SULLIVAN & CROMWELL LLP

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SEC Adopts T+2 Settlement Cycle

SEC Amends Rule 15c6-1, Requiring Settlement of Securities Transactions in Two Business Days Following Trade Date

SUMMARY

The SEC has adopted an amendment to Exchange Act Rule 15c6-1(a) to shorten the standard settlement cycle for most securities transactions effected by a broker-dealer from T+3 to T+2. The amendment does not change the settlement cycle for securities sold in cash only firm commitment underwritings and still permits parties to affirmatively contract for a longer settlement. However, the SEC is not amending other SEC rules that key off the "settlement date." As a result, the move to a shortened settlement cycle will have ancillary consequences for how market participants comply with these rules, including:

- Regulation SHO's requirements to close-out/buy-in positions;
- prospectus delivery under the Securities Act of 1933;
- confirmation delivery under Exchange Act Rule 10b-10; and
- close-out transactions under Exchange Act Rule 15c3-3(m).

The amendment will go into effect on September 5, 2017.

BACKGROUND

The SEC adopted the current version of Rule 15c6-1(a) under the Securities Exchange Act of 1934 ("Exchange Act") in 1993. The current rule generally requires any securities transaction effected by a broker-dealer to settle no later than three business days after the trade date ("T+3"), unless the parties have expressly agreed otherwise at the time of the transaction. On September 28, 2016, the SEC published a proposal to amend Rule 15c6-1(a) to shorten the settlement cycle to two business days after the trade date ("T+2").[1] The SEC noted its belief that a shortened settlement cycle would reduce a number of risks, including credit risk, market risk and liquidity risk and, as a result, reduce systemic risk

for participants in the U.S. securities markets. Further, the shortened settlement cycle proposed would align with settlement cycles in several non-U.S. securities markets which operate on a T+2 basis. The SEC invited comments on the proposed rule considering, among other things, whether an immediate shift to a T+1 settlement cycle would be preferable and appropriate, and what changes to market conventions, documentation or infrastructure in the securities lending market would be necessitated by the proposed change.

On March 22, 2017, after considering comments in response to the proposing release, the SEC adopted the amendment to Rule 15c6-1(a) as proposed, noting overall support from the industry for the move to a shortened settlement cycle.[2]

AMENDMENT TO SECURITIES TRANSACTION SETTLEMENT CYCLE

The SEC adopted as proposed the amendment to Rule 15c6-1(a) to shorten the standard settlement cycle, unless otherwise expressly agreed to by the parties at the time of the transaction. The SEC did not amend the provisions to Rule 15c6-1 that permit a T+4 settlement cycle for securities sold for cash in firm commitment underwritings that price after 4:30 P.M. Eastern time, and longer settlement cycles for the settlement of securities sold for cash in a firm commitment underwriting where the managing underwriter and issuer agree to a longer settlement period. In the adopting release, the SEC made clear that the current practice for firm commitment underwritings for cash would be unaffected by the amendment to Rule 15c6-1(a). Subject to the exceptions enumerated in the rule,[3] the T+2 requirement in paragraph (a) of Rule 15c6-1 applies to all securities.

While the adopting release focuses on securities that currently settle on a T+3 standard settlement cycle, the SEC noted that certain types of transactions routinely settle on a settlement cycle shorter than T+3. Registered open-end mutual funds, for example, generally settle on a T+1 basis (certain retail funds, on the other hand, typically settle on T+3). Options, as well, generally settle on a settlement cycle less than T+3. These types of transactions that typically settle on a shorter settlement cycle will be unaffected by the amendment shortening the standard settlement cycle to T+2.

The SEC believes that the shortened settlement cycle will reduce a number of risks for participants in the U.S. securities markets, particularly in the clearance and settlement process, including reducing the number of unsettled trades overall, the time period of exposure to those unsettled trades and potential price movements in the securities underlying unsettled trades. The SEC indicated its view that earlier settlement will reduce liquidity costs and capital demands that clearing broker-dealers face and will allow for improved capital utilization and lower costs on a business and transactional basis.

The move to a T+2 settlement cycle also will help to address mismatches in settlement cycles in respect of certain funds and the securities in the funds' portfolios. Open-end mutual funds that settle through NSCC, for example, generally settle on T+1, while the securities within the funds generally settle on T+3.

This gap in settlement exposes the fund to potential liquidity risks. The SEC noted that closer alignment of the settlement cycles between the underlying portfolio securities and the securities issued to investors through these funds could result in mitigated risk to the funds and ultimately to the investors.

The change to a T+2 settlement cycle is also important in cross-border transactions. The shorter settlement cycle will align the U.S. market with a number of non-U.S. markets already operating on a T+2 settlement cycle. According to the SEC, this alignment could reduce the need to hedge risk and reduce financing/borrowing costs for market participants that engage in cross-border transactions. Moreover, the SEC notes that the T+2 settlement cycle also aligns with the T+2 settlement cycle generally used for spot FX transactions and that this would enhance the ability to trade in securities denominated in foreign currencies.

The SEC believes that the realized reductions in credit, market and liquidity risk over all will reduce systemic risk, and the reduced total volume and value of outstanding obligations in the settlement pipeline at any given time will better insulate the financial sectors from the potential consequences of serious market disruption.

IMPACT ON OTHER SEC RULES AND GUIDANCE

A number of SEC rules, either expressly or through issued guidance, require market participants to perform certain regulatory obligations by the settlement date or within a specified number of business days after the settlement date, or are otherwise keyed off the settlement date. The SEC is not proposing to amend these rules or update issued guidance in connection with the amendment to Rule 15c6-1(a). As a result, shortening the standard settlement cycle to T+2 will affect compliance with these existing regulatory obligations.

SEC Rules and Regulations

Certain provisions of Regulation SHO under the Exchange Act, for example, key off "settlement date" to determine the time frames relating to sales of equity securities and fails-to-deliver on settlement date and close-out/buy-in obligations. Rule 204, in particular, provides that a participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, or, if a participant has a fail-to-deliver position, the participant must, by no later than the beginning of regular trading hours on the applicable close-out date, immediately close out the fail-to-deliver position by borrowing or purchasing securities of like kind and quantity. Under the current T+3 standard settlement cycle, the close-out for short sales is required by the beginning of regular trading hours on T+4. If a fail to deliver results from a long sale or a sale from bona fide market-making activity, the participant must close out the fail-to-deliver position by T+6. Under the T+2 settlement cycle, the existing close-out requirements for fail-to-deliver positions resulting from short sales would be reduced from T+4 to T+3, and for long sales or sales from bona fide market-making activity from T+6 to T+5.

In addition, Rule 200(g) of Regulation SHO permits a market sale order to be marked long if it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction. Under SEC guidance, broker-dealers who initiate bona fide recalls on T+2 of loaned securities that sellers are "deemed to own" may currently mark such orders as "long." As a result of the change to a T+2 settlement cycle, bona fide recalls will need to be initiated on a T+1 basis rather than the current T+2 basis.

The move to a T+2 settlement cycle will speed up obligations in other rules as well, including:

- Prospectus Delivery. Section 5(b)(2) of the Securities Act of 1933 requires the delivery of a prospectus prior to the delivery of a security in a registered transaction. The change to a T+2 settlement cycle will require the preparation and delivery of prospectuses on an accelerated basis where the prospectus is not eligible for "access equals delivery."[4]
- Rule 10b-10 Confirmation Delivery. Exchange Act Rule 10b-10 requires a broker-dealer to give or send a customer a written confirmation disclosing information relevant to the transaction at or before completion of the transaction.[5]
- Financial Responsibility Rules under the Exchange Act.
  - Rule 15c3-3(m) currently provides 13 business days by which a broker-dealer must close out a customer sale transaction (either by obtaining possession of customer securities or effecting a buy-in transaction). That time period will be reduced to 12 business days for trades that settle on T+2.
  - Rule 15c3-1(c)(9) explains what it means to "promptly deliver" securities and "promptly transmit" funds (referencing settlement), which concepts are incorporated in many provisions of the financial responsibility rules, including paragraphs (k)(1)(iii), (k)(2)(i) and (k)(2)(ii) of Rule 15c3-3, paragraph (e)(1)(A) of Rule 17a-5, and paragraph (a)(3) of Rule 17a-13.

Prime Broker No-Action Letter

Under the Prime Broker No-Action Letter,[6] prime brokers are permitted to "disaffirm" all previously affirmed institutional trades of a customer reported by executing brokers to the prime broker for clearance and settlement. Currently the cutoff time for prime brokers to disaffirm trades is T+2. Commenters expressed concern that without industry consensus, the move to a T+2 settlement cycle will shorten the time frame for prime brokers to disaffirm trades, with the cutoff time moving to the morning of T+1, which could, as a result, decrease prime brokers' ability to manage their exposure to risk that could arise from margin calls issued by prime brokers on T+1. The commenters requested the SEC to revisit the No-Action Letter and evaluate potential updates to the Letter driven by, among other things, the move to a T+2 settlement cycle. The SEC indicated in the adopting release that the SEC staff would consider whether any changes to the Prime Broker No-Action Letter were appropriate in connection with the implementation of T+2.

LOOKING FORWARD

In the proposing release, the SEC solicited comments on whether the standard settlement cycle should be shortened to T+1. The SEC requested the staff in the adopting release to complete a report analyzing a move to a T+1 settlement cycle by September 5, 2020.

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ENDNOTES

1 Exchange Act Release No. 78962 (Sep. 28, 2016), 81 FR 69240 (Oct. 5, 2016), *available at* https://www.sec.gov/rules/proposed/2016/34-78962.pdf.

2 Exchange Act Release No. 80295 (Mar. 22, 2017), __ FR ____ (Mar. __, 2017), *available at* https://www.sec.gov/rules/final/2017/34-80295.pdf.

3 Rule 15c6-1 applies, as a general matter, to transactions for stocks, bonds, exchange-traded funds, certain mutual funds, and limited partnership interests that trade on an exchange. The rule does not apply to transactions in exempted securities, government securities, municipal securities, commercial paper, bankers' acceptances, or commercial bills, or limited partnership interests that are not listed on an exchange or for which quotations are not disseminated through an automated quotation system of a registered securities association.

4 The time frame for filing prospectuses in registered securities offerings would not change.

5 Rule 10b-10 does not expressly refer to the settlement cycle but, rather, defines the term at or before "completion of the transaction" by reference to Exchange Act Rule 15c1-1. Rule 15c1-1 generally defines "completion of the transaction" to mean the time when: (i) a customer is required to deliver the security being sold; (ii) a customer is required to pay for the security being purchased; or (iii) a broker-dealer makes a bookkeeping entry showing a transfer of the security from the customer's account or payment by the customer of the purchase price. The time frame for confirmation delivery would not change for firm commitment underwritings that settle on T+4 or any other period longer than T+2.

6 Prime Broker Committee, SEC No-Action Letter (Jan. 25, 1994), *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/pbroker012594-out.pdf.

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