

Report of the Study Group on the Shortening of  
the Stock Trading Settlement Cycle (T+2)  
(abstract)

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Secretariat for Study Group on the Shortening of the Stock Trading  
Settlement Cycle (T+2)

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## I. Purposes of setting up the study group and its contents of discussion

Against the backdrop of the globalization of securities transactions, the reform of Japan's securities trading settlement system, which was initiated after the Financial System Council's First Working Group on securities settlement system issued the report "Reform of the Securities Settlement System toward the 21st Century" (June 2000), has been proceeding based on the recognition that the realization of secure and efficient securities settlement system is an urgent and important issue for enhancing the competitiveness of Japan's capital market among international markets and with reference to the discussions conducted at the Council on Securities Delivery and Clearing/Settlement Systems Reform that was set up in July 1999.

Various initiatives have been implemented in the past to improve the securities settlement system's security and efficiency. Japan Securities Depository Center started the operations of its settlement matching system and DVP settlement service for general transfers respectively in September 2001 and May 2004. Also, the Act for Partial Revision of the Act on Transfer of Bonds, etc., for Achieving Rationalization of Settlements for Transactions of Shares, etc., was promulgated in June 2004, which enabled share certificates etc., to be dematerialized in addition to corporate bonds, government bonds, investment trust funds that had already been dematerialized, and the dematerialization of share certificates etc., was achieved in January 2009. Thus the straight through processing (STP) of the settlements of share certificates etc., has been making steady progress.

On the other hand, the stock trading settlement cycle still remains T+3 despite that the working group under the Council on Securities Delivery and Clearing/Settlement Systems Reform studied and discussed the possible shortening of the settlement cycle and sorted current situations and issues in its report "Toward Advancing the Securities Settlement Reform" (November 2002).

In the cases of overseas major markets including the US, Europe and Asia, the shortening of the settlement cycles for stocks etc., to T+2 has been implemented or is being discussed toward its implementation. It is necessary to secure necessary consistency in the settlement system with other major overseas stock markets from the viewpoint of maintaining the international competitiveness of Japan's market. It is therefore deemed necessary at least to promptly start examining the impacts on the market and other factors of the shortening of the stock trading settlement cycle based on the initiatives implemented so far for reforming Japan's securities settlement system.

Based on such ways of thinking, the “Study Group on the Shortening of the Stock Trading Settlement cycle (T+2)” was set up in August 2014 as the securities industry’s study sessions with Japan Securities Dealers Association, Tokyo Stock Exchange and Japan Securities Clearing Corporation serving as its secretariat, which met four times from September of the same year to discuss anticipated effects of the shortening of the settlement cycles for stocks etc., in Japan and issues envisaged in the process of its implementation. This report summarizes the outcome of the discussions conducted at the study group.

The study group also introduced and shared the status of major overseas markets including Hong Kong where the T+2 settlement has been already established, Europe where the settlement cycle has been shortened to T+2 since October 2014 and the US where a detailed study regarding the shortening of the settlement cycle to T+2 was commenced from October 2014..

## II. Anticipated effects of implementing the shortening of the stock trading settlement cycle

### 1. Expected advantages of implementing the shortening of the stock trading settlement cycle

Expected advantages of the shortening of the stock trading settlement cycle have been examined and summarized in the following four points:

#### 1-1: Reducing settlement risks

While the reduction of settlement risk is recognized as a global issue especially after Lehman Brothers' collapse, the shortening of the settlement cycle that reduces the unsettled amount is expected to mitigate the following settlement risks:

##### (1) Liquidity risk in case of bankruptcy

- The risk of not being able to receive funds or securities from the counterparty as scheduled

##### (2) Replacement-cost risk

- The risk of not being able to realize the equal or positive current market value of the transaction in case a counterparty defaults

#### 1-2: Improving capital efficiency and reducing collateral burdens

The shortening of the settlement cycle would improve the utilization of securities and funds and increase liquidity. Furthermore, against the backdrop of the globally increasing needs among the market participants for the improvement of efficiency of capital utilization and for the reduction of collateral burdens such as margins given the recent tightening of margin and capital requirements, the shortening of the settlement cycle would decrease the amounts required for the clearing fund and thereby the collateral burdens.

#### 1-3: Rationalizing and streamlining the settlement operation for the entire industry

The entire industry would take initiatives necessary for implementing the shortening of the settlement cycle, which would drive further rationalizing and streamlining the settlement operation throughout the industry. It should be noted, however, that the necessity to seek rationalization and efficiency must be fully examined beforehand.

#### 1-4: Maintaining and enhancing the international competitiveness of Japan's market

The above-said effects are expected to improve the security, efficiency and convenience of Japan's market and to help maintain and secure its international competitiveness.

Moreover, if Japan's settlement cycle remains T+3 while other major markets are moving toward the T+2 settlement, the Japanese market might be regarded as a market involving higher settlement risks, investment in the market might be avoided, and its global status could be deteriorated.

Foreign investors need to integrate their settlement operations globally and could become less willing to invest in Japan if the settlement cycle of the country alone is different. It is necessary to maintain Japanese market's international competitiveness by introducing the settlement framework consistent with the international standard.

#### 2. Anticipated disadvantages of implementing the shortening of the stock trading settlement cycle

Anticipated disadvantages of implementing the shortening of the stock trading settlement cycle were also discussed and summarized in the three points described below. Regarding points (1) and (2), more concrete issues are described below in "III. Anticipated issues toward implementing the shortening of the settlement cycle," for which response measures should be considered provided the shortening of the settlement cycle is to be implemented. Also, based on the perspective discussed in point (3), costs and benefits for the overall market should be taken into consideration.

##### (1) Increase in fail risk

Tighter schedule for post-trade processing due to the shortening of the settlement cycle might lead to an increase in fails. Especially, fails are expected to increase in trading with non-residents due to time differences, which might seriously impact the market given that a substantial part of stock transactions involve non-residents.

##### (2) Increase in operational risk

The shortening of the settlement cycle would require the currently T+3-based post-trade processing to be completed more promptly, which might increase administrative burdens and thereby operational risks.

(3) Increase in costs associated with the revision of operational flows and systems redevelopment, etc.

The shortening of the settlement cycle would require the internal systems and operational flows that are currently structured based on the T+3 settlements to be changed extensively, which is expected to increase market participants' costs for systems investment and redeveloping internal structures, etc.

### **III. Anticipated issues toward implementing the shortening of the settlement cycle**

Discussions on the anticipated issues toward implementing the shortening of the settlement cycle identified the following points as major issues:

It should be noted that the following descriptions comprehensively indicate opinions expressed at the study group and not necessarily the participants' consensuses.

#### 1. Response measures for fails

##### (1) Revising the settlement time etc., in clearing and settlement infrastructures

Revisions of the settlement time in and operation hours of clearing and settlement infrastructures, which would facilitate the post-trade processing according to European and US time, are expected to help reduce fails (delays in the delivery of securities from customers to brokerage firms) in non-residents' transactions. Implementation of such revisions, however, would require development of internal systems and changes in work hours and therefore need to be fully examined.

Furthermore, it would be necessary to examine the adequacy of banks' cut-off time (foreign and domestic exchanges) and to request banks to transfer funds to brokerage firms promptly.

Also, in examining the above-said points, extension of the operating hours of BOJ-Net and the inter-bank payment system need to be considered.

##### (2) Revision of rules on fails

It is necessary to consider revising rules on fails including changes in delinquent charge rates and the methods of mandatory executions of buy-ins and how to handle a right related to a fail occurring on a date when the right is fixed, taking into account a possible increase in fails in transactions with non-residents.

##### (3) Accelerating the processing and improving the environment for stock lending transactions

Lending transactions are deemed to be increasingly important as fail coverage tools to avoid the occurrence of fails in transactions on exchanges especially because the number of fails in

transactions with non-residents is expected to increase.

Therefore, it is necessary to enhance the STP as well as to promote the DVP settlement system for stock lending transactions, including the reviews of rules, administrative processing flows and internal infrastructures regarding such transactions.

Also, we could consider requesting large-amount lenders to cooperate in T+0 lending and utilizing so-called tri-party transactions and automated lending schemes.

## 2. Mitigating administrative burden increase

### (1) Transactions with non-residents

#### (i) Acceleration and STP of post-trade processing

Considering the differences in time and holidays from Europe and the US, the post-trade processing of transactions with non-residents is expected to become even tighter.

It is, therefore, necessary to have overseas investors and custodians accelerate post-trade processing including the T+0 transmissions of settlement instructions and to consider the STP of post-trade processing including simplifying and standardizing to the possible extent the operations and communication processes by domestic and foreign execution and settlement parties.

#### (ii) Checking the effects of FX transactions

It is necessary to check the effects on fund settlements with non-residents in case the current T+2 settlements are maintained for FX spot transactions.

### (2) Transactions with domestic investors

#### (i) Institutional investors

In order to improve the efficiency of post-trade processing, it is necessary to promote the utilization of settlement matching systems and DVP settlement services for general transfers and to consider standardizing the post-trade processing of transactions with investors not using these systems or services.

Also, while transaction reports (documents provided upon the conclusion of contracts) are currently issued in many cases when margin transactions are executed with institutional investors, it is necessary to consider whether it is possible to abolish the provision of transaction reports (documents delivered upon conclusion of contracts) unless it is required by law or regulations.

(ii) Individual investors

Especially in the case of over-the-counter transactions, the time for investors to confirm the contents of their transactions would be shortened. It is, therefore, necessary to fully consider whether to promote the electric provision of transaction reports (documents delivered upon conclusion of contracts) or to continue to use the conventional methods such as telephone and fax, weighing up needs and burdens of such reporting.

(3) Transactions outside the exchanges and transactions between brokerage firms

Regarding off-exchange transactions including those at proprietary trading systems, it is considered desirable to implement T+2 settlement as in the case of transactions on exchanges.

As to bilateral transactions between brokerage firms, it is necessary to examine whether it is possible to make them subject to JSCC's netting.

3. Issues associated with the shortening of the stock trading settlement cycle

(1) Error correction processing

It is necessary to consider changing the schedule of error correction processing at the exchanges.

(2) Reviewing transactions and operations related to stock trading

(i) Margin transactions

It is necessary to re-examine the schedule of providing margin collateral and additional margins and, in case of shortening the provision period, to consider reviewing the standard operational flows.

(ii) Launching, exchanging or converting ETF, DR and convertible bonds

It is necessary to consider reviewing the standard operational flows in the case of

ETF/DR/convertible bonds being launched, exchanged or converted.

(iii) Procedure to transfer outstanding amounts

It is necessary to consider reviewing the standard operational flows for the procedure to transfer outstanding amounts between brokerage firms based on the needs of various segments of investors.

(iv) Implementation of convertible bond settlements on record dates

It is necessary to consider measures that enable convertible bonds to be settled on record dates (dates to fix stockholders' rights) as in the case of stocks.

4. Treatment of securities other than stocks

(1) Dematerialization of BOJ subscription certificates

It is necessary to consider dematerializing (making paperless) Bank of Japan subscription certificates that are the only listed securities currently settled by the delivery of physical certificates.

(2) Shortening of the settlement cycles of securities other than listed securities

(i) Bonds and foreign securities

From the perspective of investors' convenience, in case T+2 settlement is implemented for listed instruments, it is considered desirable to implement T+2 settlement for bonds and foreign securities, too.

(ii) Investment trusts

For investment trusts as well, the implementation of T+2 settlement would be desirable from the perspective of investors' convenience and in view of foreign countries' (especially the US') initiatives toward the shortening of settlement cycle.

On the other hand, however, it is deemed difficult at this stage to implement T+2 settlement across the board, given that redemption periods are not standardized and that funds in investment trusts are invested in a variety of instruments including foreign instruments.

## 5. Disseminating information to investors

It is necessary to promote investors' understanding of changes in the market system and practices due to the shortening of settlement cycles (the timing of rights-off, fail rules, difference from other instruments' delivery dates) and to prompt every category of investors to develop necessary systems respectively.

#### **IV. Preparation period for and timing of implementation of the shortening of the settlement cycle**

Whether or not Japan should implement the shortening of settlement cycles for stocks, etc. needs to be fully examined observing the developments in the US and keeping a global perspective so that Japan will not get left behind.

Also, if the shortening is to be implemented, a sufficient time period should be secured between the decision and implementation, for market participants would need to take response measures for the issues described in this report including developing their internal structures and systems. Besides, various other changes have already been scheduled regarding the settlement and market infrastructures. Accordingly, the timing of implementation should be considered taking into account such circumstances as well.

Companies that participated in the Study Group on the Shortening of the Stock Trading Settlement cycle (T+2)

Member	Ace Securities Co., Ltd.
Member	SMBC Nikko Securities Inc.
Member	Okasan Securities Co., Ltd.
Member	J.P. Morgan Securities Japan Co., Ltd.
Member	Securities Japan, Inc.
Member	Daiwa Securities Co., Ltd.
Member	The Tachibana Securities Co., Ltd.
Member	Toyo Securities Co., Ltd.
Member	Nomura Securities Co., Ltd.
Member	BNP Paribas Securities (Japan) Limited
Member	Matsui Securities Co., Ltd.
Member	Mizuho Securities Co., Ltd.
Member	Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.
Member	Rakuten Securities, Inc.
Observer	Japan Securities Depository Center, Incorporated
Observer	The Investment Trusts Association, Japan
Observer	Japan Securities Finance Co., Ltd.
Secretariat	Tokyo Stock Exchange, Inc.
Secretariat	Japan Securities Clearing Corporation
Secretariat	Japan Securities Dealers Association

(20 companies in total; listed in the order of Japanese alphabet)