

AUGUST 17, 2021

Leading the Way to T+1

BY ERIC J. PAN

More than 170 million equity transactions trade and settle every day in the United States on behalf of hundreds of millions of investors, including those who invest in regulated funds, such as mutual funds and exchange-traded funds. The trading and settlement systems are incredibly resilient, but heightened volatility during the pandemic in March 2020 and the meme investing frenzy earlier this year produced an extraordinary volume of trades to settle and unusually high demand for margin payments on broker-dealers and other market participants.

Shortening the settlement cycle will make the financial system more resilient to these challenges for the benefit of investors. The *settlement cycle* is the time between the *trade date*, when an order is executed in the market, and the *settlement date*, when participants exchange cash for securities. Currently, securities are settled in two business days after a trade is executed (T+2). We should shorten the settlement cycle to one business day (T+1). Moving to T+1 will benefit funds and their investors by mitigating risk, improving operational efficiencies, and maximizing investment opportunities.

Benefits of T+1 to Regulated Funds and Investors

Because regulated funds are a primary source for the daily trading transactions, ICI is **collaborating** with the Securities Industry and Financial Markets Association (SIFMA), the organization representing the broker-dealer community, and the Depository Trust & Clearing Corporation (DTCC), the regulated securities clearinghouse, to shorten the settlement cycle. Together, ICI, SIFMA, and the DTCC represent the end-to-end stakeholders in processing and settling these transactions.

Shortening the settlement cycle will provide tangible benefits for regulated funds and investors. These benefits include:

- » **Streamlining fund operations and lowering costs.** Currently, securities in a fund's underlying portfolio settle on a different cycle than the fund shares themselves. When a fund buys or sells portfolio securities, it generally takes two days—or T+2—to receive the securities or cash. Meanwhile, when a fund investor buys or redeems shares from the fund, it usually takes T+1 for the fund to receive the money or shares. Shifting to a uniform T+1 settlement cycle for both securities and fund shares aligns the portfolio side with the fund share side, removing any disconnect between the cash movement from the two components, and making the fund more operationally efficient and reducing costs.

- » **Mitigating cash flow risks and better meeting investors' needs.** Moving to T+1 will enable funds to better manage risk and more efficiently take advantage of investment opportunities. Fund managers carefully monitor and manage the cash flowing in and out of their funds, but there is always risk when there is a difference in settlement times between the portfolio securities and mutual fund shares. Moving to T+1 will reduce this risk because the mutual fund will receive cash for portfolio securities and fund shares on the same day. This allows fund managers to have a complete picture—on a timelier basis—of the money moving in and out of the fund so that they can more nimbly buy and sell securities to meet their fund's investment objective and better serve investors.
- » **Reducing the possibility that counterparty risk will negatively affect investors' returns.** Market disruptions or volatility increase the risk that a counterparty—or the other participant in a trade—won't be able to meet its trading obligation, which could have adverse ramifications for the fund's returns. Reducing the time it takes to trade and settle securities in a portfolio mitigates that risk because there is less of a possibility that a counterparty won't be able to hold up its end of the trade because the trade is pending for a shorter period, making it less likely that counterparty risk could negatively affect a fund's performance during times of market stress.
- » **Helping funds more effectively navigate market volatility on behalf of investors.** When markets change, fund managers need to be able to swiftly buy or sell securities to best serve their investors. Moving to T+1 will enable funds to receive the securities one day sooner or move them out of the fund's portfolio earlier. This helps investors because it enables fund managers to change their positions in fund securities quicker, which is especially important when markets are experiencing volatility.

Focusing on Making T+1 a Reality

Moving to a T+1 settlement cycle will be a complex undertaking. It will require significant planning, execution, and testing—and it will fundamentally change the US market structure. That's why we are currently working with SIFMA and the DTCC to identify and analyze the key products, markets, and processes that will need to be modified to move to T+1. We should complete this work by the end of the third quarter of 2021 and then will develop a definitive time frame for moving to T+1.

Some have asked about moving straight to T+0 or settling trades at the end of the day they are placed. It would seem logical that the good reasons to move to T+1 also would apply to a move to T+0. But a move to T+0 is not the same thing as a move to T+1, as it raises additional questions and issues that would need to be identified and resolved—questions and issues that are even more complex and difficult than those associated with the move to T+1. Most notably, T+0 would leave very little recovery time should systems interruptions take place, should system information dependencies not be met, or should high market volatility occur. Jumping to T+0 also would require a complete reengineering of areas such as global settlements, foreign exchange, margin investing, and securities lending to meet regulatory and contractual requirements in perhaps less than 12 hours, where today's cycle allows more than 24 hours.

In addition, T+0 would potentially:

- » require investors to pre-fund accounts;
- » place smaller market firms and vendors at a competitive disadvantage due to the resources necessary to complete a move to T+0; and
- » obligate industry stakeholders, including the Federal Reserve's payment systems, to maintain services much longer during the day, which could increase the potential for failure.

Finally, requiring all activity to be completed in the same business day of perhaps 12 hours or less would affect the buy-side or sell-side's ability to complete nonautomated activity, which could expand the rate of trade fails in the system, leading to increased risk.

Does this mean the industry is opposed to considering a move to T+0? No. It simply means the industry recognizes the great number of challenges to moving to T+0, and we will continue to investigate ways to further shorten settlement times through cost-benefit analysis, considering risk mitigation, investor impact, and operational resiliency. This investigation needs to be done carefully.

In the meantime, we should focus our attention on shortening the settlement cycle to T+1 and securing the tangible benefits of T+1 as soon as possible. Achieving this goal will be for the benefit of all investors across the United States.

Eric J. Pan is president and CEO of the Investment Company Institute.