

Regulatory Hotline

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SEBI INTRODUCES T+1 ROLLING SETTLEMENT ON AN OPTIONAL BASIS

BACKGROUND

The Securities and Exchange Board of India (“SEBI”), pursuant to requests received from various stakeholders, and discussions with Market Infrastructure Institutions (Stock Exchanges, Clearing Corporations and Depositories), issued a circular on September 7, 2021¹, to be effective from January 01, 2022, vide which it has provided flexibility to the stock exchanges to offer either T+1 or T+2 rolling settlement cycle (“Circular”). Accordingly, a stock exchange may choose to offer T+1 settlement cycle on any of the scrips, subject to fulfilment of certain prescribed conditions.

In this edition of the monthly digest, we will discuss the changes brought about by SEBI through the Circular, and the potential advantages and drawbacks of the same.

THE CIRCULAR

The settlement cycle means the time period within which the settlement of trades (i.e. buy and sell transactions) happens. Currently, all equity trades on National Stock Exchange (“NSE”) and Bombay Stock Exchange (“BSE”) are settled on a T+2 settlement cycle. This implies that any equity buy / sell transaction done on a T day is settled on a T+2 day, wherein T=Trading day and +2 means 2 consecutive working days after T day (excluding all holidays).

The Circular now grants the discretion to NSE and BSE to exercise the option of switching to a shorter settlement cycle of T+1. In case a stock exchange opts for T+1 settlement cycle for a scrip, it shall have to mandatorily continue with the same for a minimum period of 6 months (“Minimum Period”). Subsequently, if the exchange intends to switch back to T+2 settlement cycle, it would be able to do so by giving a 1-month advance notice to the market (“Notice Period”). Any further subsequent switches, i.e. from T+1 to T+2 or vice versa, shall be subject to the satisfaction of the Minimum Period and Notice Period requirements. Furthermore, the elected settlement option for security shall be applicable to all kinds of transactions in such security on the concerned stock exchange.

ANALYSIS

To ensure that the process of transfer of securities is carried out in a time efficient manner, SEBI has in the past, reduced the rolling settlement cycle a couple of times. The T+5 cycle was reduced to T+3 in 2002², and thereafter in 2003, it was reduced to T+2.³ With the same objective again, SEBI seems to have proposed the T+1 cycle.

Potential Advantages

SEBI had released a discussion paper titled ‘Risk Management – Safer Markets for Investors’ on April 18, 2013⁴ (“Discussion Paper”) wherein it had discussed about reducing the settlement cycle to T+1 as a measure to streamline the risk management system of the Indian stock exchanges. The Discussion Paper highlighted the importance of reducing the time for settlement of trades considering that the overall risk in the system depends upon the number of unsettled trades at a point in time. It stipulated that a shortened settlement cycle of T+1 would reduce the number of outstanding unsettled trades and thereby decrease the unsettled exposure to a clearing corporation by 50%, thereby reducing the systemic risk. It was also observed that the financial crisis of 2008 had exposed the risks related to a longer settlement cycle and therefore, a shortened cycle would not only reduce but also free up the capital required to collateralise such risks.

The Discussion Paper also argued that a short settlement cycle would boost the market liquidity and result in increased operational efficiency and reduced costs. Moreover, a shortened settlement cycle would lead to a narrow time window for a counterparty insolvency / bankruptcy to impact the settlement of a trade.

Potential Downsides

A T+1 cycle might lead to hassles for foreign portfolio investors (“FPIs”) on account of the difference in time zones and multiple intermediaries involved.⁵ The FPIs, under this settlement cycle, would have to predict the entry price and pre-fund their transactions which could be tricky at times.

Interestingly, countries that had earlier moved to T+0/T+1 cycle, had to switch back to T+2 cycle to stop the foreign investors from exiting. Taiwan moved back to T+2 from T+1⁶ and Russia switched back to T+2 from T+0 in 2013 to attract foreign investors.⁷ Further, China’s T+0 settlement cycle for equities has proven to be extremely efficient for domestic investors, however very cumbersome for the foreign players accessing the market.⁸

Further, the Discussion Paper also pointed out few issues to deal with when considering the curtailment of the

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settlement cycle. It highlighted that few retail investors still prefer to make payment for their trades by cheques and considering that clearing of such cheques could take more than a day, questions can be raised on the practical feasibility of T+1 cycle. Furthermore, the cost of modifications of existing trading and settlement systems for increased automation and efficiency may outrun the benefits envisaged by the move.

It is also to be noted that the option provided by SEBI to the exchanges to opt for T+1 or T+2 cycle may lead to ambiguity in the market. Currently, certain stocks are traded on both NSE and BSE and are settled on T+2 basis. In the event where the NSE and BSE opt for different settlement cycles for the same stock, it would be interesting to see how the trade settlements happen on the exchanges. Furthermore, in case of short-term trading, where the intent is to not hold the stocks but to sell them forthwith, any confusion with respect to settlement cycle adopted by a certain stock exchange may result in adverse consequences for the investor.

Global Standards

The United States of America ("USA") shortened its settlement cycle from T+3 to T+2 in 2017 and is now deliberating a move to T+1. The USA's decision to switch to T+2 was influenced by the 2008 financial crisis which led the authorities to contemplate risks associated with a longer settlement cycle. Interestingly, the shortened cycle has reduced transaction costs that has further reduced the counterparty risks faced by the intermediaries, and has improved security liquidity in the USA market, especially for the securities that are hard to borrow.⁹

The Depository Trust & Clearing Corporation ("DTCC"), USA, had released a white paper in January 2018 suggesting a move to T+1 cycle.¹⁰ Subsequently, DTCC released a second white paper early this year laying down the plan to move to T+1 cycle over the next two years that involved a transition step-list from completing distributed ledger technology ("DLT") prototype development on a digital platform by quarter 1 of 2021 to official transition to the T+1 cycle by the end of 2023.¹¹

CONCLUSION

Most of the stock exchanges in developed countries like USA¹², UK¹³ & Japan¹⁴ currently follow T+2 trade settlement cycle. Unlike SEBI, DTCC has initiated gradual implementation and an industry-wide consultation process to mitigate the concerns of all the stakeholders.¹⁵

For the effective implementation of the T+1 cycle, the technological infrastructure would have to be appropriately updated by the market intermediaries, including the stock exchanges, in order to adapt and conform to the requirements of a shorter rolling cycle. These may include a set-up to accommodate increased trading volumes and lesser time for trade error corrections.¹⁶ Further, SEBI should also engage in talks with the FPIs, stock brokers and banks to understand and mitigate any concerns they may have.

From an industry standpoint, reduced settlement cycles should lead to transactional feasibility. Ideally, NSE and BSE should opt for the same settlement cycle for a particular scrip. That would avoid any confusion and maintain interoperability across the two exchanges.

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You can direct your queries or comments to the authors

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¹ SEBI Circular dated September 7, 2021 - SEBI/HO/MRD2/DCAP/P/CIR/2021/628 available at

https://www.sebi.gov.in/legal/circulars/sep-2021/introduction-of-t-1-rolling-settlement-on-an-optional-basis_52462.html

² SMD/Policy/Cir-04 /2002 available at https://www.sebi.gov.in/legal/circulars/jan-2002/circular-4-dated-january-30-2002_16130.html

³ SEBI Circular No. 19 - Calendar for the implementation of T+2 rolling settlement w. e. f. April 1, 2003' available at

https://www.sebi.gov.in/legal/circulars/mar-2003/circular-no-19-calendar-for-the-implementation-of-t-2-rolling-settlement-w-e-f-april-1-2003_15830.html

⁴ Discussion paper on Risk Management: safer markets for investors; https://www.sebi.gov.in/reports/reports/apr-2013/discussion-paper-on-risk-management-safer-markets-for-investors_24640.html.

⁵ Cost benefit analysis of shortening the settlement cycle (October 2012) available at https://www.dtcc.com/-/media/Files/Downloads/WhitePapers/CBA_BCG_Shortening_the_Settlement_Cycle_October2012.pdf

⁶ Taiwan Securities Association Trust Association of R.O.C – T+2 DVP Q&A available at <http://www.twsa.org.tw/down/doc/law/T2DVPQA1217-1.pdf>

⁷ Moscow Exchange introduces major upgrade to settlement of Russian securities (2013) Moex, available at <https://www.moex.com/n2852>

⁸ Reducing Settlement Cycles – An Asia Pacific Perspective available at <https://www.regulationasia.com/reducing-settlement-cycles-an-asia-pacific-perspective/>

⁹ Settling down: T+2 settlement cycle and liquidity, Working Paper, 2020: <https://www.thecgo.org/research/settling-down/#1-introduction>

¹⁰ Modernizing The U.S. Equity Markets Post-Trade Infrastructure, White Paper, 2018 available at <https://www.dtcc.com/-/media/Files/downloads/Thought-Leadership/modernizing-the-u-s-equity-markets-post-trade-infrastructure.pdf>

¹¹ Advancing Together: Leading The Industry To Accelerated Settlement : A White Paper To The Industry (2021) available at: <https://www.dtcc.com/-/media/Files/PDFs/White%20Paper/DTCC-Accelerated-Settle-WP-2021.pdf>

¹² SEC Adopts T+2 Settlement Cycle for Securities Transactions (2017) available at <https://www.sec.gov/news/press-release/2017-68-0>

¹³ Introduction of T+2 standard settlement period (Market Notice – December 2013) available at <https://docs.londonstockexchange.com/sites/default/files/documents/n1413.pdf>

¹⁴ T+2 Stock Settlement Cycle Go-live Date is Fixed available at <https://www.jpjx.co.jp/english/news/0010/20190514.html>

¹⁵ <https://www.dtcc.com/-/media/Files/PDFs/White%20Paper/DTCC-Accelerated-Settle-WP-2021.pdf>

¹⁶ Canada's TMX Exchange paper (2021) <https://www.cds.ca/resource/en/420>;

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