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OPINION

Lex

US equities/settlement: superfast settlement could bedevil the market

It makes sense to cut the time taken to settle a trade yet resist pressure for real-time execution

When it comes to settlement times for US stock trades, a Goldilocks pace — fast but not too fast — should suit the markets best.

The speed at which trades settle was thrust into the spotlight in January after frenzied trading in shares of GameStop, and other meme stocks popular with Reddit day traders, forced brokers such as Robinhood to impose trading restrictions.

Currently, it takes two business days post-trade — or T+2 in industry jargon — to deliver shares to the buyer and cash to the seller. In that time, brokers have to deposit cash margins with the US stock market's central clearing hub, the Depository Trust and Clearing Corporation (DTCC). Sudden lurches in asset prices means the DTCC can ask for substantially more collateral, raising trading costs.

After the meme stock hiccup, Robinhood blamed the settlement system for the debacle. It argued that instant settlement would be better for the market by eliminating sudden increases in margin requirements.

In theory that makes some sense. Custodian banks such as State Street and Fidelity are considering using blockchain technology to settle stock trades. But in practice, real-time settlement means all transactions are funded on a transaction-by-transaction basis. For big firms that trade billions of dollars a day, this actually reduces market efficiency. It eliminates so-called "netting" opportunities, in which all pending trades are pooled together and settled simultaneously. There are additional complexities when one considers foreign investors, options, ETFs and futures.

Instead, DTCC's proposal to cut the settlement time to one day (T+1) by 2023 is far more sensible. Banks and brokers will benefit because a shorter settlement period would free up liquidity, otherwise tied up to insure against trading parties failing to deliver cash or shares.

That said, the current system works well. The DTCC's margin requirement helps ensure brokers have the finances to back the trades they are executing. It was Robinhood's risk management system that underestimated its liabilities. Rather than turning the room to screw the lightbulb in, try twisting the lightbulb more efficiently.

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