Financial Institution Compliance Update

May 24, 2016

This communication is designed to provide you with quick snapshots and timely perspectives on recent regulatory developments.

Overview of T+2 Implementation

Background

The settlement period for most securities in the U.S. is Trade Date plus 3 business days, commonly referred to as "T+3". The financial services industry, in coordination with regulators, is planning to shorten the settlement cycle to Trade Date plus 2 business days, or "T+2", by the 3rd quarter of 2017. The products subject to the shortened settlement cycle include equities, corporate bonds, municipal bonds, unit investment trusts and financial instruments comprised of these securities.

There are multiple benefits for U.S. broker/dealers moving to T+2 including:

- reduced credit and counterparty risk
- operational process improvements
- increased cash efficiency
- more liquidity
- lower collateral requirements and
- enhanced global settlement harmonization

These benefits would make U.S. broker/dealers compatible with the 23 European countries that already moved to a T+2 settlement cycle in October 2014.

Relevancy

The T+2 Industry Implementation Playbook issued on December 18, 2015 provides a detailed guide on the T+2 readiness initiative broken into three (3) main components:

1. Trade processing
2. Asset servicing (Dividends and Reorganizations)
3. Documentation (including remedial activities)

1. **Trade Processing** consists of four (4) subsections and are defined as follows, with 4th quarter 2016 suggested milestone timeframes to meet the target date of 3rd quarter 2017:

   a) **Trading systems and reference data** – Firms will need to reconfigure trading systems to allow for a T+2 settlement cycle. Firms should consider conducting a risk assessment early in the implementation phase to identify resource needs as well as any additional trading hardware and software expenses.

   In addition, funding processes for both institutional and retail customers and their payment systems (e.g., Automated Clearing House) should be reconfigured to allow for T+2 settlements.

   Foreign exchange policies and procedures should be reviewed to ensure that the exchange of currency is scheduled to coincide with the shortened settlement cycle.

Systems for the Depository Trust and Clearing Corporation's (DTCC) Fund/SERV (Mutual funds) processing and the National Securities Clearing Corporation (NSCC) for Exchange Traded Funds (ETF) systems must also be reconfigured to allow for T+2 mutual funds/ETF settlement. Firms will have to work with NSCC, DTCC's subsidiary, and DTCC itself on the conversion.

Firms that use other trade-matching systems should coordinate with their vendors (e.g., Financial Information Exchange and Society for Worldwide Interbank Financial Telecommunications) to evaluate trade order management and trade-capture processes in order to be ready for T+2 implementation.

Firms should also be developing test plans as part of their preparation.

b) **Trade matching** – Firms using NSCC's Real Time Trade Matching system which covers corporate bonds, Unit Investment Trusts, and Munis must be matched no later than 11:30 AM on T+2 in order to settle timely. For Omgeo (vendor) processing for equities via the Depository Trust Company (DTC), a subsidiary of DTCC, NSCC, Continuous Net Settlement (CNS) and exchange traded derivatives, matching must take place no later than 12PM on T+1.

c) **Trade affirmations** – Affirmed trades must be submitted to Omgeo by 12 PM on T+1. NSCC's CNS and the Institutional Delivery Netting systems (a joint service of DTC and NSCC) must be adjusted as well to support the 12PM on T+1 cut-off for affirmed trades.

d) **NSCC Envelope Settlement Services (ESS) processing/physical securities** – Firms that participate, must assess their current processes and platforms in order to be able deliver physical securities no later than T+2.

2. **Asset Servicing** (Dividends and Reorganizations) consists of two main subsections with 4th quarter 2016 suggestive milestone timeframe.

   a) **Dividends** – Firms must adjust the ex-date period for regular way calculations and modify the due bill period calculation for regular way and irregular dates. Firms must also adjust the ex-date notification announcement systems for T+2 settlements to ensure proper entitlements are captured for corporate action events.

   b) **Reorganizations** – DTC needs to review its Participant Tender Offer Program and the Participant Subscription Offer Program to ensure the (cover/protect) date is the offer expiration date plus two business days. Firms need to adjust their internal systems as well in order to synchronize with DTC. Firms and CNS must modify their voluntary reorganization processing of applications for T+2 settlements.

   Additionally, Firms and DTC must adjust their interim accounting processes to allow for income entitlements (e.g., stock loan and repo income tracking).

3. **Documentation** – There are 4 main sub-sections regarding documentation requirements to allow for T+2 that Firms need to prepare for. The 4 sub-sections are customers' statements, service agreements, operating procedures, and internal controls and both customer education and staff training materials.

   a) **Customer statements** need to include customer communication references as to T+2 settlements.

   b) **Service agreements** (bi-lateral contracts) between Firms and their vendor and service bureau relationships need to be adjusted to allow for T+2 settlement.

   c) **Operating procedures and internal controls** – Compliance and procedure manuals need to be updated to reflect T+2 settlements.

d) **Customer education and staff training** – Firm websites showing news info need to be updated to educate customers on the T+2 settlement cycle and the impact it has on customers (e.g., limited cash float). In addition, internal policies and procedures, vendor training materials as well as compliance manuals and training programs will also need updating.

Recommendations

We recommend Firms revisit the processes noted above and develop a Risk Assessment Program (RAP). The RAP is an essential tool in order to aid Firms in better understanding their current and future state (T+2) risk and control environment. It will also provide Firms with action plans to address any gaps or enhance less-than-adequate controls to achieve T+2 readiness. Specifically, here are some measures Firms can take to enhance their T+2 RAP:

- Develop a risk assessment methodology that identifies all the business users impacted from a T+2 conversion (e.g., Trading, Middle Office, Compliance, Operations, Technology, service bureaus and vendors). Those impacted areas need to self-assess on the applicability and level of impact of a T+2 conversion in their Risk Control Self Assessments.
- Upon identification of the users impacted, those users − along with the department(s) driving (designated committee) the RAP from inception to day of conversion − need to draft detailed written overviews or process flows (process overviews) on their respective business models for the three sections discussed above.
- Process overviews should include each business' line management input (e.g., front office to back office) to provide in-depth knowledge of processes, controls, products, services and markets that would be impacted by T+2.
- All process overviews should list key risks, controls and gaps as they pertain to a T+2 conversion.
- Schedule technology meetings with designated management and users of the T+2 RAP. Meetings should communicate the results of the identified risk, controls, risks and gaps. Gaps should be tracked for their timely and complete resolution throughout the T+2 RAP.
- Firms also need to research, examine and communicate with all their impacted vendors and service bureaus on a defined time table as to their readiness for T+2.
- Broker/dealers should be made aware of the timelines documented in vendor and service bureau project plans in order to coordinate parallel strategies and efforts with their T+2 RAP.
- The aforementioned process overviews identified key risk controls and gaps for users and the designated committee should also apply to both vendors and service bureaus.
- As controls are created and/or enhanced, scheduled user testing that includes impacted proprietary and hosted vendor applications should be performed.
- Testing vendor applications that are hosted offsite should also take place.
- User testing should be conducted in a non-live environment.

Additional T+2 readiness awareness

- Firms should also periodically send advance notices to their customers to keep them abreast of the changes ahead and how they'll be impacted.
- Throughout the entire initiative, Firms should determine the feasibility of exploring opportunities to leverage the EU's T+2 experiences.

Summary

Firms should document from the above bulleted tasks how the inherent risks, control effectiveness, and (ultimately) residual risk factors interplay in order to compute an overall risk score which can be balanced against the financial institution's risk appetite.

How Experis can help

Experis Finance offers industry experience in all aspects of broker/dealer activities including Trading, Internal Audit, Compliance, Operations and Technology. Our Risk Advisory Services, and in particular our broker/dealer subject matter experts can assist in conducting interviews on the various users to be impacted by T+2. Experis can create/assist in creating process flows and help identify the key risks and controls as well as any gaps in your organization as it pertains to becoming T+2 compliant by September 30, 2017. Moreover, we can partner with user groups and designated departments to help address identified gaps and control enhancements. Experis can also assist in writing new and/or updated procedures and then implement action plans throughout various phases or migrations. We can also independently test new or enhanced controls during migration phases and report results to the designated committee and senior management users.

Our team of professionals is experienced in working with clients to address these issues in order to help them successfully avoid costly fines and penalties. If you have any questions about or concerns about your implementation of these steps, contact an Experis representative at financialservicesindustry@experis.com or visit our website Experis Finance.