, without causing disruption to secondary market settlement. Without this exemption, APs may be forced to carry excess inventory, thereby increasing the associated cost of settlement and potentially impacting bid-ask spreads. Alternatively, they may be forced to rely on cash-only fund creation and redemptions, which will again impact overall costs for trading ETFs. More broadly, the Task Force is also examining potential to introduce central settlement for ETFs, like that offered in the US by the DTCC-owned National Securities Clearing Corporation (NSCC).

Here in Canada that will be many years out from now, but these are all steps we are taking to prevent any downstream impact of moving to T+1 in the secondary market. It might be fair to say that policymakers did not fully work through the implications of this decision for how the primary and secondary markets interact. We are working to obtain broader industry agreement that this is the best step forward. I do not believe any AP firm or issuer would want the implications of remaining with T+2 settlement in the primary market to impact trading with ETF investors in the secondary market.

TOWARDS REAL-TIME SETTLEMENT

Will T+1 settlement be the intermediate step in an advance to T+0 and towards real-time settlement?

However, we will not be transitioning to T+0 with our current technology and settlement processes. Something will need to shift before we can support real-time settlement. In dialogue with my U.S. counterparts, we are discussing what operational structures should look like for Associated Participants to settle ETF shares on T+0. Early indications are that processes will be manual and cumbersome, valuing shares by making intraday adjustments to a prior-day valuation, involving warranted deliveries of collateral, and potentially resulting in a rise in buy-ins. If this is an example of how T+0 will operate on a small scale, we are a long way from moving to same-day settlement for ETFs without adopting new technologies and substantially different ways of working.

There are still some pressing questions that will still need to be addressed. How will short-selling be managed in a same-day settlement environment for example? How will short-sellers source the borrow before they short the stock — and how will this 'locate' obligation be structured in a T+0 environment? I envisage that the industry will move in small steps in the first instance — testing T+0 for transactions where we know this is workable and then expanding this to a wider set of instruments.

CLOSING THOUGHTS

What advice do you have for clients to help them to be ready for the May 2024 transition deadline?

For our clients, the key message is to keep speaking to us, identifying how we can help them and what additional tools that we can offer that they have not been using until now. Even API connectivity can be important, for example, in enabling systems to talk machine-to-machine and to remove manual intervention when communicating instructions and communicating data. At CIBC Mellon, we know that we are ready to go. Now it is a question of sharing this information and helping our clients to transition as effectively as possible.

FOR MORE INFORMATION

CIBC Mellon is pleased to engage with clients on this front and continue the conversation. Please contact your Relationship Manager if you would like more information.

CIBC MELLON

A BNY MELLON AND CIBC JOINT VENTURE COMPANY[SM]

www.cibcmellon.com

©2023 CIBC Mellon. CIBC Mellon is a licensed user of the CIBC trade-mark and certain BNY Mellon trade-marks, is the corporate brand of CIBC Mellon Trust Company and CIBC Mellon Global Securities Services Company and may be used as a generic term to reference either or both companies.

000 - KL58- 10- 23