SUMMARY

Shortening the Securities Transaction Settlement Cycle

Shortening the standard U.S. settlement cycle

On February 15, 2023, the U.S. Securities and Exchange Commission ("SEC") published final rules and rule amendments[1] to shorten the standard U.S. settlement cycle for most broker-dealer transactions in securities from two business days after the trade date ("T+2") to one business day after the trade date ("T+1").[2] ***These changes apply to all asset managers, whether they are registered with the SEC as investment advisers ("RIAs") or not, who transact in U.S. securities markets (collectively, "managers").***

T+1 settlement is mandated in the U.S. starting Tuesday, May 28, 2024 – the day following the 2024 Memorial Day weekend.

The SEC believes that accelerating U.S. settlement to T+1 will reduce risk, promote investor protection and increase operational and capital efficiency. The Adopting Release cites periods of high market volatility as having highlighted potential market vulnerabilities that the SEC believes would be mitigated by a shortened settlement cycle.[3]

The transition to T+1 settlement is scheduled to occur on Tuesday, May 28, 2024. Canada plans to transition to T+1 settlement on the same date. Other jurisdictions are evaluating and considering a move to T+1, but there are no commitments as yet. As such, many key markets around the world can be expected to remain at T+2 settlement at the time of the U.S. T+1 transition, temporarily or indefinitely.

The resulting cross-border market misalignment poses difficulty and increased costs for managers who are domiciled in or trade with those markets, whether due to time zone differences that reduce the window to address settlement issues or the need to raise capital from T+2 positions to fund T+1 settlement. While acknowledged in the Adopting Release, these were viewed as acceptable burdens for the sake of efficiencies anticipated from accelerating U.S. settlement. No exceptions or accommodations have been made for those negatively impacted by the U.S. move to T+1.

The newly adopted rules and rule amendments include:

- Shortening the standard settlement cycle to T+1 for broker-dealer securities transactions, subject to very limited exemptions;[4]
- Shortening the standard settlement cycle for firm commitment offerings priced after 4:30 p.m. Eastern Time ("ET") from the current four business days after the trade date ("T+4") to T+2;
- New requirements for broker-dealers and RIAs related to same-day affirmations; and
- New requirements to facilitate straight-through processing applicable to clearing agencies that are central matching service providers ("CMSPs").

Recall that the standard settlement cycle for most securities transactions was shortened from three business days after the trade date ("T+3") to T+2 in 2017. However, there are

1 SEC, "Shortening the Securities Transaction Settlement Cycle", SEC Rel. No. 34-96930 (Feb. 15, 2023) ("Adopting Release").

2 The definition of "business day" did not change in the Adopting Release. As a result, the current challenges in jurisdictions with different time zones and holiday schedules will be exacerbated by the move to T+1, as it removes a full business day from the settlement cycle that better accommodated these differences.

3 Adopting Release, *supra* note 1, at 8.

4 Security-based swaps are exempt, as are security transactions accounted for under Rule 15c6-1(b)(2), which was retained to consider one-off exemptions "consistent with the public interest and the protection of investor".

factors that complicate the move to T+1 that were not relevant in the 2017 move to T+2, so the experience of the 2017 transition to T+2 does not provide a reliable guide to how the transition to T+1 will be. We will discuss those factors in this summary.

U.S. settlement cycle shortened to T+1, but not for everything

The Adopting Release amends Rule 15c6-1 under the Securities Exchange Act of 1934 ("Exchange Act") to shorten the standard settlement cycle for most broker-dealer transactions from T+2 to T+1, with certain exceptions noted below.

The revised rule also shortens the standard settlement cycle for firm commitment offerings priced after 4:30 p.m. ET from T+4 to T+2. However, the SEC will permit parties to such an underwritten transaction (i.e., the firm commitment transaction) to agree at the time they enter into the agreement for the transaction to adopt a longer settlement period if needed.

Broker-dealers are expressly prohibited from effecting or entering into contracts with customers that do not comply with these accelerated deadlines, unless the parties expressly agree to a different settlement date at the time of a specific transaction.

In addition to new issue securities in firm commitment offerings as identified under paragraph (c) of Rule 15c6-1, exempted securities include security-based swaps, government securities, municipal securities, commercial paper, bankers' acceptances and commercial bills. The Adopting Release also retained Rule 15c6-1(b)(2), which allows for one-off exemptions where providing this relief is "consistent with the public interest and the protection of investor".[5]

The SEC did <u>not</u> exempt U.S.-listed ETFs with an underlying basket that includes foreign securities or ADRs.[6]

Process changes to accommodate accelerated settlement

The Adopting Release sets out specific requirements that will affect broker-dealers, RIAs and CMSPs.

Broker-dealer written agreements, policies and procedures

In order to achieve accelerated settlement for subject securities, the SEC adopted new Rule 15c6-2 under the Exchange Act which requires a broker-dealer to either:

(1) Enter into standing written agreements with the relevant parties (such as investment managers and bank custodians, as agents of a broker-dealer's customer) to ensure completion of allocations, confirmations and affirmations as soon as technologically practicable and no later than the end of the day on the trade date ("T+0"); <u>or</u>

5 Adopting Release, *supra* note 1, at 50.

6 Neither U.S.-listed ETFs with an underlying basket that includes foreign securities nor ADRs (which represent foreign securities) were exempted from T+1 settlement, despite different settlement cycles for the underlying securities. The Commission acknowledged the potential risks and costs of the related this mismatched settlement but disagreed that exemptions were necessary. *Id.* at 56-59.

(2) Establish, maintain and enforce written policies and procedures reasonably designed to address certain objectives related to completing allocations, confirmations and affirmations as soon as technologically practicable and no later than the end of T+0.[7]

For broker-dealers opting to take the policies and procedures approach, Rule 15c6-2(a) details the specific requirements of these broker-dealer policies and procedures.[8]

Note that the Adopting Release does not require managers to similarly adopt such written policies and procedures. This is because managers may not always be among the relevant parties completing the allocation, confirmation and affirmation, given that custodians or other third-party agents may act on their behalf. However, the SEC encouraged managers to evaluate whether their own policies and procedures are sufficient to ensure compliance with broker-dealer obligations.

Requirements for RIA recordkeeping

As customers of these broker-dealers who are now subject to Rule 15c6-2 as discussed above, RIAs also are now subject to corresponding new requirements, giving the SEC a method to double-check accelerated settlement compliance.

Specifically, the SEC has amended Rule 204-2 under the Investment Advisers Act of 1940 ("Advisers Act"), commonly referred to as the "Books and Records Rule", to require RIAs to "make and keep records of the allocations, confirmations, and affirmations for securities transactions subject to the requirements of Rule 15c6-2(a)" in an expansion of the rule's general requirement to make and keep certain books and records relating to their investment advisory business.

Under amended Rule 204-2, RIAs are required to:

> "make and keep true, accurate and current certain records with respect to any transaction that is subject to the requirements of Rule 15c6-2(a), specifically those transactions where a broker-dealer engages in the allocation, confirmation, or affirmation process with another party or parties to achieve settlement of a securities transaction that is subject to the requirements of [Rule 15c6-1(a)]."

In other words, they must keep records corresponding to fulfillment of broker-dealers' customer obligations under Rule 15c6-2(a).

More specifically, the Adopting Release identifies the records that RIAs are required to keep as:

- Each confirmation received; and
- Any allocation and each affirmation sent or received, with a date and time stamp for each allocation and affirmation that indicates when the allocation and affirmation was sent or received.

RIAs will be required to keep originals of all confirmations received, and copies of all allocations and affirmations sent or received, whether received in written (print) or electronic form. They may maintain these records electronically if they establish and

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7 *See id.* at 86.
8 *Id.* at 94.

maintain required procedures under Rule 204-2. Equally, an adviser may rely on a third party to make and keep the required records, although using a third party to make and keep records on their behalf does not in any way reduce an RIA's recordkeeping obligations under Rule 204-2.

By establishing corresponding recordkeeping requirements for both sides of subject trades, the SEC has a window through which it can monitor compliance with T+1 requirements. The SEC believes the amendments will help to ensure that all parties' obligations in achieving a matched trade have been met.

Preparatory action items for RIAs:

- Ensure ability to obtain and retain required trade records in a form/format consistent with amended Rule 204-2.
- Confirm counterparties have correct postal/email addresses for delivery of confirmations and ensure that these addresses are regularly verified and updated to ensure that changes are accounted for.
- Confirm all allocation and affirmation messages can be captured and retained. In the U.S., these generally are in electronic form, as Financial Information eXchange ("FIX") protocol messages.
- Establish a process to periodically check that all required records are being delivered, recorded and retained, given the potential for system changes, transmission errors and such.
- Consider any adjustments required to the RIA's compliance program under Advisers Act Rule 206(4)-7.

Straight-through processing by CMSPs

In order to facilitate straight-through processing ("STP") by CMSPs, the SEC adopted new Rule 17Ad-27 under the Exchange Act, which requires CMSPs to establish, implement, maintain and enforce policies and procedures reasonably designed to facilitate STP. For reference, STP generally refers to processes that allow for the automation of the entire trade process from trade execution through settlement, without manual intervention.

As a corresponding requirement for CMSPs, the SEC amended Regulation S-T under the Securities Act of 1933 to require CMSPs to file an annual report on their progress with STP. Those annual reports will be filed through the SEC's EDGAR system in XBRL reporting language.

Changes to trade cut-off times

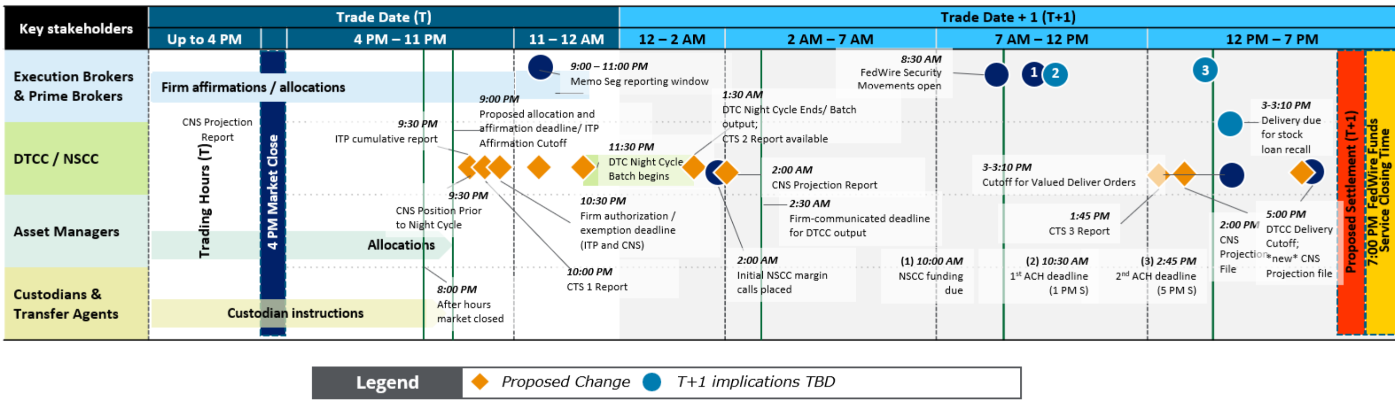
All market participants will need to update processes and make changes to ensure they can meet T+1 settlement obligations. The deadline for institutional trade affirmation at Depository Trust Clearing Corporation ("DTCC") is changing from the current 11:30 a.m. ET on T+1 to **9:00 p.m. ET on T+0**. The industry recommendation is for allocations to occur intraday but be completed no later than **7:00PM ET on T+0** to ensure that all market participants have sufficient time to process their confirmations and affirmations by the 9:00 p.m. ET DTCC affirmation cutoff time.

Firms using National Securities Clearing Corporation's ("NSCC's") Real Time Trade Matching platform should assess processes to match trades by 9:00 p.m. ET on T+0 for trades to be eligible for the NSCC and Depository Trust Clearing ("DTC") night cycle processing. If the night cycle is missed, orders can be sent to settle these trades in the DTC Day cycle. NSCC will accept trades up to 1:30 p.m. ET on T+1 to be eligible for settlement date processing (Note: This is a change from the current requirement of 11:30 a.m. ET on T+2.)

All market participants are encouraged to adopt technological solutions to automate communication of allocations in order to meet these accelerated cut-off times. Slower communication methods such as emails and faxes undoubtedly will delay trade settlement and may prevent firms from meeting T+1 settlement obligations. They also will complicate recordkeeping obligations for RIAs.

All market participants should make allocations as soon as practicable after execution of order to ensure sufficient time for confirmation and affirmation processing. No accommodations or exemptions have been granted to market participants in time zones that are disadvantaged by accelerated settlement. Firms located outside of the U.S. may need to consider pre-allocating trades prior to the close of their business day or the complete execution being filled to ensure the allocation process is completed in a timely manner.

The chart below depicts the new T+1 trade processing flow, with associated deadlines.



Source: Depository Trust Clearing Corporation.

Preparatory action items for managers:

- Review existing trade workflow to assess processing changes to meet required affirmation, allocation and settlement deadlines for T+1 standard settlement and T+2 settlement for new issue securities in firm commitment offerings.
- Ensure adequate staffing to cover accelerated cutoff deadlines.
- Review stock loan agreements with counterparties to ensure accelerated settlement compliance for trades involving locate and borrow. Review associated internal practices to identify those requiring amendments.
- Review rehypothecation agreements with counterparties to ensure accelerated settlement compliance for trades. Review associated internal practices, including

practicality of lending shares in light of accelerated settlement deadlines. (Projected recall deadline is 3:00 p.m. ET on T+1.)

- Review corporate actions processing with counterparties to assess any required changes to meet T+1 settlement.
- Consider and confirm the ability to meet the accelerated disaffirmation cutoff on 5:00 p.m. ET on T+1.

Market misalignment issues

Misalignment with markets remaining on a T+2 cycle raises a number of unintended consequences for all managers and their counterparties.

Managers depend on counterparties for the "mechanical" aspects of accelerated settlement, some of whom in turn have limited to no control over dependencies of the settlement cycle such as foreign exchange ("F/X") conversion timing, non-U.S. bank cut-off times for processing and global holiday schedule differences, among other things. The Adopting Release does not provide exemptions or accommodations for these factors.

The misalignment issue will affect all managers who will continue to trade in T+2 markets, though it will disproportionately impact those based outside of the U.S. who are more likely to rely on F/X conversion to settle U.S. trades. This F/X conversion generally occurs at two days post execution, or T+2. It therefore did not present an issue when the U.S. moved from T+3 settlement to T+2 in 2017.

Alternative sources of funds to settle U.S. trades on T+1 may therefore need to be in place, whether by (i) liquidating other, more readily available assets, (ii) pre-funding trades in USD, or (iii) borrowing USD to meet an accelerated U.S. settlement deadline. As cited in the Adopting Release:

> "…market participants may extend the closing time for their FX trading desks, or they may pre-fund certain T+1 transactions that would otherwise be funded by an FX transaction that is executed on the same day as the securities transaction in the U.S. In addition, as one commenter stated, asset managers may, in some cases, redeem money market positions, or rely on other financial resources, to meet their financing needs."[9]

These funding alternatives will increase the cost to fund transactions, create allocation inefficiencies and result in opportunity costs where T+2 positions must be liquidated early to fund T+1 transactions. These factors may cause managers to reconsider market exposures and may dissuade participation in U.S. markets to a degree that cannot be determined until after the T+1 transition date.

Aside from these liquidity and collateral concerns, smaller managers also are disproportionately harmed by operational requirements. They are less likely to be able to put in place the staffing and resources to support off-hours processing that would be required to meet accelerated deadlines from their forward time zones. Trade errors and breaks may not be addressed in sufficient time to meet accelerated deadlines, resulting in settlement fails. However, processing changes required of trading counterparties seek

[9] Adopting Release, *supra* note 1, at 39.

to reduce issues related to errors and breaks, so there may be less need for these interventions than at present.

Additional preparatory action items for managers outside the U.S.:

- Ensure adequate staffing and resources to support off-hours processing.
- Review the implications of funding U.S. T+1 trades, including liquidity constraints and dependency on F/X conversion.
- Consider the impact to portfolio rebalancing and what funding arrangements may need to be put in place in advance.

4/ Other resources

A number of publicly available resources have been published by the industry working group and steering committee formed by DTCC, SIFMA and ICI to address the U.S. transition to T+1 securities settlement. Links to those resources are referenced below, and can be selected from DTCC's homepage for T+1 at https://www.dtcc.com/ust1. Please bear in mind that all resources are subject to change or update, so it is good practice to periodically check the DTCC website for new releases.

Industrywide testing is set to begin in August 2023, following the updated industry test plan DTCC released in February 2023. This testing is designed to support full end-to-end testing for T+1 and will run in DTCC's T+1 test environment for its members. Although this test plan focuses on managers' counterparty activity, it provides a helpful view into the upcoming T+1 changes.

T+1 Securities Settlement Industry Implementation Playbook

https://www.dtcc.com/ust1/industry-playbook

DTCC T+1 Test Approach: Detailed Testing Framework

https://www.dtcc.com/ust1/-/media/Files/PDFs/T2/UST1-Detailed-Test-Document

T+1 Related Documentation

https://www.dtcc.com/ust1/documentation

5/ Questions?

For any questions on the transition to T+1, please contact Suzan Rose, AIMA Senior Advisor, at srose@aima.org.