Clear Street®

Preparing for T+1 and Beyond

A buy-side roadmap for a compressed settlement cycle

February 2024

Abstract

On February 15, 2023, the Securities and Exchange Commission (SEC) adopted a rule to shorten the standard settlement cycle from two business days after the trade date (T+2) to one business day after the trade date (T+1)(i).

The change, effective May 28, 2024, is intended to provide numerous market benefits, including lower risk, improved efficiencies, increased liquidity, and reduced volatility. For hedge funds and asset managers, the shorter timeframe between execution and settlement can also reduce the margin needed to offset settlement risk.

Paradoxically, the impending transition to T+1 has introduced an element of short-term risk to the market. With the SEC enforcing a shorter settlement cycle, industry participants must ensure their technology and internal operations - and those of their clients and counterparties - can accommodate the change.

Both the buy- and sell-sides should prepare to combat vulnerabilities, including legacy technology and settlement delays. In the short term, mitigating these risks will rely heavily on people-based solutions. Long-term solutions require systemic technology upgrades at all stages of the settlement cycle. This whitepaper outlines:

- Required changes and their effective dates;
- Analysis of the potential issues industry participants could face in adapting to T+1;
- Details of the preparation associated with these challenges;
- And possible solutions.

SEC Final Rule Updates

The rule amendments adopted by the SEC aimed at shortening the settlement cycle from T+2 to T+1 are detailed below. These rules become effective on May 28, 2024.

Key 2024 Transition Dates

Friday May 24	Sat & Sun May 25/26	Monday May 27	Tuesday May 28	Wednesday May 29
Last day to trade T+2	Conversion Weekend	US Conversion Weekend CA/MX 1st T+1 Trade Date	US 1st T+1 Trade Date CA/MX Double Settlement	US Double Settlement

Rule 15c6-1: Settlement Cycle

The final rule amends Rule 15c6-1 of the Exchange Act to shorten the standard settlement cycle by:

- Prohibiting broker-dealers from the purchase or sale of a security that provides for payment of funds and delivery of securities (other than an exempted security, government security, municipal security, commercial paper, bankers' acceptances, or commercial bills) later than the first business day after the date of the contract (T+1), unless otherwise expressly agreed to by the parties at the time of the transaction.
- Adding security-based swaps to the list of exempted securities.

Key Requirements

- All allocations must be submitted on trade date (T+0) for settlement on T+1 (recommended 7 p.m. E.T.);
- All trade confirmations and affirmations must be made on trade date (T+0) for settlement on T+1 (recommended 9 p.m. E.T.);
- Breaks should be resolved by trade date (T+0);
- Recommended adoption of industry tools for automation (including Alert, FIX, Match to Instruct (M2i), and Central Trade Manager).

Rule 15c6-2: Same-Day Allocation, Confirmation, and Affirmation

The final rule adopts new Rule 15c6-2 of the Exchange Act to require broker-dealers engaging in the allocation, confirmation, or affirmation process with another party or parties to achieve settlement of a securities transaction subject to the T+1 settlement cycle to:

- Enter into written agreements with the "relevant parties" to ensure completion of the processes as soon as "technologically possible" and no later than the end of the trade day; or

- Establish, maintain, and enforce written policies and procedures "reasonably designed" to ensure completion of the processes as soon as "technologically possible" and no later than the end of the trade day. The policies and procedures must:

  - Identify and describe any IT systems, operations, and procedures used to coordinate with relevant parties to ensure completion of the processes for the transaction;

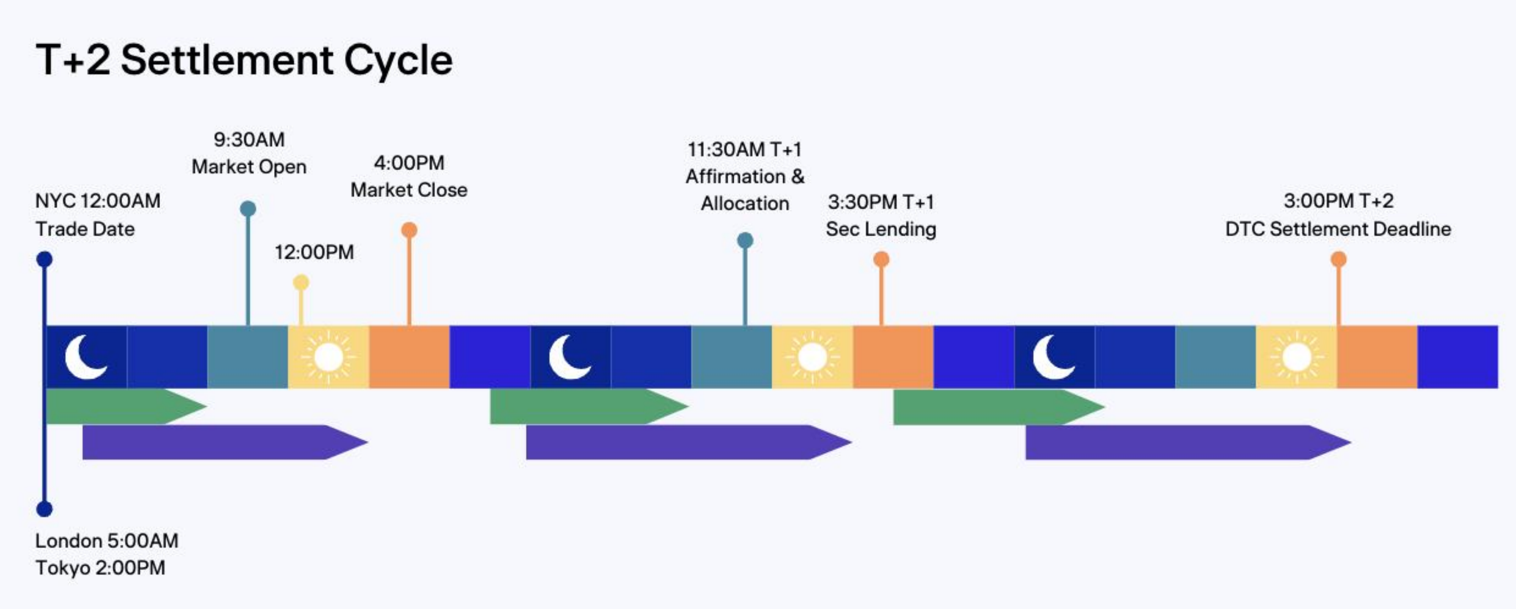
  - Set target time frames on trade date for completing the processes for the transactions;

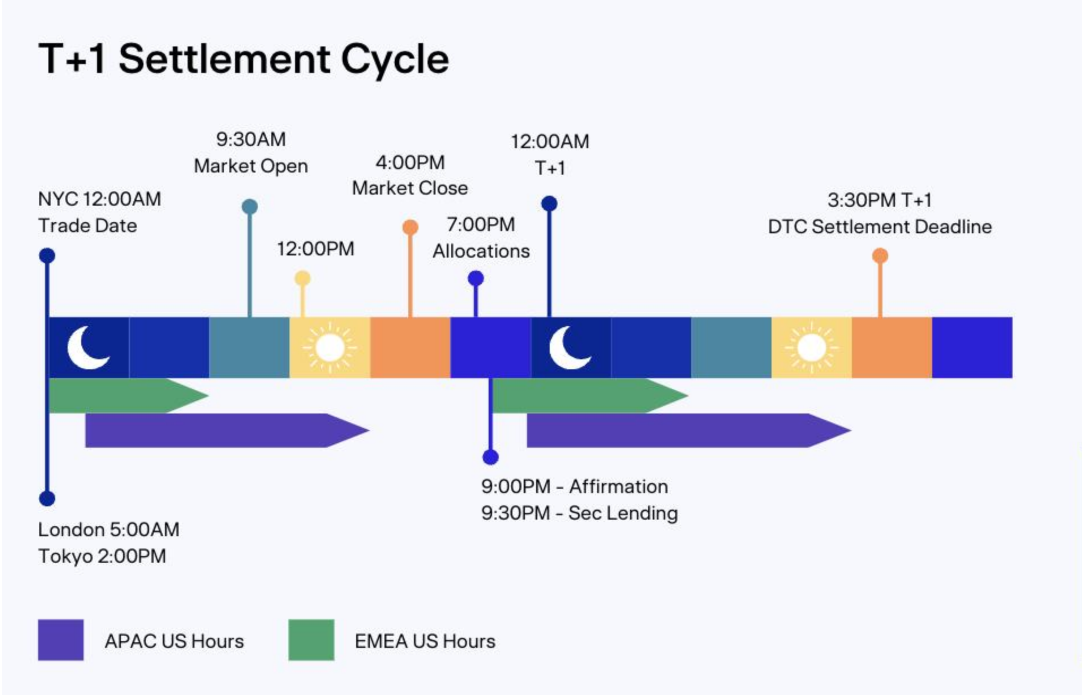
  - Describe procedures for communicating trade information, investigating discrepancies in trade information, and adjusting trade information to help ensure that the processes can be completed by the target time frames;

  - Describe plans to identify and address delays in the process; and

  - Measure, monitor, and document the rates of the processes completed as soon as possible and no later than the end of the day on trade date.

Global T+1 Timing Impact





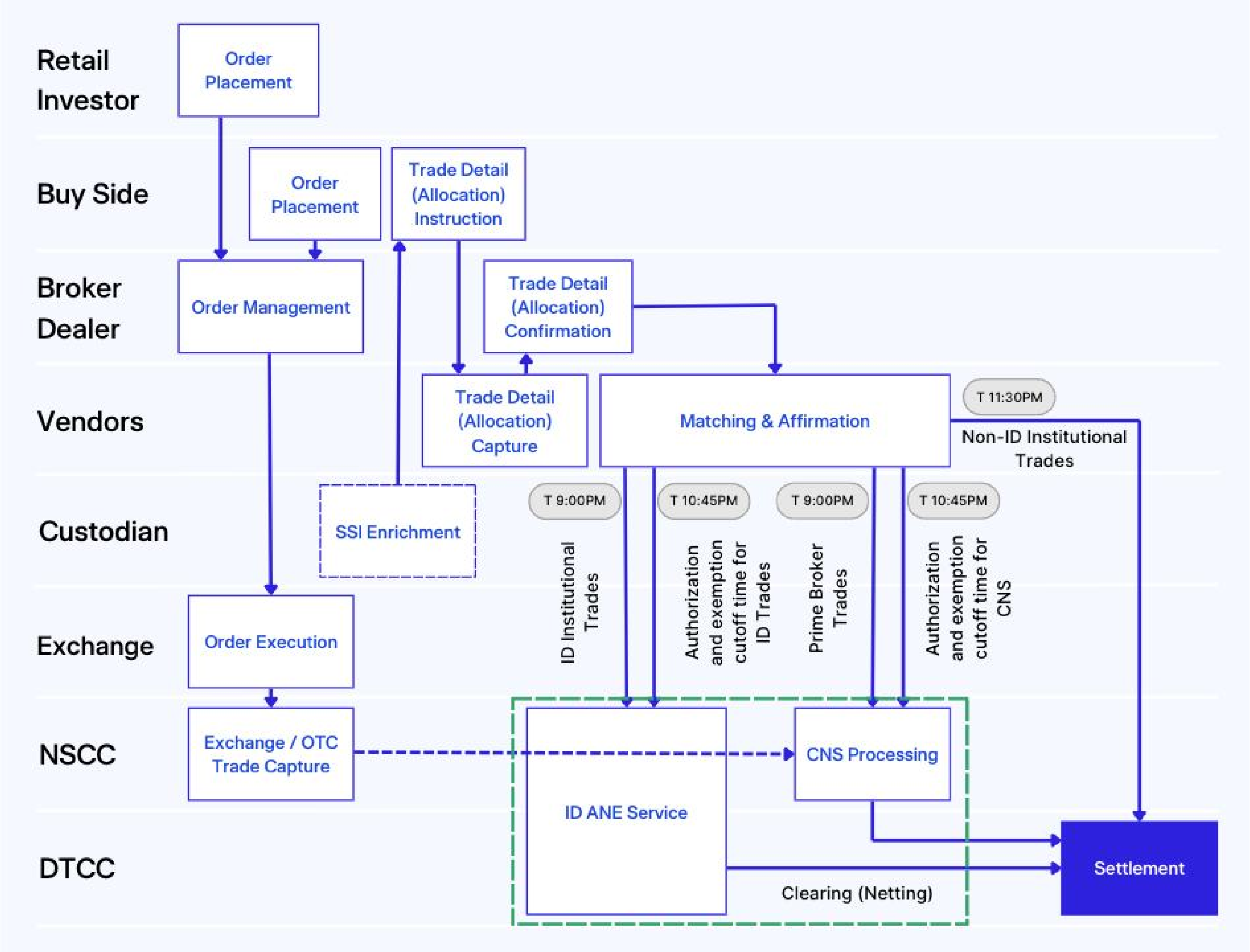
Key Time Loss:

Allocations: -16.5 hours
Affirmations: -14.5 hours
Sec Lending: -18 hours

Source: Citi

The Implementation Playbook

To assist market participants' transition to T+1, the Securities Industry and Financial Markets Association (SIFMA), the Investment Company Institute (ICI), and The Depository Trust & Clearing Corporation (DTCC) published the T+1 Securities Settlement Industry Implementation Playbook (ii). The playbook details the different activities market participants will need to consider as they prepare for the transition to T+1 settlement. This includes implementation activities, timelines, dependencies, risks, and the potential impact of these risks.



T+1 settlement trade flow

Source: SIFMA

Product Impacts

T+1 will touch nearly every aspect of the front, middle, and back offices. The broad effects of a shorter settlement cycle will impact a range of products, including equities, ETFs, prime brokerage, and financial instruments comprised of various security types.

Allocations & Affirmations

- Allocations need to be submitted by 7:00 PM ET on trade date (T).
- Allocations must be sent using industry platforms (CTM, FIX, Approved Template).
- SSIs should be updated in Alert to streamline settlement and new accounts.
- The affirmation cut-off is 9:00 PM ET on trade date (T).

Prime Brokerage & Clearing

- Confirm changes to the timing of trade file submissions and straight-through processing (STP) requirements.
- Earlier reporting for exceptions / ID breaks will be provided on trade date.
- CTM, FIX, Approved Template.
- SSIs should be updated in Alert to streamline settlement and new accounts.
- The affirmation cut-off is 9:00 PM ET on trade date (T).

Securities Lending

- The industry is still discussing recall issuance deadlines.
- Existing requirements for Locates will not change under Rule 204 of Regulation SHO. Broker-dealers remain obligated to deliver the security to the registered clearing agency in time for settlement.

ETF Creation & Redemption

- Industry focus on T+0 creation ability:
  - Domestic– restrictive order windows (cut off is 9:30 AM ET)
  - International–an extra day of collateralization
- Domestic equity settlement at previous day prices.
- FICC and INTL are FOP settlements.

Product Impacts

Equity Derivatives

- The financing accrual period for OTC Equity Swaps is expected to adjust to a T+1 timeline in line with the underlying security for impacted markets.
- Where operationally practical, the settlement cycle on equity swap cash flows (unwind performance and resets) will also adjust to follow a T+1 timeline, and swap configuration options will be available where settlement cycles for cash flows need to be extended.

Exchange Traded Derivatives & Listed Options

- Physical settlement for exercise/assignment will move from T+2 to T+1.
- Notifications for exercise/assignments will be sent earlier; however, still on the settlement date.

Foreign Exchange

- A compressed funding window creates challenges, particularly for EMEA/APAC clients.
- CLS cutoffs will remain unchanged but still open to discussion across the industry.

Dual-Listed Products

- Generally, trades executed in the US will follow the T+1 settlement cycle.
- The industry is still discussing all the impacts on dual listed securities, particularly trades executed in non-US markets but settling in DTCC, as well as the impact on F shares.

Corporate Actions

- The one-day gap between the U.S. and Canada and Mexico creates transition risk.
- Proactively communicate any trades around.
- Corporate Action deadlines.

Preparing for the Change

T+1 presents a challenge to a wide range of market participants, and meeting these challenges is likely to be problematic for some, particularly those relying heavily on manual processes.

Speaking in May 2023, Valentino Wotton, head of institutional trade processing at the Depository Trust & Clearing Corporation (DTCC), said, "To meet the accelerated settlement timeframe, it is critical that market participants eliminate manual processes and maximise automation in the post-trade pre-settlement space" (iii).

The primary financial burden resulting from the transition is expected to fall on broker-dealers, clearing firms, and prime brokers. However, industry research shows that many buy-side firms are unaware of the breadth of internal implications of T+1 on their businesses, let alone the impact on their clients. An informal poll by SS&C conducted in February 2024 found that only 28% of investment firms have a detailed plan for T+1. Of those surveyed, 10% had not started preparations, and 27% were still in the early planning stage (iv).

To better understand market readiness, Clear Street conducted qualitative industry research, including interviews with market participants from various sell-side institutions. Interviewees were questioned on their understanding of the requirements of T+1, the extent of preparation for T+1, and the risks and associated costs of non-compliance. The research identified four critical vulnerabilities:

1. **Legacy technology**

The demand for modern clearing platforms with throughput and integration will not be easily met by larger firms with legacy technology. Firms running batch cycles on mainframe technology will face a bigger challenge than those who have invested in modern infrastructure.

2. **Counterparty risk**

As the DTCC said, “Firms are only as strong as their weakest counterparty.” The move to T+1 will touch every part of the front, middle, and back office. Removing a full day from the settlement cycle means counterparty preparedness may be an in-scope firm’s most considerable risk. For example, counterparties should check with providers to see if there will be any changes to the timing of trade file submissions and if there will be any changes to stop requirements.

3. **Time zone synchronization**

Post-trade time compression will be complicated for investors trading across time zones, and operational risk will increase with a shorter window to resolve breaks or exceptions. For example, there is potential for settlement mismatches due to timing discrepancies between ETF shares and underlying trades. Changing settlement cycles across different markets could exacerbate overnight funding requirements as well.

4. **Higher costs due to delays**

Settlement fails will become more challenging to resolve on a tightened timeline and can lead to a buildup of counterparty credit risk and negatively impact market liquidity. Additionally, there is an open risk management question about the timing to un-affirm an already affirmed trade. Current timings may be preserved to maintain protections for clearing brokers when counterparties fail to meet margin.

Although there will be no regulatory penalties in place if trades are not affirmed on T and do not settle on T+1, missing the affirmation cutoff will trigger semi-automated, or even manual, processes for broker-dealers and custodians and decrease STP. A decline in STP and increased costs for transactions outside of the affirmation process will contribute to the overall impact of inefficient processes.

Failure to address the impending implications of T+1 could be costly, and technology will be paramount in meeting the demands required to support the new clearing cycle. A shorter settlement period inherently means less time to correct mistakes, and systems that successfully address this change will prioritize automation and resiliency. If implemented correctly, these attributes can effectively reduce failure and error risks while supporting increased processing demands.

Solutions

Financial institutions must replace manual processes with automation and system enhancements wherever possible. An Accenture survey of executives at capital markets firms on the buy-side and the sell-side found that while 83% of respondents say automation is already embedded in their trade lifecycle, 35% reported that at least 50% of their trades are manually touched (v).

Short-term solutions for a compressed settlement cycle are likely to be people-based and focused on increased support. In contrast, longer-term solutions are more likely to be technology-based and centered around widespread modernization.

a) People-based solutions
The near term requires people-based solutions, and market participants should prepare to allocate resources now. The buy-side should work proactively with sell-side counterparties to ensure operational processes and broker policies are aligned ahead of the transition.

- Firms will need to dedicate time and human resources to managing the transition to T+1.
- Firms will require additional staff with the expertise to assess and manage risks and provide the necessary support in case of increased errors and inefficiencies following the transition.
- 24-hour support will be required given the shorter processing times, particularly when settling overseas trades and dealing with errors.
- Market participants must proactively communicate with their clients now to ensure they are automating processes and employing the necessary human support.

b) Technology-based solutions

The industry is at a consensus that legacy technology needs to be upgraded. System enhancements like automation will be needed to eradicate manual processes wherever possible to meet the compressed settlement timeframe. With the deadline fast approaching, this demands significant investment in a short period. Risks are only exacerbated for larger organizations.

- Systemic automation, particularly regarding clearing and settlement, is essential for faster and more accurate processing. As the buy-side considers their readiness, they should pay particular attention to middle- and back-office processes.

- The first step for many firms is switching from manual to automated processes for matching and confirmation and in areas like amendments and transfers. Letter of authorization instructions should be reduced or eliminated, wherever possible.

- Real-time processing is ideal, given the extremely tight timescales and the need to accommodate delays from external entities such as the DTC.

- System enhancements should be implemented to ensure real-time or same-day capability and to send asset transfers for mismatched settlement cycles.

- Where automation is not already in place, market participants should be seeking to assess and implement upgrades to their systems and solutions that will enable it.

In summary, while T+1 intends to reduce systemic and operational risk, there is a likelihood of an increased risk in the short term - particularly for hedge funds and asset managers - if market participants fail to anticipate and adequately prepare for the transition. For most of the buy-side, the immediate step will be checking their brokers' post-trade capabilities and requirements. Market participants should consider adding automated post-trade solutions that enable efficient post-trade pre-settlement processes.

Cloud-native clearing, settlement, and custody for T+1

With urgency comes an opportunity in the capital markets. The throughput and integration demands for modern clearing platforms are not easily navigated in large organizations, especially when replacing a legacy solution in flight. As firms employ modern infrastructure to replace legacy technology, automate processes, and de-silo fragmented data, there will be the opportunity to continue to optimize settlement cycles, drive value creation, lower costs, and minimize risks.

Clear Street's infrastructure is built on modern technology and operates with robust, real-time data sets. Our tech stack utilizes modern cloud-native infrastructure, including resilient service orchestration, event-driven real-time processing, and scalable data warehousing – a sharp contrast to the batch processing offered by mainframes.

Our entire suite of software systems is built upon this consistent and cohesive technology stack, enabling the components to communicate seamlessly and stay in sync, eliminating the need for tedious reconciliation processes.

We're building the platform that reimagines the legacy workflows and silos that are essential to increasing access to the financial markets, all while transparently decreasing risks and costs. Our cloud-native clearing, settlement, and custody stack can work in a shortened settlement regime.

It's never been more apparent that the forces of volatility, regulatory change, and speed are demanding tools that allow firms to make sense of the markets in real-time.

Learn more and contact us at https://clearstreet.io/.

Citations

i) SEC Release Nos. 34-96930 Shortening the Securities Transaction Settlement Cycle
ii) T+1 Securities Settlement Industry Implementation Playbook, Published August 2022, Last Updated April 2023
iii) Asset Servicing Times
iv) T+1 Settlement Cycle – Now is the Time to Prepare
v) Accenture, T+1 Survey Results

Disclosures

Clear Street does not provide investment, legal, regulatory, tax, or compliance advice. Consult professionals in these fields to address your specific circumstances. These materials are: (i) solely an overview of Clear Street's products and services; (ii) provided for informational purposes only; and (iii) subject to change without notice or obligation to replace any information contained therein.

Products and services are offered by Clear Street LLC as a Broker Dealer member FINRA and SIPC and a Futures Commission Merchant registered with the CFTC and member of NFA. Additional information about Clear Street is available on FINRA BrokerCheck, including its Customer Relationship Summary and NFA BASIC | NFA (futures.org).