KPMG

T+2 and You

Considerations for the Equity Administrator

By Leann Balbona, Global Incentive Compensation Services; Karen Field, Washington National Tax; and Turgay Mehmet, Advisory, KPMG LLP

Trade date plus three business days (T+3) is shortly about to change to T+2 later this year. The financial industry has been gearing up for this change for some time. What should corporate issuers and equity managers consider as they are faced with one day less to settle equity awards?

Background[1]

Prior to this time, settlement for certain securities and asset classes moved from trade date plus five business days (T+5) to T+3 in 1995. Part of the reason for the change was due to certain market-facing activities and the market crash on October 19, 1987. In response to these events, the Securities and Exchange Commission (SEC) adopted Rule 15c6-1 under the Securities Act of 1934, shortening the settlement (i.e., when securities are available to the employee plan participant) to no later than T+3.

The Depository Trust & Clearing Corporation (DTCC) was formed in 1999 as a holding company to combine The Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC). The financial crisis of 2008 brought further regulation to the financial industry and for financial instruments.

In April of 2014, DTCC recommended shortening the U.S. trade cycle from T+3 to T+2. The DTCC partnered closely with market participants and industry organizations where both an Industry Steering Committee (ISC) and working group were formed to study and prepare for this major change.[2]

The ISC is cochaired by the Securities Industry and Financial Markets Association (SIFMA) and Investment Company Institute (ICI). The ISC oversees the Industry Working Group (IWG) and Sub-Working Groups (SWGs). These groups were responsible for assessing the scope, requirements, and changes needed to facilitate the implementation of T+2.

Both the ISC and IWG are composed of senior-level representatives from industry associations and firms that represent various segments of the industry. The mission of the ISC is to provide guidance, direction, and support as the industry moves toward a two-day, or T+2, settlement cycle.[3]

The SEC issued a Proposed Rule to change the settlement period for broker-dealer trades. The Proposed Rule, published in the Federal Register on October 5, 2016, would change the settlement period for broker-dealer trades from three days from the trading date (T+3) to two days from the trading date (T+2).[4] A concerted effort between government and industry is underway to prepare for T+2 settlement.

Effective date for T+2

The effective date proposed is September 5, 2017,[5] subject to regulatory support and completion of industry-wide testing in the second and third quarters of 2017. However, equity administrators should continue to monitor the final effective date and regulations being considered in this area.

---

[1] For an in-depth discussion, see *T+2 Industry Implementation Playbook* dated December 18, 2015, prepared by Deloitte & Touche LLP in conjunction with the ISC and as commissioned by the SIFMA and ICI.

[2] See the *DTCC Recommends Shortening the U.S. Trade Settlement Cycle* dated April 2014.

[3] See U.S. T+2 ISC members at UST2.com.

[4] 81 FR 69240

[5] See UST2.com, Frequently Asked Questions, *What is T+2?*

Where has T+2 already been adopted?[6]

Outside the United States there has been a concerted effort to arrive at T+2 settlement. Starting in October 2014, 23 EU member states adopted T+2.

Austria	**Italy**
Belgium	**Latvia**
Czech Republic	**Lithuania**
Cyprus	**Luxembourg**
Denmark	**Netherlands**
Estonia	**Norway**
Ireland	**Portugal**
Finland	**Slovakia**
France	**Sweden**
Greece	**Switzerland**
Hungary	**United Kingdom**
Iceland	

In Q4 2015, Spain adopted T+2, followed by Australia and New Zealand in March 2016. The United States and Canada plan to adopt T+2 in Q3 2017, and Japan is considering.

Note that settlement cycle time is dictated by where the underlying security is settled.

Asset classes impacted

The in-scope assets include the following:

- Equities
- Corporate bonds
- Municipal bonds
- Unit investment trusts
- Other instruments (American Depository Receipts (ADR), Electronically Traded Funds (ETF), Exchange Traded Products (ETP), mutual funds, options, rights, and warrants).

Equity professionals should review the awards offered by their organization and confirm which asset classes will be impacted by the settlement cycle change.

In the United States, the main asset class where we are seeing impact is with nonqualified stock options that many U.S. SEC registrant companies grant to their employees.

Internal Revenue Service – U.S. payroll

Proper handling of withheld payroll taxes from equity compensation is already challenging. Under the next-day withholding Rule, when an employer withholds more than $100,000 in employment taxes, these withheld amounts must generally be remitted to the Internal Revenue Service (IRS) the next business day after settlement (with a slightly different rule for employee stock option deposit timing).[7] The IRS has been successfully collecting penalties for employer failures to timely deposit equity withholding for stock options under the next–day rules, currently T+4.

The IRS borrowed the T+3 concept for the timing of withholding for stock option plan exercise, allowing a broker T+3 for delivering the shares or cash to an employer so the employer can deposit stock option withholding with the IRS (discussed further below).[8]

While the IRS has not yet commented on the rule change, the SEC's T+3 rule[9] was the maximum length of time allowed to settle stock options and thus the trigger point for the next-day withholding deadline.

Therefore, if the T+2 rule goes into effect as proposed, the time for an employer to settle stock options will be reduced by one day, which will in turn accelerate the next-day deposit requirement by one day. Under the new T+2 rule, the employer may have to remit these taxes by no later than three days from exercise (two days from exercise to settle the trade, and the next-day to remit the taxes), meaning that U.S. tax deposits will be due on T+3. This is still a longer period of time than is allowed for most equity compensation, such as restricted stock awards or restricted stock units, where the IRS generally requires next-day withholding where the aggregate payroll withholding for awards for a given day exceed $100,000.[10]

Where employees expect to redeem company shares through a broker in order to pay for other expenses, this new rule may actually be helpful, shortening the timing to complete the sale and transfer of proceeds.

Equity professional considerations

As the equity manager looks to this change in settlement date coming in the very near future, there are some areas where companies may want to focus in the coming months to help ensure that proper documentation, communication, and systems are up to date and operational to support T+2 settlement plus contingency plans for IT systems and interfaces.

---

[6] For an in-depth discussion, see *T+2 Industry Implementation Playbook* dated December 18, 2015.

[7] See IRC Code Section 31.6302-1(c)(4) and for an in-depth discussion on equity compensation withholding, please see: Scott Schapiro, Carlo Osi, Karen Field, Terri Stecher, and Kelli Cacciotti, "Late Deposits of Federal Employment Taxes for Equity Compensation Transactions—Pitfalls to Avoid", *What's News in Tax*, - July 25, 2016.

[8] Ibid.

[9] IRS Field Directive, March 14, 2003 Memorandum, *Assertion for the Penalty for Failure to Deposit Employment Taxes.*

[10] Ibid.

Some areas of attention include the following:

- Documentation
- Service Level Agreements (SLAs) with vendors
- Systems and interfaces
- Communication
- Payroll
- Treasury
- Mobile population.

Documentation

Certain key documentation should be reviewed and updated to address shorter settlement prior to September 2017. Some areas to consider are as follows:

- Plan documents
- Terms and conditions
- Internal control procedures
- Process maps
- Brochures and FAQs
- Online help guides.

SLAs with vendors

Many times companies have turnaround/cycle times as part of their SLAs with share plan administrators, tax, and other vendors. Evaluate these current SLAs in light of the new settlement rule coming. Consider adjusting to address and meet the new T+2 settlement.

Systems and interfaces

Companies and their vendors should be going through or planning for rigorous testing to help ensure that T+2 settlement can be achieved. If there are interfaces involved with your systems or between your vendors (share plan administrator and tax), the timing of these interfaces should be reviewed and in certain cases adjusted if necessary. Further, evaluation of "rainy day" contingency plans should be evaluated. We have seen cases where secure e–rooms or having a default tax rate on file for settlement can help with ensuring there is no disruption to your settlement process.

Communications

Internal communications to your key stakeholders in the company and plan participants is critical. Further coordination and communication between finance, treasury, and payroll teams both within and outside the United States should be considered a priority to be in a state of readiness prior to September 2017.

Payroll outside the United States

Companies will want to coordinate with local country payrolls to assess the potential impact of the shorter settlement cycle and work with them to help ensure they have adjusted their documentation, procedures, and processes to address payroll deposits. Payroll reporting and deposit deadline dates vary by country.

Treasury

Treasury stakeholders will also need to be alerted and work closely with equity professionals since they are typically moving funds around to help settle awards and pay taxes in local countries.

Mobile population

With mobile employees, gathering the necessary information to determine their tax rate continues to be a challenge for companies. Having one less business day to process transactions that fall under the reduced settlement period could introduce new challenges.

Having a shorter lead time to secure accurate data to process these types of awards, companies should consider looking at an automated solution given T+2 is a hard settlement date.

How KPMG can help

While a day may not seem like a huge shift, it is a change that corporate issuers and their equity administrators should be addressing. Moving to a shorter settlement allows for the benefit of faster cycle time to provide awards to your employees, achievement of earlier settlements that many broker-dealers are already doing, and improved global alignment of settlement.[11]

This rule change can affect many parts of your company's equity program, from documentation, communication, systems, and the payroll withholding approach for employers that are using the T+3 rule for stock options under the IRS next–day withholding deposits rules.

KPMG professionals can advise employers and equity and payroll administrators while also helping companies evaluate that payroll systems or withholding practices are in compliance with IRS requirements before the change becomes effective. We can also assist with an overall review of equity plan administration processes, help identify process improvements, and help mitigate risk on withholding deposit timing.

[11] See the *DTCC Recommends Shortening the U.S. Trade Settlement Cycle dated April 2014.*