MEMO# 34044

February 18, 2022

SEC Proposes to Shorten the Settlement Cycle to T+1

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TO: ICI Members
ICI Global Members
Accounting/Treasurers Committee
Derivatives Markets Advisory Committee
Equity Markets Advisory Committee
ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee
Fixed-Income Advisory Committee
Operations Committee
SEC Rules Committee
Securities Operations Advisory Committee
Small Funds Committee
Transfer Agent Advisory Committee SUBJECTS: Derivatives
Fund Accounting & Financial Reporting
Operations
Recordkeeping
Trading and Markets
Transfer Agency RE: SEC Proposes to Shorten the Settlement Cycle to T+1

On February 9, the Securities and Exchange Commission proposed rules to shorten the standard settlement cycle for most broker-dealer transactions from two business days after the trade date ("T+2") to one business day after the trade date ("T+1").[1] The Commission also proposed new requirements for the processing of institutional trades by broker-dealers, investment advisers, and central clearing agencies. The proposal, which would require compliance with a T+1 standard settlement cycle by March 31, 2024, aligns in many respects with the report that ICI, DTCC, SIFMA and Deloitte published last December outlining the Industry Steering Committee's recommendations for achieving a T+1 standard settlement cycle and proposing the transition to T+1 settlement by the second quarter of 2024 ("ISC Report).[2] This memorandum summarizes relevant portions of the proposal.

Comments on the proposal are due the later of: (i) April 11, 2022, or (ii) 30 days following the proposal's publication in the Federal Register. ICI plans to file a comment letter on the proposal.

Shortening the Standard Settlement Cycle

To implement a T+1 standard settlement cycle, the Commission proposes to:

- Amend Exchange Act Rule 15c6-1(a) to prohibit a broker dealer from effecting or entering into a contract for the purchase or sale of a security (other than an exempted securities, government securities, municipal securities, commercial paper, bankers' acceptances, and commercial bills[3]) that provides for payment of funds and delivery of securities later than on a T+1 basis, unless otherwise expressly agreed to by the parties at the time of the transaction.[4] The Commission cites several benefits to moving to T+1 settlement, including reduction of different risk exposures for counterparties, the CCP, and the CCP's participants. Further, the Commission also believes that market participants have made sufficient progress to facilitate a transition to T+1.
- Delete Exchange Act Rule 15c6-1(c), which currently provides a T+4 settlement cycle for firm commitment underwritings for securities priced after 4:30 p.m. ET. These transactions would thus be subject to the proposed T+1 standard settlement cycle,[5] although underwriters and counterparties would continue to be able to agree to another settlement cycle when needed. In proposing this deletion, the Commission notes that since the Rule was adopted, the "access equals delivery" standard[6] for prospectus delivery has eliminated the basis for this T+4 settlement cycle.

The Commission seeks comments on all aspects of the proposed shortening of the settlement cycle to T+1. Notably, the Commission asks whether market participants expect an increase in prefunding requirements for institutional investors in a T+1 environment,[7] and whether the proposal would have any impact on trading of derivatives and exchange-traded products (ETPs).[8]

New Requirement for Same-Day Affirmation

The Commission proposes rules to "improve the processing of institutional trades by accelerating the confirmation and affirmation of such trades between broker-dealers and their institutional customer." While the ISC Report recommended as a best practice that allocations be completed by 7:00 p.m. ET and affirmation occur by 9:00 p.m. ET on the trade date,[9] the Commission specifically proposes a T+0 requirement. The proposal notes that, while the industry has progressed significantly in automating and streamlining institutional trade processing since the Commission considered the issue in 2004, it still believes that more recent progress toward affirmation on a T+0 basis has been insufficient.[10] By elevating the best practice to a requirement, the Commission states that it hopes to promote more standardized processes and further support the transition to T+1 or faster settlement.

Specifically, new Exchange Act Rule 15c6-2 would require that, where parties have agreed to engage in an allocation, confirmation, or affirmation process, a broker dealer would be prohibited from entering into contracts for the purchase or sale of a security with their institutional customers unless those contracts require the parties to complete allocations, confirmations, and affirmations as soon as technologically practicable and no later than by the end of the trade date.

The Commission asks a significant number of questions on many aspects of the "same-day affirmation requirement," including whether the perceived benefits would accrue to all participants (broker-dealers, institutional customers, custodians, or matching utilities), and whether such benefits accrue differently based on the entity's size. The proposal also asks whether proposed Rule 15c6-2 introduces new risks.

The Commission further proposes to amend Advisers Act Rule 204-2 to require registered investment advisers to make and keep records of confirmations received and allocations and affirmations sent, each with a date and time stamp. Advisers would be required to keep originals of confirmations, and copies of allocations and affirmations, but may maintain records electronically if they satisfy certain conditions.[11] The Commission notes that affirmation and other activities may be performed on an adviser's behalf by a third party, such as middle-office outsourcing provider, a custodian or a prime broker, and advisers currently may not maintain these records themselves. However, the Commission believes that this proposed requirement would better help advisers show that they comply with the contractual requirements, e.g., in a Commission examination.

New Requirement for CMSPs to Facilitate Straight-Through Processing

The Commission proposes a new rule to facilitate straight-through processing[12] through a central matching service provider (CMSP) with respect to institutional trades.[13] Specifically, new Exchange Act Rule 17Ad-27 would require a clearing agency that is a CMSP to establish, implement, maintain, and enforce policies and procedures that facilitate straight-through processing;[14] and to describe in an annual report its current procedures, progress, and the steps it intends to take to facilitate straight-through processing of institutional trades.[15] The proposed rule is intended to ensure that use of a CMSP will further transition users as much as possible away from relying on manual processes for various aspects of trade settlement.

Impact on Other Rules

The Commission also notes that the shortening of the settlement cycle to T+1 may affect compliance with certain Commission Rules and guidance, and it asks about any other potential impacts on these rules:[16]

- Under Rule 204 of Regulation SHO, the closeout date of a fail-to-deliver position resulting from short sales would be reduced from T+3 to T+2, and the closeout date for long sales or bona fide market making activity would be shortened from T+5 to T+4.
- Under Rule 200(g) of Regulation SHO, recalls of loaned securities would need to be delivered by T+3 to be available to close out any fails on long sales by the beginning of regular trading hours on T+4. Accordingly, broker-dealers that lend securities pursuant to a recall period of three business days would need to initiate a bona fide recall on T+0, and brokers that lend securities pursuant to a recall period of two business days would need to initiate a bona fide recall by T+1.
- Under the Rule 15c3-3(m) of the Exchange Act (a broker-dealer financial responsibility rule), the number of days that a broker-dealer will have to obtain possession of customer securities before being required to close out a customer transaction, will reduce from 12 to 11 business days.
- Under Rule 10b-10 of the Exchange Act, which requires that a broker-dealer deliver a customer a written confirmation disclosing specified information "at or before completion" of the transaction, the broker-dealer would have a shortened timeframe to deliver such confirmation in a T+1 environment. The ISC Report recommended clarifying what constitutes "delivery" for electronic confirmations under Rule 10b-10,[17] but the Commission instead noted that it already provided such guidance

and asked whether the guidance should be updated.[18]

- SRO rules and operations that expressly or indirectly reference the settlement date may need to be amended in connection with the transition to T+1. Because the Commission is proposing two other rule changes to facilitate s T+1 settlement cycle, some SRO rules and operations may be affected to a greater extent than occurred during the T+2 transition.

Compliance Date

The ISC Report recommended a specific timeline to provide market participants with the time needed to assess firm-level required changes and allocate resources and budgets accordingly to support the migration to T+1, including the creation of an early 2023 comprehensive testing plan. This timeline suggested adopting the necessary regulatory changes "in time to implement T+1 in Q1/Q2 2024," and that thereafter, "a lengthy and necessary amount of time would be required for T+1 implementation."[19]

The Commission acknowledges the ISC Report's recommendations on the timeline for implementation, but still requires compliance with a T+1 settlement cycle by the end of Q1, i.e., March 31, 2024. In doing so, the Commission states believing that the "planning for testing" and "industry-wide testing" needed for the transition to T+1 can take place earlier than recommended, suggesting that the industry would not need the full Q1 and Q2 of 2024 for implementation.[20] Instead, the Commission argues that "the systems and operational challenges necessary at the industry level can be planned, tested, and implemented in advance" of the proposed compliance date.[21]

Pathways to T+0

The proposal also states that it is actively assessing the benefits and costs associated with shortening the standard settlement cycle to T+0, and that as the securities industry plans how to implement T+1, this process should include consideration of potential paths to achieve T+0.[22] The proposal also suggests that, in the Commission's view, T+0 could occur pursuant to at least three different models: (i) netted settlement at the end of the day on T+0; (ii) real-time settlement done on a gross basis; (iii) and "rolling" settlement, where trades are netted and settled intraday on a recurring basis.

However, the proposal does acknowledge the challenges to implementing a T+0 settlement standard cycle raised in the ISC Report.[23] The Commission thus seeks comment on potential approaches to overcome the challenges identified in the report.

The Commission also identifies three possible approaches or frameworks for considering how to implement T+0 settlement, and seeks comment on all aspects of these approaches:

- A wide effort, led by the Commission or an industry working group, to develop and publish documents like the ISC Report, in which industry experts propose solutions to potential impediments to T+0 and develop a timeline for education, testing, and implementation;
- An approach where implementation begins first with technology and operational changes by key infrastructure providers; and
- An approach where exchanges and clearing agencies offer pilots or similar small-scale programs to establish T+0 as an optional settlement cycle in certain circumstances.

Notably, the proposal also seeks comments on several related issues, including the challenges open-end mutual funds and ETFs might experience if US markets were to adopt T+0 settlement.[24]

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endnotes

[1] Shortening the Securities Transaction Settlement Cycle, Release Nos. 34-94196; IA-5957 (Feb. 9, 2022) ("T+1 Proposing Release"), available at https://www.sec.gov/rules/proposed/2022/34-94196.pdf.

[2] The Commission referenced this report extensively in the T+1 Proposing Release. See Accelerating the U.S. Securities Settlement Cycle to T+1 (Dec. 1, 2021) ("ISC Report"), https://www.sifma.org/wp-content/uploads/2021/12/Accelerating-the-U.S.-Securities-Settlement-Cycle-to-T1-December-1-2021.pdf.

[3] See also Rule 15c6-1(b)(2), which provides that the Commission may also exempt from T+1 settlement certain contracts for the purchase or sale of securities, either unconditionally or on specified terms, if the Commission determines that such an exemption is consistent with public interest and the protection of investors. See T+1 Proposing Release at 37 n.89.

[4] Rule 15c6-1(a) would maintain the ability for counterparties to agree to an "override provision" so that settlement can occur later than T+2, provided that the agreement is express and reached at the time of transaction. Regardless of the reduction from T+2 to T+1, the Commission is not amending other exclusions that currently exist in the rule.

[5] The ISC Report had recommended amending paragraph (c) to provide a T+2 settlement cycle for firm commitment offerings, citing issues regarding complex documentation and operational elements of equity offerings that may delay settlement to T+2 in a T+1 environment. The Commission, nonetheless, stated that such issues do not justify proposing a separate T+2 settlement cycle for equity offerings. Instead, the Commission noted that, if documentation may require more time to complete than is available under a T+1 environment, then the parties to the transaction can agree to a longer settlement period pursuant to paragraph (d).

[6] Securities Act Rule 172 "access equals delivery" model permits, with certain exceptions, satisfying final prospectus delivery obligations by the filing of a final prospectus with the Commission, rather than delivery of the prospectus to purchasers.

[7] T+1 Proposing Release at 56, Request for Comment 13.

[8] Id. at 57, Request for Comment 16. On ETPs, the Commission asks: whether shortening

the settlement cycle would affect the costs of creating or redeeming shares in ETPs that hold portfolio securities that are on a different settlement cycle; whether such a change in costs would affect the efficiency of the arbitrage between an ETP's secondary market price and the value of its underlying assets; and whether such a change would lead to other downstream effects such as an increase in the use of cash or custom baskets. Similarly, the Commission asks whether the proposed amendments would affect derivative transactions if a derivative were to settle on a different timeframe than its underlying reference assets.

[9] ISC Report at 13.

[10] The Commission cites DTCC statistics from 2011 regarding affirmation rates achieved using one central matching service provider, which shows that on average, 45% of trades were affirmed on trade date, 90% were affirmed by the end of T+1, and 92% were affirmed by noon on T+2. Since that time, the Commission notes that currently only about 68% of trades achieve affirmation by the end of the trade date, and further highlights that the processes for matching institutional trades continue rely to on a number of manual elements. T+1 Proposing Release at 63.

[11] Rule 204-2(g).

[12] Straight-through processing refers to the automation of the entire trade process from trade execution through settlement without manual intervention. Straight-through processing under the rule occurs when a market participant or its agent uses the facilities of a CMSP to enter trade details and complete allocation, confirmation, affirmation, and/or matching processes without manual intervention.

[13] CMSPs are clearing agencies defined in Section 3(a)(23) of the Exchange Act.

[14] The rule does not require CMSPs to remove a manual process if doing so would clearly undermine the prompt and accurate clearance and settlement of securities transactions, but if the CMSP allows a manual process, it should explain in its policies and procedures why those manual processes remain necessary.

[15] The report would be filed with the Commission via EDGAR and published on its website.

[16] The Commission believes that no changes to these rules are necessary to adopt the proposed rules, partly because these specific rules mostly use terms such as "trade date," "settlement date," or "completion of the transaction," but they do not reference a particular settlement cycle (e.g., T+2). T+1 Proposing Release at 95, 103.

[17] ISC Report at 16.

[18] T+1 Proposing Release at 105 n. 222.

[19] ISC Report at 6-7.

[20] T+1 Proposing Release at 109.

[21] Id.

[22] See also id. at 53, Request for Comment 2 (asking whether the efforts to shorten the settlement cycle to T+1 are a logical step on the path to T+0 settlement, or if shortening to

T+1 would require investments or processes that would be outdated or unnecessary in a T+0 environment).

[23] The ISC Report stated that the Industry Working Group (IWG) also considered the impacts and benefits of moving to T+0 settlement. The ISC and IWG concluded, by consensus, that T+0 is not achievable in the short term given the current state of the settlement ecosystem. See ISC Report at 10-12.

[24] T+1 Proposing Release at 129-133.
