US T+1 (US + Canada)

Updated in May 2024

The last move operated by the US market as regards the settlement cycle took place in September 2017. By shortening the cycle (from T+3 to T+2), the United States joined the European countries that had switched to T+2 in October 2014, putting an end to a almost three-year misalignment. This transition was intended to reduce systemic risk and inefficiency.

Stresses experienced by the US market in the recent years has led DTCC (the Central Securities Depository – CSD) to issue a white paper on a potential accelerated settlement. An industry-led project gathering several representative organisations was created with the intent of developing an industry consensus, analysing the impacts, potential risks and defining an implementation approach.

In parallel the US regulator (Securities and Exchange Commission - SEC) worked on the update of the current rules and also finanly decided the date for the requirement to enter into force.

Due to its proximity to the US market, the Canadian one, although not having the same settlement lodel, has decided to closely follow the American move.

On the 15 February 2023, the SEC adopted rule changes to shorten the standard settlement cycle for most broker-dealer transactions in securities from two business days after the trade date (T+2) to one (T+1). The final rules will become effective 60 days after publication in the Federal Register. The compliance date for the final rules is May 28, 2024.

The Canadian market has retained May 27, 2024.

The decision made by the US has open the door for reflection in Europe (both in the Union and in the UK) where analytical work has been / will be launched to determine the interest / consequences / prerequisites ... of such a move.

1. Overview

a. Key aspects of the US Regulation

- **Background**

Following episodes of increased market volatility due to the COVID-19 pandemic, DTCC (US Depository Trust & Clearing Corporation) published a white paper in February 2021 highlighting the benefits of a move to T+1. The work undertaken by the industry in 2021 and 2022 gave rise to a set of recommendations covering all the post-trade process (from the allocation/ affirmation to the corporate actions).

They are designed to benefit investors and reduce the credit, market, and liquidity risks in securities transactions faced by market participants.

Main benefits listed by the industry (December 2021 report)

01

Reduction of risk

In particular during periods of high volume and volatility

Moving to T+1 will reduce the systemic, counterparty and operational risks while preserving the benefits of settlement netting at NSCC

02

Reduction in liquidity requirements

NSCC participants (*) will see a reduction in margin requirements

T+1 will align the settlement cycle of registered US mutual fund shares with the portfolio securities settlement cycle

(*) although being a CCP, NSCC processes also the client legs of a market transaction

03

Infrastructure modernisation

T+1 will emphasise the need for automation and provide opportunities to accelerate industry adoption of STP process and re-engineer others

Promotion of the "match-to-instruct" functionality

04

Standardisation of industry processes

T+1 will lead to recommended best practices and implementing behavioral changes and ultimately to more transparency and a real-time / near-time access to critical data

05

Reduction of costs

The industry foresees a long-term cost reduction for market participants

Points of attention:

- ❑ Potential reduced percentage of trades that timely settle through the NSCC's CNS system
- ❑ Possible increased risk of fails
- ❑ Equity and debt offerings

- **The new rules**

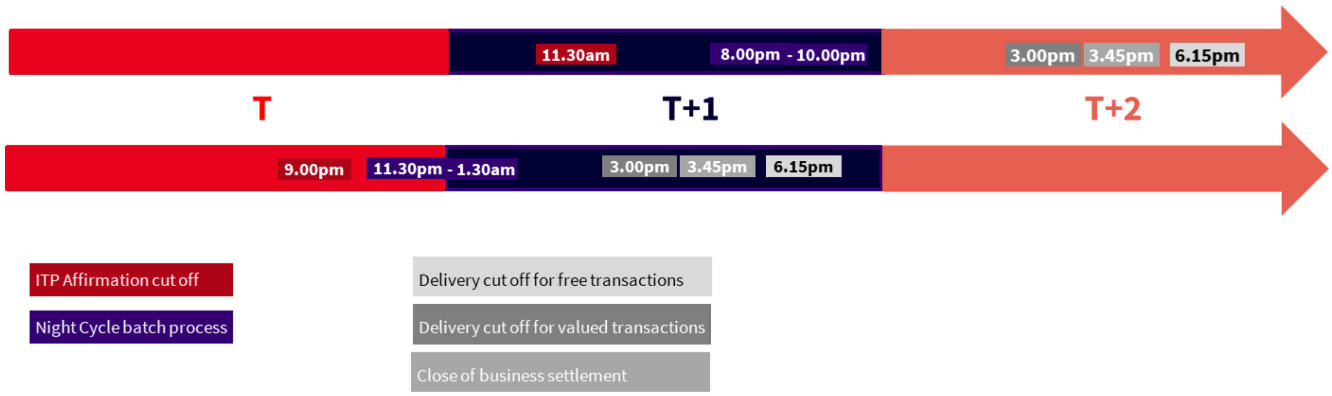
US securities and Exchange commission adopted rule amendments and new rules to move standard settlement cycle to T+1:

- Shorten the standard settlement cycle for most securities transactions from two business days after trade date (T+2) to one (T+1), unless the parties expressly agree to a different settlement date at the time of the transaction ;
- Securities in scope: all securities eligible for settlement in DTCC, as the products subject to the shortened settlement cycle include equities, corporate and municipal bonds, unit investment trusts, and financial instruments comprised of these security types.
- Improve the processing of institutional trades through new requirements for broker dealers and registered investment advisers related to same-day affirmations;
- Facilitate straight-through processing through new requirements applicable to clearing agencies that are central matching service providers (CMSPs).

b. Challenges raised

The shift to a T+1 trade settlement cycle represents a critical step for the U.S. financial services industry and the shorten of the settlement cycle to 24 hours create significant challenges for all actors.

- **New timeline (hours are ET ones)**



The new timeline leaves quite no more time to participate to the night settlement since the latter will start a few hours after the closing of the market.

- **Matching and information**

In order to be processed for settlement, a transaction needs to be matched.

Unlike the European matching that compares two settlement instructions, the US one is an "affirmation model" with a passive / active approval by the receiver (the system is "deliver based"). Profiles are defined within DTCC.

There are two ways for DTC to trigger a settlement matching:

- For transactions that have been affirmed, the receiver is considered by default as approving the trade (passive matching) but has the ability to define exceptions and then officially approves;
- For transactions that are not affirmed and for other transaction types, the matching is active using receiver's parameters. However, the receiver may opt for a passive matching for small delivery orders.

One reason for a trade to be unmatched is because it has been "DK'd". A DK'd trade results when one of the parties has a dispute or rejects the trade due to a given discrepancy.

<u>Attention points</u>

- Affirmed transactions benefit from a more STP process (and less fees) and thus will more likely be processed during the night settlement cycle.
- On the other hand, they will suffer from a very tight timing. Affirmation shall not take place after 9:00pm, meaning that all the allocations / confirmations process is achieved before. The Industry Working Group (IWG) recommends "that trades are allocated as soon as possible or at the latest 7:00pm"
- Even with a 7:00pm cut off it means that European asset managers will have to be at work until 1:00am Paris time to fix issues and thus permit the settlement during the night.
- DTCC promotes its CTM – Match to Instruct solution, as the only way to really achieve a 100% affirmation in time (auto-affirmation)

- **Funding and lending**

In order for a transaction to settle, there should be the provision of stock and cash (one should keep in mind that there is, in the US, the possibility for the buyer to voluntary trigger a buy-in):

- Non-US clients will have to pay in USD, meaning there will be a need for a FX trade that will have to settle on the same date (i.e. T+1). But in order to benefit from the night settlement cycle, the amount in USD shall be available on T evening.

- Lending / borrowing:
- Due to the reduced settlement cycle, there should be an increased of borrowed securities to avoid fails;
- But in the meantime, and for the same reason, the recall by the lender will have to be reviewed (in terms of cut-off, automation or process);
- Specific case to be analysed: when a third-party lender is involved

<u>Attention points</u>

- Pre-funding could be an answer to the FX issue
- Fail coverage could be an appropriate tool to help settle
- For a EU entity, to continue to lend American securities could raise question

- **Others areas of attention**

Not everything is fine once the trade is settled …

- Corporate actions: The move to T+1 will imply a change in their rules. Tomorrow, ex-date and record date will be the same (referred as "regular way ex-date") and will be equal to T.
- EU funds with US securities: the different settlement cycles may create / increase misalignments between the assets and liabilities of the fund, and, for funds not 100% US securities, within the assets. Misalignements between assets and liabilities already exist even for EU markets (the T+2 requirement applies for transactions executed on the market) but it will be exacerbated with a T+1 cycle. Impacts related to the UCITS ratios?
- Accurate SSI will also be a cornerstone: for tax reasons there might be numerous accounts, those not always in Alert (or not easily accessible); this may lead to "to be corrected" settlements. To avoid settlement issues, some participants

currently use a “pivot account” for settlements and realign after; this process will need to take into account the new timing of corporate actions. Since the one that confirms the allocation is not the final client there will be a lot of different underlying SSIs and today it is more likely at the settlement stage that one discovers that the account used is not the correct one

c. Other aspects

- **Good to know**

  - No fines or penalties for late matching or late settlement are foreseen for the time being;
  - Even if foreign investors to US have to struggle to comply for deadline for settlement affirmation and confirmation, ther are no exemption for international client;
  - Testing is for the time planned only between DTC and DTC participants;
  - Short Sale Practices: regulation SHO requires broker-dealers to identify a source of borrowable stock before executing a short sale in any equity security with the goal of reducing the number of situations where stock is unavailable for settlement. But, because currently the locate is usually done two days before settlement, the stock may not be available from the source at the time of settlement, possibly resulting in a fail.

- **Pain points and adaptations required**

TIMING ISSUE

So that we need to avoid :

- Traffic congestion
- Slowness in the message flow transmission

CORPORATE EVENT IMPACT

ex date and record date are equal

PREPARATION

- Client education / evolution in order to guarantee STP rates closed to 100%
- Speed up position control in cash and securities
- Speed up interfaces reducing redundancy and batch timing
- Increase affirmation rate

d. Side effects

- **Corporate actions in the EU**

If it is clear that when an American financial instrument is traded on a EU trading venue then the settlement cycle is the European one (T+2) and not the US one, there was no evidence on how to apply a corporate action on such ISIN for transactions executed in the EU. A dedicated working group has been set-up in order to address the point. Several scenario have been explored.

2. Reference text(s)

- Shortening the US Equities Settlement Cycle | DTCC
- Final rule: Shortening the Securities Transaction Settlement Cycle
- SEC.gov | Shortening the Securities Transaction Settlement Cycle

sylvie.bonduelle@sgss.socgen.com