SEC Adopts T+2 Settlement Cycle for Securities Transactions

On March 22, 2017, the US Securities and Exchange Commission (SEC) approved shortening the standard settlement cycle for most broker-dealer securities transactions to two business days after the date of the trade.[1] This new settlement cycle, known as T+2, will replace the current T+3 standard for settling most securities transactions three business days after the trade. Under T+2, when an investor buys (or sells) a security through a brokerage firm, generally the investor must deliver payment (or the security) to the firm not later than the second business day after the trade is executed.

Discussion

The SEC amended Rule 15c6-1(a) to generally prohibit broker-dealers from effecting or entering into contracts for the purchase or sale of securities that provide for the payment of funds and the delivery of securities later than on a T+2 basis unless the parties expressly agree otherwise at the time of the transaction. Broker-dealers will be required to comply with the new T+2 settlement requirements beginning on September 5, 2017.

The SEC stated in the adopting release that it "believes that shortening the standard settlement cycle to T+2 at this time will lead to a reduction in credit, market, and liquidity risk, and as a result, a reduction in systemic risk for U.S. market participants."

The T+2 settlement cycle does not apply to exempted securities, government securities, municipal securities, commercial paper, bankers' acceptances or commercial bills. In addition, Rule 15c6-1 exempts the following transactions from the T+2 settlement cycle:

- Contracts for the purchase and sale of 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;
- Contracts for the purchase and sale of securities that the SEC may exempt by order from time to time; and
- Contracts for the sale for cash of securities that price after 4:30 p.m. Eastern time and that are sold by an issuer to an underwriter pursuant to a firm commitment offering registered under the Securities Act of 1933 (the Securities Act) or sold to an initial purchaser by a broker-dealer participating in such offering.

As is currently the case, pursuant to SEC orders, there is a limited exemption from Rule 15c6-1 for securities that do not generally trade in the United States[2] as well as for contracts for the purchase or sale of any securities issued by an insurance company that is funded by or participates in a separate account.[3]

The SEC observed that a further shortening of the settlement cycle beyond T+2 could be beneficial, although it might require comparatively larger investments by market participants. To consider this issue further, the SEC directed the staff to prepare a report by September 5, 2020, examining the implementation and impact of the establishment of the T+2 standard settlement cycle and the possible movement to an even shorter settlement cycle.

The SEC recognized that the T+2 settlement cycle could potentially impact other SEC rules and guidance that require market participants to perform certain obligations on or within a specified number of days of the settlement date or that are otherwise keyed off of the settlement date. However, the SEC did not adopt any rule changes involving the settlement cycle other than the amendment of Rule 15c6-1(a) and only offered limited guidance on such other rules. For example, in the area of short sales governed by Regulation SHO, the SEC clarified that recalls of loaned securities that are initiated no later than the settlement day may be marked "long" if the seller otherwise complies with Regulation SHO's net long requirements and directed the staff to update its Frequently Asked Questions on Regulation SHO to reflect the shortened settlement cycle. The SEC did not offer guidance regarding operational difficulties that may arise under the shortened T+2 settlement cycle where a broker dealer is required to deliver a physical prospectus, instead encouraging industry participants to bring any specific prospectus delivery issues to the staff.

In related actions, in February 2017 the SEC approved changes to stock exchange and FINRA regulations to conform to the amendment of Rule 15c6-1(a) and to support the move to a T+2 standard settlement cycle.[4]

Practical Considerations

The T+2 settlement cycle will apply, beginning September 5, 2017, to the securities transactions that currently settle on a T+3 basis. These include transactions for stocks, bonds, exchange-traded funds, certain mutual funds and limited partnerships that occur on a securities exchange.

The shortened settlement cycle will primarily affect secondary broker-dealer transactions. Parties engaging in a specific transaction may provide for a settlement period other than T+2 as long as such settlement period is expressly agreed to by the parties at the time of the transaction.

Firm commitment underwritten offerings registered under the Securities Act and priced after 4:30 p.m. Eastern time will not be subject to the new T+2 settlement cycle and may settle no later than T+4 unless otherwise expressly agreed to by the parties pursuant to Rule 15c6-1(c). In any event, the settlement date for a public offering conducted on a firm commitment basis is typically expressly agreed upon by the parties in the underwriting agreement. Therefore, the amendment to Rule 15c6-1(a) does not necessarily affect the timing for closing such public offerings. The issuer and the managing underwriters can agree in the underwriting agreement that the closing date for all of the securities sold in offering will be based on a T+3 (or other) settlement cycle. Nevertheless, the SEC shortened the standard settlement cycle to reflect technological developments that facilitate quicker settlement of securities transactions and to harmonize US settlement timing with changes in global practice. Consequently, it is possible that a T+2 settlement cycle might become the standard consensual practice for firm commitment public offerings. Companies that are considering selling securities in an underwritten offering (including companies that are currently private but are contemplating initial public offerings), as well as other market participants, should monitor the development of industry settlement practices for firm commitment offerings and discuss the issue with their potential underwriters.

If T+2 becomes an industry practice for primary offerings, companies that are considering selling securities in an underwritten offering and their advisors will be well advised to prepare and sign as much of the paperwork ahead of time as possible. Furthermore, companies and their advisors might also want to consider ways to reduce the paperwork associated with offerings. For example, companies and trustees might consider the use of master notes whereby all series of notes issued under an indenture are represented by a single note with the specific terms incorporated from the applicable prospectus supplement. Issuers might consider establishing medium-term note (MTN) programs where many of the conditions precedent documents are delivered when the program is established and the offering document associated with each issuance is a two- or three-page, "fill-in-the-blank" pricing supplement. Underwriters may also want to reevaluate the need for printed prospectuses, which are unlikely to be available prior to a T+2 settlement.

Companies that maintain equity-based compensation plans should consider how the shortened settlement cycle will affect the administration of such plans. If a plan provides for the issuance of stock that can be sold in the open market on the same day (for example, by means of a broker-assisted cashless exercise to cover an option exercise price and/or tax withholding), the company may need to accelerate the process by which it delivers the newly issued stock to the broker. Companies may also need to more quickly calculate and deliver the tax withholding payments to the Internal Revenue Service relating to same day sales of stock issued under an equity-based compensation plan. Companies providing such plans for their employees, officers or directors should consult with the administrators and brokers for their plans, as well as their transfer agents, to determine whether any procedures should be adopted or modified to facilitate the transition to T+2.

Inquiries to the SEC staff regarding the implementation of the T+2 settlement cycle may be emailed to the staff's dedicated email address: T2settlement@sec.gov.

For more information about the topics raised in this Legal Update, please contact the author, Laura D. Richman, at +1 312 701 7304, any of the following lawyers or any member of our Corporate & Securities practice.

Laura D. Richman
+1 312 701 7304
lrichman@mayerbrown.com

John P. Berkery
+1 212 506 2552
jberkery@mayerbrown.com

Edward S. Best
+1 312 701 7100
ebest@mayerbrown.com

Robert F. Gray, Jr.
+1 713 238 2600
rgray@mayerbrown.com

Michael L. Hermsen
+1 312 701 7960
mhermsen@mayerbrown.com

Deborah Hoffman
+1 312 701 7219
dhoffman@mayerbrown.com

Philip J. Niehoff
+1 312 701 7843
pniehoff@mayerbrown.com

Jodi A. Simala
+1 312 701 7920
jsimala@mayerbrown.com

Endnotes

[1] The adopting release is available at https://www.sec.gov/rules/final/2017/34-80295.pdf.

[2] See Securities Transactions Settlement, Exchange Act Release No. 35750 (May 22, 1995), 60 FR 27994, 27995 (May 26, 1995).

3 See Securities Transactions Settlement, Exchange Act Release No. 35815 (June 6, 1995), 60 FR 30906, 30907 (June 12, 1995).

4 See https://www.sec.gov/rules/sro/nyse/2017/34-80021.pdf, https://www.sec.gov/rules/sro/nysemkt/2017/34-80020.pdf, https://www.sec.gov/rules/sro/nasdaq/2017/34-80013.pdf and https://www.sec.gov/rules/sro/finra/2017/34-80004a.pdf.