CARLTON FIELDS

Shortened Settlement Cycle Sprouts at SEC (T+1 for T+2)

May 11, 2022

Rule changes recently proposed by the SEC would shorten the time within which most securities transactions effected by a broker-dealer must be settled. Specifically, most settlements would be required to occur by the first business day after the trade date (T+1), rather than the currently required second day (T+2).

The shortened settlement cycle would apply to many securities transactions by both retail and institutional investors. For example, transactions in shares of investment companies that are traded on exchanges (e.g., ETFs and closed-end funds), which now are permitted to settle on T+2, would have to settle on T+1. So would transactions in shares of non-exchange-traded mutual funds (although most mutual funds already settle on a T+1 basis, as a matter of business policy).

Also, where the new T+1 requirement applies, the SEC's proposal would make certain new requirements applicable to broker-dealers and investment advisers if the transaction is a "block" transaction as to which the parties follow what the proposal refers to as a "confirmation" and "affirmation" process to facilitate allocation of the block among multiple accounts.

This latest proposal follows similar rule amendments that the SEC adopted in 1993 (shortening the standard cycle from T+5 to T+3) and in 2017 (further shortening it to the current T+2). As with those previous actions, the SEC believes moving to a T+1 cycle would reduce certain credit, market, and liquidity risks, which will also reduce systemic risks for central counterparties and other market participants. For example, mutual funds that already settle purchases and redemptions of their shares on a T+1 basis may be able to more efficiently and precisely manage their cash flows and liquidity requirements, to the extent that the SEC's current proposal would result in fund portfolio transactions settling closer to when fund share purchases and redemptions settle.

For similar reasons, the SEC and the industry also have been considering the possibility of eventually moving to a "same-day settlement" (i.e., T+0) requirement. And that is one of the many things about which the SEC's proposing release requests comments from interested parties.

The SEC's current proposal would leave in place an order that the SEC issued in 1995 that provides an exemption for most insurance products (including variable annuities, variable life insurance, and certain other insurance products that are registered as securities). Accordingly, transactions in these exempted insurance products would be exempt from the new T+1 requirement in the same way that the 1995 order now exempts them from the current T+2 requirement. This exemption reflects the fact that transactions in insurance products are subject to numerous requirements and considerations (including under state insurance law and SEC regulatory requirements) that make a T+2 or T+1 settlement mandate inapposite and unnecessary. For example, many such transactions remain subject to special pricing and processing requirements under the Investment Company Act of 1940 and/or FINRA rules, and the regulators have shown some flexibility in administering such requirements. That flexibility reflects, as appropriate, the unique character of some transactions in insurance product securities.

Given the possible operational adjustments that the new T+1 requirement may require on the part of certain industry participants, the SEC is proposing that the new requirement not become mandatory until March 21, 2024. The comment period on this proposal expires on April 11, 2022.

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