ALERT MEMORANDUM

SEC Issues Proposed Rule to Support Move to Shorter Standard Settlement Cycle

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On September 28, 2016, the Securities and Exchange Commission (the "SEC") published a proposed rule (the "Proposed Rule") to amend Rule 15c6-1(a) under the Securities Exchange Act of 1934, as amended, which would shorten the standard settlement cycle in the United States for most securities transactions from three business days after the trade date ("T+3") to two business days ("T+2") after the trade date. Under the Proposed Rule, any trade with a settlement cycle longer than T+2 would require (subject to certain exceptions) express agreement on the settlement cycle at the time of the transaction.

In the proposing release (the "Proposing Release") for the Proposed Rule,[1] the SEC explained that the Proposed Rule is designed to benefit all market participants by reducing liquidity, market, credit and systemic risk. The Proposed Rule reflects a change the U.S. securities industry has advocated for some time and follows considerable effort by the industry to identify the operational and regulatory changes required for a transition to T+2.

Comments on the Proposed Rule are due on or before December 5, 2016.

[1] The Proposing Release is available at https://www.sec.gov/rules/proposed/2016/34-78962.pdf.

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Background

The standard settlement cycle has not changed since 1993, when the SEC adopted the current version of Rule 15c6-1(a), which (subject to certain exceptions) prohibits any broker-dealer from entering into a contract for the purchase or sale of a security that provides for payment and delivery later than three business days after the trade date, unless otherwise expressly agreed to by the parties at the time of the transaction.[2] The Proposed Rule would replace the existing rule's reference to three business days with a reference to two business days.[3]

In recent years, as technology and market infrastructure have improved, many foreign jurisdictions have shortened their settlement cycles, with most European Union member states reducing their settlement cycles to T+2 by 2014, Australia and New Zealand moving their settlement cycles to T+2 in March 2016, and many major markets in Asia adopting T+2 or even T+1 settlement cycles. The SEC noted one of its considerations in proposing to amend the rule was to align U.S. markets with other global markets.

The current industry effort to shorten the settlement cycle began with a 2012 Boston Consulting Group white paper commissioned by The Depository Trust & Clearing Corporation ("DTCC"), which analyzed the costs and benefits of moving to T+2 and revealed significant interest from a broad spectrum of participants in the U.S. securities industry in shortening the cycle. Based on these findings and input from industry associations, DTCC released a position paper in April 2014 advocating for a national move to T+2. Subsequently, DTCC, the Investment Company Institute, the Securities Industry and Financial Markets Association ("SIFMA") and other market participants formed an industry steering group ("ISG") to facilitate the move to T+2 and published an Implementation Playbook in December 2015, setting out a detailed timeline for the switch to T+2 by September 5, 2017.[4]

The ISG also identified rules and regulations issued by the Financial Industry Regulatory Authority ("FINRA"), the Municipal Securities Rulemaking Board ("MSRB"), the New York Stock Exchange, Nasdaq, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation that would require amendment for an effective transition to T+2. So far, FINRA, the MSRB and Nasdaq have amended, or taken steps to amend, rules identified by the ISG.

Observations

— The SEC acknowledged the impact of the industry's coordinated push for T+2 in the Proposing Release, and the Proposed Rule is consistent with the ISG's recommendation.

— While the SEC did not propose amending any other rules, it noted that the Proposed Rule would reduce market participants' timeframes for compliance with other rules. For example, the Proposing Release pointed out that the move to T+2 would reduce the time available to effect a close-out under Rule 203 of Regulation SHO, to comply with the "buy-in" requirement in Rule 15c3-3(m), and to send transaction confirmations to customers pursuant to Rule 10b-10. The SEC requested input as to whether the implications of the Proposed Rule for these other rules would present compliance challenges.

[2] Among the exceptions under the current rule is a provision that subjects contracts for the underwritten sale of securities pricing after 4:30 p.m., Eastern Standard Time (as is generally the case for equity offerings), to a four business day ("T+4") standard settlement cycle. This exception would not be adjusted by the Proposed Rule.

[3] Parties to a trade would continue to be able to affirmatively agree to a longer settlement cycle at the time of entering into a transaction. Any such agreement would generally be disclosed in any offering document for a transaction or, where there is no offering document, in the confirm for the trade.

[4] The ISG's playbook is available at http://www.ust2.com/pdfs/T2-Playbook-12-21-15.pdf.

— The SEC has requested comment on whether the standard settlement cycle should instead be shortened to T+1 or T+0, suggesting that a move to T+2 could be a step to ultimately adopting a shorter settlement cycle. In the Proposing Release, the SEC mentioned several potential challenges involved in moving to a shorter cycle than T+2, including:

- a real-time trade matching requirement; and
- increased funding costs for certain market participants who rely on the settlement of foreign exchange ("FX") transactions to fund domestic securities transactions, as most spot FX transactions settle on a T+2 cycle.

— If the Proposed Rule is adopted, the SEC would consider the ISG's September 5, 2017 target date and the current status of industry implementation in setting a compliance date.

Key Issues for Comment

The Proposing Release requested comments on various issues, with the following likely to be areas of notable comment on the Proposed Rule:

— Whether the alternative of immediately shifting to a T+1 or T+0 would be appropriate and preferable to T+2. In light of the SEC commentary noted above, commenters seeking to encourage the SEC to facilitate or adopt a shorter settlement cycle should be prepared to address what changes might be necessary to trade allocation and matching and FX settlement practices.

— The potential utility a distributed ledger system (e.g., blockchain) or related technology would have in the context of a shortened settlement cycle and whether clarifications or relief with respect to other SEC or self-regulatory organization rules might be necessary or appropriate for at least an interim period to facilitate the development of those new technologies. For example, certain technologies might present questions relating to clearing agency registration and regulation and trade confirmation and affirmation requirements.

— Whether clarifications or relief would be appropriate in connection with certain types of securities transactions. For example, the SEC notes that, absent relief, the Proposed Rule would apply to security-based swap transactions, but it is not clear how the Proposed Rule would apply to such transactions given the generally bilateral, executory nature of security-based swap transactions.[5] The SEC also inquired whether the conditions for existing exemptions from Rule 15c6-1 (e.g., for foreign securities or variable annuity contracts) are still appropriate.

— Whether the standard settlement cycle for contracts for the underwritten sale of securities pricing after 4:30 p.m., Eastern Standard Time should be reduced from T+4.

— The potential impact with respect to cross-border and cross-asset class transactions, given the settlement cycles present in other jurisdictions or for other asset classes.

— Whether the Proposed Rule will affect the costs of creating or redeeming shares in Exchange-Traded Funds ("ETFs") that hold portfolio securities that are on different settlement cycles, and if so, if it would reduce the effectiveness of the arbitrage between an ETF's secondary market price and the value of its underlying assets.

— The necessary changes to market conventions, documentation or infrastructure in the securities lending market (e.g., initiating recalls of loaned securities on T+1 instead of T+2) and whether such changes might impede

[5] Security-based swaps are currently covered by a temporary exemption from Rule 15c6-1. SIFMA previously requested a permanent exemption for security-based swaps. *See* the request available at https://www.sec.gov/comments/s7-27-11/s72711-10.pdf.

an effective transition to a T+2 settlement cycle.

— The parameters that should be used to identify an appropriate compliance date for the Proposed Rule, including comments on the ISG's September 5, 2017 target date.

Commenters might also want to consider what steps the SEC should take (and the process through which it would take them) if implementation challenges arise after the SEC finalizes the rule change.

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