T+1: Why This Time Feels Different from T+2

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Introduction

On Tuesday, May 28, 2024, the first trading day after the U.S. Memorial Day holiday, regular-way settlement for U.S. equities, fixed income, and other select products will shorten from the current trade date (T) plus two business day cycle (T+2) to T plus one business day (T+1).

The post-trade exchange of money and securities, known as the settlement cycle, is not generally top of mind for the investing public. However, smooth and predictable settlement is essential to the global economy in the same way a power grid or water treatment plant is essential infrastructure to a local community. As discussed below, the drivers of the current move to T+1 differ from the 2017 move to T+2 in a few interesting ways that relate to settlement infrastructure.

Settlement Infrastructure

Like a power grid or water treatment plant, the settlement cycle has key infrastructures. One of the most important is called a central counterparty (CCP), which becomes the seller to all buyers and buyer to all sellers after trade execution but before settlement. The CCP infrastructure is highly efficient, as it permits "multilateral netting," which significantly reduces the volume of shares and money that need to be exchanged between parties in a transaction. On a typical day, the National Securities Clearing Corporation (NSCC), the CCP for U.S. equities, "processes an average of about $1.7 trillion in equities transactions. The multilateral netting process reduces that number by about 98%, and the total value settled is around $38 billion." Importantly, the CCP also insulates individual market participants from the failure of the other party in the transaction between the trade date and settlement date (known as counterparty risk). The counterparty risk absorbed by CCPs requires them to collect money from market participants, called margin, to insure against this risk. This margin, and the capital it requires from broker-dealer members, play a central but different role in the current and past shortening of the settlement cycle.

2017 Move to T+2

The last adjustment of the settlement cycle occurred in September 2017, which shortened the settlement cycle from T+3 to T+2. The primary cause of that change had its roots in the regulatory focus on the safety and soundness of the U.S. financial system following the 2008 financial crisis. The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act, among many other things, empowered the banking system regulator (the Board of Governors of the Federal Reserve System, or FRB), and the securities regulator (the Securities and Exchange Commission, or SEC) to jointly engage in rulemaking and oversee the stability of systemically important market infrastructures. This included enhanced regulation of clearing agencies that are systemically important financial market utilities (SIFMUs). Specifically, Dodd-Frank Section 807, the Clearing Supervision Act, provides for joint SEC and FRB examination and coordination regarding designated SIFMUs, including the NSCC. A consequence of this joint focus included upward pressure on the margin the NSCC collects from its broker-dealer members to guard against the potential failure of its largest counterparty. These increases in margin required broker-dealer NSCC members to obtain and supply billions of dollars in margin capital to the NSCC. BetaNXT CEO Stephen C. Daffron was a board member of the Depository Trust and Clearing Company (DTCC) – the NSCC's parent company – during this period, and he explains:

"At this point, every broker-dealer was being pushed to its regulatory liquidity limit by the ongoing maelstrom of the Lehman-sparked financial crisis, so this increased demand for margin from the NSCC was incredibly painful—and potentially destabilizing. The NSCC board was made up of the leadership of those broker-dealers (including me) who spoke on behalf of their firms and their clients to mitigate the negative effects of the increased drain on their scarce liquidity."

Stephen C. Daffron,
Chairman and Chief Executive Officer
BetaNXT

In addition, the NSCC put in place additional tools for intraday adjustments to margin requirements based on unique volatility scenarios.

Seeking relief from these increased margin requirements, the industry rallied to remove risk to the NSCC by reducing the risk that broker-dealer NSCC members pose to it during settlement. Fundamentally, the risk that the broker-dealer NSCC member poses to the NSCC is a function of time and the price volatility of the settling assets. The time between a trade and settlement is the single biggest factor in determining the margin required to protect the NSCC from a potential member failure. As such, the industry organized itself—through the Securities

Industry and Financial Markets Association (SIFMA), the Investment Company Institute (ICI), and other trade associations (Joint Trades)—to push for a reduction of the settlement cycle for most products from T+3 to T+2.

I had the good fortune to work for SIFMA during the push for T+2 and the conversion activities once T+2 became a reality. Though the operational, technology, and project considerations required significant effort, the "longest pole in the tent" was always regulatory certainty. Specifically, to ensure the entire clearance and settlement ecosystem would move in unison, the SEC needed to change the regular way settlement timing in the keystone settlement rule—SEC Rule 15c6-1 (the Rule)—from three business days after a trade to two business days. Successfully persuading the SEC to change the Rule, even without controversy, required the assembly of a bulletproof conversion playbook, full cooperation across buy- and sell-side firms (both small and large) through the Joint Trades, and a little bit of luck.

Fortune smiled upon the industry through 2016-2017, as the shortened settlement cycle rule changes had a speedy and favorable path through SEC rulemaking. With a coordinated push from the Joint Trades, the SEC proposed the move to a T+2 settlement cycle on September 28, 2016. The industry locked hands and supported the rulemaking, advocating strongly for a Labor Day 2017 compliance date as the lowest risk conversion weekend. A scant 175 days later, on March 22, 2017, Acting Chair Michael S. Piwowar and Commissioner Kara M. Stein adopted a final T+2 rule with the recommended compliance date of Labor Day, Monday, September 4, 2017. The time between proposal and final rule may be a speed record, buoyed by its non-controversial nature and Acting Chair Piwowar taking up the rulemaking as a priority between the outgoing Obama and incoming Trump administrations. The transition to T+2 over the Labor Day holiday in 2017 was generally smooth and included coordinated international settlement period changes to T+2 in Canada, Mexico, and several other markets. It set a shining example of industry cooperation and coordination to reduce risk and ensure a more efficient and sound financial market.

T+2 Command Center
Thank You

With double settlement complete, we are now operating in a T+2 regular way settlement environment.

The T+2 Command Center greatly appreciates the hard work of many in making this conversion a success.

T+2 Conversion Success Message, September 8, 2017

Move to T+1

The upcoming shortening of the settlement cycle to T+1 had quite a different genesis. During the COVID-19 pandemic, there was widespread individual investor adoption of app-based trading tools through technology-focused broker-dealers (for our purposes, I will oversimplify this group to "digital brokers"), coupled with individual investor participation in social media platforms like Reddit, Discord, and game-streaming platform Twitch. This led to high volatility and volume in certain, generally legacy retailer stocks like GameStop, Bed Bath and Beyond, AMC Theaters, Nokia, and Blackberry (so-called "meme stocks"). In January 2021, the meme stock phenomena resulted in a market event where several broker-dealers faced volatility-driven margin calls from the NSCC, which led a few firms to restrict individual investor trading in certain meme stocks. The forces that led to the January 2021 market events are fascinating and multi-faceted, including the availability of new market-access technology, payment for order flow practices, and technology-enabled social behavior.

However, the element relevant to the T+1 discussion is price volatility; specifically, where price volatility intersects with the NSCC's margin calculations. The volatility GameStop (GME) experienced in January 2021 best illuminates how price volatility translated into risk to the NSCC during the time between a trade's execution and settlement, as outlined in the SEC's January Report on those events:

[GameStop]'s intraday share price increased approximately 2,700% from its intraday low on January 8 to its intraday high on January 28, followed by a decrease of over 86% from that day to the closing price at the end of the first week of February. The daily closing price changes at the end of January were also highly volatile in dollar terms, ranging from a rise of $199.53 (between January 26 and 27) to a fall of $153.91 (between January 27 and January 28).

As a function of price volatility, the risk increases that on settlement day (a) a buyer will refuse to pay more than a stock is then worth, or (b) a seller will refuse to deliver a security to a buyer who pays less than a stock is then worth. On a larger scale, this translates into the risk that a broker-dealer with a large obligation to settle transactions for stocks that are worth significantly less than when the trade occurred may become insolvent and fail. As the CCP absorbs this risk on behalf of the seller of securities, it must increase the margin it collects to insure against the potential failure of the broker-dealer. This would put the CCP in the position of paying settlement obligations (i.e., providing the money to the sellers of securities) for the failed broker dealer. As the meme stocks experienced historic volatility in January 2021, retail participation in meme stocks, including GameStop, rose significantly: “by [Wednesday,] January 27, the number of unique accounts trading GME on a given day increased from less than 10,000 at the beginning of the month to nearly 900,000.” Volume in GameStop and other meme stocks during this period arose largely from individual investors trading through a handful of digital brokers.

Early on the morning of Thursday, January 28, the NSCC—reacting automatically to the risk of concentrated, high-volume, unsettled settlement obligations in volatile meme stocks at these digital brokers—assessed significant special margin calls to certain digital brokers as their readily available capital (i.e., excess net capital) was below a threshold of their core margin requirements. Faced with these special margin calls and coupled with additional volatility-driven increases in ordinary margin requirements, these digital brokers were required to (a) raise capital to meet the margin call, (b) reduce the risk in their portfolios to drive down their margin requirements or (c) some combination of the two. Some of the tactics these impacted digital brokers used to reduce risk included suspending trading in the volatile meme stocks, thereby lowering the concentration of unsettled, risky trades in their portfolios. That morning, the NSCC assessed it safe to waive parts of the special margin requirements and no NSCC member failed to meet its margin calls. However, the suspension of trading in these securities by digital brokers was not well-received by individual investors and social media communities active in meme stocks.

The trading suspensions and general uproar over the January 2021 market events drew the attention of the government. Specifically, the U. S. House Financial Services Committee (HFSC), with jurisdiction over securities and exchanges, held three hearings regarding these market events, with the first occurring on February 19, 2021, entitled: *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide.* These hearings included testimony and congressional questioning of a broad spectrum of financial industry representatives: SEC Chair Gary Gensler, FINRA CEO Robert Cook, DTCC CEO Michael Bodson, the CEOs of digital brokers and market makers, and meme stock investor RoaringKitty, among others. The topics were as varied as the witnesses, though the substantive regulatory questions generally focused on three areas: (1) short selling, (2) equity market structure, and (3) clearance and settlement. The first two are well-worn topics in the aftermath of a market crisis, with short sellers demonized or lionized, and the market structure’s fairness to the investing public questioned or championed.

However, the third, clearance and settlement, is a smaller bore issue, with a slightly more wonkish following, including me.

Throughout the hearings, the role of volatility-driven intraday margin calls revealed itself as a catalyst to individual investor disruption, confusion, and frustration in January 2021. As a result, the ability of a shorter settlement cycle to lower the likelihood of a similar event was woven into many discussions within the hearings and public-facing statements of participants. Unsurprisingly, the June 2022 HFSC report on matter—penned by the Democratic majority—included shortening of the settlement cycle in its broad list of policy recommendations, referring to the just released SEC shortened settlement cycle proposal, discussed below. The Republican HFSC members—then the committee minority, now the majority—focused more intently on how a shorter time between trade and settlement would have reduced the volatility-related margin calls, and subsequent trading disruptions individual investors experienced during the January 2021 market events. Specifically, the Republican HFSC member response to the HFSC committee report more narrowly concluded:

[T]he evidence shows a shorter period for settlement of securities transactions may have prevented the need for many of the trading restrictions during the meme stock event and reduced overall risk to the securities clearing system. Congress and the SEC should expedite the effort to modernize the settlement process along those lines.

The SEC moved aggressively to propose the shortening of the settlement cycle, as it voted unanimously on February 9, 2022, to approve the Rule Proposal. In administrative agency rulemaking, this is lightening fast. The proposal put forth a potential T+1 settlement cycle, but also asked for industry comment on a potential shorter settlement cycle such as T+0. Separately, the proposal put forth meaningful new same-day affirmation rules for broker-dealers and registered investment advisers. Same-day affirmation, though not necessary to settle a trade, requires a broker-dealer's institutional customer to complete the process of allocating, confirming, and affirming its trades no later than the end of the trade day. The industry comments generally focused on the wisdom of incremental change to T+1 and warned against a radical change to end of day or real-time settlement as unwise. Further, there was broad consensus that a Labor Day move to T+1 would permit the industry and non-U.S. markets the time to develop and test the changes necessary for a smooth and low risk move to T+1.

Shortening the Securities Settlement Cycle

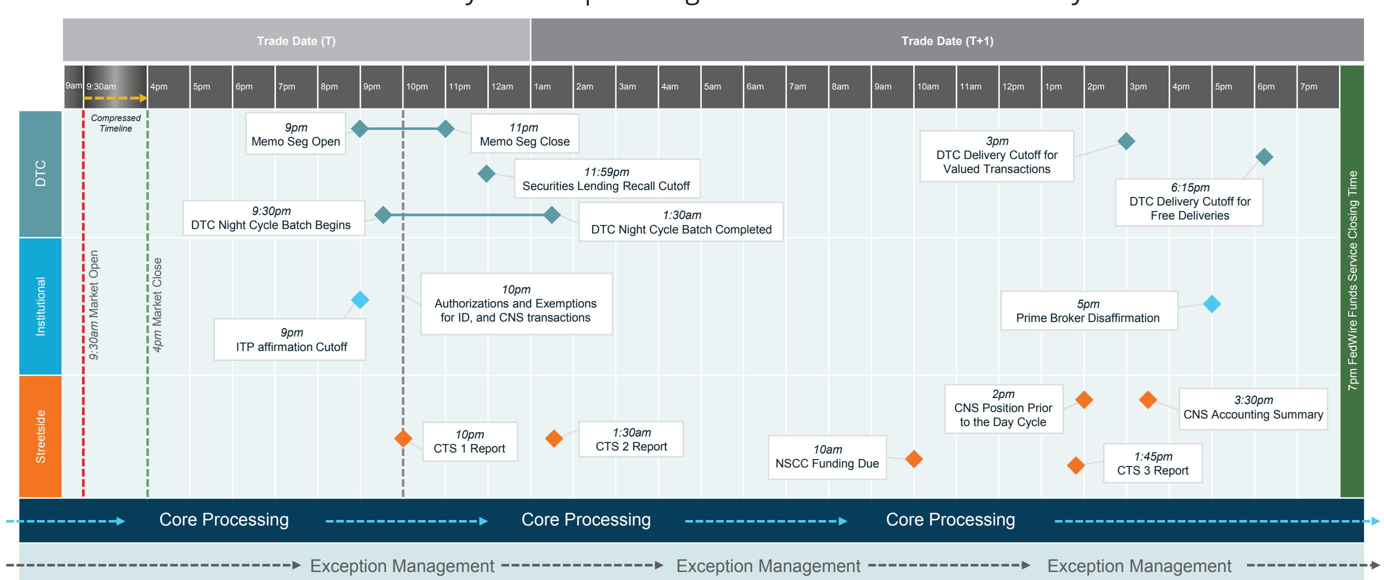
Fedruary 15, 2023

Chair Gary Gensler	Approved
Caroline A. Crenshaw	Approved
Jaime Lizárraga	Approved
Hester M. Peirce	Not Approved
Mark T. Uyeda	Not Approved

One year later, almost to the day, on February 15, 2023, the SEC adopted changes to the Rule to require T+1 regular-way settlement as well as new broker-dealer and registered investment adviser same-day affirmation requirements. The adopting release set the compliance date for the move to T+1 on May 28, 2024, the Tuesday after Memorial Day. These rules were not approved unanimously, as Commissioners Pierce and Uyeda dissented specifically on the nearness of the conversion date. Commissioner Pierce stated, "I support the plan to move to T+1, but do not support the proposed timeline for making this change" and Commissioner Uyeda stated, "In my view, we are in an imprudent rush away from a sensible transition date and, for that reason, I am unable to support the final rule." The industry was generally disappointed with SEC's unwillingness to give it until Labor Day 2024 to prepare for T+1. This disappointment generally aligned with the rationales dissenting Commissioners outlined, including the need for time to perform significant internal and industry testing as well as time to ameliorate the challenges that testing might reveal. Importantly, the U.S. Memorial Day conversion creates complexity for the Canadian market as they move to T+1 along with the U.S., as Canada does not have a Memorial Day holiday on May 27, 2024 and plans its conversion one day misaligned from the U.S. markets.

Coupled with the aggressive timeline, the technology and process challenges of the move to T+1 are different in kind from the 2017 move to T+2. In that move, final 24 hours were removed from a 72-hour cycle, which

T+1 Minute by Minute | Leaning 24 hours out of the Current Cycle



required a lot of careful analysis and planning, but not a significant amount of behavioral change as batch cycles and related cut-offs largely did not change. It was a straightforward belt tightening. With respect to the move to T+1, the change is more complex and has a higher degree of difficulty. Specifically, T+1 will see the relevant batch cycles moving closer together over the 29.5 hours between the opening of a trading day and the closing of regular way settlement for that trading day, with significant focus on the ~5 hours between market close and the beginning of night cycle processing on T. The behaviors that feed those batches, including that of the institutional customers largely untouched by the T+2 move, are required to compress into the precious time between them.

In sum, the 2017 move to T+2 was a largely voluntary effort, a partnership between the industry and regulatory parties to make clearance and settlement less risky. This partnership fostered an atmosphere of steady calm that assisted in a smooth transition. On the other hand, the upcoming move to T+1 is an event-driven SEC mandate with a higher degree of complexity and less time to address challenges that may arise from that complexity. Based on the aggressive compliance date, the atmosphere this time is more turbulent, though the industry will no doubt persevere. We must; our customers and the investing public are counting on us.

T+1 | BetaNXT Leading the Way

BetaNXT is deep into testing the changes made for the move to T+1 and readying our go-live playbooks. Following the move from T+3 to T+2 in 2017, BetaNXT took significant steps to lay the foundation for the move to T+1 we are seeing now. BetaNXT parameterized many settlement-related processes and integrated efficiency-enhancing DTCC products. Additionally, we implemented exception management tools essential to navigate fewer hours to address fails, breaks, and other time-sensitive workflows.

In closing, we must pull ever closer as an industry to coordinate across business models and functions as we count down the weeks and days to the T+1 conversion. Success will require not only a commitment to the formal tasks of conversion, but importantly a trust and candor in our communications that reflect our shared goal. As BetaNXT CEO Steve Daffron outlined at SIFMA OPS last year, analogizing the upcoming shortening of the settlement cycle to his days in the Army jumping out of airplanes and how we need to work with each other to make sure the jump goes successfully: “when the green light goes on, we’re all going out the door together.”

About the Author

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An industry advocate and regulatory expert, Will oversees the regulated services BetaNXT provides its clients, including compliance with financial operations and non-financial regulatory reporting rules. He also engages with regulators and industry groups on behalf of BetaNXT's clients, particularly as it relates to retail and wealth management operations and technology.

Notes

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About BetaNXT

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