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# Issues to be addressed as Japanese equity markets migrate to T+2 settlement

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## Executive Summary



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### NOTE

1) Most recently, US equity markets completed their transition to T+2 settlements in September 2017.

2) Final Report of the Working Group on Shortening Stock Settlement Cycle in the Japanese Market ([http://www.jsda.or.jp/shiraberu/minasama/t2/e\\_final\\_houkokusyo20160630.pdf](http://www.jsda.or.jp/shiraberu/minasama/t2/e_final_houkokusyo20160630.pdf))

*The Japanese security industry is preparing to transition to T+2 settlement of equity trades by July 2019, following the lead of major overseas markets. A smooth transition will require diligent preparation on an industry-wide basis.*

### Why T+2 settlement of equity trades?

Substantial progress has been made in globally reducing securities settlement risk in response to the Lehman Brothers' September 2008 bankruptcy. One driver of such progress is initiatives to shorten securities' settlement cycles (i.e., the period between trade execution and settlement (delivery)). In Japan, equity trades are currently settled on the third business day following the trade date (T+3), whereas T+2 settlement is already the norm in major overseas markets<sup>1)</sup>.

Japanese market participants and market infrastructure providers are working together to shorten the equity settlement cycle to T+2 under the leadership of the Japan Securities Dealers Association's (JSDA) Working Group on Shortening Stock Settlement Cycle, established in July 2015. In June 2016, the Working Group released its final report<sup>2)</sup>, which set a provisional timeline for migration to T+2 by next spring. The transition date is slated to be preceded by a multi-month testing period from the fourth quarter of 2018 through the first quarter of 2019. The timeline's announcement has prompted the securities industry to step up preparations for T+2. In late April 2018, the Japan Securities Clearing Corporation (JSCC) announced a detailed schedule for weekend/holiday testing leading up to the T+2 switchover. A month later, a scheduled switchover date of July 16, 2019, was announced. The announced timeline should further expedite market participants' T+2 preparations.

### Benefits and drawbacks of T+2 settlement of equity trades

What are the benefits of shortening the settlement cycle by one day? First, migration to T+2 will reduce settlement risk as already mentioned. If the lag between trade execution and settlement is shortened by one day, the backlog of unsettled trades, which can be regarded as a proxy for settlement risk, would be reduced by the equivalent of one day of trading volume. Second, investors and securities firms that trade equities will be able to deploy their funds and equity

holdings more nimbly by virtue of receiving delivery of stocks and cash one day earlier. Third, reducing the backlog of unsettled trades may enable securities brokers to reduce the amount of risk-based collateral they keep on deposit at clearinghouses. Lastly, bringing Japan's equity settlement cycle into conformance with major overseas markets' by migrating to T+2 will benefit overseas investors that want to standardize their settlement workflows on a global basis. In this sense, migration to T+2 is important to maintain if not enhance Japanese markets' international competitiveness.

On the downside, shortening the equity settlement cycle has two main drawbacks. First, a shorter settlement cycle may increase back-office workloads. The planned transition to T+2 does not entail any radical changes in either workflows from trade execution through settlement or the configuration of market infrastructure involved in such workflows. One reason for the absence of such changes is that equity trade matching and settlement processes are already conducted electronically in the wake of Japanese securities settlement reforms dating back to the turn of the millennium. Another reason is that even after migration to T+2, there will always be at least one full business day between trade execution and settlement dates. However, matching and exception handling processes that have hitherto been effectively allotted two days will have to be completed in one day. Market participants need to further improve their back-office efficiency in preparation for potentially increased workloads.

The second drawback is that settlement fails (past-due deliveries) will likely increase. The JSDA Working Group noted in its final report that migration to T+2 may result in settlement fails increasing to some extent even if the stock lending market is sufficiently liquid and to a greater extent when it is not<sup>3)</sup>. Increased settlement fails would be a problem in that the investors on the receiving end of the additional fails (failed parties) would not receive securities to which they are entitled by the scheduled delivery date. Settlement fails are especially problematic when the scheduled settlement date is a record date<sup>4)</sup> and the securities' delivery is delayed beyond the record date. In such cases, the failed parties would be deprived of their shareholder rights. In Japan, shareholders' names are recorded in the issuer's shareholder register. To safeguard shareholders' rights, efforts must be made to provide redress to shareholders deprived of their rights by settlement fails occurring on a record date because such fails are impermissible.

3) Footnote 7 on page 3 of the report's English version.

4) Date on which shareholder rights vest in shareholders of record.

### Industry initiatives in preparation for T+2 settlement of equity trades

Market participants and market infrastructure providers, led by the JSDA Working Group, are actively discussing how to mitigate the drawbacks of migration to T+2 settlement.

In response to concerns about back-office workloads, securities brokers must take the initiative to check their internal work processes and IT systems and upgrade them as needed. For trades with nonresidents in particular, it is important to make sure that back-office processes can be completed on time even on heavy volume days with many trade cancellations and corrections. Brokers must upgrade their workflows and systems to be T+2-compatible by autumn 2018 and verify the adequacy of their upgrades through the settlement system testing scheduled to commence in December 2018.

Concerns about increased fails are being addressed by the Working Group and others from two perspectives: reducing fails' incidence and rectifying fails when they do occur.

Measures to reduce fails' incidence mainly involve standardizing and speeding up processing of securities lending transactions to avert fails. When brokers do not have enough shares of a stock to deliver to a trade counterparty, they borrow the shares they lack from another broker or institutional investor. Stock loans cannot be processed expeditiously unless they are processed uniformly on both sides of the transaction. For example, brokers calculate stock loan fees and margin requirements and confirm them with both the borrower and lender. However, if brokers round fractional numbers differently or use different valuation procedures when doing such calculations, their respective calculation results will differ from each other. Identifying the cause of such discrepancies tends to be time-consuming. In response, the JSDA Working Group has prepared and published guidelines regarding uniform processing of stock loans, including specifics such as daily deadlines for stock loan transactions and methods of calculating margin requirements and stock loan fees. While publication of such guidelines is a step in the right direction, the guidelines will be meaningless if not put into practice. It is crucial that participants in the stock loan market concertedly upgrade their back-office processes and IT systems to comply with the guidelines.

Another issue the securities industry is working on is redress for shareholders harmed by settlement fails (i.e., shareholders unable to take delivery of their shares on the originally scheduled settlement date). It is doing so on the assumption that fails will become more common. As part of these efforts, the JSCC and JSDA both published guidance on dealing with fails in September 2017. Led by the JSDA Working Group, the industry will presumably continue to devise specific measures to address fails.

Migration to T+2 settlement is essential to maintain if not enhance Japanese equity markets' international competitiveness. Although T+2 settlement will impose a considerable burden on market participants' back-office processes, it also presents an opportunity to build low-risk, highly efficient market infrastructure and practices. Market participants and market infrastructure providers must move forward with preparations to ensure a smooth transition to T+2.

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