Trade Settlement: Know Your T+1 Blind Spots

VAL WOTTON
Managing Director and General Manager, Institutional Trade Processing, DTCC

DTCC

As market participants across the industry anticipate the U.S. shift to T+1 settlement come May 28, 2024, operational readiness is now top priority for firms with trade relationships in the U.S. While many of the larger firms have commenced T+1 testing since the kick-off of the Depository Trust and Clearing Corporation (DTCC)'s programme on August 23, 2023 – with no significant operational issues reported so far – many of the smaller firms are just now beginning to recognize the impact that T+1 is likely to have on their organizations.

Related: A launch status check for T+1

How can we ensure that moving to the new settlement cycle will be seamless on day one? And how do we ensure that the intricacies of the US post-trade processing chain, critical to operational efficiency, are clearly understood by firms of all sizes across the globe?

WHAT DOES AFFIRMATION MEAN IN U.S. POST-TRADE PROCESSING?

Depending on their respective time zones, firms outside the U.S. will have less than one business day to process and settle their trades in a T+1 settlement timeline.

To prepare, non-U.S. firms must first understand the affirmation process – unique to the U.S. – and its impact on post-trade processing. Affirmation is an acknowledgement by an investment manager or buy-side firm, custodian, or prime broker that the trade details submitted by the broker align with their own. In the U.S., affirmation takes place prior to the transmission of settlement instructions to The Depository Trust Company (DTC) via the DTCC system called TradeSuite ID, which handles affirmation and electronic confirmation of the trades. In contrast, in many markets outside the U.S., the affirmation process is embedded within the depository system, akin to pre-settlement matching between the local broker and the local custodian (acting on behalf of the buy-side firm).

WHAT ARE SOME COMMON ASSUMPTIONS?

There are several options on how buy-side firms can execute affirmation: they can either self-affirm or delegate the task to their custodians or prime brokers. Better still, they can turn to technology to auto-affirm. Regardless of the option, the affirmation obligation sits with buy-side firms.

It's important to remember that "affirmation" is not the same thing as "settlement". Affirmation is the step that occurs just before the settlement instruction is sent to DTC via DTCC's TradeSuite ID.

Related: DTCC comments on industry's affirmation progress

Because of the tight settlement timeline, all affirmations should occur by 9pm ET on trade date, the cut-off time for DTC's first batch of settlement processing for T+1. But missing the 9pm ET cut-off time does not equate to trade failure.

Trades can still be sent to DTC for settlement after 9pm ET – by 11:30pm via the Night Delivery Order. The final cut-off time for sending trades to the DTC is 3:20pm ET on T+1 – leveraging the Day Delivery Order. Trades settled after the first affirmation deadline cost more. For instance, trades settled via a night delivery costs three times more for the deliverer and two times more for the receiver. These costs can add up to a substantial amount as trade volumes increase.

WHAT ARE THE REGULATORY OBLIGATIONS?

When the Securities and Exchange Commission (SEC) adopted final T+1 rules, it instituted new requirements around same-day affirmation (SDA) practices for broker-dealers to help ensure timely settlement in a T+1 environment. Importantly, the requirement for broker-dealers is that they take certain actions so that 100% of all trades are affirmed as soon as technologically practicable and no later than the end of trade date, and as reinforced by FINRA [the US Financial Industry Regulatory Authority] in a recent regulatory notice.

Based on the current T+2 settlement structure, approximately 74.5% of trades are affirmed by 9pm ET on trade date – according to DTCC's latest analysis dated February 2024.

Firms across the globe run the risk of incurring reputational damage and additional costs due to trade fails or settling trades via delivery orders and non-compliance. Improvement in affirmation rates – aided by technology – can help to reduce the likelihood of trade failure and provide needed efficiency.

Further, firms should note that the SEC examination division recently issued a risk alert titled Shortening the Securities Transaction Settlement Cycle.

HOW TO ADDRESS REMAINING CONCERNS?

Firms must identify the best approach to manage several cross-border considerations brought about by time-zone disparities. First, resources will be required during off-working hours to process trades on Saturdays and local public holidays and to resolve trade mismatches, and other issues that may arise as trades move through the allocation-confirmation-affirmation sequence. Depending on the complexity of the issue and investment mandate, front, middle or back offices may be required to work collaboratively to clarify and fix trade exceptions.

In a tight settlement cycle with minimal room for error, firms should leverage solutions that automate affirmation and settlement instructions once a centrally matched trade between a buy-side firm and broker occurs, removing manual or third-party involvement. This not only helps to pave the way to settlement finality but also supports faster exception resolution and volume fluctuations.

Second, firms must review alternatives available to handle foreign exchange (FX) transactions to mitigate settlement risks and avoid pre-funding. Automated solutions to expedite the FX lifecycle are especially useful for firms with high FX volume.

Third, firms should establish best practice for securities landing and inventory management. Digital capabilities are available in the market today to help monitor securities movement to efficiently manage sale notifications and recalls.

Ultimately, adopting an advanced, automated operating model – either by enhancing existing systems or relying on available third-party solutions – is pivotal to T+1 success. The urgency to remove operational risks associated with manual intervention is even more crucial in Asia-Pacific given that migrating from T+2 to T+1 reduces the processing time for cross-border trades to just a few hours in some locations. The success of T+1 depends on efficiency within firms, both large and small. By working together and increasing automation, the industry can reap all the benefits that an accelerated settlement cycle can bring, including lower capital requirements and reduced risks.

This article was originally published to The Asset on April 17, 2024.

© 2024 DTCC. All rights reserved. DTCC and DTCC (Stylized) are registered and unregistered trademarks of The Depository Trust & Clearing Corporation. The services described above are provided under the "DTCC" brand name by certain affiliates of The Depository Trust & Clearing Corporation ("DTCC"). DTCC itself does not provide such services. Each of these affiliates is a separate legal entity, subject to the laws and regulations of the particular country or countries in which such entity operates. See www.dtcc.com for a detailed description of DTCC, its affiliates and the services they offer. DTCC Public (White) 30499 GM050124.