T+1 SETTLEMENT

Impact and suggested changes to the mutual fund settlement cycle in view of the transition of the US securities settlement cycle from T+2 to T+1 in May 2024

Background

The planned transition to a T+1 settlement cycle for US securities on the 28th May 2024 raises many challenges for UK-based investment managers, one of which is the misalignment with the fund subscription and redemption settlement cycle. In short, how to address a potential mismatch between the receipt or payment of cash into the fund and the obligation to fund a trade. As an investor subscribes into a fund, the fund will ordinarily look to invest into securities on the same trade date to ensure the investor is receiving the maximum performance of the fund. The challenge comes where that subscription cash settles on T+3/4 whereas the security transaction may need to be funded to settle on T+1.

In the US, many mutual funds commonly have a T+1 fund settlement cycle so a T+1 security settlement cycle brings the product into closer alignment. In Canada, the authorities view that a move to a T+1 mutual fund settlement cycle improves cashflow management, but also recognise the challenges it can present, particularly for global baskets, so are not currently mandating a move at this time.

In the UK, the Investment Association has been working with the industry to understand current processes and appetite to accelerate the fund settlement cycle. Currently a T+3 fund subscription and redemption settlement cycle is common in the UK, however there is a large minority of funds using a T+4 fund settlement cycle with others on a T+2 or T+1 fund settlement cycle. Whilst there's further variation in the fund settlement cycle across fund ranges in the EU, it's understood they're fairly similar to the UK.

Considerations

In discussing approaches to a fund settlement cycle it has become clear that there is not an optimal approach for catering for a T+1 underlying market settlement timing:

- **For funds at a T+3 and T+4 subscription & redemption settlement cycle**
  A move to a T+1 securities settlement cycle exacerbates an already present settlement cycle mismatch. Firms will have to cover the funding gap, either by using an overdraft, negotiating for extended settlement or otherwise. Redemptions can mean that the cash is held for additional days before being released to the investor, with potential CASS considerations. The model does provide for flexibility and can be useful where the fund mandate is for a range of products with varied settlement cycles (e.g., T+1 securities in the US, T+2 in EMEA with some markets still T+3).

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- **For funds at or moving to a T+2 subscription and redemption settlement cycle**
  A move to a T+1 securities settlement cycle continues to present a challenge with a funding gap, albeit with a one-day gap that many firms are familiar with addressing now. The model provides a degree of flexibility where the fund has a global mandate.
- **For funds at or moving to a T+1 subscription and redemption settlement cycle**
  A move to a T+1 securities settlement cycle is aligned with the subscription and redemption settlement cycle and should provide for the most efficient funding model. A T+1 subscription and redemption settlement cycle poses other challenges, with an extremely tight timeline around NAV calculation, FX processing for overseas investors and more.

Equally the fund settlement cycle may also be impacted by:

- **The securities it invests in**
  Funds with a narrower mandate (e.g., country or product specific) may find it easier to adopt a short settlement cycle compared to those with a broader scope.
- **The umbrella range**
  Fund managers generally prefer to keep terms such as the fund settlement cycle consistent within a fund umbrella range. This may impact firms looking to only change the fund settlement cycle for a US weighted fund.
- **Infrastructure**
  In the UK, BACs is a well utilised payments system for sending and receiving investor fund settlements at scale, but has its own timing limitations. Similarly, there’s a reliance on investment platforms and the fund's transfer agent each of whom has their own requirements and capabilities.
- **Cost of change**
  There is a cost associated in amending the fund settlement cycle, with changes required for documentation and communication.

Interactions with other groups

The IA has discussed these considerations with the wider UK fund ecosystem, including platforms, transfer agents and depositaries. As some UK funds already operate on a T0, T+1 and T+2 basis there is little concern over the capability of these entities to cater for shorter settlement timings. It is also agreed that industry consistency would be helpful, as well as a target transition date.

Recommendations

In view of the considerations listed and members’ varied business models, it is challenging to set a good practice or recommendation, however, in feedback from to the funds ecosystem we believe that it is important to give the industry a focal point for firms who wish to mitigate challenges presented by the market change, even if this is not necessarily adopted by all funds.

Accordingly the IA suggests that:

1. **Firms transition to a T+2 fund settlement cycle for funds with a North American focus, or those with heavy North American weighting at, or soon after, the end of May 2024;**
2. **Firms start work on considering transitioning the rest of their funds to T+2 in order to future proof against the UK and/or Europe moving to a T+1 security settlement cycle as we expect;**
3. **Firms currently operating at T+4 and so increasingly misaligned but unable to adopt a T+2 fund settlement cycle yet, consider moving to T+3 at a minimum.**

FCA Change Event Arrangements

In 2014/15, the IA made a similar recommendation in relation to market changes in most of Europe to T+2. At that time, the FCA agreed that firms did not need to seek formal FCA approval where solely the settlement cycle was being changed for that reason. In response to our request for a similar arrangement to be put in place this time, the FCA has confirmed that ‘as long as any changes to the prospectus only concern settlement periods and will have no adverse impact on investors, they **need not be treated as 'significant' changes**. The AFM will just need to submit the revised prospectus for filing with the FCA when the update becomes effective'.

Additionally, they stated that they 'welcome initiatives by the industry to review fund settlement cycles, to ensure they are in line with the practice of the underlying markets in which their funds invest. While we would expect each firm to make decisions based on the best interests of its own customers, we note that adopting a 'phased approach' may lead to greater overall complexity and uncertainty for investors, as different funds will have different settlement cycles. Consequently, it would be prudent for firms to ensure, when providing the appropriate disclosures and information to their investors in line with the consumer information and consumer support elements of the Consumer Duty, to consider what additional steps they could take to explain the differing fund settlement cycles that may be operating in the wider funds market and the potential impact, if any, on investors and their investments'.

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Appendix

Transition weekend timings

A firm wishing to entirely align its changes would follow the following timetable. All dates are May 2024:

<table>
<tr><th></th><th>Weds 22/5</th><th>Thur 23/5</th><th>Fri 24/5</th><th>Sat 25/5</th><th>Sun 26/5</th><th>Mon 27/5</th><th>Tues 28/5</th><th>Wed 29/5</th></tr>
<tr><td>UK T+4 fund moving to T+3</td><td>Last T+4 trade date</td><td>First T+3 trade date</td><td></td><td colspan="2" rowspan="4">Weekend: Market closed</td><td rowspan="4">US & UK bank holiday</td><td></td><td rowspan="2">Settlement date</td></tr>
<tr><td>UK T+3 fund moving to T+2</td><td></td><td>Last T+3 trade date</td><td>First T+2 trade date</td><td></td></tr>
<tr><td>US market pre-conversion T+2 flow</td><td></td><td></td><td>Last T+2 trade date</td><td></td><td>Last T+2 settlement date</td></tr>
<tr><td>US market post-conversion T+1 flow</td><td></td><td></td><td></td><td>Conversion day - First trade date</td><td>Double settlement date</td></tr>
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