The imminent introduction of a T+5 settlement regime will make the Australian equities market more internationally competitive.

By ANGUS G. RICHARDS

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THE Australian equities market is one of a minority of world markets which have a “demand” settlement discipline. This will change with the introduction of a rolling “trade date plus five business days” (T+5) regime for ASX transactions. Under the T+5 regime, transactions are due to settle on the fifth business day after the date of the trade and a seller who fails to deliver securities on the due day will be subject to a monetary penalty. This paper reviews the reasons why the ASX is moving to a T+5 settlement discipline, and outlines some of the consequences for the securities industry.

Most major world equity markets already operate with a fixed-period settlement discipline. These range from the fortnightly account settlement arrangements of the London Stock Exchange (in which generally all transactions over a two-week dealing period are due to settle on the sixth business day after the end of that period), to the more-common rolling fixed-period settlement. Examples of rolling fixed-period settlements include:

- US and Canada: T+5
- Japan: T+3
- Germany: T+2
- Hong Kong: T+1

* Hong Kong intends to change to a T+2 settlement discipline in 1992.

Prompted by securities settlement risks manifested after the October 1987 collapse of world security markets, the Group of Thirty (a private, independent organisation whose charter is to raise awareness and understanding of major international economic and financial issues) published a report giving a series of recommendations aimed mainly at reducing risks arising from deficiencies in clearance and settlement systems for securities transactions (Clearance and Settlement Systems in the World’s Securities Markets, Group of Thirty, New York and London, 1989). These recommendations were widely published and were actively supported by the Fédération Internationale des Bourses de Valeurs (FIBV) and the International Society of Securities Administrators (ISSA). One of the main recommendations of the Group of Thirty was that all securities markets should have in place a rolling T+5 fixed-period settlement regime by 1990, and T+3 by 1992.

The key justification for a short fixed-period settlement discipline is that a minimum delay between trade date and settlement date minimises counterparty risk and market exposure for unsettled transactions. A fixed-period regime also

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has the advantage of predictability; ie, the counterparties to a securities transaction both know when securities are due to be delivered, and when funds in the appropriate currency are due to be paid to effect settlements.

By comparison, in the current ASX demand settlement environment, a buying broker and its buying client may only become aware that funds are due when delivery is received from a selling broker.

Another recommendation of the Group of Thirty looked forward to standardisation of settlement disciplines across different instruments; eg, equities, exchange-traded options, futures and foreign exchange. Predictability of settlement date also reduces the funding costs for intermediaries, since it minimises situations in which they are obliged to carry securities for one or more days, pending settlement with their principals.

The fact that a move to T+5 is imminent for the ASX invites two questions: Why T+5 rather than same-day (T) or next-day (T+1)? Why has the ASX persisted for so long with the demand settlement system?

Factors which militate against introducing a very short (T or T+1) settlement regime include:

- The typical role of intermediaries in equity transactions, and the time delays inherent in the processes for confirming transactions between intermediaries and principals;
- The volume of international trading in the Australian equity market, which, coupled with time zones around the globe, inherently leads to delays in the confirmation cycle for foreign-sourced transactions;
- The typical use of global custodians and sub-custodians by international investors, which leads to a chain-of-command for confirmations.

To quote from the Group of Thirty report: Participants may therefore need to step back from the "same day" goal and consider the realities of today's international markets.

**T+5 in Australia**

Until the 1980s, a short fixed-period settlement discipline was judged to be impractical, perhaps even unnecessary, in the Australian equities market. The reasons included inevitable delays in the movement of transfer documents between major cities, delays inherent in the communication from brokers to clients both locally and internationally, and delays in the processing of transfers by sellers and share registries.

Further, until the relatively recent experience of sustained high real interest rates, funding costs for intermediaries were less of a problem.

Three important developments in the past decade have put paid to the view that a fixed-period settlement discipline is unnecessary. These are:

- the emergence of derivative markets as a potent force in trading strategies that include deals in the underlying equities;
- increasing awareness among major Australian companies of the advantages of encouraging foreign portfolio investment in their securities; and
- the participation (albeit attenuated to some degree by the "wild west" image created by recent corporate failures) of foreign institutional investors in Australian securities markets.

Derivative-linked trading strategies need certainty of settlement to help synchronise settlements in the different markets (equities, exchange-traded options and futures) and to promote prompt delivery by short sellers.

Certainty of settlement encourages foreign interest in the market in at least two ways. Foreign institutions accustomed to fixed-period settlement in their home markets are perplexed and sometimes deterred by a demand settlement discipline. Also, for foreign investors, frequently a foreign-exchange transaction settlement will be linked to the settlement of an equities transaction, and optimally these two settlements are synchronised.

The progressive evolution of the ASX's flexible accelerated security transfer (FAST) scheme, introduced in 1989—complemented by processes for same-day electronic "delivery" of transfer documents across the country—now makes it feasible to move to a T+5 settlement discipline.

**FAST**

FAST enables eligible securities to be dematerialised (ie, held in uncertificated mode) at the discretion of a shareholder, alleviating one of the major impediments to rapid processing of transfers following market transactions. Transactions in FAST-eligible securities now represent more than 70 per cent of the total value of ASX turnover. The major companies participating in FAST now have, typically, about 40 per cent of their shares in uncertificated holdings.

Another innovation along the path to more timely settlements was the elimination of the requirement for sellers to sign market transfer forms. Transfers are now effectively executed on a transferor's behalf by the selling broker.

Three matters in particular must be noted in the context of the current evolution from demand to T+5 settlement for ASX market transactions:

- Paradoxically, while the introduction of a T+4 discipline will bring predictability, it will also represent a slowing down of settlement for a significant proportion of ASX transactions. The facilities of FAST, coupled with a liquid wholesale securities lending market, currently enable settlement of some 70 per cent of transactions in FAST-eligible securities by T+3.
- The ASX will regulate the T+5 discipline in respect of the settlements that it directly controls; ie, transactions between ASX member organisations. Enforcement of the T+5 discipline between brokers and their clients will be a matter of commercial arrangements governing the broker/client contracts, but it is expected that brokers will pass on any penalty costs that are attributable to delays on the part of clients.
- Although a transition from demand to T+5 settlement is extremely simple in concept, it has broad ramifications which bring fundamental changes to the procedural and regulatory framework of the securities industry. Protracted consultative and bureaucratic processes are endemic to such change. Hence it is not a trivial task.

**Securities lending**

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Guarantee Fund to SLS transactions. Guarantee fund protection will not extend to securities loans entered into directly through the wholesale lending market.

To further encourage borrowing of securities rather than failing to meet settlement obligations, the ASX has sought exemption from financial institutions duty for the money collateral flows associated with SLS transactions.

Electronic interstate deliveries

When ASX brokers deal through the national automated trading system (SEATS), the counterparties are likely to be in different states. To minimise the likelihood of a broker being penalised for failing to meet a T+5 settlement obligation, the ASX has introduced for FAST-eligible securities a delivery mechanism which is independent of distance and free of the uncertainties of courier services.

The FAST Interbroker Delivery System (FIDS) enables a delivering broker to lodge transfer documents with the ASX in one state and have corresponding transfers provided to receiving brokers in all states within a short time. In the transit process, securities move through an unqualified clearing nominee (SECH Nominees) which is wholly owned by exchange.

Netting

After protracted debate, a consensus emerged among ASX brokers that transaction netting should be a precondition of the introduction of T+5 settlement. Under a netting procedure, a broker’s obligations to deliver a quantity of a particular security to other brokers on a settlement day are offset against the deliveries of that security that he expects to receive from brokers on that day.

The introduction of transaction netting has entailed significant changes in computer systems, both for the ASX and for brokers’ back-office accounting systems. Transaction netting also requires a secure legal framework to ensure that after transactions have been netted for settlement, any claims against the National Guarantee Fund are no longer admissible in respect of those original transactions; rather, claims should be admissible only in respect of unsettled obligations derived from the netting process. The complex legislative changes to achieve this result are contained in amendments to the Corporations Law and are supported by amendments to the ASX Business Rules.

Changed “ex period”

Traditionally, the Australian securities market has operated on the basis of a five-day “ex period” for corporate actions. Under this regime, securities are quoted ex the entitlement to a shareholder benefit on the fifth business day before the issuer’s record date for the benefit (inclusive of the record date itself). During the five-day ex-period, under the rules of the exchange, brokers should only lodge cum transfers with issuers’ registries.

Clearly, this arrangement is not compatible with a T+5 settlement regime, since it would preclude registration before the record date for transfers arising from the past five days of cum-benefit trading.

To minimise the number of claims for benefits on the part of unregistered cum-benefit buyers, the introduction of T+5 settlement will be accompanied by the introduction of a seven-day ex-period, and changed rules governing registration lodgements during the ex-period. This entails changes to the
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Brokers will be entitled to pass on fail penalty costs attributable to their selling clients, but the manner in which this is done is seen to be a matter of commercial arrangements between broker and client. Similarly, on the buy side, brokers will be entitled to pass borrowing costs on to the defaulting client. To encourage the timely delivery of securities to buyers, it is intended that the penalty costs associated with a failure to deliver should be higher than the costs of borrowing securities.

Many institutional investors and custodians in the Australian market have already taken advantage of the benefits of uncertificated holdings by joining the FAST scheme. Only a small minority of private investors have availed themselves of uncertificated holding facilities by participating in FAST under a sponsorship agreement with an ASX broker. It is expected that the more active private investors will come to appreciate the advantages of uncertificated holdings in the T+5 environment, and that will lead to an increased use of sponsored holdings under the FAST system.

To ensure that investors are not disadvantaged in terms of their ability to trade certain securities when T+5 is in place, there will be exceptions to the T+5 discipline. In particular, trading in newly issued securities and rights will not be subject to T+5 settlement until the relevant documents have been mailed to shareholders; ie, the initial trading in such securities will be on a deferred-settlement basis.

Future evolution of market settlement
The introduction of the FAST system in 1989 was the first stage of a three-stage strategy for bringing the Australian equities settlement system up to the standards prescribed by the Group of Thirty. The introduction of a T+5 fixed-period settlement discipline represents the second stage. The planned third stage is to replace physical movement of transfer documents with facilities for electronic transfer of securities, making achievement of the goal of T+3 settlement technically feasible. Foreign investors and their Australian custodians will need to evolve more timely confirmation disciplines to adapt to a T+3 regime.

The third stage also includes the introduction of "delivery versus payment" for settlement of transactions between primary market participants, alleviating another area of risk that was highlighted in the work of the Group of Thirty.

In comparison to some foreign markets, Australia's initiative to achieve this third stage is constrained by two key factors:

- Australian equities are registered securities, as distinct from the bearer equities which predominate in continental Europe.
- Australian issuers strongly oppose any scheme for settlement and transfer of ownership which does not preserve the traditional relationship between a company and its shareholders.

The latter constraint precludes the adoption in Australia of the securities depository approach common in foreign markets. Accordingly, the move to the third stage is being based on the concept of a central clearing house which maintains a sub-register on behalf of issuers. The objective is for frequently traded holdings of institutions and private clients to be held in uncertificated mode and recorded in the sub-register.

Holdings which remain certificated, or which are uncertificated but "controlled" by the issuer, will continue to be recorded directly by an issuer's principal share register. Appropriately, this development is known as the clearing house electronic sub-register system (CHESS). Under current plans and constraints it is expected that CHESS will be introduced progressively from 1993.