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Capital Markets, Insurance, and Government Sponsored Enterprises**

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“Effective Regulation of the Over-the-Counter Derivatives Markets”**

Chairman Kanjorski, Ranking Member Garrett and Members of the Subcommittee, my name is Larry E. Thompson, General Counsel for The Depository Trust & Clearing Corporation (DTCC) and I'd like to thank you and the members of the Subcommittee for the opportunity to share with you today our views on the over-the-counter (OTC) derivatives market. DTCC brings a unique perspective to your discussion, as the primary infrastructure organization serving the capital markets in the U.S. and a 36 year history of bringing safety, soundness, risk mitigation and transparency to our financial markets.

As an example, following the Lehman bankruptcy last year, DTCC played a significant role in unwinding over \$500 billion in open trading positions from trades in equities, mortgage-backed and U.S. government securities, without any loss to the industry—and avoiding additional burden on taxpayers.

Today, I'd like to share some insights gained from the financial crisis of the past year and to emphasize one fundamental policy point, to which I will return later in my testimony. Fragmentation of data in the financial industry can impede the ability of regulators to protect investors and the integrity of the financial services system as a whole. These core policy goals are advanced when information on trades are held on a centralized basis. DTCC has long done this for all domestic trades of equity and other securities. In recent years, it has been asked to do this by most market participants for credit default swaps (CDS), one type of OTC derivative contract. As a result, DTCC has become a primary resource for regulators needing information on such contracts at times of crisis.

We believe maintaining a single trade repository for OTC derivatives contracts is an essential element of safety and soundness for two primary reasons. First, it helps assist regulators in assessing systemic risks, thereby protecting consumer and financial markets. Second, as a practical matter, it provides the ability from a central vantage point to identify the obligations of trading parties, which can speed the resolution of these positions in the event of a firm failure, as we found last year in the case of Lehman Brothers. Today, we are working closely with market participants to meet commitments that were recently made to the Federal Reserve and other global regulators to register all remaining unregistered CDS trades in our Trade Information Warehouse by July 17th -- a deadline we fully expect to meet.

However, there is no absolute assurance a single trade repository for OTC derivatives will be retained unless that public policy objective is expressed in law. While DTCC supports the role of central counterparties (CCPs) in OTC derivative trading to provide trade guarantees, the CCPs do not obviate the need to retain the full details on the underlying trading positions in a central trade repository to support regulatory oversight and transparency in this market.

Now, many of you may not have heard of DTCC before. That's purposeful. We have traditionally kept a low profile, given the critical nature of the role we play in U.S. financial markets. Last year DTCC settled \$1.88 quadrillion in securities transactions across multiple asset classes. We essentially turnover the equivalent of the U.S. GDP every three days—and we provide the post-trade processing efficiency and low cost that attracts investment capital that helps fuel the U.S. economy.

DTCC, through its subsidiaries, provides clearing, settlement and information services for virtually all equities, corporate and municipal bonds, U.S. government securities, mortgage-backed securities, commercial paper and other money market instruments, and over-the-counter derivatives. In addition, DTCC has supported the enormous growth and consumer choice in the purchase of mutual funds and annuity transactions, by linking funds and carriers with the firms who market these products. Lastly, DTCC's depository is the largest securities depository in the world, providing custody and asset servicing for 3.5 million securities issues from the United States and 110 other countries and territories valued at \$30 trillion.

Equally important, we are a market-neutral, member-owned and governed organization. We are regulated by the SEC, the Federal Reserve Board of Governors and the New York State Banking Department for many of our activities.

DTCC's Roots: Founded at a Time of Crisis

DTCC, throughout its history, has played a central role in helping our financial markets during a period of crisis. Our subsidiaries, The Depository Trust Company (DTC) and National Securities Clearing Corporation (NSCC), were created in the 1970s to help address the famous paperwork crisis on Wall Street, when thousands of messengers carried bags of stock certificates and checks to settle trades and recordkeeping strains

forced the New York Stock Exchange to shut down on Wednesdays to process the backlog of trade records. During this period the NYSE traded an average of 15 million shares daily. Today, across the 50+ equity markets DTCC supports, we can have 19.3 billion shares traded in a single day. In the mid-1980s, we implemented similar protections for the U.S. Treasury markets, providing automation and processing safeguards to protect the certainty and attractiveness of trading in U.S. Government securities. In the late 1980s, we removed the barriers preventing the growth in sales of mutual funds—and providing U.S. investors with unprecedented choice and low cost.

At its core, DTCC is a huge data processing business, involving the safe transfer of securities ownership and settlement of trillions of dollars in trade obligations, under tight deadlines every day. At the same time, DTCC's primary mission is to protect and mitigate risk for its members and to safeguard the integrity of the U.S. financial system. Mitigating risk means we not only have the capacity to handle unpredictable spikes in trading volume, but that we have the business continuity and resiliency to withstand both the "unthinkable" –and even the "unknowable."

Not to digress, but to give one example. At the time of one of our nation's darkest tragedies, immediately following the September 11 attacks, DTCC was 10 blocks from the World Trade Center. While the stock exchanges did not open, DTCC still had a job to do and never missed a beat. Despite the chaos that Tuesday morning, nearly 400 employees remained at DTCC's headquarters, even though lower Manhattan was sealed off by the government, to complete that day's settlement of more than \$280 billion in outstanding trades from the prior Friday and Monday. And throughout that week, working from backup facilities, DTCC had completed settlement of nearly \$1.8 trillion in trades that were in the "pipeline", which was a critical step to allowing our capital markets to open the following Monday.

The crisis following the Lehman bankruptcy was equally challenging. However, because of our ability to manage risk and see exposure from a central vantage point across asset classes, DTCC was instrumental in helping ensure that market risk – and systemic risk – was controlled. Working with market participants and regulators, DTCC successfully closed out over a half trillion dollars in exposure from Lehman's trading in equities, mortgage-backed and U.S. government securities. Most would agree this was the largest and most complex wind-down in DTCC's history, but with nearly 36 years of experience in managing risk events, we were able to complete this wind down in a matter of a weeks with no impact to DTCC's retained earnings, loss to our market participants' clearing fund deposits—or additional exposure to taxpayers.

Bringing Automation and Efficiency to OTC Derivatives

As I've testified, DTCC's help has always been sought by market participants and regulators, in response to crisis, and this holds true for the OTC derivatives market as well. By 2003, the market for OTC credit derivatives had taken off, but only 15% of the trades were being captured electronically. The trading process was manual and error-prone. Both the global dealers and regulators felt the market for these instruments faced growing risks, if a solution was not found. DTCC was asked to develop and we delivered

an automated matching and confirmation system, called Deriv/SERV, within nine months. Today, over 95% of all OTC credit derivatives are captured in this automated environment and matched by Deriv/SERV, an average of 41,000 transactions per day.

With major dealers making ambitious commitments about improving their operational practices to global regulators, DTCC's collaboration with the industry is continuing to bring a wider universe of the OTC derivatives market on to its electronic matching and confirmation platform, which is helping to significantly reduce the level of unconfirmed trades that remains in the market. These services, I might add, are provided at cost to global dealers or sell-side firms and at no charge to buy-side customers.

However, after entering the OTC derivatives space, it was clear to DTCC and market participants that the downstream process for credit default swaps was another major area of concern. Once credit default swap trades were completed, these contracts could be resold or reassigned multiple times over their five-year lifecycle, but the process for recordkeeping and reconciling these transactions was largely manual.

DTCC launched the Trade Information Warehouse in November 2006, to provide an automated central repository to house and service all CDS contracts. During 2007, working with the industry, DTCC updated the Warehouse with information on over 2.2 million outstanding CDS contracts, and our Deriv/SERV matching engine is now supplying the Warehouse with more than 41,000 transactions daily. Today, our Trade Information Warehouse is the only comprehensive data base or repository of OTC derivative activity in the world.

I'd submit to you Mr. Chairman, and Members of the Subcommittee, that had DTCC not had the foresight to create this Trade Information Warehouse and load the Warehouse with all these records of CDS trades in 2007, we might still be sitting here today in 2009 trying to sort out the total exposure of trading obligations following the Lehman bankruptcy, i.e., who traded with whom, at what point in time and at what price?

However, our trade repository does more than simply maintain comprehensive records on these CDS transactions. The Warehouse also handles the calculation, netting, and central settlement of payment obligations between counterparties, and it has automated the processing of "credit events" – situations where the protection against default provided by a credit default swap is activated.

Managing Multiple Credit Events from a Central Vantage Point

Since last year, DTCC has now seamlessly processed or is processing, through the Warehouse, more than 40 credit events, including the Lehman Brothers and Washington Mutual bankruptcies as well as the conservatorships for Freddie Mac and Fannie Mae. No one could have foreseen the storm of credit events that shook the market last year and this year, but thanks to the central infrastructure we built for the CDS market and our ability to see and manage these credit events from a central vantage point, ensured a more seamless and safe final disposition of hundreds of billions of dollars in CDS payouts triggered by these bankruptcies and government takeovers.

If I may cite the March 9, 2009 report, prepared by the Senior Supervisors Group, which comprises the senior financial regulatory supervisors from seven major countries, including Germany, France, UK, Swiss, Japan and the U.S.:

"DTCC's credit event processing service enabled firms to manage the large number of affected CDS trades during the recent events. All surveyed participants indicated that without the DTCC service and the [Trade Information Warehouse], the process would have been manual and burdensome and they could not have completed timely processing."

Having all CDS trade information in one centralized infrastructure was highlighted in the report as making it easier for market participants to identify affected trades and facilitate handling of various lifecycle events, such as settlement and credit event processing. In the crux of the crisis, the process of having to glean and coordinate the necessary information from more than one repository would have been a frightening prospect.

Enhancing Transparency

As the only source of key data on the CDS market, DTCC recognizes and supports the public policy goals articulated in U.S. Treasury Secretary Geithner's May 13 Letter to the House and Senate Leadership on the need to promote transparency in the OTC markets.

DTCC has been working closely with market participants and regulators to achieve that vision. Since November 2008, DTCC has been publishing weekly on its website, key statistics and data from the Warehouse on the size and turnover of the CDS market.

Increased public disclosure on CDS data has been instrumental in bringing better clarity to the market's true risk exposures to credit events, which first surfaced following the Lehman Brothers bankruptcy filing in September 2008. At the time of the Lehman crisis, rampant speculation valued the market's CDS risk exposure from the bankruptcy to be as high as \$400 billion, causing unease and a sense of panic in some quarters. Since we held the vast portion of information on CDS positions in our Warehouse, we took the unprecedented step to issue a press release on a Saturday in mid-October to clarify that based on our Warehouse records, the exposure to Lehman was closer to a net notional value of about \$6 billion. Ultimately, at the close of this credit event, the actual value was \$5.2 billion, changed hands between counterparties.

Last week, we issued a similar press release following the GM bankruptcy, reportedly to be the largest for an industrial company in U.S. history, surpassed only in dollar value by the Lehman bankruptcy CDS numbers.

This past Monday, June 8, in the New York Time's Breaking Views Column, the Warehouse was praised for bringing greater transparency on CDS exposure following the GM bankruptcy:

"The vague guesses of four years ago have been replaced by hard data. The Depository Trust & Clearing Corporation, which now collects trading information, was able to say

last week that the \$35.3 billion in outstanding swaps trades on GM netted down to possible payments between market participants of an unremarkable \$2.2 billion.”

Today, when credit events such as GM occur, having this data more readily accessible to the public through our weekly postings has helped demystify CDS instruments somewhat and help avoid the market anxiety that was so pervasive during the Lehman crisis.

Working with Global Regulators

The marketplace for OTC derivatives is truly global in nature, but we would express caution about the proliferation of trade repositories. When we originally designed the Warehouse with market participants, we spent a long time making sure there would be no duplication of data and that transfer of information happens when it is supposed to. None of those control mechanisms would work very well in a context where there is more than one Warehouse. Additionally, every regulator in the world, if it was seeking to ensure the soundness of firms under its purview, would need access to all global central repositories in order to effectively supervise the risks firms were taking. The risks associated with the market for OTC derivatives will not be easily managed, if you can not see the positions globally.

To this end, we regularly provide information to regulators worldwide in support of their own regulatory missions, including the European Central Bank and the Financial Services Authority in the U.K.

Here at home, we also recently filed an application with both the Federal Reserve and the NY State Banking Department to create a new subsidiary to operate the Warehouse, as a regulated member of the Federal Reserve System, aligning ourselves with the direction that our regulators have set and formalizing the interaction that we are already having with regulators in the U.S. and abroad.

Central Counterparty (CCPs) Services and the Trade Warehouse

So with all this good news about our central repository, why are we here testifying before Congress? Well, we are concerned that regulatory calls to require the use of central counterparty (CCP) solutions for standardized derivatives transactions could mislead some to think this, in itself, will provide a complete cure for the problem. As an organization that provides CCP services in other markets, like equities and government securities, we support and recognize the value a CCP can bring to the derivatives markets. In fact, we've stated publicly that our Trade Warehouse will support all efforts to create CCP services planned in the U.S. and overseas, on a non-discriminatory basis.

DTCC is a not-for-profit cooperative that is market neutral. Just as we support over 50 trading venues in equities, including the NYSE and Nasdaq, as a central infrastructure, we are committed to working with all existing and proposed central counterparty solution providers in the OTC derivatives market to achieve this goal. From our perspective, linking to the Warehouse's central infrastructure will not only accelerate implementation of CCP processing for OTC derivatives, it will also allow these service providers to focus

their development more clearly on margining and risk management without any extraneous operational concerns.

At the same time, we are concerned that some in the OTC derivatives market may assume once a trade guarantee is provided through a CCP, there may be less need for a central registry to track the underlying position data. We reject this view, based on our long experience managing the risk flowing from the failure of a single member firm. At the critical juncture of a firm failure, knowing the underlying position data of multiple transactions in a timely manner will be significant in providing transparency to regulators—and in protecting confidence in the market itself. We believe the role of having a central repository should be reinforced as a matter of public policy.

And so, as I wrap up my remarks, I would like to reiterate the importance DTCC places on the progress made to-date with market participants and regulators to foster a sound, safe and transparent OTC derivatives market. Our Trade Warehouse or central registry connects and services over 1,400 global dealers, asset managers, and other market participants, providing a central operational infrastructure covering approximately 95% of all current credit derivatives traded worldwide. This trade repository was designed to be, and we recommend that it be mandated to extend and include other OTC derivative asset classes.

Lastly, recognizing the complex nature of these instruments, DTCC does want to offer to work with the Subcommittee, to foster continuing dialogue and collaboration. DTCC is ready to work with Members of Congress, the Administration, global regulators and market participants to help accomplish our shared vision of greater transparency, risk mitigation and resiliency in this dynamic market. We appreciate your time today and are happy to respond to your questions.

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