U.S. Move to T+1 – This Time It’s Different

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J.P. Morgan
Why is the U.S. moving to Trade Date plus 1 (T+1) settlement cycle and where are we in the process?

Over the years, as industry and regulators views on risk have evolved and as technology capabilities have improved so has the desire and the ability of the U.S. and other global financial markets to shorten the settlement cycle. In the U.S., with the passage of the Securities Acts Amendments of 1975, Congress empowered the Security Exchange Commission (SEC) with the authority to establish a national clearance and settlement system. In 1995, the SEC used that authority to shorten the settlement cycle from T+5 business days to T+3, then shortened the settlement cycle again from T+3 to T+2 in 2017. Underpinning the compression in the settlement cycle has been the view that reducing the period between trade execution and trade settlement reduces credit, operational, market and counterparty risk while at the same time reducing margin requirements, increasing market liquidity and allowing for more efficient use of capital. The focus on margin and its correlation to volatility in the price of stocks has also more recently become a focus of policymakers and regulators following events such as the COVID-19 outbreak, and the GameStop Corp (GME) trading event in 2021.

This view on risk reduction was a key driver behind the proposal led by Securities Industry and Financial Markets Association (SIFMA), the Investment Company Institute (ICI) and the Depository Trust & Clearing Corporation (DTCC) to move the U.S. market to a T+1 settlement cycle for U.S. securities which are cleared and settled through the Depository Trust Company (DTC). The roadmap to T+1 was laid out in the December 2021 industry whitepaper, “Accelerating the U.S. Securities Settlement Cycle to T+1”2, which set out the technical requirements and the regulatory amendments required for a successful implementation. On February 9, 2022 the SEC issued a proposed rule3 to amend the standard settlement cycle to T+1. The proposed rule, which may come into effect as early as March 31, 2024, formally amends rules to shorten the settlement cycle to T+1. This includes new requirements for same-day affirmation, makes amendments to the recordkeeping obligations for registered investment advisers regarding trade allocations, confirmations and affirmations, and imposes obligations for central matching service providers to facilitate the adoption of straight-through processing.

For all the anticipated benefits, there is also an acknowledgement that T+1 could pose logistical challenges for financial institutions, particularly those operating in different time zones or leveraging outdated technologies for trade instruction (e.g., fax, email). While the industry awaits publication of the SEC’s final rule, all market participants should begin assessing the impacts a T+1 settlement cycle in the U.S. will have on operating models, processes and technology, and should begin preparing for implementation in the first half of 2024. This focus should not be isolated to U.S.-based market participants only because T+1 for U.S. settlements will impact all investors and practitioners, regardless of their domicile, trading U.S. securities that are cleared and settled through the DTC.

We’ve done this before - what’s different this time?

While the move from T+3 to T+2 in 2017 was deemed a success, the move to T+1, removing half of the time allowed for settlement, will drive a more critical need to ensure trades are instructed correctly the first time and on time. Specifically, T+1 settlement will eliminate the one-day cushion between trade execution and settlement which is often used today to true-up settlement mismatch and prevent settlement failure. The loss of that cushion may give rise to operational complexities that were not realized with the implementation of T+2.

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To reduce those operational complexities and the risk of settlement fails, it is essential that all market participants, their agents and Financial Market Infrastructures adjust current operating models, implement new processes and update outdated technologies. Without a coordinated approach there is a significant risk of increased settlement failures which would be antithetical to the overarching purpose of reducing risk and would reduce liquidity, increase cost and create other systemic concerns with post-trade activity.

What should clients be focusing on now?

Below, we highlight five key areas for consideration which also underscore why the effort to move to T+1 is different:

- Misalignment of international settlement cycles
- Cash funding including projection and foreign exchange (FX)
- Allocation, confirmation and affirmation processes
- Reducing manual processes across the trade lifecycle
- Stock lending and depositary receipts

Misalignment of international settlement cycles

Trade settlement mismatch - India began its transition to T+1 earlier this year. Some other markets have announced their plans to align with the U.S. (e.g., Canada) and others are expected to follow (e.g., Latin American markets). However, many markets will remain in a T+2 settlement cycle at least for the near term. This may be a challenge for some market participants as their systems will need to manage different settlement cycles. Clients based in the Asia-Pacific region will be disproportionately impacted by T+1 for U.S. settlements because the significant time-zone differences further compresses the settlement window. Clients that use proceeds from the sale of a security in one market to fund the purchase of another in a different market should carefully consider the new timelines and cutoffs that will apply in a U.S. T+1 environment and the impact to their settlement funding processes.

Fund and market settlement mismatch - In some jurisdictions, including EMEA, fund settlement cycles with end investors are typically longer than T+1. The change to T+1 will therefore create a mismatch or increase the current mismatch between the fund settlement cycle and the market. Clients should consider how cash flows will be managed, for example by using any borrowing facilities permitted by regulations and fund governing documents or agreeing to non-standard settlement cycles. If considering shortening fund settlement cycles to align with, or more-closely align to the market, clients should consider how this may impact investors, fund distributors or platforms.

Cash funding including projection and FX

The reduction in the settlement period means custodians may be required to deliver cash projections late on trade date versus early on T+1 and trade counterparties must make cash available sooner. Clients that hold currencies other than U.S. Dollars (USD) to fund activity will have to make sure the FX process is adjusted to allow for the timely delivery. FX transactions traditionally settle on a T+2 basis. For international participants wanting to purchase U.S. securities, prefunding the transaction with USD or arranging for a short-dated T+1 FX settlement will be required. Failure to optimize these processes may result in higher pre-funding requirements, which may offset any gains realized through the reduction of margin requirements. J.P. Morgan recommends that clients perform an end-to-end review of cash funding including FX and time zone requirements to mitigate excessive pre-funding or overdrafts.
**Allocation, confirmation and affirmation processes**

Timely and efficient trade confirmation, allocation and affirmation processes reduce the risk of settlement failure and improve settlement efficiency. The current counterparty confirmation cut-off time of 6:00 PM ET on Trade Date (T) will remain the same in a T+1 environment. The industry roadmap for T+1 recommended that the cut-off for trade allocation and affirmation be pushed back from T+1 to T; this recommendation was adopted by the SEC in its proposed rule. The roadmap further recommended that allocations be completed by 7:00 PM ET on T to ensure that firms have sufficient time to process affirmations by 9:00 PM ET on T. To meet these new timelines, market participants and their agents will need to implement operational and behavioral changes as well as technology enhancements.

Allocations are used by clients that require block trading. In today’s environment, nearly 80% of allocation (Price et al., 2021, p. 13) is done on T+1 and it is possible that clients performing allocations may need to adjust their processes so that allocations commence before the end of T. This will likely require moving away from a nightly cycle and to a multi-batch process to reduce the risk of missing the new deadline.

If trades require allocations, clients can only commence the affirmation process after the allocation is completed. Allocations that fail to meet the proposed 7:00 PM ET deadline could challenge client affirmation deadlines and disrupt settlement timelines.

Some custodians may offer an affirmation service for their clients. Those custodians will need to address how to meet the proposed 9:00 PM ET affirmation cut-off time on T. Clients who self-affirm will need to update their operating models and processes to meet the new affirmation deadline.

The affirmation process is aimed at reducing the risk of settlement failures; however, trade affirmations are not mandatory in the U.S. market and some clients chose not to affirm trades. Whether or not clients affirm, we recommend all clients assess the submission timing of their settlement instructions as those currently sending settlement instructions on T+1 may find that in 2024 this model will leave little time for custodians to determine the settlement is in good order and may result in settlement failures.

**Reducing manual processes across the trade lifecycle**

While risk reduction has been a key driver for compressing settlement times globally, innovation and technological developments have been the key enablers of faster settlement. For example, in the 1970’s and 1980’s developments in communications technologies significantly reduced the need for in-person and physical processes which ultimately enabled faster settlement and the move to T+3 in 1995. Fax is an example of an innovation which, at the time, enabled faster settlement. In 2022, even with significant evolution in technology, the use of certain technologies such as fax, email and other manual processes are still prevalent in a T+2 settlement environment.

It is likely that in the run-up to T+1, manual processes will come under pressure and some clients may be confronted with the decision to replace legacy technologies and processes to meet reduced settlement deadlines and prevent settlement failure. Clients should consider eliminating the use of fax and other manual processes where possible.
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Stock Lending and depositary receipts

Clients should consider the impact to the stock lending process and begin the discussion with their agent lenders. Due to the shorter settlement cycle, the timeline to recall securities will be compressed. Lending agents will need to consider creative solutions including improved swap and substitution technology, holdbacks and buffers (where appropriate) and pre-notification in order to help lending clients meet the tightened timeline requirements while maintaining their lending programs.

Clients who rely on the issuance of depositary receipts (DR) to settle outward delivery in the U.S. market should carefully consider the impacts of the reduced settlement timing when depositing the underlying non-U.S. ordinary shares. The compressed U.S. cycle also effectively reduces the non-U.S. settlement cycle of the ordinary shares that is required for DR issuances. This effect is especially pronounced for Asia-Pacific issuer DR programs, where there will effectively be a same-day settlement requirement of the ordinary shares to mitigate late settlement of DRs.

How is J.P. Morgan Securities Services preparing for the transition and what can clients expect from us in the coming months?

We have been close to the T+1 initiative since its conception. Similar to the T+2 initiative, we are advocating the firm’s and clients’ positions in industry association discussions and we contributed to industry association comments to the SEC’s proposed rule. We will continue to closely monitor for the publication of the SEC’s final rule.

We have commenced our T+1 transition program. The program is comprised of subject matter experts from across the organization who are developing a multi-year plan, driven by client and product-focused work streams, to manage the transition. The primary program workstreams include client communication, technology development, testing and implementation, operating model change and industry advocacy. The Securities Services’ program is closely integrated with the J.P. Morgan enterprise-wide T+1 Transition program to leverage the resources of the broader firm and to coordinate our efforts.

In the coming weeks and months, we will be reaching out and engaging with clients through one-to-one meetings, webinars and additional briefings as our program progresses. This briefing marks the first in a series. In future editions we will focus on other topics in the asset serving space (e.g., corporate actions) and other impacted areas of the market such as exchange-traded funds.
Contributors

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