Trade vs. Settlement Date: What's the Difference?

There are two important dates to know when making an investment: the trade date and the settlement date.

When an investor's buy or sell order gets confirmed in a brokerage account, the day this occurs is known as the trade date. But behind the scenes, the real transaction has yet to take place. A security goes through a settlement process in order for the transfer from a seller to a buyer to occur.

This delay between the day a transaction is made and the day the underlying security ownership has been settled is a period known as T+2 in financial markets. Here's a closer look at this process.

Why Is There a Delay Between Trade and Settlement Dates?

Given modern technology, it seems reasonable to assume that everything should happen instantaneously.

But the current settlement rules go back decades, way back to the creation of the Securities and Exchange Commission (SEC) in 1934, when all trading happened in person and on paper.

Back then, a piece of paper representing shares of a security had to be in the possession of traders in order to prove they actually owned the shares. Moving this paper around sometimes took as long as five business days after the trade date, or T+5.

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What is the T+2 Rule?

The T+2 rule refers to the fact that it takes two days beyond a trade date for a trade to settle. For example, if a trade is executed on Tuesday, the settlement date will be Thursday, which is the trade date plus two business days.

Note that weekends and holidays are excluded from the T+2 rule. That's because in the U.S., the stock market is open from 9:30 a.m. to 4:00 p.m. Eastern time Monday through Friday.

The T+2 rule has been enforced by the SEC since 2017. Before then, the T+3 rule was in place.

What Investors Need to Know About T+2

This delay in settling applies to trading of almost all securities. An exception is Treasury bills, which can settle on the same day they are transacted.

Investors who plan on engaging in cash account trading need to know about trade vs. settlement date. Cash accounts are those in which investors trade stocks and exchange-traded funds (ETFs) only with money they actually have today. Meanwhile, margin trading accounts allow investors to trade using borrowed money or trade "on margin."

An investor may notice two different numbers describing the cash balance in his or her brokerage account: the "settled" balance and the "unsettled" balance. Settled cash refers to cash that currently sits in an account. Unsettled refers to cash that an investor is owed but won't be available for a few days.

T+1? T+0? Real-Time Settlement?

Market observers have called the T+2 rule to be reevaluated, as the settlement process may be able to be sped up and improve trading conditions.

In February, the clearinghouse for U.S. stock trades–the Depository Trust & Clearing Corp.–said in a report that the settlement process should be changed from two days to one. Clearinghouses are middlemen in financial markets that ensure the transfer of a security goes through. They stand ready in case one side of a transaction–either the buyer or seller–defaults.

The DTCC, which cleared $1.77 trillion of securities trades on average each day in 2020, was already researching settling. However in January, wild price swings in so-called meme stocks–those popular on social-media platforms like Reddit–led to trading restrictions of these shares. This, in turn, prompted greater scrutiny of regulations and rules around clearing and settlement.

Moving to T+1, T+0 or real-time settlement would need the approval of the SEC and collaboration of dozens of players across Wall Street. But the real-time transactions made possible in the cryptocurrency market by blockchain technology have escalated chatter for modernizing securities markets.

Potential Violations of the Trade Date vs. Settlement Date

Comprehending the difference between trade date vs settlement date can allow investors avoid potentially costly violations of trading rules.

The consequences of these violations could differ according to which brokerage an investor uses, but the general concept still applies. Violations all have one thing in common: They involve trying to use cash or shares that have yet to come under ownership in an investor's account.

Cash Liquidation Violation

To buy a security, most brokerages require investors to have enough settled cash in an account to cover the cost. Trying to buy securities with unsettled cash can lead to a cash liquidation violation, as liquidating one security to pay for another requires settlement of the first transaction before the other can happen.

Let's look at a hypothetical example. Say an investor named Sally wants to buy $1,000 worth of ABC stock. Sally doesn't have any settled cash in her account, so she raises more than enough by selling $1,200 worth of XYZ stock she has. The next day, she buys the $1,000 worth of ABC she had wanted.

Because the sale of XYZ stock hadn't settled yet and Sally didn't have the cash to cover the buy for ABC stock, a cash liquidation violation occurred.

Investors who face this kind of violation three times in one year can have their accounts restricted for up to 90 days.

Free Riding Violation

While a free ride might sound like a good thing, in this case it's definitely not. Free riding violations occur when an investor buys stock using funds from a sale of the same stock.

For example, say Sally buys $1,000 of ABC stock on Tuesday. Sally doesn't pay her brokerage the required amount to cover this order within the two-day settlement period. But then, on Friday, after the trade should have settled, she tries to sell her shares of ABC stock, since they are now worth $1,100.

This would be a free riding violation. Sally can't sell shares she doesn't yet own in order to purchase those same shares.

Incurring just one free riding violation in a 12-month period can lead to an investor's account being restricted.

Good-Faith Violation

Good-faith violations happen when an investor buys a security and sells it before the initial purchase has been paid for with settled funds. Only cash or proceeds from the sale of fully paid-for securities can be called "settled funds."

Selling a position before having paid for it is called a "good-faith violation" because no good-faith effort was made on the part of the investor to deposit funds into the account before the settlement date.

For example, if Sally sells $1,000 worth of ABC stock Tuesday morning, then buys $1,000 worth of XYZ stock Tuesday afternoon, she would incur a good-faith violation (unless she had an additional $1,000 in her account that did not come from the unsettled sale of ABC).

As we can see by these examples, it's not hard for active traders to run into problems if they don't comprehend cash account trading rules, all of which derive from trade date vs. settlement date. Having adequate settled cash in an account can help avoid issues like these.

The Takeaway

The trade date is the day an investor or trader books an order to buy or sell a security. But it's important for market participants to also be aware of the settlement date, which is when the trade actually gets executed.

For many securities in financial markets, the T+2 rule applies, meaning the settlement date is usually two days after the trade date. An investor therefore will not legally own the security until the settlement date.

While there's been chatter that the settlement process needs to speed up to either T+1 or real-time settlement, it's still important for investors and traders to know these rules so they don't make violations that lead to restricted trading or other penalties.

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