***The Consumer Finance Podcast*: Imminent Shift: Preparing for the T+1 Settlement Impact on Equity-Based Compensation**
Host: Chris Willis
Guest: Sheri Adler
Date Aired: May 23, 2024

Chris Willis:

Welcome to *The Consumer Finance Podcast*. I'm Chris Willis, the co-leader of Troutman Pepper's Consumer Financial Services Regulatory Group. Today, we're going to be talking about a recent change in securities law that has a surprisingly important impact on employers giving equity grants to their employees, which of course, many financial services companies do.

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I said today we're going to be talking about a recent change in securities law. Of course, this reminds me of why I like being at Troutman Pepper so much because our financial services industry team really has the expertise to handle any need that a financial services company has from the kind of consumer financial services stuff that I normally have on the podcast to employee benefit issues and everything in between. Joining me today to talk about this important employee benefit issue is my partner, Sheri Adler, who's been on the podcast lots and lots of times.

Sheri, welcome back and thanks for being here again today.

Sheri Adler:

Thanks so much for having me, Chris. Looking forward to it.

Chris Willis:

What we're talking about today is the recent securities industry shift to shorten the deadline for settlement for broker-dealer transactions from two business days after the trade date, which has

historically been called T+2, to one business day after the trade date T+1, which goes into effect on May the 28th. Sheri, can you give us some background on that?

Sheri Adler:

Sure. That's right, Chris. In May of 2023, the SEC adopted rule amendments to shorten the standard settlement cycle for most broker-dealer transactions from two days to one day post-transaction. The idea was a focus on promoting investor protection, reducing risk, and increasing operational and capital efficiency. Looking back on the history of this over the 20th century, in the 1920s, the capital markets actually had a one-day settlement cycle for transactions in securities, so where we are going back to.

Over the 20th century, it grew to five days, given the growing number of investors, the rising volume of transactions, and increasing complexity of the infrastructure that was needed to settle these transactions. Since the late 1980s, the SEC has been working with the securities industry to minimize the time it takes to settle securities transactions in an effort to protect investors and reduce risk. In 1993, there was a move from the prevailing practice of five days, T+5, to three days, T+3, and then in 2017 down to T+2. Now, here we are moving to T+1. Everyone gets really scared when we talk about potentially one day moving to T+0, so we won't even go there.

According to the SEC, the move now to T+1 is in part informed by episodes that happened in 2020 and 2021 of increased market volatility. It highlighted potential vulnerabilities in our US securities market. For example, in March 2020, following the outbreak of COVID, there was market volatility. In January 2021, there was heightened interest in certain meme stocks, which ushered in volatility as well. Those shares of stocks that we all remember that went viral based on social media with very high prices, high trading volume in a short period of time. The fear is that investors can experience a big loss if the stocks become overvalued, and the price dramatically plummets.

All of this was informing the SEC's consideration of shortening to T+1 as it explains in its rule-making.

Chris Willis:

Okay. Obviously, the shortening of the settlement time will be of interest to broker-dealers. But we're not here to talk to broker-dealers today, and you're not a broker-dealer lawyer. Of course, neither am I. Rather you're an employee benefits and executive compensation lawyer. Let's give the audience the connection. How does the T+1 settlement period being shortened impact your practice as an executive compensation lawyer?

Sheri Adler:

Chris, great question. As everyone knows, public companies, including financial institutions, tend to compensate their executives and high-level employees in part in equity-based awards. These are the types of awards that we work on all the time. When shares underlying one of these awards are delivered to an employee, the company has a tax withholding obligation. Generally speaking, the timing of the tax withholding rules piggybacks off the securities settlement timing rules.

What that means is if there's less time to settle an equity award under the securities rules, there will be less time to pay the withholding taxes to the IRS for that award. That's the connection at a high level. I will note that in theory, the SEC's T+1 settlement timing rules wouldn't apply to transactions that are purely between the issuer and the employee, where there's no open market transaction. For example, the settlement of an RSU or a restricted stock unit, where there's no open market sale to fund withholding taxes, it's being funded internally from share withholding at the company.

At the same time, it doesn't seem to be of much practical import because most of our clients use brokerage firms to help manage their equity systems, and the industry as a whole is generally moving to a T+1 timeline. The IRS guidance which was put out under the old T+ 2 framework, that helps us to understand when withholding is due for the settlement of an equity award. It generalizes and it really keys the timing off of the T+2 security settlement rules, whether or not an open market transaction is involved.

We have made the assumption for the purposes of this discussion that companies as a general rule are going to move to T+1 after Memorial Day for the settlement of their equity awards, and we're going to discuss how that impacts the timing for paying withholding taxes without differentiating for the purposes of this discussion between various different withholding methods.

Chris Willis:

Okay. Well, let's take a step back. For the most common types of equity awards that you see in your practice, when does the tax become due?

Sheri Adler:

Good question. Let's start with non-qualified stock options. You're granted a non-qualified stock option no tax. No tax on grant. You vest. You now can exercise a portion of that option, still no tax liability. Then you decide, okay, I am going to exercise. That is when the tax liability arises, and you're taxed on the spread, meaning the difference between the fair market value of a share upon the exercise day over the exercise price that was paid, which is generally the fair market value on the grant date, right? So the differential between the value today and the value on the grant date. Generally, stock appreciation rights are also taxed at exercise. They work very similarly. That's options.

We also have restricted stock. These are actual shares that are transferred subject to forfeiture conditions. So subject to, let's say, time-based vesting over time. Here, the default is there's no tax on grant, but these are taxed upon vesting based on the fair market value at the time. That said, you have the option to make an 83(b) election within the first 30 days of grant which means that you're opting in to be taxed in full upon grant. In which case, there's no subsequent tax upon vesting. You're taking it all into income upfront.

Third very common type of equity award are restricted stock units or RSUs. You see these both as time-based and as performance-based vesting conditions. In those types of awards, these are a promise to pay shares in the future, assuming that certain vesting conditions are met. There, there's no tax on grant. Technically speaking, there's no tax on vesting. The tax arises when the award is settled based on the fair market value at that time. In other words, when the shares are delivered. Sometimes, this is right after vesting. But sometimes, there's a deferral in

place, and the awards are not settled until years later, maybe separation from service or retirement.

We actually get questions on this a lot because people assume that tax is due immediately on vesting and that the award has to be settled right away on the vesting date. Usually, if you look at an award agreement, there's some flexibility there. For example, it might say, “We will settle this award within 30 days of vesting.” Again, the income tax liability, it doesn't arise until the settlement process begins. I'll just make one caveat which is that for non-qualified deferred compensation, FICA tax could be due earlier.

Chris Willis:

We know that a company has to withhold taxes when tax become due for an employee. What are the different methods for withholding?

Sheri Adler:

Well, the simplest method is cash. The employee writes a check, or amounts are withheld from cash wages. That's the easiest way when you're paid in cash, right? Just hold back some of that cash. We all see that on our pay stubs all the time. For an equity award, you can't pay tax and shares to the IRS. You need to pay cash. Here, the employee would actually need liquidity in order to pay that withholding liability in cash to the company, so the company can remit it to the IRS. That's why it's not very common of big public companies to require this, right? You'd be asking people to write a check when they get their equity awards.

Two other methods which are used involve payment and shares. One is net settlement or share withholding. In that scenario, shares from the award are held back to cover a withholding obligation, and only the net amount of shares are delivered to the individual. Again, the company can't pay tax and shares to the IRS. So even if the company is holding back a certain amount of shares and only delivering the net amount to the employee, the company still needs liquidity and cash reserves, so it can transmit the cash to the IRS to fulfill the withholding obligations.

The third method is sell to cover. Here, a broker sells enough shares on the market to cover tax withholding. It's an open market transaction. This solves the liquidity problem for the employee and the employer. Because no one has to come up with the cash to remit to the IRS, the shares are sold on the open market to fund the withholding liability.

Chris Willis:

Okay. We know what the different methods are for the withholding. When does the employer have to pay the federal income tax that's been withheld to the IRS?

Sheri Adler:

Generally, the employer has a certain deposit period during which all the tax liabilities are accumulated. Then they're paid by a certain due date. There's this very important next-day deposit rule which says that if an employer accumulates $100,000 or more in taxes on any day

during a deposit period, it has to deposit the tax by the next business day, regardless of the normal schedule.

Chris Willis:

Okay. Are there penalties for doing this deposit late?

Sheri Adler:

Yes. They range from 2% to 15%. They go up. It's based on the number of days that the company is late.

Chris Willis:

That sounds significant. How does the next-day deposit rule work for withholding on equity awards?

Sheri Adler:

That's a great question, Chris, because that's the crux of this issue. When does the company need to remit the taxes for an equity award to meet the next-day deposit rule? Under the prior SEC rule, companies generally had, as we know, T+2 days to settle broker-dealer securities transactions. Meaning if the company initiated settlement of an RSU on a Tuesday, that was T or the transaction date, it had until Thursday, T+2, to deliver the shares for that award into the employee's brokerage account.

Note that the amount of the withholding liability that arose is tied to the T date, the Tuesday date, the date the RSU settlement was initiated or the stock option was exercised. We know that the employer under the old rule had until Thursday, T+2, to deliver shares. We know that the amount of the withholding liability was determined based on Tuesday or T. But when did the employer actually have to remit the cash to the IRS?

Under IRS guidance from 2020, companies were generally considered in compliance with the next-day deposit rule if they deposited the withholding the day after the award settled, so long as the award settled within two business days. In our example, the company would have been in compliance if it deposited the withholding to the IRS by Friday or T+3, the day after the transaction fully settled in the brokerage account on Thursday. In other words, they didn't have to remit the taxes the day after the initiation of the settlement which would have been Wednesday, but they had until the day after the completion of the settlement transaction, so Friday.

Chris Willis:

Okay. Now, I see what we're getting to in terms of what this rule change means because now the SEC has changed settlement requirements from T+2 to T+1. What does that mean for equity plan administration then?

Sheri Adler:

Right. Assuming that no new IRS guidance comes out and we're still going off of all this guidance from 2020, what that means is that if the company initiates settlement of the RSU on a Tuesday, like our example, and if it needs to have shares in the employee's brokerage account by Wednesday, T+1, then under the current IRS guidance as it stands, the company has to pay withholding by Thursday, the day after the award settles to meet the next day deposit rule. We've now shortened our timeline by one day.

Chris Willis:

What practice pointers do you have for companies that are getting ready to implement this T+1 change with respect to their equity award programs?

Sheri Adler:

Yes. Chris, I hear a lot of worry from some companies, just because some companies will say, "Look, it was hard enough to do this when we had on a T+2 timeline to get this done by T+3." Now, on a T+1 timeline to get the equity award withholding done and remitted to the IRS by T+2, there is some nervousness there about how the systems are going to work all together to get this done efficiently.

First and foremost, companies just need to get organized administratively. I've seen a lot of companies that a lot of third-party vendors that are just – there are meetings happening between the stock administrator, treasury, legal, payroll. You want to get all the interested parties involved, so everyone's on the same page to ensure that the process is happening timely. Again, it's the same process, but it's condensed. That may mean that there needs to be tweaks to how this is being done, perhaps more automation.

Another question that from a legal side we've been getting a lot relates to the fair market definition used to calculate withholding. We already talked about how the amount of the withholding liability is tied to the T date. That gets figured out based on the transaction date, the fair market value as of that date. But there's flexibility in the rules as to how to determine the fair market value as of the T date for the purposes of figuring out the withholding amount. In other words, the rules require a reasonable method be used, but they don't say fair market value means closing price on the date of the transaction.

Let's just say that a company is using closing price on the day of a transaction to figure out withholding liability. In that case, if settlement was initiated on a Tuesday, the company couldn't start working out the withholding until Tuesday night after market close because they're waiting for that price. Now, the deposit is going to be due Thursday. If you have a lot of employees that are involved, this can be an arduous process, and that may seem like it's not enough time. But what if a company uses closing price on the day preceding the transaction, so Monday closing price as their fair market value for RSUs that are being settled starting on Tuesday? Then the company can start working on the withholding calculations Monday night. They've gained an extra day.

We have seen companies starting to look at this and consider their methodology for figuring out fair market value and think about whether there's something that they could change, too, that

could help give them a little bit more time that still works within the rules. If this is something a company is looking at, the company will want to make sure that it's being consistently applied across the board, and it doesn't look like they're manipulating the definition of fair market value to get different outcomes in different scenarios. You'll also want to look at the equity plan. You want to see if there's a definition of fair market value for withholding that's hardwired into the plan or not.

Then there's different things we can talk about. Does it require a plan amendment? Can the board amend it? Does it not require a plan amendment? There are various processes we've been talking with clients about from a legal perspective. But I think as a high-level matter, this is something that companies are finding is worth looking at if they're feeling nervous about the time crunch involved in the move to T+1.

Chris Willis:

That is all very interesting. Now, you can really see how big of a challenge this may be for employers that use equity awards to compensate their employees. I'm really glad, Sheri, that you were able to come on the podcast today and let our audience know about these important changes because many of our clients, of course, probably do use equity awards in the financial services industry to award extra compensation to executives or top employees, as you said at the top of the podcast. Thank you for being on today.

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