



***The Depository Trust &
Clearing Corporation***

REDUCING SYSTEMIC RISK AND ENHANCING MARKET EFFICIENCY IN EUROPE: THE ROLE OF A CENTRAL DATA REPOSITORY

Response by The Depository Trust & Clearing Corporation to the European Commission's consultation on derivatives markets

28 August 2009

Executive Summary

The Depository Trust & Clearing Corporation (DTCC) believes that a single central data repository for each over-the-counter (OTC) derivatives asset class, which supports global trading of these instruments and which European regulators oversee, would address three objectives cited by the Commission and others as critical to the stability and growth of the European economy:

- Enhancing market transparency for regulators and the investing public
- Reducing systemic risk by ensuring regulators can see a firm's underlying position and exposure from a central vantage point
- Promoting a pan-European capital market.

Contracts in the different OTC asset classes can vary significantly. A repository will have to meet the consequent range of needs, reflecting each product's life cycle processing characteristics. However, one requirement that all share is reporting.

A single central data repository, which meets the needs of each asset class and serves Europe, can therefore help to meet the three public policy objectives because:

- Only a single central repository can provide a reliably comprehensive picture of market participants' exposure within a given asset class, and hence the systemic as well as firm risk.
- Multiple unsynchronised repositories within a given asset class, whether in Europe or globally, will result in operational inefficiencies and higher costs for market participants – creating "Giovannini barriers" in the OTC derivatives market and hindering regulators' access to readily usable and reliable data.

DTCC envisages a “global solution” for each asset class. This solution recognises both the global nature of trading in OTC derivatives and the value of a “regional approach” which respects the critical importance of oversight by European regulators, who must safeguard the integrity and soundness of Europe’s financial markets.

A system which is global on a functional and logical basis but provides the necessary legal and physical implementation on a regional basis will:

- Provide market participants and regulators with a global view of risk
- Satisfy regional supervisory policy and legislation
- Avoid unnecessary complexity and the costs of duplicated investment.

Introduction

This paper is DTCC’s response to the European Commission’s Consultation Document “Possible initiatives to enhance the resilience of OTC Derivatives Markets” (SEC (2009) 914 final, 3 July 2009).

We support the thrust of the Commission’s thinking on strengthening derivatives markets.

The first part of this response explains what DTCC is, how a repository works, the advantages of a single central repository, and how such a repository could meet the requirements of regional and national regulators for transparency and safety, while preserving the efficiency of a global market.

The second part contains specific answers to a number of the questions raised by the Commission in its Consultation Document, including those specifically about the role of central data repositories:

- Are there market segments for which a central repository is not necessary or desirable?
- Which regulatory requirements should central data repositories be subject to?
- What information should be disclosed to the public?

About DTCC

The Depository Trust & Clearing Corporation (DTCC) brings to the discussion considerable experience and expertise in the operation of critical post-trade market infrastructures. DTCC has a nearly 36-year history of acting as a market-neutral provider of clearing, settlement and depository services to the financial services industry. The organisation is owned and governed by our members and operated on an “at cost” or not-for-profit basis. DTCC is the product of 20 years of consolidation effort among multiple, competing central counterparties (CCPs) and central securities depositories (CSDs). Our central depository provides custody and asset servicing for 3.5 million securities issues from the US and 117 other countries and territories, valued at

\$27.6 trillion. In 2008, we settled more than \$1.88 quadrillion in securities transactions.

Today, DTCC's customers are increasingly global financial institutions which are headquartered in Europe as well as in the US and handle globally traded instruments. In response to these changes, DTCC is, more and more, developing services to accommodate global regulatory requirements, and now encompass a networked community of thousands of financial firms in dozens of countries.

Throughout its history, DTCC has brought safety, soundness, risk mitigation and transparency to the financial markets. As an example, following Lehman Brothers' bankruptcy last year, DTCC played a significant role in unwinding over \$500 billion in open trading positions from trades in equities, mortgage-backed and US government securities, without any loss to the industry – and saved taxpayers from shouldering an additional burden. We also have a history of working closely with regulators, especially during crises, to support their need for transparency and trade data to more effectively assess and mitigate risk – operational, market and systemic risk.

DTCC has been present in Europe since 1995 and today provides a number of services in Europe. Through our subsidiary, EuroCCP, we are one of the leading pan-European central counterparties in the equities market.

DTCC's Deriv/SERV Matching and Confirmation Service – launched in 2003 – automates the legal confirmation process for OTC derivatives. From a time when only 15% of OTC trades were electronically processed, the share of credit derivatives traded worldwide and captured electronically through Deriv/SERV has risen to 95% today. Recently, DTCC and Markit announced plans to combine their trade confirmation and electronic processing platforms to extend benefits to end users through a newly formed, jointly owned company, MarkitSERV.

In addition, DTCC's Trade Information Warehouse (TIW) – launched in 2006 – is the world's only comprehensive database and repository for OTC credit derivatives. The establishment of this global repository marked the first time that the financial services industry had addressed OTC derivative inventory control and transparency systematically. TIW provides a central automated repository to house and service virtually all credit default swap (CDS) contracts.

At the height of the Lehman Brothers crisis, TIW held a large proportion of the information on CDS positions. Although market speculation put the CDS risk exposure from Lehman Brothers at \$400 billion, DTCC was quickly able to tell the market publicly that the true exposure to Lehman Brothers was closer to a net notional value of about \$6 billion. The actual value that changed hands eventually was \$5.2 billion. Since then, TIW has been publishing aggregated OTC derivatives data for the public on a weekly basis on the website www.dtcc.com, and has been providing regulators in the Americas and

Europe information which they require, with the agreement of the market participants where necessary.

How a central repository works

A central repository occupies a technical space in a global trading environment. For CDSs, DTCC supports the needs of customers to hold, record and update information on trades in OTC derivatives from CCPs and more than 1400 market participants worldwide. In addition, a repository connects to other service providers and acts as a hub for the exchange of trade information and other relevant data. A proportion of the trades held by a repository will be cleared by CCPs, but one of a repository's unique advantages is that it can also record non-cleared and non-standard trades. The latter is a special advantage for the OTC markets.

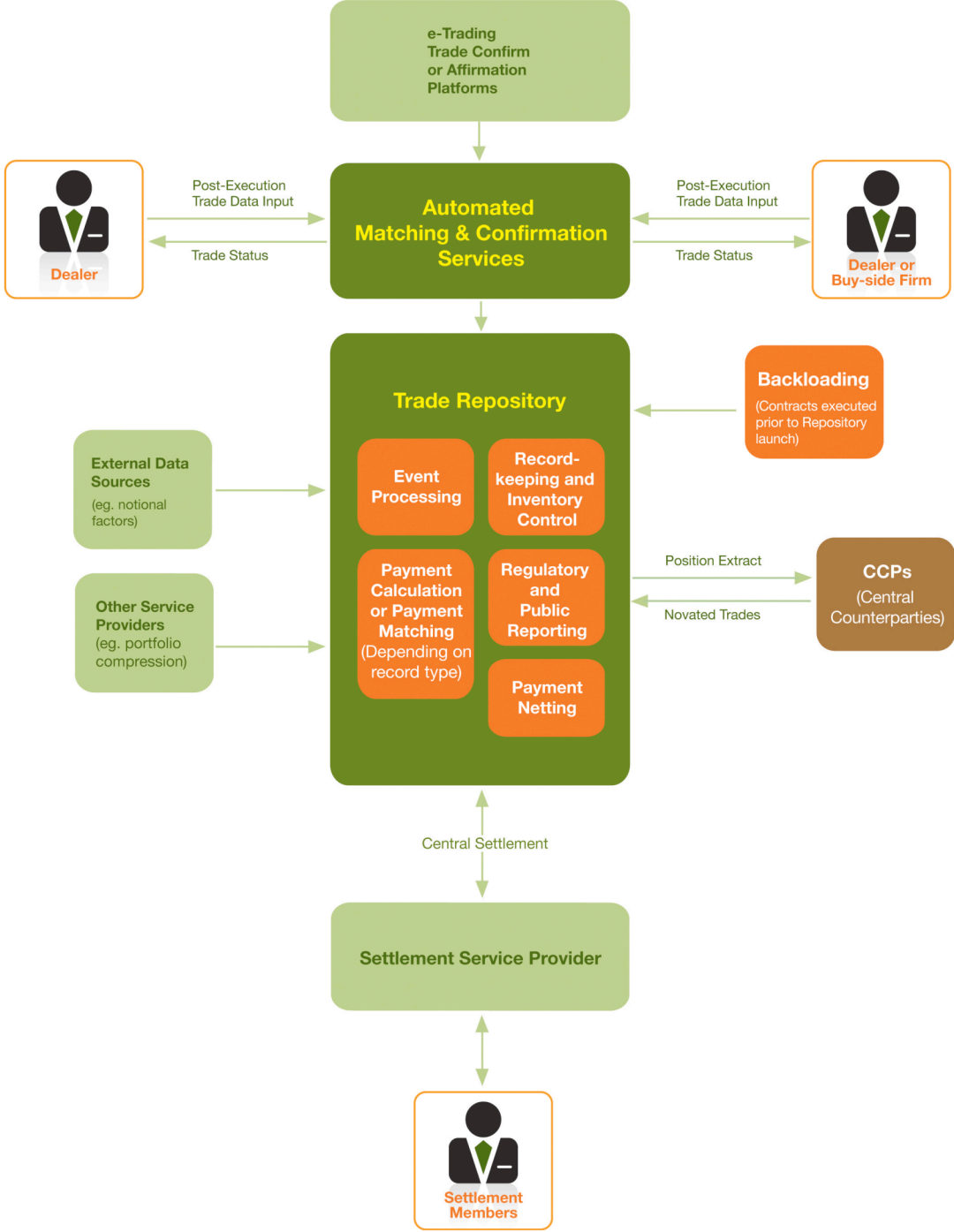
In the case of DTCC's central repository for CDSs, it is completely neutral. Unlike CCPs, it is not party to a trade – and is impartial about the source of a trade. It is an industry utility, user governed and not-for-profit. Its primary focus is in helping market participants and regulators manage and mitigate risk.

Among the DTCC CDS repository's functions are:

- Improving market transparency by public reporting
- Enhancing the transparency of deal-books and balance sheets for firms
- Managing life cycle credit events (for example, corporate mergers and bankruptcies)
- Calculating and netting cashflows
- Calculating payments and conveying instructions to payment systems
- Calculating bilateral margin and conveying instructions to collateral agents and payment systems
- Enabling participants to assign (change ownership of) contracts electronically
- Novating contracts to CCPs
- Standardising treatment of identical cleared and non-cleared contracts
- Improving market and firm position transparency to regulators by regulatory reporting.

For other asset classes (such as interest rates, equity derivatives, commodities, etc.) the nature of the products will dictate a repository's functions. Care must be taken to ensure a one-size-fits-all approach is imposed neither globally nor regionally. DTCC agrees with the comments in the Commission Staff Working Paper accompanying the Commission Communication, "Ensuring efficient, safe and sound derivatives markets" (SEC 2009) 905 final, 3 July 2009) highlighting the different fundamental natures of the asset classes.

KEY ELEMENTS OF OTC CREDIT DERIVATIVES MARKET INFRASTRUCTURE



A single central repository will be more effective than multiple repositories in increasing market transparency for regulators and the investing public and reducing systemic risk by ensuring regulators can see a firm's underlying position data and exposure from a central vantage point

Practical experience bears out the benefit of a single repository. For example, the 9 March 2009 report by the Senior Supervisors Group – which consists of the senior financial regulatory supervisors from seven major countries: Canada, France, Germany, Japan, Switzerland, the UK and the US – highlighted that it was easier for market participants to identify affected trades and to facilitate handling of various life cycle events, such as settlement and credit event processing, when all CDS trade information was in one central infrastructure.

It will be argued that multiple providers allow competition. But the nature of the products can lead to significant risks and complexities if provision is fragmented. Strong user governance and “at cost” service provision can prevent a single repository from abusing its position.

To illustrate the case better, the analogy is sometimes made between OTC derivatives repositories and securities CSDs, where competition has advantages, notably in the Eurobond market where two international CSDs successfully compete. But the analogy does not hold for the OTC derivatives market because a trade repository holding bilateral contracts is fundamentally different from a CSD holding issues of securities.

Unlike securities such as equities and bonds – where the inventory of securities in issue is known – each OTC contract life cycle is unique. Specifically:

- Securities are created in a legal process by which an issue of a known quantity is registered and distributed to investors, who can choose to keep them in different locations. The quantities and types of securities in existence are commonly publicly recorded. After a securities issue is initially created, corporate actions and/or other defined processes can affect the quantity issued and the economic features of the entire issue.
- For OTC derivative contracts, however, two parties to a new transaction create fresh inventory each time they execute new bilateral contracts. In addition, the two parties can agree to amend the contract at any stage in the contract's life by trading rather than a corporate action. Each contract has to be regarded as a legal whole that requires specific processing during the contract life cycle.

This difference is also reflected in settlement processing:

- With securities, institutions trade securities knowing that each has a unique identifier backed by known holdings in securities accounts. As a result, securities can be easily moved between trading parties' accounts, whether the positions are held in the same or in different

- depositories. If securities are in the seller's account, the transaction is complete upon delivery versus payment (DVP) to the buyer's account.
- By contrast, OTC derivatives contracts do not have a unique identifier. Each contract is a separate instrument representing ongoing obligations between the contracting parties. Transfer of ownership of a contract rarely results in the transfer of ownership of an underlying security, and obligations are often settled in cash through correspondent banks.

These features of OTC markets – the lack of a known universe of issued and recorded positions and the control DVP affords – mean that the checks and balances characteristic of securities markets do not generally apply in OTC markets. A single central repository's inventory control and, where needed, life cycle event processing remedy precisely this deficiency and afford the protection available in cash markets.

A single central repository has transparency and systemic risk reduction advantages over multiple repositories in all the services it supports, limited only by the extent to which a service is relevant to an asset class:

- Overall inventory control
- Overall transfer control
- Life cycle event processing
- Support for bilateral margins
- Being a data hub for market transparency
- Being a data and processing hub for other service providers.

Overall inventory control

A single central repository is invaluable for firms and regulators because it can give them a clear view of their individual and aggregate positions, which is very hard to obtain in any other way. The practical issue is that trades in a given asset class are global, and consequently there is no clear way of allocating them between competing repositories or deciding who is responsible for the allocation.

The key for firms and regulators is that a central repository can record and keep current all bilateral amendments to OTC contracts. It also prevents errors such as contracts being entered in two repositories inadvertently or a contract not being entered into any repository. With a single central repository, it is instantly clear where a contract should be stored, and whether it has been placed in the repository.

Overall transfer control

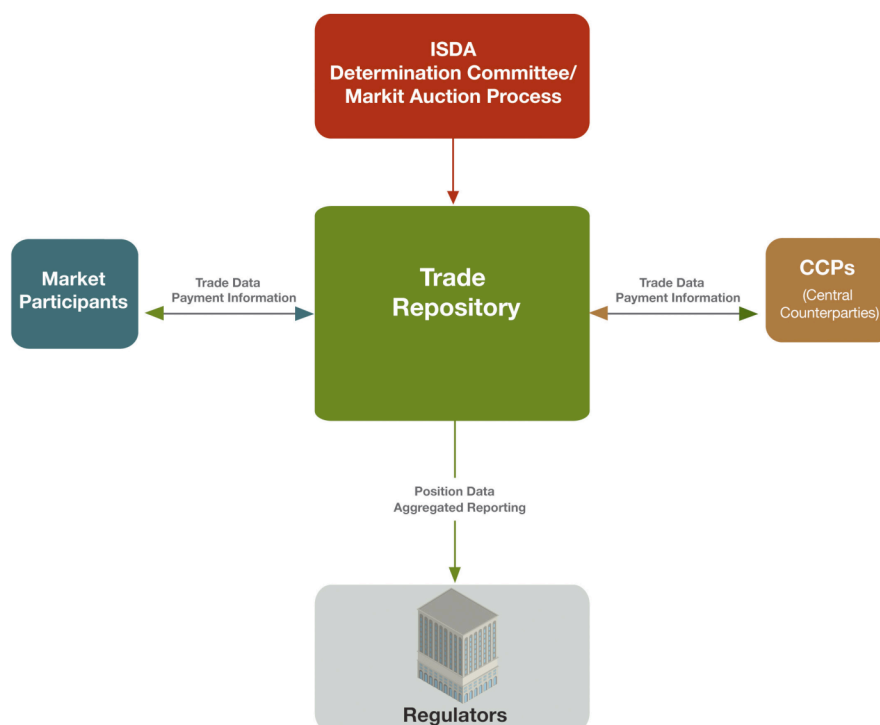
Transfer of securities between accounts in a CSD occurs under the law of the jurisdiction under which the CSD falls. By contrast, the master documents for OTC derivative contracts specify the governing law. For example, the contract might be between a German bank and a French bank but under English law. The rights and obligations under this law can be assigned irrespective of

where the record of the contract is held. Controls must reflect what the contracts allow, reassuring the party receiving a contract that it is sound. Multiple repositories used to record and exchange information on all these changes will be very complex and the likelihood of information being lost or recorded in incompatible ways is high.

Life cycle event processing

OTC derivatives contracts in some asset classes, but not all, may contain bilateral obligations triggered by specified events, for example a credit event (such as a bankruptcy) or corporate action (such as a merger). The event may be governed by local law but the contracts come under the contract governing law. An automatic central control process is needed to ensure that all like contracts are adjusted, and all like obligations settled, identically. It is also crucial that all amendments are made simultaneously, to avoid parties to the contracts facing considerable risk. It would be very hard for multiple repositories to coordinate their activities so that all life cycle events are equally captured and acted upon.

EXAMPLE: FLOWS ARISING FROM CREDIT EVENT PROCESSING IN A SINGLE CENTRAL REPOSITORY



Support for bilateral margins

OTC derivatives contracts create obligations between two parties which are usually collateralised. Firms holding too little collateral from their trading

counterparties may pose a systemic risk. To be most useful, information about collateral must be consistent with the contracts subject to netting under credit support annexes (CSAs), which define the terms or rules under which collateral is transferred between the parties to a contract. Multiple repositories could not yield one coherent data set for regulators or support disciplined bilateral margining.

Being a data hub for market transparency

A single central repository can produce very detailed market data for market participants, furnish regulators with data and publish aggregated data for public use. A single repository is best placed to collate and provide this data because counterparties and underlying entities may be spread across several jurisdictions and contracts are legal wholes which cannot be divided between repositories.

In addition, the information is complex, and it would be difficult to ensure that positions in multiple repositories were complete and not duplicated. Multiple repositories will frustrate regulators' access to the complete picture of risk on globally traded instruments that a single, central repository can provide. They will also complicate regulatory jurisdiction rather than simplify it because all regulators will be equally interested in all repositories in order to judge the systemic risk and credit risk to the entities they regulate.

With multiple repositories for a given asset class, all regulators would need to agree on rules for where trades are registered to prevent duplication or gaps. But there is no standard for identifying underlying entities and no reliable method for classifying contracts by jurisdiction, whatever the asset class. Moreover, OTC derivatives life cycle events can lead to a contract no longer being eligible for registration with a particular repository and require re-registration with another repository, posing significant operational risks.

Being a data and processing hub for other infrastructure providers

Competition between providers of services to OTC derivatives markets has often depended as much on a provider's ability to connect with a critical mass of market participants as on the quality of the service and the value it adds. A single repository is better positioned to support centrally other service providers, such as CCPs, by providing inventory controls which show firms that a contract they believe has been torn up is the same contract that their counterparty sees, and assuring market participants and regulators that similar contracts are treated consistently when life cycle events occur. A single central repository helps to remove exit barriers for market participants switching between competing service providers such as CCPs. It also greatly cuts the cost of infrastructure for CCPs in different jurisdictions by being a single gateway and controlling novation to these CCPs, thereby fostering competition.

By way of illustration, we believe that it would have been impossible to start clearing CDS in Europe in the time set by the Commission without a single

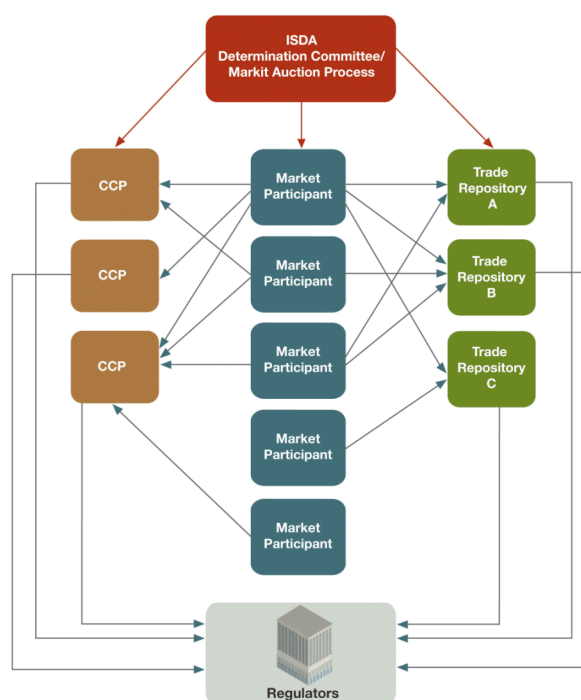
central repository as the infrastructure's hub. ICE Trust and Eurex are able to rely on comprehensive contract data from the central repository to substitute a new CCP-guaranteed contract for that data.

A single central repository will be more effective than multiple repositories in promoting a pan-European capital market

The two Giovannini reports on clearing and settlement in Europe identified a host of inefficiencies in Europe's clearing and settlement practices which make cross-border securities transactions – essential to the development of a deep and liquid European capital market – more costly, more complex and less safe than domestic transactions.

Within a given asset class, multiple repositories will create Giovannini barriers in the OTC derivatives market. Conversely, a single central repository for that asset class can help to promote a pan-European capital market. By ensuring that all positions, whether cleared or uncleared, are recorded in a single central repository – and managing in the repository the life cycle events of those positions in asset classes where this functionality is needed – the operational infrastructure supporting OTC derivatives will be standardised and better controlled. Without an infrastructure of this sort, unsynchronised repositories are likely to develop fragmented OTC contract operating processes which will in due course diverge, leading to more uncertainty, less safety and transparency, higher costs and more barriers to market participants switching service providers.

EXAMPLE: FLOWS ARISING FROM CREDIT EVENT PROCESSING IN MULTIPLE REPOSITORIES



In summary, multiple repositories within an asset class increase costs, decrease transparency and are likely to provide an incomplete picture of

exposure and risk for market participants and regulators. The control processes unique to bilateral contracts work best with a single central repository and the systemic risk benefits are compromised if there is more than one.

Regional dynamics in a global market

An important aspect of providing one seamless view is that the OTC derivatives markets are global while regulation and supervision tends to be regional and national. There is a range of possible solutions which allow for preserving a global perspective while acknowledging the need for suitable regional and national oversight and control.

A desirable solution is that information about an asset class held by a single global repository could be simultaneously captured in regionally based data facilities (called regional repositories), for example in Europe, the Americas and Asia. This would ensure that a global view of the market is readily available in different time zones, subject to local regulatory and legal requirements. It would also meet concerns about business continuity. But it also suffers from the potential disadvantage that division by region may not be straightforward in all OTC markets. For example, which region has primary ownership of the same contract captured simultaneously?

Another possible solution is that global repositories could be divided by asset class – for example, a global repository for equities derivatives and a different global repository for credit derivatives – and each would be located in a different region. This approach has the advantage that each region has jurisdiction over a global infrastructure. There is a natural division of OTC markets by asset class (with each asset class having different functional needs), yet it would still be straightforward to form a global view of exposure and risk.

Whatever the ultimate solution, regional supervisors will need to operate in a coordinated manner with their global counterparts and develop safeguards against disruptive events. Safeguards might include the right to withhold information and only partially share information, a framework which could readily be agreed and incorporated legally and technically in the repository's structure. A design that gives equal rights in multiple jurisdictions over different data subsets would create some balance between jurisdictions, and prevent interrupting the sharing of information without agreement, but not require separate logical infrastructure.

Because interrupting the sharing of information without agreement is likely to increase systemic risk to nobody's advantage, the built-in checks and balances should make it highly unlikely that such safeguards, if installed, would need to be invoked.

Conclusion

A single central repository for each OTC derivatives asset class can meet the objectives of enhancing market transparency, reducing systemic risk and preventing the creation of Giovannini barriers in the OTC derivatives market. A repository's functionality will vary greatly by asset class because the nature of each market's contracts differs.

To prevent potential abuse of dominance, the single central repository could be structured as a utility operated at cost and, through a governance structure designed to ensure it is responsive to the needs of market participants and regulators, fulfil a vital function supporting – but not competing with – other market actors. Providing regulators with the data they require to manage systemic risk and helping ensure the integrity of financial markets lies at the heart of its business.

Responses to specific consultation questions

There are specific questions in the Commissions' Consultation Document to which we wish to respond. The questions and our answers are set out below.

1. What would be a valid reason not to use electronic means as a tool for contracts standardisation?

Electronic means is a valid tool for standardisation, but it should be noted that simply transferring unstructured text to an electronic format is insufficient. A shared understanding of legal form using defined terms and structured data is the key which allows for a processing of the content of data. Then and only then can risks be better controlled through centralised industry infrastructures such as CCPs and a repository and through more effective regulatory oversight.

2. Should contracts standardisation be measured by the level of process automation? What other indicators can be used?

Measuring automation is a valid approach, and by its nature will provide efficient and accurate assessment. A number of metrics can be used. We think that a focus on execution and confirmation automation levels would provide the best measure for standardisation because these processes will use a fully valid legal record of a derivative contract. Execution and confirmation automation levels therefore accurately reflect contract standardisation, rather than other metrics which may only require subsets of data to be standardised and automated and hence provide a poorer quality indicator.

5. How could the coverage of collateralised credit exposures be improved?

There is opportunity to more closely tie confirmation, central repository and bilateral margin exposure data. This will improve the timeliness and efficiency of bilateral collateral processes, specifically allowing mark-to-market differences to be isolated from trade data or population differences.

9. Are there market segments for which a central data repository is not necessarily desirable?

A central data repository is not necessarily desirable for well-established markets operating under standardised rules, such as FX (spot and forwards, but perhaps not derivatives), and markets too small to pose a systemic threat, such as property, longevity and weather contracts. When a non-standardised market reaches a systemically important size, it should become subject to regulatory requirements and repository-based processing.

Furthermore, the scope of functionality provided by a repository for each asset class will vary greatly due to the nature of the contracts in those markets.

We believe that CCP cleared OTC contracts that remain OTC in nature after clearing (that is, do not become fungible with an exchange listed product) should be registered in the repository along with non-cleared transactions.

10. Which regulatory requirements should central data repositories be subject to?

Broadly, the regulatory regime for a repository should be very similar to that for critical market infrastructures such as CCPs. The main distinction is that, unlike CCPs, a repository is not central to a market's risk management through legal novation as a party to the transaction, so not all the requirements are appropriate. But for all other matters, a central data repository should comply with best practice as set out, for example, by the CPSS-IOSCO and ESCB-CESR Recommendations.

Furthermore, a repository should be required to adopt non-burdensome open-access policies which allow other service providers to access its data. Such policies benefit a central operational infrastructure.

11. What information should be disclosed to the public?

We believe that public disclosure and transparency will raise investor confidence in financial markets – which is especially important for OTC markets. That said, regulators, working with the appropriate industry governance committees, should determine what data is released, when it is released and how timely it is. In general, any such publication should conform to the principle that publicly available information be aggregated and anonymous. This information should come from cleared and non-cleared data sets.

12. Do you agree that the eligibility of contracts should be left to CCPs? Which governance arrangements might be necessary for this decision to be left to the CCPs risk committees?

A CCP should determine the eligibility of contracts it clears, according to its commercial assessment of its ability to manage the risks associated with the contracts. Regulators need to prevent a CCP from taking excessive risks driven by competitive pressures. Regulators should also ensure that a CCP's risk committee is independent and that its members have sufficient knowledge and experience to judge the adequacy of risk management measures.

19. What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?

As with Question 11, we believe that this is generally a matter for regulators to determine, working with the appropriate industry governance committees. The main criteria are that the data should be of the quantity and quality regulators need to assess risk and view market activity, and that certain data produced for regulators that could be commercially sensitive would not be made public. Participant level data could therefore be made available to regulators. This data should use cleared and non-cleared data sets. For example, if regulators want to monitor how much clearing is used, the data supplied should be a single set containing cleared and non-cleared transactions.

Sourcing data from a single central repository ensures that the data regulators receive for a given asset class has integrity and is usable. With multiple sources of data, there is the risk that formats and definitions will differ, making data difficult to analyse, aggregate and compare.

20. How could European legislation help ensuring safety, soundness and a level playing field between CCPs?

In addition to safety and soundness requirements, European legislation could help to ensure interoperability and the ability of users to transfer business between competing providers.

22. How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?

This would best be done through a single central data repository for each asset class in systemically important markets. The authorities could look at how repository data could be used most efficiently to generate the required analysis.

23. How should position reporting of derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on the exposures to particular contracts?

This would best be done through a single central data repository for each asset class in systemically important markets. Using the same data source for transaction reporting and position reporting yields the considerable benefits of superior consistency and comprehension.

Published by:

Depository Trust and Clearing Corporation (DTCC)

<http://www.dtcc.com>

August 2009

Reproduction – in total or in part – only with the written permission of the publisher

Contact

Bill Stenning

wstenning@dtcc.com