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Client Alert

April 1, 2024

T+1 SETTLEMENT IS COMING MAY 28, 2024: WHAT MARKET PARTICIPANTS NEED TO KNOW

Starting on May 28, 2024, the standard settlement date for purchases and sales of registered or freely-trading securities (like stocks and bonds) in the U.S. (meaning the date of the official transfer of securities to the buyer's account and the cash to seller's account) will be reduced from "trading day plus two business days"^[1] (or T+2) to "trading day plus one business day" (or T+1). Participants in the U.S. capital markets, from buyers and sellers of securities, to broker-dealers, hedge funds and legal counsel, must be aware of and prepared for this important change.

In adopting the T+1 requirement, the Securities and Exchange Commission (SEC) determined that improvements in technology, especially online trading of securities and the prolific use of uncertificated securities and funds, no longer requires two trading days to settle. In legal parlance, amended SEC Rule 15c6-1 provides that *a broker-dealer is prohibited from entering into a contract for the purchase or sale of a security that provides for payment of funds or delivery of securities later than the first business day after the date of the contract, unless otherwise agreed to by the parties*. The change in the rule was primarily to tighten the delivery requirements for transactions done by market participants that buy and sell securities on any given day through a brokerage firm – in other words, ordinary brokerage transactions. In simple terms, for buyers of securities, your full-service or online brokerage firm must receive payment from you no later than the next business day after the trade is executed. For sellers, you must deliver your security to the brokerage firm no later than the business day after the sale. For example, if a security is sold at 3 pm ET on Monday, that security must be delivered on Tuesday and the buyer must make payment on Tuesday as well. Interestingly if a transaction prices or occurs after 4 pm ET, then the next day is T+0, not T+1 so there is a little more time to close the transaction.

For the vast majority of securities transactions, the change to T+1 will go unnoticed because most brokerage firms already require investors to have the needed funds in cash accounts before making a purchase and most securities are held by the selling brokerage firm in electronic form in advance of a sale. If, however, an investor wishes to use an Automated Clearing House (ACH) payment or the seller holds physical certificates, then the buyer and seller will need to make alternative arrangements (meaning predelivery of payment and the securities) to meet the T+1 requirement. While this makes perfect sense for trading outstanding securities on exchanges, this overlooks the needs of the capital-formation end of the securities industry. Hedge funds, public companies and their auditors and legal counsel do not operate in the world of ordinary brokerage transactions!

When a public company sells newly issued securities, the company must issue and deliver the securities to the purchasers, and the purchasers must make funds available, on the next business day. More importantly, unlike ordinary brokerage transaction, direct issuances of registered securities by a company with the participation of a FINRA member broker-dealer (such as registered direct (RD), confidentially marketed public offering (CMPO), initial public offering (IPO), “at-the-market” offering program (ATM) or for securities issued in connection with a “de-SPAC” transaction, involves many more deliverables (including, transfer agent instructions, legal opinions, certificates, resolutions and “cold comfort” letters) and many more parties (including attorneys, the transfer agent, the SEC, the trading market and often the company’s auditors). **The practical implication of T+1 is that all of these deliveries must be ready, and the transaction participants must be closely aligned, in order to make T+1 work.**^[2]

However, the T+1 rule does provide an exception: “*unless otherwise agreed to by the parties*”. To avoid the inevitable crunch that T+1 will cause, why don’t we just agree to make the settlement date longer? **In short, it depends on the type of transaction.** If the transaction is for registered securities (an RD, ATM, CMPO, IPO, etc.), there is a high likelihood (if not a certainty) that immediately following announcement of the transaction, usually T+0, a hedge fund buyer of the securities will have sold some of the securities through a brokerage firm to third parties. To do so, the seller of the securities must give assurances to its executing broker that the shares will be delivered within T+1 of the sale to the third party. In an ATM, this is always going to be case as the whole point of an ATM is that the selling agent is selling the securities on behalf of the issuer to third parties through ordinary brokerage transactions. Therefore, if the parties were to agree to a longer settlement period, the selling agent would be putting themselves in jeopardy of the new rule when they engage in selling transactions.

Again, you might ask, then why not just have the buyer agree to hold the securities an extra day to get us back to T+2? As stated above, it simply could never work for an ATM, and asking hedge fund buyers in a transaction to hold securities is probably going to drive down interest in any proposed transaction so for these buyers, the financing is significantly less attractive, and companies could be left without critical funding options.

Where does this leave us? Unfortunately, squarely on the shoulders of the companies, broker-dealers and lawyers. **It will be more imperative than ever to ensure that, as soon as a transaction is agreed upon, and even before documents are executed, all deal participants are fully up to speed on what is required to close the transaction the next day (T+1).** For deals that are in gestation for a few weeks if not months, much can be prepared ahead of time. For shorter gestation periods, it will require the lawyers and issuer to be fully

ready to move to close quicker. The use of closing checklists and market established forms will be key to flawless execution as will open communications with counterparties in the deal and the correct allocation of responsibilities.

Moreover, the SEC has imposed new requirements on broker-dealers to adopt procedures to cover topics listed in the T+1 rule and to review and potentially modify customer agreements to clarify when the new settlement cycle applies. Registered investment advisers will be required to adopt new procedures to track trade confirmations they receive and the allocations they make.

[1] "Trading day" is typically the day following the day that principal transaction documents are executed, when trading exchanges are open for business.

[2] There is some relief in a "firm commitment" underwriting, where the settlement period has been decreased to two business days ("T+2") if the managing underwriter and issuer agree. As noted above, this relief is of little practical effect.

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If you have questions or would like additional information, please contact your primary EGS attorney with whom you work.



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