CLIENT ALERT

SEC Proposes Rules to Shorten the Standard Securities Settlement Cycle

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On February 9, 2022, the Securities and Exchange Commission (the "SEC") unanimously voted to propose rule amendments to shorten the standard securities settlement cycle (the "Proposed Amendments").[1] The SEC indicated that it believes that shortening the standard securities settlement cycle would promote investor protection, reduce risk, increase operational efficiency, and mitigate potential vulnerabilities in the U.S. securities market. The SEC cited, as its primary motivation for the initiative, the need to address financial exposures and potential risks to the stability of the U.S. securities market as highlighted by periods of increased market volatility in March 2020 following the COVID-19 outbreak and again in January 2021, following heightened interest in certain meme stocks. The Proposing Release solicits comments on a number of potential paths to and challenges associated with eventually achieving a T+0 standard settlement cycle. If adopted, the Proposed Amendments would also require registered investment advisers to date and time stamp allocations and affirmations on trade date and would prohibit broker-dealers from entering into contracts for the purchase or sale of a security (other than exempted securities) unless those contracts require that the parties complete allocations, confirmations, and affirmations as soon as technologically practicable and no later than the end of the day on trade date.[2] The public comment period will remain open until April 11, 2022. If adopted as proposed, compliance with the T+1 standard settlement cycle and the other rule amendments would be required by March 31, 2024.

1 *See* Shortening the Securities Transaction Settlement Cycle, Exchange Act Release No. 94196 (Feb. 9, 2022) (the "Proposing Release"), available here, 87 Fed. Reg. 10,436 (Feb. 24, 2022) (to be codified at 17 C.F.R. pt. 232, 240, 275), available here.

2 As noted in the Proposing Release, investment advisers often aggregate orders for multiple clients into a block trade for execution. After execution of the block order by a broker-dealer, the investment adviser will allocate securities within the block to the accounts of its clients participating in the

Background

The Proposing Release describes the history of the standard settlement cycle, including when the SEC first began to consider a T+1 standard settlement cycle in the late 1990s. It noted that, in 2012, the Depository Trust and Clearing Corporation ("DTCC") commissioned a study that found that moving from a T+3 to a T+2 settlement cycle would be significantly less costly and take less time to implement than either an immediate or gradual transition to T+1, while still delivering significant benefits with respect to reducing risks and costs for market participants. This and related studies ultimately led to amendments to Rule 15c6-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the adoption of a T+2 standard settlement cycle in 2017. More recently, DTCC, the Investment Company Institute, the Securities Industry and Financial Markets Association, and Deloitte & Touche LLP published a report that presented industry recommendations to implement a T+1 standard settlement cycle in the U.S.[3] The Proposing Release seeks to follow up on these recommendations.

The Proposed Amendments

The Proposed Amendments include four primary changes to implement a T+1 standard securities settlement cycle. First, the Proposed Amendments include amendments to Exchange Act Rule 15c6-1 to establish a standard settlement cycle of T+1 for most broker-dealer transactions. Second, the Proposed Amendments would repeal Exchange Act Rule 15c6-1(c), which currently establishes a T+4 standard settlement cycle for certain firm commitment offerings. Third, the Proposed Amendments would establish new requirements for broker-dealers and registered investment advisers intended to improve the rate of same-date affirmations. Fourth, the Proposed Amendments would require central matching service providers ("CMSPs")[4] to establish, implement, maintain, and enforce written policies and procedures designed to facilitate straight-through processing. This alert discusses each of these proposed changes below in more detail.

1. *Shortening the Length of the Standard Settlement Cycle*

    a. Proposed Amendments to Exchange Act Rule 15c6-1(a)

Rule 15c6-1(a) under the Exchange Act currently provides that, unless otherwise expressly agreed by the parties at the time of the transaction, a broker-dealer is prohibited from entering into a contract for the purchase or sale of a security (other than exempted securities, government securities, municipal securities, commercial paper, bankers' acceptances,

block trade. The allocation instructions are communicated to the broker-dealer to allow the broker-dealer to generate a confirmation of trade detail for each client account that the investment adviser will affirm. *See* Proposing Release at 27-28, 87 Fed. Reg. at 10,443-10,444.

3 *See* Deloitte, DTCC, ICI, & SIFMA, Accelerating the U.S. Securities Settlement Cycle to T+1 (Dec. 1, 2021) here, *cited in* Proposing Release at 11 n.18, 87 Fed. Reg. at 10,438 n.18.

4 CMSPs electronically facilitate communication among a broker-dealer, an institutional investor or its investment adviser, and the institutional investor's custodian to reach agreement on the details of a securities trade.

and commercial bills) that provides for payment of funds and delivery of securities[5] later than the second business day after the date of the contract (*i.e.*, T+2). Exchange Act Rule 15c6-1(a) extends to the purchase and sale of securities issued by investment companies (including mutual funds), private-label mortgage-backed securities, and limited partnership interests that are listed on an exchange or for which quotations are disseminated through an automated quotation system of a registered securities association. Exchange Act Rule 15c6-1(a) allows the parties to the transaction to agree that settlement will take place later than two days after the trade date, provided that such an agreement is express and reached at the time of the transaction. Such an agreement, sometimes referred to as the "override provision," is intended to apply only to "unusual transactions."[6]

The Proposed Amendments would amend Exchange Act Rule 15c6-1(a) to enable a T+1 standard settlement cycle by prohibiting a broker-dealer from effecting or entering into a contract for the purchase or sale of a security (other than an exempted security, a government security, a municipal security, commercial paper, bankers' acceptances, or commercial bills) that provides for payment of funds and delivery of securities later than the first business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. The Proposed Amendments would not affect the existing exclusions enumerated in Exchange Act Rule 15c6-1(a) or the "override provision." The SEC intends for the "override provision" to continue to apply only to unusual cases to ensure that T+1 is the standard settlement cycle.

In support of the proposed change from a T+2 to T+1 standard settlement cycle, the Proposing Release cites "substantial progress" toward identifying the technological and operational changes necessary to establish a T+1 standard settlement cycle. The SEC also notes that "significant industry support" for such change has emerged.[7] Although the SEC recognizes that the change from T+2 to T+1 will impose costs and burdens on market participants, it concludes that the anticipated benefits, including reduction of credit, market, and liquidity risks, outweigh the anticipated costs.

b. Proposed Elimination of Exchange Act Rule 15c6-1(c)

The Proposed Amendments would eliminate Exchange Act Rule 15c6-1(c), which establishes a T+4 settlement cycle for firm commitment underwritings for securities that are priced after 4:30 p.m. Eastern Time ("ET"). Rule 15c6-1(c) states that the standard settlement cycle set forth in Exchange Act Rule 15c6-1(a) does not apply to contracts for the sale of securities that are priced after 4:30 p.m. ET if sold by an issuer to an underwriter pursuant to a firm commitment offering registered under the Securities Act of 1933 or sold to an initial purchaser by a broker-dealer participating in such offering. The Proposed Amendments would delete Exchange Act Rule 15c6-1(c) to set a T+1 standard settlement cycle for firm

[5] The definition of "security" in Section 3(a)(10) of the Exchange Act covers, among others, equities, corporate bonds, UITs, mutual funds, ETFs, ADRs, security-based swaps, and options.

[6] Unusual transactions include seller's option trades that typically settle as many as sixty days after execution, as specified by the parties to the trade at execution. *See* Proposing Release at 37, 87 Fed. Reg. at 10,446.

[7] *See* Proposing Release at 40-41, 87 Fed. Reg. at 10,447.

commitment offerings priced after 4:30 p.m. ET. The override provisions in paragraphs (a) and (d) would continue to allow contracts currently covered by paragraph (c) to provide settlement on a time frame other than T+1 if the parties expressly agree to a different settlement time frame at the time of the transaction.

The Proposing Release notes that the expanded application of the “access equals delivery” standard for prospectus delivery supports removing paragraph (c) from Exchange Act Rule 15c6-1 because delays in the process that made delivery of the prospectus difficult to achieve under the standard settlement cycle have been mitigated by the “access equals delivery” standard.

c. New Requirement for “Same-Day Affirmation”

Same-day affirmation is a process under which broker-dealers and their institutional customers allocate, confirm, and affirm the trade details necessary to achieve settlement of a block securities trade by the end of trade date. The Proposed Amendments include new Rule 15c6-2 under the Exchange Act to require that, where parties have agreed to engage in an allocation, confirmation, or affirmation process,[8] a broker or dealer would be prohibited from effecting or entering into a contract for the purchase or sale of a security (other than an exempted security, a government security, a municipal security, commercial paper, bankers’ acceptances, or commercial bills) on behalf of a customer unless such broker or dealer has entered into a written agreement with the customer that requires the allocation, confirmation, affirmation, or any combination thereof, to be completed as soon as technologically practicable and no later than the end of the day on trade date, in such form as may be necessary to achieve settlement in compliance with Exchange Act Rule 15c6-1(a).

In the Proposing Release, the SEC indicated that implementing a T+1 standard settlement cycle, as well as any potential further shortening beyond T+1, would require a significant improvement in the current rates of same-day affirmations to ensure timely settlement in a T+1 environment because same-day affirmation would require broker-dealers and their institutional customers to review and reconcile trade data earlier in the settlement process. The SEC stated that it believes that same-day affirmation should improve the accuracy and efficiency of institutional trade processing, including resolution of errors.

d. Proposed Amendment to Recordkeeping Rule for Investment Advisers

The Proposed Amendments would amend Rule 204-2 under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) by adding a provision in paragraph (a)(7)(iii) to require that the adviser retain a record of each confirmation received (if the adviser is a party to a contract under Exchange Act Rule 15c6-2) and each allocation and each affirmation sent, including a date and time stamp for each allocation and affirmation that indicates when the allocation or affirmation

[8] The Proposed Amendments do not define the terms “allocation,” “confirmation,” or “affirmation” because the SEC stated that it believes that the terms are widely used and generally understood by market participants who engage in institutional trade processing.

was sent to the broker or dealer. The rule would allow investment advisers to maintain copies of the records electronically, provided that the storage complies with certain conditions.[9]

2. *New Requirement for CMSPs to Facilitate Straight-Through Processing*

CMSPs facilitate communications among a broker-dealer, an institutional investor or its investment adviser, and the institutional investor's custodian to reach agreement on the details of a securities transaction. Once trade details have been agreed among the parties or matched by the CMSP, the CMSP can then facilitate settlement of the transaction. The Proposing Release explains that a shortened standard settlement cycle may lead to the expanded use of CMSPs, as well as increased focus on enhancing the services and operations of the CMSPs themselves. As such, the Proposed Amendments are designed to eliminate the use of tools that encourage or require manual processing, alongside the continued development and implementation of more efficient automated systems in the institutional trade processing environment to reduce risk and costs and ensure the prompt and accurate clearance and settlement of securities transactions.

To address these concerns, the SEC has proposed new Rule 17Ad-27 under the Exchange Act, which would require a CMSP to establish, implement, maintain, and enforce policies and procedures to facilitate straight-through processing for transactions involving broker-dealers and their customers. Straight-through processing generally refers to processes that allow for the automation of the entire trade process—from trade execution through settlement—without manual intervention. In the context of institutional trade processing under this rule, straight-through processing occurs when a market participant or its agent uses the facilities of a CMSP to enter trade details and completes the trade allocation, confirmation, affirmation, and matching processes without manual intervention.

Under proposed new Rule 17Ad-27, a CMSP would facilitate straight-through processing when its policies and procedures enable its users to minimize or eliminate, to the greatest extent that is technologically practicable, the need for manual input of trade details or manual intervention to resolve errors and exceptions that can prevent settlement of the trade. The CMSP's policies and procedures would be required to establish a holistic framework for facilitating straight-through processing. The Proposing Release noted that, with respect to the use of electronic trade confirmation services, which often rely on legacy technologies, a CMSP's policies and procedures should establish a timeline for transitioning users away from manual processes to matching services that reduce a party's reliance on the manual, often sequential, entry and reconciliation of trade information.

Proposed Exchange Act Rule 17Ad-27 also would require a CMSP to submit every twelve months to the SEC a report that describes the following:

[9] Advisers Act Rule 204-2(g) permits investment advisers to maintain records electronically if they establish and maintain required procedures.

- The CMSP's current policies and procedures for facilitating straight-through processing;
- Its progress in facilitating straight-through processing during the twelve month period covered by the report; and
- The steps the CMSP intends to take to facilitate and promote straight-through processing during the twelve month period that follows the period covered by the report.

The Proposed Amendments would make the annual report publicly available on the SEC's website to enable the public to review and analyze progress on achieving straight-through processing.

3. Impact on Certain Commission Rules and Guidance and SRO Rules

The Proposing Release discusses the potential impact of the Proposed Amendments on compliance with other existing SEC rules and guidance that reference the settlement cycle or settlement processes in establishing requirements for market participants. The SEC concludes that it does not believe any changes to the existing rules are necessary to adopt the Proposed Amendments.

a. Regulation SHO under the Exchange Act

Several provisions of Regulation SHO may be impacted by shortening the settlement cycle to T+1 because certain provisions use the terms "trade date" and "settlement date" to determine the time frames for compliance relating to sales of equity securities and fails-to-deliver on the settlement date. The SEC noted that, because these references are not to a particular settlement cycle, the time frames for these provisions would change in tandem with changes in the standard settlement cycle. The Proposing Release noted that the shortened settlement cycle would shorten the close-out periods under Rule 204 of Regulation SHO and the provisions of Rule 200(g) regarding when a broker-dealer would need to initiate a bona fide recall of a loaned security to be able to mark the sale of such security "long."

b. Financial Responsibility Rules under the Exchange Act

Certain provisions of the SEC's broker-dealer financial responsibility rules reference explicitly or implicitly the settlement date of a securities transaction. For example, paragraph (m) of Exchange Act Rule 15c3-3 references the settlement date to prescribe the time frame within which a broker-dealer must complete certain sell orders on behalf of customers. Settlement date is also incorporated into paragraph (c)(9) of Exchange Act Rule 15c3-1, which defines what it means to "promptly transmit" funds and "promptly deliver" securities within the meaning of paragraphs (a)(2)(i) and (a)(2)(v) of Exchange Act Rule 15c3-1. The concepts of promptly transmitting funds and promptly delivering securities are incorporated in other provisions of the financial responsibility rules, including Exchange Act Rule 15c3-3, Exchange Act Rule 17a-5, and Exchange Act Rule 17a-13.

c. Rule 10b-10 under the Exchange Act and Prospectus Delivery

The Proposing Release indicates that a T+1 standard settlement cycle should not raise any significant legal or operational concerns for broker-dealers regarding confirmation delivery under Exchange Act Rule 10b-10 or for issuers or broker-dealers regarding prospectus delivery.

d. Changes to Rules and Operations of Self-Regulatory Organizations ("SROs")

The SEC stated that it anticipates that the proposed transition to T+1 would require changes to SRO rules and operations to achieve consistency with a T+1 standard settlement cycle. The Proposing Release noted that certain SRO rules reference existing Exchange Act Rule 15c6-1 or currently define "regular way" settlement as occurring on T+2 and, as such, may need to be amended to reflect the shortened settlement cycle if adopted.

4. Pathways to T+0

While the Proposed Amendments do not propose a T+0 standard settlement cycle, the SEC indicates that it would like to better understand the challenges that market participants may need to address and resolve to achieve T+0. Accordingly, the Proposing Release identifies three possible approaches or frameworks for considering how to potentially implement T+0 settlement, and describes several challenges identified as impediments to implementing a T+0 standard settlement cycle. The SEC specifically requests comment on these challenges, as well as any comments identifying other challenges or necessary building blocks associated with implementing T+0. In particular, the Proposing Release discusses issues associated with maintaining multilateral netting at the end of trade date, achieving same-day settlement processing, enhancing money settlement, mutual fund and ETF processing, institutional trade processing, securities lending, access to funds and prefunding of transactions, potential mismatches of settlement cycles, and dematerialization.[10]

Conclusion

In light of the unanimous support for the proposal by the SEC, as well as statements of industry support,[11] it seems likely that the Proposed Amendments will be adopted. Despite the broad support for many of the changes reflected in the Proposing Release, market participants, particularly broker-dealers and registered investment advisers, will have much to address in order to be prepared to timely meet the new requirements of a shortened settlement cycle.

[10] Dematerialization refers to securities trading in the U.S. markets issued in book-entry form only.

[11] *See* Proposing Release at 40-41, 87 Fed. Reg. at 10,447.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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