Considerations for moving the settlement cycle to T+1 for mutual fund purchases and redemptions

1. Liquidity risk issues

Liquidity issues currently arise under a mutual fund order T+2 settlement cycle because there is a mismatch between the settlement of trades in portfolio securities and the settlement cycle of mutual fund orders. This occurs because there is a one-day delay in IFMs knowing a mutual fund's net purchase or net redemption position (i.e., it is not known until T+1, at which time portfolio trades can be placed to finance redemptions). Changing both the portfolio securities and mutual fund order settlement cycles to T+1 would not solve this mismatch issue. If portfolio securities were to move to a T+1 settlement cycle and a T+2 settlement cycle was retained for mutual fund orders, this liquidity mismatch issue could be basically eliminated for many types of funds. Note, this would not be the case for funds that hold significant amounts of the types of securities/instruments set out in 2 below. Moving to T+1 for mutual fund orders, where these types of securities/instruments are predominant in the portfolio, would exacerbate the current mismatch issue. Accordingly, appropriate exemptions for such funds would be required in an amended NI 81-102.

Regardless, the Canadian mutual fund industry may wish to move to a T+1 settlement cycle for mutual fund orders with or without alternative sources of liquidity. Alternative sources of liquidity could potentially be achieved through amendments to NI 81-102 to permit higher levels of temporary borrowing to finance redemptions and/or inter-fund borrowing from related funds. Note, this latter option is permissible in the U.S. but creates conflicts of interest and adds operating complexity, which makes it a "break the glass" type option.

It should be noted that the greater the number of failed portfolio trades, the greater the time necessary to rectify all of them to help ensure liquidity at the fund level. Conversely, as the time to settle mutual fund orders at the fund level decreases, there is relatively more importance on there being fewer failed trades. So, if the level of failed portfolio trades is currently too high and there is not a strong belief that this level will decrease materially, it could be imprudent to move to a T+1 settlement cycle for mutual fund orders. In these circumstances, moving to a T+1 settlement cycle for mutual fund orders could exacerbate fund liquidity issues and the related negative interest and opportunity cost investment issue consequences indicated below.

In today's environment, portfolio managers often ask for shortened security trade settlement cycles to finance redemptions, but this would likely not be available in a T+1 environment.

2. Investment issues

Investment issues arise where there is a mismatch between the settlement cycle of trades in portfolio securities and the settlement cycle of mutual fund orders. This mismatch issue can be addressed by the mutual fund borrowing up to 5% of NAV temporarily and/or the fund retaining more cash/highly liquid securities, such as money market instruments, to finance redemptions. These strategies entail interest charges and potential opportunity costs, respectively.

When a mutual fund experiences net sales, it is advantageous for the fund's purchase orders to settle on T+1 instead of T+2, so that purchase proceeds can be received and invested more quickly. Settling on T+2 may result in the fund incurring opportunity costs.

The settlement cycles of certain types of portfolio securities may be problematic for settling mutual fund net redemption orders on T+2:

a) EU markets are not proposing to move to T+1 settlement and will remain at T+2;

b) Certain other global assets settle on T+3 (i.e. Japan);

c) Underlying mutual fund holdings may cause settlement delays, particularly where the mutual funds are managed by unaffiliated IFMs;

d) OTC derivatives; and

e) FX transactions.

3. Operational Risk

Would reducing the settlement cycle to T+1 create undue operational risk?

4. Marketing issues

If securities, including certain ETFs, trade on exchanges and have a T+1 settlement cycle, do IFMs want mutual fund orders to settle on T+2?

Given that there are portfolio holdings that may necessitate a T+2 settlement cycle for mutual fund orders (see 3 above) and ETF orders (see 5 below), do IFMs want different settlement cycles for different types of mutual funds and ETFs?

5. ETFs

ETFs entail different considerations than mutual funds because, while their units typically trade intraday on exchanges, they also need to create and redeem baskets of portfolio securities from time to time. As a result of this creation/redemption process, ETFs whose portfolios consist of foreign securities with T+3 settlement cycles have exemptive relief from the current T+2 settlement requirements. IFMs would like to avoid having to obtain additional regulatory relief through individual applications if a T+1 settlement cycle for ETF orders comes to fruition. It would be much more preferable for appropriate exemptions to be set out in an amended NI 81-102.

6. Alignment between the U.S. and Canadian mutual fund industries

The Canadian and U.S. mutual fund industries do not require the same settlement cycle for mutual fund orders because the Canadian and U.S. mutual fund industries do not compete. US mutual funds are not sold in Canada and Canadian mutual funds are not sold in the US.

The U.S. mutual fund industry is different than Canada's in that it already settles mutual fund orders on T+1 and has done so for many years. So, the regulatory change to move to T+1 in the U.S. is, in effect, no change to the mutual fund order settlement status quo.

The U.S. securities markets are much more liquid than Canada's, which is one reason why the U.S. mutual fund industry has already been settling on T+1 for many years with no significant issues. Since the Canadian markets are much less liquid, it is more challenging for the Canadian mutual fund industry to settle on T+1 for mutual fund orders.

The U.S. has other factors that help funds meet liquidity needs such as higher borrowing limits, advance notice of major mutual fund orders and inter-fund borrowing.

The U.S. mutual fund industry has not had issues settling its redemption orders on T+1 even though U.S. equity trades settle on a T+2. Nevertheless, when U.S. portfolio securities trades settle on T+1, there will be better alignment between the portfolio trade settlement cycle and the U.S. mutual funds' order settlement cycle, which will enhance funds' liquidity.

7. Should the CSA adopt a "market-based" approach? This which would leave the required maximum mutual fund order settlement cycle unchanged at T+2 but permit mutual fund orders to be settled on T+1 at the discretion of the IFM (as is currently the case)? This would permit IFMs to retain/change settlement cycles for mutual fund orders as they wish in response to the change in the settlement cycle for portfolio securities. Alternatively, should the CSA adopt a "regulatory-based" approach, which would mandate a T+1 settlement cycle for mutual fund orders (with appropriate exemptions as contemplated in 1 and 5 above)?