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SEC Adopts The T+2 Trade Settlement Cycle

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Introduction and brief summary of the rule

On March 22, 2017, the SEC adopted a rule amendment shortening the standard settlement cycle for broker-initiated trade settlements from three business days from the trade date (T+3) to two business days (T+2). The change is designed to help enhance efficiency and reduce risks, including credit, market and liquidity risks, associated with unsettled transactions in the marketplace.

Acting SEC Chair Michael Piwowar stated, "[A]s technology improves, new products emerge, and trading volumes grow, it is increasingly obvious that the outdated T+3 settlement cycle is no longer serving the best interests of the American people." The SEC originally proposed the rule amendment on September 28, 2016.

The change amends Rule 15c6-1(a) prohibiting a broker-dealer from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than T+2, unless otherwise expressly agreed to by the parties at the time of the transaction. This means that when an investor buys a security, the brokerage firm must receive payment from the investor no later than two business days after the trade is executed. Also, when an investor sells a security, the investor must deliver the investor's security to the brokerage firm no later than two business days after the sale.

The rule does not apply to private exempt transactions such as private placements. The rule also allows a managing underwriter and issuer to agree to a trade settlement cycle other than T+2 as long as the agreement is express and reached at the time of the transaction. Firm commitment offerings are also exempted. In particular, Rule 15c6-1(c) allows registered firm commitment underwritten transactions that price after 4:30 p.m. ET to use a T+3 or T+4 settlement cycle.

The reduction of the settlement cycle to T+2 will also assist in aligning global clearing of securities as many markets, including the United Kingdom and many European countries, are already on the T+2 schedule.

Compliance with the new rules is effective on September 5, 2017.

Background

DTC provides the depository and book entry settlement services for substantially all equity trading in the US. Over $600 billion in transactions are completed at DTC each day. Although all similar, the exact clearance and settlement process depends on the type of security being traded (stock, bond, etc.), the form the security takes (paper or electronic), how the security is owned (registered or beneficial), the market or exchange traded on (OTC Markets, NASDAQ…) and the entities and institutions involved.

All securities trades involve a legally binding contract. In general, the "clearing" of those trades involves implementing the terms of the contract, including ensuring processing to the correct buyer and seller in the correct security and correct amount and at the correct price and date. This process is effectuated electronically.

"Settlement" refers to the fulfillment of the contract through the exchanging of funds and delivery of the securities. In 1993, Exchange Act Rule 15c6-1 was adopted, requiring that settlement occur three business days after the trade date, commonly referred to as "T+3." Delivery occurs electronically by making an adjusting book entry as to entitlement. One brokerage account is debited and another is credited at the DTC level and a corresponding entry is made at each brokerage firm involved in the transaction. DTC only tracks the securities entitlement of its participating members, while the individual brokerage firms track the holdings in their customer accounts. Technology, of course, plays an important role in the process and ability to efficiently manage settlements.

There may be two brokerage firms between DTC and the customer account holder. Brokerage firms that are direct members with DTC are referred to as "clearing brokers." Many brokerage firms make arrangements with these DTC members (clearing brokers) to clear the securities on their behalf. Those firms are referred to as "introducing brokers." A clearing broker will directly route an order through the national exchange or OTC Market, whereas an introducing broker will route the order to a clearing broker, who then routes the order through the exchange or OTC Market.

The Dodd-Frank Act added a definition of, and responsibilities associated with, a "financial market utility" or FMU. Clearing brokers are FMU's. FMU's provide the actual functions associated with clearing trades through the DTC system. As part of that process, a division of DTC, the National Securities Clearing Corporation ("NSCC"), becomes the buyer and seller of each contract, netting out and settling all brokerage transactions each day, making one adjusting entry per day. The net entry debits or credits the brokerage firm's account as necessary. When one of the counterparties in the process does not fulfill its settlement obligations by delivering the securities, there is a "failure to deliver." Overall, failures to deliver are less than 1% of all transactions.

Likewise, a cash account is maintained for each brokerage firm, which is netted and debited and/or credited each day. These accounts can be in the billions. Clearing firms can either settle each day or carry their open account forward until the next business day. Because all transactions are netted out, 99% of all trade obligations do not require the exchange of money, which helps reduce some risk. NSCC's role in this process is referred to as a central counterparty or CCP. This process is continuous.

Looking at the process from the top down, the CCP carries the risk that the clearing firm (or FMU) will not have the financial resources to perform its obligations. In turn, the clearing firms have risks from their customers, including introducing brokers, who in turn ultimately have risks from the individual account holders. The risks are compounded by changing values of the securities being traded, during the settlement process. The faster a trade settles, the lower the cumulative risk at each level of the process.

This is a very simplified high-level description of the process. Technically, the roles of DTC and its subsidiaries, CEDE and NSCC, as well as clearing agencies and introducing brokers involve a complex set of regulations, with different definitions, obligations and roles for the different hats the entities wear depending on the type of security being traded (stock, bond, etc.), how the security is owned (registered or beneficial), the form the security takes (paper or electronic), the market or exchange traded on (OTC Markets, NASDAQ…) and the entities and institutions involved (retail or institutional).

Exchange Act Rule 15c6-1

Exchange Act Rule 15c6-1 prohibits a broker-dealer from effecting or entering into a contract for the purchase or sale of a security, subject to certain exemptions, that provides for the payment of the funds or delivery of the securities later than the third business day after the contract (i.e., trade) date unless expressly agreed upon by both parties at the time of the transaction. The rule amendment shortens this time period to two business days.

Exempted securities include government and municipal securities, insurance products, commercial paper, limited partnership units that are not listed on an exchange or automated quotations system (OTC Markets), and sales in a firm commitment underwritten offering that are priced after market close. Firm commitment offerings can rely on an extended T+4 settlement cycle. The new rule does not amend the exemptions or the settlement cycle for firm commitment underwritten offerings.

One of the SEC's roles is to enhance the resilience and efficiency of the clearance and settlement process such that the system itself does not add to, but rather subtracts from, the risks associated with trading in securities. To further this goal the SEC has amended Rule 15a6-1(a) to shorten the settlement cycle to T+2. The SEC believes this change will reduce various risks in the marketplace, including: (i) the credit risk that one party will be unable to fulfill its delivery obligations (of either cash or the securities) on the settlement date; and (ii) the market risk that the value of the securities will change between the trade and settlement such as to result in a loss to one of the parties.

To drill down further on the summary of the settlement and clearing process described in the background section of this blog, the following is a high-level description of what happens following the execution of a trade. When a trade is submitted to an exchange or alternative trading system (such as OTC Markets), it is matched with a counterparty. That is, a buy order is electronically matched to a sell order. As long as there is a match, the trade is locked in and sent to NSCC.

On the trade date (T), NSCC validates the trade data and communicates receipt of the transaction. At that moment the parties are legally committed to complete the trade. Before the new amendment, at midnight on the first day (T+1), NSCC substitutes itself as the legal buyer and legal seller. Technically, the first buy/sell contract is replaced by two new contracts, one between NSCC and the buyer and the other between NSCC and the seller. The NSCC substitution will now occur at the point of trade comparison and validation.

Historically, on the second day (T+2), NSCC would issue a trade summary report to its members which summarizes all securities and cash to be settled that day, and show the net positions for each. NSCC also sends an electronic instruction to DTC to process the net security and cash settlements. This will now occur on T+1. Finally, on the third day (T+3), DTC process the electronic settlement by transferring cash and securities between the broker-dealer accounts and the broker-dealers, in turn, put the securities and/or cash in their customer accounts. With implementation of the rule change, this final step will be completed on the second day (T+2).

Although institutional trading is similar, there are unique aspects and there can be additional participants. For example, an institution may have a custodian of its securities in addition to its broker, may use a matching provider and may avail itself of different netting and settling processes within the brokerage and DTC systems. Although the detailed process may differ, ultimately both retail and institutional trades will now fully settle in the new T+2 timeline.

As mentioned, the length of the settlement cycle impacts the exposure to credit, market and liquidity risks for the participants. The participants, including NSCC, take measures to reduce these risks, including by requiring funds to be kept on deposit by clearing and brokerage firms effecting such participants' liquidity. Even then, however, all participants are exposed to market risk during the settlement process, including a decline in value of the traded securities and the risk that such decline could exceed the broker's capital deposit or result in a failure to deliver.

A reduction in risks would reduce the necessity to mitigate such risk, including reducing the funds that must be kept on deposit by participants. It is undisputed that reducing the settlement cycle reduces these risks. Firms may pass these benefits on to other market participants, including retail investors in the form of reduced margin charges. Also, obviously if funds are tied up for three days pending a settlement of a transaction, whether you are the retail investor or clearing agency, there is a lack of available liquidity to participate in other transactions during that time.

The SEC also believes that shortening the standard settlement cycle will promote technological innovation and changes in market infrastrucutres and operations, incentivizing market participants to make work further to make the markets more efficient.

The rule amendment requires the SEC to conduct a study no later than September 5, 2020, on the impact of the T+2 amendment and the potential impact of further reducing the trade settlement cycle to T+1.

Conforming Stock Exchange Rule Amendments

On February 10, 2017, the SEC approved rulemaking proposals submitted separately by the New York Stock Exchange, the NASDAQ Stock Market and the NYSE MKT that will conform stock exchange rules to the amendments to Rule 15c6-1, with the amendments to become operative concurrently with the SEC compliance date.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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