ASX Consultation Paper

Shortening the Settlement Cycle in Australia: Transitioning to T+2 for Cash Equities

Consultation Questions

Q1. Do you agree with the expected benefits from the introduction of a T+2 settlement cycle for cash equities? If so, please outline the key benefits to your organisation.

There are a number of advantages with the introduction of T+2 settlement, as detailed in the consultation paper, although Pershing does not necessarily agree with all of them.

- Reduction in Risk – the shortening of the time between trade execution and settlement/clearing will have a minor impact on reducing exposure to counterparty default, although this is not expected to be significant give the low fail rates across our business
- Cash Market Margin Savings – while there is some loss of netting by reducing the settlement cycle, and therefore the number of trades outstanding, there will undoubtedly be a reduction of the CMM requirement
- Liquid Capital Requirements – While the change may improve the Daily Capital Liquidity ratio, the very high ASX Minimum Core Capital Requirements for Third Party Clearers means that there is no benefit to Pershing

Q2. What level of reductions in cash market margin and liquid capital requirements do you expect for your organisation from the introduction of a T+2 settlement cycle? Please indicate if you wish this information to remain confidential to ASX and the regulators, RBA and ASIC.

We anticipate a reduction of approximately 30% in the CMM requirements, although this will vary daily. As per Q1 above, while there may be an improvement in the Daily Capital Liquidity ratio, the very high ASX Minimum Core Capital Requirements for Third Party Clearers means that there is no benefit to Pershing

Q3. Do you expect the costs associated with the implementation of T+2 to be relatively small, moderate or significant for your organisation? Can you provide a cost range for your implementation of T+2?

Pershing anticipates implementation costs to be relatively small, assuming that the primary system vendor (GBST) does not pass on any development charges. Cost of the implementation will primarily be reporting changes, and project management.

Q4. Do you consider that the potential net benefits expected from the introduction of a T+2 settlement cycle for cash equities warrants its introduction in the near term? If so, do you consider that:

a. **an implementation date in Q1 2016 should be targeted?**
b. **an earlier implementation date in 2015 is feasible for all industry participants and should be considered? If so, what implementation timing do you think should be targeted?**
c. **sequencing the transition to a T+2 settlement cycle with other markets is important, noting that EU member states will be required to operate a T+2 settlement cycle from January 2015?**

While the introduction of T+2 certainly will reduce some risk in the market, Pershing is not convinced of any significant saving in either costs or Capital. As a result, we do not have a view on an implementation timetable, although alignment with Europe will certainly aid the transition for offshore clients.

Q5. To what extent do you currently utilise an automated centralised trade matching system? Please indicate which system you use.

Pershing uses both IRESS ETC and OMGEO

Q6. What percentage of trades are verified manually by your organisation? If you use manual verification processes, what is the main reason for doing so?

There is no manual verification of trades

Q7. What is the percentage of trades where affirmation is completed on T+0?

Current affirmation rates on T+0 are close to 95%

Q8. What are the main reasons for failure to achieve SDA?

There are a small number of clients who confirm on the morning of T+1, although Pershing has no visibility to why these cannot be matched on T+0.

Q9. In what timeframe could your organisation be reasonably expected to achieve an SDA rate of over 90%?

The existing SDA rate already exceed 90%

Q10. What is the expected investment required for your organisation to implement a T+2 settlement cycle? Do you agree the changes required to implement a T+2 settlement cycle are largely configuration and behavioural changes rather than wholesale system changes?

With regards to trade matching, there is not likely to be any significant cost with transitioning to T+2.

Q11. Please indicate the most significant reason for a delay in the release of settlement instructions to the market?

The most significant reasons for the delay in releasing settlement instructions are that either the contracts need to be rebooked to another account, or that the client has not provided appropriate instructions.

Q12. What are the key reasons for delaying the matching of settlement instructions until late in the afternoon of T+2 or in the morning of T+3?

The key reason to delay matching instructions is if Pershing is short stock due to either the seller of another participant failing to deliver. Once stock borrowing arrangements have been finalised, instructions will be sent.

Q13. Are investor location and time zone differences the main driver for delayed settlement instruction matching? Please indicate the main jurisdictions where delays are common.

Investor location and time zones are definitely factors in delayed instructions. These failures occur across all jurisdictions, however this is particularly the case for clients domiciled in Europe for Pershing.

Q14. Should the ASX require continued publication of settlement instructions so that they cannot be removed after initial publication and potentially delay the opportunity to match settlement instructions?

Pershing's view is that the existing processes surrounding settlement instructions should remain in place under a T+2 environment.

Q15. Should the ASX consider enriching message information to facilitate more timely settlement instruction matching?

Yes. As the window for settlement will be reduced from T+3 to T+2, participants will require CHESS messages to be further enhanced. This will allow Participants to better manage their settlements and mitigate the risk of potential failed settlements.

Q16. Do you think that the introduction of a T+2 settlement cycle is feasible with the existing 10.30am settlement batch cut-off? Please state reasons for your view. If you act on behalf of foreign investors, please indicate the percentage of current trading volumes executed by foreign clients in Asian, US and European time zones.

Pershing's view is that the existing 10.30am settlement cut off is the most appropriate going forward, even under a T+2 environment. Moving the batch later in the day is unlikely to have any significant effect on failure rates, and will cause issues in the cash settlement for retail clients. Offshore institutional clients who have not instructed prior to 10.30 on T+2 are still unlikely to settle if the settlement batch is later in the day.

Q17. What are the main internal processes and procedural changes that your organisation would need to introduce to ensure T+2 and batch cut-off settlement deadlines are met? If you do not think moving to a T+2 settlement cycle is feasible with the existing 10.30am settlement batch cut-off, do you think delaying settlement batch cut-off to 11.30am or 12.00pm would provide sufficient additional time to assist in facilitating timely settlement? If so, would the benefits exceed the cost of the flow-on impacts (for example, the likely need to change payment provider deeds and delaying the ASX settlement authorisation notification, payment provider authorisation, and registration cut-off times, together with delaying participant back office processing related to post settlement activity)?

There are not likely to be any significant procedural changes required for the move to T+2. Pershing will review when matching messages are issued, when ACH collateral is withdrawn, and the timing of stock borrowing/lending, however these changes are not expected to have a major impact. Pershing is not supportive of any proposal to move the settlement batch beyond the existing 10.30am, as there will be a significant impact on cash and securities settlement for retail clients.

Q18. What are the main internal processes and procedural changes that your organisation would need to introduce to ensure later batch cut-off settlement can be supported, including internal funding arrangements and operational resource availability?

A later batch cut off would have a significant impact on cash settlement for retails clients. Pershing currently settles via Bpay, cheque, Direct debit/credit and CMA/CMT sweeps. The cut-offs and timing for each of these processes would need to be reviewed and updated. There are also bank imposed cut-offs so while it's unlikely operational resource availability would be affected, there's no doubt that already tight time constraints would be further strained.

Q19. Would extending the CHESS system start or end of day times assist with achieving timely settlement in a T+2 settlement cycle? For example, would it assist with off-shore processing?

In our view, this would have no effect.

Q20. What are the key drivers for settlement failure? Is the lack of access to stock borrowing arrangements or availability of stock a significant driver for failed delivery?

The key drivers for settlement failure are lack of client instructions. This is likely to intensify under a shortened settlement cycle. Pershing does not have any issues with access to stock borrowing, so this is not a primary factor in fail rates.

Q21. Please indicate whether you believe the continuation of the current regime and the automatic close-out requirement will provide the appropriate incentives for timely settlement in aT+2 environment.

In our view, the current incentive regime is sufficient for T+2

Q22. Should the current close-out regime be changed to settlement date +1 (T+4) instead of settlement date +2 (T+5) with the introduction of a shortened settlement cycle?

Close out should remain at Settlement Date +2, so if settlement becomes T+2, close out should become T+4.

Q23. Do you think further consideration should be given to using CHESS's existing RTGS functionality to manage late settlements? What would your organisation need to do to use CHESS's existing RTGS functionality? What would your payment provider need to do to use CHESS's existing RTGS functionality?

With the likely increased level of fails for institutional clients, there is going to be a requirement for a more robust method of DVP settlement after the batch has completed. Further consideration should definitely be given to using the Chess RTGS functionality to achieve this.

Q24. Do you think further consideration should be given to running an additional settlement batch to manage late settlements? How do you expect an additional settlement batch would impact your organisation, including the potential cost impact

Pershing would not support an additional settlement batch, as there would be significant impacts in downstream cash and stock processing.

Q25. If running an additional settlement batch introduces material additional costs or regulatory considerations for industry stakeholders or the ASX, would this change your response?

No. Pershing is not supportive of an additional settlement batch, regardless of cost.

Q26 Do you have other suggestions for addressing late settlements? Are you able to quantify whether late settlements are a significant issue for you? In your view, is the current mechanism – moving securities free-of-payment through CHESS while moving cash separately – sufficient?

The capacity to match and settle an individual DVP transaction after the settlement batch would be the preferred method for Pershing. It would enable us to manage the downstream effects, while still minimising settlement failure. It would further eliminate the existing credit risk issues in the current process.

Q27 What role do you think that investor education can play in minimising the potential for increased settlement failure following the introduction of a T+2 settlement cycle? Do you think there is merit in ASX working with the industry to undertake investor education in relation to the transition to T+2?

Investor education will be vital in ensuring that clients are well prepared for T+2. This not only applies to retail clients, who will need to adjust their facilities for paying for trades, but institutions and margin lenders who typically send out matching instructions late. The ASX should take the lead on educating investors.

Q28 Are there particular corporate action events for which the adoption of a T+2 ex period creates significant difficulties?

The current standard 5-day ex-period for most events allows time for a participant/custodian and investor to resolve any settlement issues and settle the transaction prior to record date in a very high percentage of cases. A reduced ex-period would result in a dramatic increase in "protection" activity, where a participant receives the entitlement on behalf of the unsettled investor. The adoption of a T+2 ex date would particularly affect dividends with an election or enrollment, accelerated offers and schemes of arrangement.

Q29 Do you think that a T+1 settlement cycle is achievable to facilitate trading in special markets?

Yes. T+1 settlement is definitely achievable

Q30 Do you support the same approach to the timing of trade netting being taken in a T+2 settlement cycle (that is, settlement date minus two business days (T+0) to allow the netted settlement obligation positions to be available to all participants one day prior to settlement)?

Yes. Pershing would like as many days as possible to understand netted obligations and to arrange borrowing for short positions.

Q31 Will there be significant impacts for your organisation if trade netting was to occur on T+0 if a T+2 settlement cycle is introduced?

There would be no significant impact

Q32 Do you expect a significant impact to securities lending activity due to the introduction of a shortened settlement cycle? If so, please outline the expected impact?

There may be an increase in lending activity due to a high fail rate from either offshore institutional clients or delays in stock being delivered from SRN, however we do not expect this to be significant.

Q33. Are there any significant additional client or business risks that have not been identified in this paper?

ASX needs to consider the removal of collateral from ACH for delivery. Current timelines will require the stock to be withdrawn on trade date, in order to make the settlement batch, however this is not currently manageable. There will also need to consideration given for SRN settlements and HIN transfers, as current timeframes and processes will not facilitate timely settlement.