

Insights

MODERNIZING UK TRADE SETTLEMENT STANDARD: THE ROAD AHEAD

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The Accelerated Settlement Taskforce is currently examining a potential migration by the U.K. from a so-called T+2 to a T+1 settlement standard, i.e., reducing the time it takes for securities transactions to settle, having [published](#) their initial views in March. [1]

Against this context, and in anticipation of a further report by the taskforce confirming implementation details to be delivered by the end of 2024, we consider in this article the rationale of adopting a new settlement standard plus any challenges, as well as the potential role of distributed ledger technology.

A T+1 settlement standard would mean that financial market trades are settled one day after the transaction date, an improvement over the existing T+2 standard, where trades are settled two days after the transaction date.

The taskforce's assessment covers the U.K.'s settlement arrangements and is ultimately part of a series of policy initiatives intended to modernize the overall financial market infrastructure.

MODIFYING TRADE SETTLEMENT STANDARD

BACKGROUND

In financial markets, there is usually a time lag between the trade date, when parties agree on the terms of a transaction, and the settlement date, when the buyer receives securities and the seller receives funds. This lag is due to a number of post trade processes, including confirming that the buyer has sufficient funds and the seller has the securities in question, which need to occur in order to ensure that a trade properly completes.

Since 2014, the U.K., along with the [European Union](#), has observed a T+2 standard, meaning that trades conducted on exchanges settle within a maximum of two days from the trade date, referred to as "T." There are, however, several exceptions to this standard, including U.K. government bonds, which settle on T+1, and mutual funds, which settle on T+3 or T+4.

Nevertheless, the general push across major markets and jurisdictions is for shorter settlement cycles. The EU has also published feedback on adopting T+1 via the [European Securities and Markets Authority](#), and will provide a final assessment of its analysis by January 2025.[2] Against this new global context, HM Treasury formed the taskforce to ultimately recommend a way forward for the U.K.

RATIONALE FOR NEW STANDARD

There are good reasons for adopting a new settlement standard. A T+1 standard reduces an investor's risk of a counterparty not fulfilling its obligations during the settlement cycle. This type of risk increases during periods of market stress and volatility since defaults by a counterparty can affect the transfer of funds and securities.

By moving from T+2 to T+1, investors will reduce the time it takes to settle, minimizing related counterparty risk. Investors will have quicker access to sale proceeds too.

At the same time, a shortened settlement cycle reduces the amount of margin and collateral required by the central clearing house, which in turn frees up capital to deploy elsewhere. As an illustration, in the U.S., the [Securities Industry and Financial Markets Association](#) observed in May that moving to a T+1 standard resulted in immediate benefits, including an increase in liquidity for the National Securities Clearing Corporation — the financial services company that provides clearing, settlement, and risk management for the U.S. financial markets — as well as higher rates of trade confirmation and settlement.[3]

ANALYSIS OF CHALLENGES

Despite these advantages, a move toward T+1 brings several unique challenges, which we highlight.

FOREIGN EXCHANGE

A large number of participants in U.K. public markets are overseas investors. These investors usually enter into foreign exchange transactions when buying pound sterling-denominated assets. Under the current T+2 standard, investors will enter into such transactions only once the underlying trade is matched. This allows the foreign exchange transaction to settle within T+1, in time for settlement of the underlying trade.

Accordingly, adopting a T+1 standard reduces the time available for the related foreign exchange transaction to settle, meaning that foreign exchange dealers are likely to charge higher fees or quote wider spreads for speedier transactions. To overcome this, investors may need to pre-buy pound sterling, though this is risky as pricing can fluctuate between the two trades. Investors can also draw on a local currency facility, although this is not always available.

SECURITIES LENDING

The timeline for securities lending will be significantly compressed on a T+1 standard. Borrowers will need to manage cash and inventory in order to collateralize loans and to be able to deliver recalled securities in time.

DIVIDENDS

On most exchanges, the ex-dividend date — being the date on which the buyer ceases to be entitled to distributions — is usually set one day before the record date — being the date when the issuer finalizes the list of dividend recipients.

This means that on the current T+2 standard, investors who sell their shares before the ex-dividend date would continue to be shareholders on the record date and entitled to the dividend as well.

On a T+1 standard, the ex-dividend date and record date will likely be the same. As a result, workflows will need to be updated so that if a transaction is not properly initiated before the ex-dividend date, e.g., where a buyer has initiated a purchase order that is still pending for a security with a distribution, there are processes to properly determine the rightful owner of those dividends.

MISALIGNMENT WITH EU

The taskforce's view is that a move to T+1 before the EU would not bring any material misalignment issues, notwithstanding the fact that certain Euromarket securities, e.g., Eurobonds, are traded on both U.K. and EU venues.

This is because transactions by U.K. market participants are executed on U.K. trading venues and by EU market participants on EU trading venues.

Nevertheless, this also means that a particular security could be traded on either a T+2 or T+1 settlement standard, depending on where the transaction is conducted. If the U.K. adopts T+1 prior to the EU, this will result in two different settlement cycles to choose from, which in turn splits liquidity for the same security.

A potential consequence is that subsequent liquidity may flow to EU trading venues, leading to a difference in spreads across EU and U.K. venue dealers, which creates potential arbitrage opportunities. One potential approach would be to coordinate the T+1 transition with the EU, to avoid divergent settlement standards. However, there is uncertainty as to the EU's timing, noting that speedier adoption by the U.K. would be a competitive advantage due to the benefits of reduced counterparty risk.

Whether the U.K. can coordinate its settlement transition with the EU likely depends on the EU's own timeline but is ultimately a question for HM Treasury.

IMPLEMENTATION

OVERVIEW

The market wide move to a T+1 standard will require improving on existing workflows so that activities can be conducted faster and more efficiently. Accordingly, it is the taskforce's view that the move will not require any novel technology to achieve. Instead, there will be increased focus on the back office to close out post trade tasks on the trade date itself, given the loss of a day.

As an illustration, the U.S. [Financial Industry Regulatory Authority](#) observed that firms could comply with the new settlement standard via a mixed approach. This could mean implementing new technology but also building up the human capital base through further hiring and re-training in order to meet compressed timelines.[4]

REGULATORY ENVIRONMENT

The Central Securities Depository Regulation was brought into the U.K. via the European Union (Withdrawal) Act 2018. It governs the operation of central depositories as well as the settlement of financial instruments in the U.K.

Various changes will need to be made to the regulation. To start, Article 5(2) of the act, which deals with the intended settlement date, should be amended to expressly recognize a settlement cycle of one business day. Language to accelerate timelines for matching, allocating and confirming transactions – and possibly to tie completion of these post trade tasks to the trade date itself – will also need to be inserted into the U.K. Central Securities Depositories Regulation.[5]

At the same time, rule books, trading documentation and exchange regulations will all need to be amended in support of the T+1 standard. This includes updating exchange regulations to reflect accelerated timelines for post trade tasks and rule books for central depositories, e.g., CREST, the U.K.-based central securities depository that holds U.K. equities and U.K. gilts, to lengthen trading hours.

Industry participants would also benefit from agreeing on best practices and guidelines regarding automation and inventory management in support of T+1.

TIMING

The taskforce views the settlement migration as a two-year project. At least one year will be needed for planning, and another for implementation. As an illustration, in the U.S., the [Securities and Exchange Commission](#) provided the market with 15 months advance notice before formally migrating to the T+1 standard.[6]

As part of the planning phase, the taskforce has recommended the creation of a technical group to examine any operational issues and to propose market standards to ensure a smooth transition.

Stakeholders will also need to make appropriate budget provisions to make the required investments in people, technology and workflows within the back office.

Finally, the taskforce recommends that any operational changes be mandated in 2025 to allow participants to adapt to updated processes. Once the market has adapted to these changes, the technical group should choose a date for formal compliance with the T+1 standard.

MOVING FORWARD

The global trend has been to arrive at a T+0 standard. Various technologies could facilitate the move toward atomic settlement, including distributed ledger technology, or DLT.[7]

DLT is in essence a replicated, shared and synchronized recording system.[8] Accordingly, incorporating DLT into the operation of a central securities depository or exchange would completely transform the settlement process. As a start, DLT could be used to embody an issuer's share register, which would be collectively maintained and held by all investors.

This would effectively remove the need for a clearing and settlement function, since all investors have direct ownership of their shares, and not simply an equitable interest if held through a bank, investment platform or broker. Accordingly, investors could transact directly with one another without needing to give instructions to a third party or intermediary.

In turn, this removes the need for post trade processes up and down the chain. By removing reliance on other stakeholders, DLT could deliver extended operations and even T+0 settlement. More broadly, DLT enables issuers to connect directly with their shareholder base, rather than via an intermediary, for the purposes of secondary capital offerings, for example, which enhances engagement and ultimately corporate governance.

Given DLT's potential to revolutionize multiple aspects of the U.K. shareholding system, our view is that planning and implementation for T+1 should ultimately take into account a future integration of DLT, and the move toward T+0.

The government has determined that the transition to T+1 should complete by no later than the end of 2027, once any operational changes are mandated in 2025.

This article was originally authored by [Tom Bacon](#) and Andrew Tsang and published on [Law360](#)

FOOTNOTES

[1] Accelerated Settlements Taskforce, March 2024

[2] <https://www.esma.europa.eu/press-news/esma-news/t1-feedback-report-shows-mixed-impacts-shortening-settlement-cycle-eu>.

- [3] <https://www.sifma.org/explore-issues/shortening-settlement-cycle>.
- [4] <https://www.finra.org/media-center/shift-to-t-plus-1>.
- [5] Regulation (EU) No 909/2014.
- [6] <https://www.sec.gov/oiea/investor-alerts-and-bulletins/new-t1-settlement-cycle-what-investors-need-know-investor>.
- [7] The UK's initiative to dematerialize the current shareholding structure and the potential role of distributed ledger technology is discussed in our previous Law360 article <https://www.law360.com/articles/1767740/uk-shareholding-report-a-missed-opportunity-for-new-tech>.
- [8] Tsang, Andrew. "Distributed Ledger Technologies: Potential Response to Data Privacy Issues in Hong Kong." HKJ Legal Stud. 15 (2021): 48.

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