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Toward T+0: Preparing For Faster Securities Settlements

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In 2017, the U.S. Securities and Exchange Commission approved rule changes shortening the standard settlement cycle for most broker-dealer transactions from three business days after the trade date to two business days, or from “T+3” to “T+2.” The shift was prompted, in part, by market desire to reduce risk from unsettled trades, shortened settlement cycles in major securities markets overseas, and advances in trading and settlement technology. Since the transition, many have wondered if the settlement cycle can, or should, be shortened even further, perhaps even to “T+0.”[1] In its adopting release for the T+2 rule changes, even the SEC stated that it “believes that shortening the standard settlement cycle will promote technological innovation and changes in market infrastructures and operations that will incentivize market participants to further pursue more operationally and technologically efficient processes, which may lead to further shortening of the standard settlement cycle.”

Excitement surrounding distributed ledger (or “blockchain”) technology has further heightened interest in faster, even instantaneous, settlement. Most major clearing systems, including DTC in the United States, have undertaken studies of the impact of blockchain technology on settlement in anticipation of industry changes.

The advent of nearly instantaneous settlement for nonroutine securities transactions would present new challenges for securities practitioners. Indeed, while the T+2 settlement cycle is typically achievable for relatively simple capital markets transactions (such as issuances of common stock or investment-grade debt by frequent issuers), more complex offerings typically require more time to complete.[2] In many high-yield debt transactions conducted on a private placement basis, for example, issuers have opted to maintain a longer T+3 or T+5 cycle. Similarly, underwriting banks leading a debt offering conducted pursuant to Rule 144A and Regulation S may, depending on the circumstances, require a few days to determine the split between note tranches, which may render settlement on a cycle faster than T+5 difficult. Unless there is an urgent need for offering proceeds, most issuers are typically comfortable with these longer settlement cycles in more complex transactions.

Nevertheless, should the SEC and market decide to move to a faster settlement cycle than T+2 as a result of technological changes or otherwise, what steps will practitioners be compelled to take to ensure the success of settlement, and what new tools may emerge to enable the practice to evolve? More interestingly, how might the law itself evolve?

Preparation for closing of a securities offering prior to pricing has always constituted prudent planning for any capital markets transaction, but T+0 will render that preparation mandatory and, in all likelihood, standardized. Since it may not always be possible to prepare closing documents if transactions are announced on an accelerated time frame or with little notice, counsel may need to prepare closing documentation for a range of possible transactions that can be used quickly should the need arise. Negotiation of routine closing documentation with known third parties, such as transfer agents and indenture trustees, might also occur prior to any particular transaction. Faster settlement will in effect require issuers to prepare for offerings as if they routinely came to market. Since the preparation and assembly of these documents will not be possible for all issuers in advance, however, the market may push to develop a standard set of publicly available closing documentation. Automation of the closing documentation process, using macros, artificial intelligence or natural language generation, may result. Of course, the speed necessary for proper execution may increase risk of error; increased vigilance in preparation will be required as practices evolve.

Content of closing documents may also change. For example, among other modifications, it will no longer be necessary for officers of the company to give certificates as to the accuracy of representations and warranties in an underwriting or purchase agreement if the time between execution of that agreement and closing of the offering is effectively zero. Customary bringdown comfort letters delivered by auditors will no longer be required since there will be time for no additional procedures between the time of issuance of the comfort letter at pricing and closing of the offering. Similarly, disclosure letters issued by counsel will also have to be updated.

Beyond certain technical, process and documentary changes to the offering process, however, could the shift to T+0 influence the securities offering model and related liability regime that has existed since 2005? At the time of the “Securities Offering Reform” in 2005, the staff of the SEC recognized that new technologies (in particular, the internet) had fundamentally altered the methods by which investors and other participants in the financial markets received and digested information regarding issuers and securities offerings. These technological changes prompted a change in law: Since issuers were able to distribute information more easily, the role and liability associated with the final prospectus mandated by Section 5 of the Securities Act of 1933 was replaced by a regime in which liability attached instead primarily to the content of a preliminary prospectus for Section 11 purposes under the Securities Act.[3]

The enactment of T+0 might well serve as a catalyst to prompt further changes, in particular with respect to the “Section 10(a)” prospectus. Indeed, what purpose does the final prospectus serve after 2005? Industry participants typically no longer require it for marketing purposes. As a legal matter, “final” prospectuses as set forth in Section 10(a) of the Securities Act are only required as a result of the requirements of Section 5. Under Section 5(b)(2), the delivery of securities is prohibited unless accompanied or preceded by a final prospectus, and Section 5(b)(1) prohibits use of any “prospectus” (that is, most written communications) following effectiveness of registration statement unless it complies with Section 10 of the Securities Act. Given the definition of the term “prospectus” in Section 2(a)(10)(a) of the Securities Act, any written communication that offers or confirms the sale of the security must be accompanied or preceded by a final prospectus. As a result, under the terms of the Securities Act, final prospectuses are required in connection with confirmation of sales and delivery of securities at closing.

The 2005 “access equals delivery” model set forth in Securities Act Rules 172, 173 and 174 effectively dispensed with final prospectus delivery requirements for both confirmation of sales and securities delivery for many common transactions. Still, a final prospectus is required to be produced: Rule 172

requires issuers to file with the SEC a final prospectus, or make a good-faith and reasonable effort to file one within the time periods prescribed by Rule 424,[4] and Rule 173 permits a purchaser of a security to request a copy of the final prospectus.[5]

Should T+0 closings become reality, the administrative burden and operational difficulties associated with the production and delivery of a final prospectus may argue in favor of eliminating them altogether. It is worth noting that in the concept release for the T+2 rules, the SEC did not expand “access equals delivery” rules to address these potential operational issues raised by some commenters; instead, it encouraged industry participants to bring such issues to their attention for future resolution. “Instantaneous” closing could act as the catalyst for such industry comment and change, and action needed on the part of the SEC to eliminate entirely the requirement to produce and distribute final prospectuses would be slight given the extent to which the original mandate of Section 5(b)(2) has been altered by Rules 172, 173 and 174 in many routine transactions.[6] Given waning interest in final prospectuses for marketing purposes and their limited use as a liability document, it is unlikely that any would be produced in the absence of these or similar rules.[7] Should faster settlement come to pass, due consideration should be given to whether production and delivery of a final prospectus is still necessary to investors in light of its current function and status, and new operational challenges to closing that will likely emerge.

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[1] What constitutes a “T+0” closing would need to be determined. For example, if an offering is priced after close of market, would the transaction settle the next morning, and, if so, prior to what time? If a transaction is priced during trading hours on a given day, would closing occur prior to the close of business, within a few hours?

[2] In these instances, initial purchasers who wish to trade prior to two business days before the closing of the initial trade will be required to specify an alternative settlement cycle to prevent failed settlements.

[3] Similarly, for purposes of Sections 12(a)(2) and 17(a)(2) of the Securities Act, Rule 159 provided that information conveyed to the purchaser after the time of sale (including in a final prospectus) would not be taken into account.

[4] Rule 172 of the Securities Act provides an exemption from the provisions of Section 5(b)(1) of the Securities Act for written confirmation of sales and an offering pursuant to a registration statement that contain information limited to that called for in Rule 10b-10 under the Securities Exchange Act of 1934 and other information customarily included in written confirmation of sales of securities, including pricing, allocation and settlement, and information incidental thereto, which may include notices under Rule 173. Among other conditions, the issuer must file with the SEC a final prospectus or make a good-faith and reasonable effort to file one within the time periods prescribed by Rule 424. Similarly, under this “access equals delivery” model, the prospectus delivery requirements of Section 5(b)(2) are in many instances satisfied if the issuer files with the SEC a final prospectus or makes a good-faith and reasonable effort to file one within the time periods prescribed by Rule 424.

[5] Under Rule 173, issuers, underwriters or dealers that are subject to final prospectus delivery requirements are required to provide purchasers either a final prospectus or notice to the effect that the sale is made pursuant to a registration statement or in a transaction in which a final prospectus would have been required but for the provisions of Rule 172. Such notices are exempt from the provisions of Securities Act Section 5(b)(1), which means that delivery of a Section 10 prospectus is not required.

Under Rule 174, dealers may rely on this access equals delivery rule to satisfy any aftermarket delivery obligations.

[6] It is worth noting that such a change would not be unprecedented; the SEC has, in prior rules, effectively done away with the need to prepare and deliver a final prospectus in response to operational burdens. Rule 434 under the Securities Act effectively permitted the use of preliminary prospectuses and term sheets in lieu of final prospectuses in connection with certain offerings, but was eliminated in 2005 because of its rare use and because of new rules regarding free writing prospectuses that permitted the use of written descriptions of the terms of the issuer securities or of the offering under more flexible circumstances. As originally conceived, however, Rule 434 was intended to "ease the burden [of] prospectus delivery within the T+3 settlement cycle by permitting delivery of final prospectuses to be made in multiple documents at different intervals in the offering process." Similar considerations would arise with "T+0".

As enacted, Rule 434(a)(1) provided that the preliminary prospectus, including a prospectus compliant with Rule 430A, when considered with the term sheet that would describe the terms of securities and all material changes to the registrant's affairs, would constitute a final prospectus for purposes of Sections 5(b)(1) and 5(b)(2) if, for example in the context of a shelf offering, a preliminary prospectus and term sheet, taken together or separately, were filed with the SEC on or prior to the date on which a confirmation was sent or given. No final prospectus as initially understood by Section 10(a) was required to be delivered to investors, or, seemingly, prepared.

[7] Rule 15c2-8 under the Exchange Act also requires broker-dealers to provide final prospectuses to customers and other parties under certain circumstances.