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Financial Reporting and Corporate Actions: Cutting through the Fog

Good afternoon, everyone.

I'm very pleased to be here today...and I'm delighted to see so many of you here for a conference about a subject that, for most people, can be pretty arcane. After all, XBRL could be the name of a new series on the Sci-Fi Network...or the latest game for the X-Box. If you saw your teenager text-messaging the letters XBRL to a friend, you might think it means "Expect to Be Really Late".

Like you, however, we've learned at my organization what XBRL really stands for...and how it allows us to identify and "tag" key data in a document electronically. We think it's one of the best tools to come our way in a long time. It cuts through the fog. It lets in the sunshine. And it can bring far greater illumination to the choices companies so often ask their shareholders to make.

As you know, the largest firms in this country now use XBRL to communicate financial information to their regulators. Over time, the expectation is that more companies will be required to file reports this way, as they already do in Europe and other jurisdictions. The goal of this mandate—the Holy Grail that SEC Commissioner Casey just talked about—is transparency.

In these "post financial crisis" days transparency – transparency of investment assets, transparency about transactions, transparency about financial performance – is a hot topic.

The need to improve transparency in the financial markets is understood to be one of the key lessons we should be drawing from the events of the last two years. And those of us in the know understand that the widespread adoption of techniques for distributing data in "structured" form is going to be key to achieving the higher levels of transparency that today's financial markets will demand. That is, adopting methods to distribute data that are based on mark-up languages such as XBRL will be imperative to gaining entry to the markets and to willing investors – issuers who do adopt XBRL will have wide and deep interest in their securities; people who don't will increasingly be shut out of the markets.

The DTCC Role

We believe that this demand for "structured data" will extend across all types of information used in the markets. But before I explain why we think that, and how we are working to support that, let me tell you a bit about DTCC to make clear why we're "out front" on this issue.

My company is DTCC, which stands for The Depository Trust & Clearing Corporation. We're the largest financial post-trade infrastructure organization in the world. After securities are traded, we step in to make sure the money from the trade goes to the seller and the securities go to the buyer. In most cases, in fact, we guarantee that these transactions will be completed.

As a result, we operate a huge data processing and risk management business involving the safe transfer of

hundreds of billions of dollars in securities and funds under tight deadlines every day. Last year alone, we settled more than \$1.8 quadrillion in securities transactions. To give you a sense of what that kind of volume represents, we essentially turn over the equivalent of the entire U.S. Gross Domestic Product every three days.

Another thing we do at DTCC is hold for safekeeping almost all the equities, corporate bonds and municipal bonds issued in this country, not to mention various securities issued in another 117 countries around the world. Because we maintain these securities and the book-entry records for them in our depository, we're also a link in the chain of communication when a company wants to do something with its stock, such as pay a dividend or issue new shares or any of dozens of other actions. For those of you who represent issuers in the markets, we are the party who handles all of your transactions with your investors, and our nominee, Cede & Co., is likely your largest shareholder.

Hundreds of these transactions – from stock splits to mergers to conversions - which we collectively call “corporate actions” – come spilling onto our desks every month –and they come in different formats and different languages...addressing different securities with different features and identification numbering schemes. Receiving these announcements, typically from many different sources, comparing and scrubbing the data in them for accuracy, and then disseminating them to all the parties involved—this is a major responsibility for us, operating around the clock out of our offices in New York, Tampa, London and Shanghai

These hard-to-decipher messages often demand time-critical action or decisions on very complex transactions such as rights issues, takeovers, conversions or tender offers. In turn, responding to these messages often means communicating decisions back through a daisy chain from investors to broker/dealers to asset managers to custodians to central securities depositories like DTC to registrars and then—finally—back to issuers.

The Fog Factor

When these messages aren't clear—and believe me, I know from experience that they're not always clear—this whole process can wind up taking place in a kind of operational fog. All of us here, I presume, have been caught in fog at one time or other. If you're driving and you suddenly find yourself moving through a swirling fog, it can be quite alarming. It's hard to see. Sometimes it's even hard to hear. As we all know, when the fog shows up in a horror movie, that's usually a sign that something frightening is about to occur.

Let me tell you that the fog surrounding financial reporting can have the same effect. In fact, let me repeat for you a horror story I told the audience at a meeting on investor communications back in May. It illustrates what happens—and what kind of monsters can lurk out there unseen—when the communication of corporate actions is wrapped in foggy language.

Some years ago, when our Corporate Actions group at DTCC's depository reported directly to me, we handled a merger between two companies. Company A was acquiring Company B in a four-for-one stock swap – four shares of Company A's common stock for each one share of Company B.

The “Company A” Incident

As our people – and everyone in the securities industry – went through the 100-plus page prospectus on the deal, we consistently saw the terms “four for one” throughout the document...on the cover...in the summary...in the detailed description of the offer... everywhere we looked. We set up the merger as a four-for-one exchange. We processed the exchange on the appropriate date, and – as we routinely do – credited the brokerage firms and others who are our participants with their allocations of the new Company A stock.

Our customer-participants, in turn, credited their customers—retail or institutional investors— with the new positions. Many of those investors, of course, promptly went out and sold these new shares. We presented our

holdings of Company B stock to the agent, and awaited receipt of the new Company A shares on a four-for-one basis.

Now you all probably know what's coming. When we got the new Company A shares, we received a quantity that equalled three new Company A shares for every Company B share—and we promptly got into a debate with the agent about the shortfall.

Only after weeks of arguing did it become obvious that the terms of the deal were shrouded in fog. They were certainly not what we had all thought they were. Company B was actually involved in a number of patent suits at the time of the merger, and had some significant exposure on some of those suits. Company A wasn't willing to take on that exposure, of course, and so it set up an escrow account against the risk, and funded the account by withholding one of the four shares that were the proceeds of the merger.

The idea was that once the suits were resolved, Company A would distribute whatever remained in the escrow account. But it was highly unlikely that anything would be left over. So Company B shareholders, in reality, would only get three shares for every one they held.

When we went back to the documents, we found, buried at about page 87, a one-paragraph statement regarding the escrow account and the withholding of the one share. It was absolutely the only reference to this throughout the entire prospectus. Did it satisfy disclosure requirements? Probably. Did it effectively communicate to investors and the industry the actual terms of the offer, in a way that eliminated the risk of misunderstanding? Absolutely not!

No one in the industry had correctly identified the actual terms of the merger; everyone had set it up as a four for one exchange, and had credited their customers in that way. Everyone in the industry had to write off the value of the one extra share we had all credited our customers. In the movie version of my story, this is where the angry guy with the chain saw comes lurching out of the fog. In our real-life version, I think our write-off was somewhere north of \$1.5 million, and we know the industry wrote off a lot more than that.

Global Impact

“The Company A Incident,” as I've come to call it, was proof that distributing information about corporate actions into the market in a way that leaves each intermediary individually responsible for interpreting the information—and translating it into a form that can be communicated to their clients—is absolute lunacy. It opens the door wide to risk, and ensures that from time to time someone somewhere will misunderstand the terms of a particular event

And, of course, that was just one event during the course of one year. When you factor in the complexity and volume of all of these types of transactions each year, the risks start to rise geometrically. Let's focus on some statistics:

In just one recent corporate action we handled at DTC, for example, there were 17 issues involving 246 participants and the submission of 876 instructions. The possibilities for error in this one corporate action alone were frighteningly large. And to give you the real scale of potential horror stories, DTCC handled over 400,000 such “announced” transactions last year – part of the total of 6.3 million unique distributions, worth a total of \$3.5 trillion that we processed in 2008.

Just two weeks ago, we handled a corporate action involving a company much in the news—CIT. That action impacted 250 different securities, and because there is no accepted standard for communicating this information, we had to have four people working an entire day just to interpret the materials and manually enter the

information into our data base. In this age of automation, that's a total anachronism. It also makes it easy for error to creep in.

How costly can errors be? A few years ago, we asked Oxera, an independent consultant in the U.K., to look at this question. Their answer was shocking. They estimated that losses on corporate actions worldwide ran somewhere between €300 and €700 million -- or between \$450 million and \$1 billion...each year.

Obviously, the risk in this business is very high, and it's not limited to the U.S. market. Worldwide, the number of "announced" corporate actions every year is close to a million.

Nor are the risks limited solely to the issuers or to one or two links in the chain. If your business operates in the middle of the chain, as mine does, you're vulnerable to risk from both directions. Mistakes in the dissemination of an announcement can be compounded by mistakes in handling the execution of the instructions.

In a rights issue, for example, if bad data cause mistakes in how an investor's instructions are communicated to the custodian, the custodian may fail to process the right instruction, and thereby fail to obtain the shares involved. Then, to re-establish a position once the error has been revealed, the custodian would have to purchase or sell the requisite number of shares at the current market price rather than the -- usually discounted -- price under the rights offering. And guess who pays the difference in the end? Initially, it's the custodian. Ultimately, of course, it's the shareholder, because these costs get passed up and down the chain as well.

For shareholders, risk is extensive...and expensive. Reducing this kind of risk--and these potential losses--should be a top priority for all of us.

The Corporate Actions Project

And that priority drives what we're trying to do with our colleagues at XBRL US -- to build a corporate actions taxonomy or event classification system based on XBRL to provide for the dissemination of all of this data in "structured" form. The goal is to make it easy and inexpensive for issuers to tag or electronically capture and identify key data as they prepare the documents for a corporate action. Our target is to have this classification system complete and ready for review early in the second quarter of next year.

Now, if I could actually speak in XBRL, you'd see right away that a key word tagged in that sentence is "inexpensive." Identifying data points or words in a document with XBRL is not an expensive process. If you've already tagged your financial information with XBRL, you don't have to bring in another team of experts to prepare corporate actions. This is a simple piece of software. You don't have to know how it works internally to use it, just as you don't need to know the coding behind a spread sheet program in order to make use of it. You simply have to fill in the boxes.

But, as I mentioned, corporate actions don't just occur in the U.S., and announcements of corporate actions get passed around all over the globe. Many financial institutions, particularly outside the U.S., communicate between each other and their clients about corporate actions using international standards prescribed by the International Standards Organization (ISO). A U.S. XBRL corporate action taxonomy will be of limited use unless it is aligned with these international standards, to ensure that globally the corporate action can be described by everyone in exactly the same way. For this reason, XBRL US and we are also working with SWIFT, the international financial network, to ensure that there is full alignment between the XBRL corporate action taxonomy being developed here in the U.S. and the international standards, which, in the new ISO 20022 format, will begin coming into widespread use in late 2010. The three of us -- XBRL US, DTCC and SWIFT -- will ensure that the XBRL data elements map to ISO 20022 message elements, so that when U.S. issuers announce a corporate action the information can immediately be translated into a message that can be distributed on a global basis with assurance that it will be received and understood. Of course we all hope, and

expect, that the U.S. will be the “bell weather” in this regard, with this same type of XBRL-based disclosure in exact alignment with financial industry messaging standards becoming the practice that is followed globally.

Next year, our target is to review the comments we receive on the XBRL taxonomy in the second quarter, and then to have any revisions completed by the end of the third quarter. We intend to have the process of aligning XBRL with the ISO 20022 standards completed by late 2010, when financial institutions begin to make serious use of the new ISO 20022 messages.

And to ensure this effort moves ahead, we’re also going to make corporate action announcements we publish at DTCC available in the new ISO 20022 messages by the end of next year. We’re in the process of rewriting our corporate actions technology, and as part of that rewrite, we’re not only moving toward the XBRL-ISO 20022 combination, but we also plan to decommission the legacy U.S. proprietary message formats generated by our old system by 2015. We want one global standard as well.

The Campaign

As we have begun talking to companies about the idea of their using XBRL to clarify their shareholder communications and corporate action announcements, we have heard two interesting messages.

One involves transparency—and liability. Several companies have suggested that, while transparency is a good thing, XBRL might somehow make them more liable for any mistakes or misinterpreted information in the document. After all, the way the process usually works now is that the company has its issuing or transfer agent draft the corporate action language. Then the announcement is reviewed by lawyers. And finally it gets issued, sometimes even as just a press release. Now, this is where the gremlins can come in. While it’s unlikely there’s any problem with the information at this point, it hasn’t been issued according to any international standard. As a result, by the time it gets picked up, reviewed, reformatted and sent out to others in the chain of communications, the gremlins can creep in and the fog can grow thick. And then the question becomes, who’s liable?

While the current system may mask accountability to a degree, companies need to understand that if a mistake is uncovered as the corporate action cascades down to investors, everyone always points the finger upstream. As a result, every participant from that point upward has to share the costs and liabilities for the error, including the issuer. You might not see the costs in that particular corporate action, but you’ll see them in the next one. It will be more expensive.

So why not avoid the potential for downstream errors in the first place? Why not tag the announcement with XBRL so that everything is obvious and errors can be caught before they begin to move into the system? If it seems simple, that’s because it is. And in the end it means less risk, less cost and less hassle.

The other message about the impact of XBRL comes from the financial community. What they tell us is that, if XBRL can speed up the communication of corporate actions, they are all for it. They complain that, by the time the various parties in the corporate action chain have scrubbed all the data and dotted all the “i’s,” the window of opportunity for the investor to make a decision about the corporate action has narrowed. Financial advisors and their investor clients may have limited time to work through the consequences of the corporate action and understand the financial implications for the investor’s portfolio. The more that XBRL can fix that situation by expediting the process of informing an issuer’s investors, the better the investor relations impact and the more effectively investors can respond.

The “Reference Data” Problem

But we happen to think that XBRL can be applied to much broader issues in the market as well. Corporate actions data represents only one slice of what the financial industry would refer to as “reference data,” mean-

ing the information about financial assets needed to identify and evaluate them. And the same problems that beset corporate actions exist in this broader field as well, suggesting that over the longer term XBRL may have a broader scope for problem-solving.

Perhaps the clearest example of this – and one that emphasizes our “transparency” theme – involves securitizations – the process of transforming loans, most prominently mortgage loans, into tradeable securities. As we all know, the financial turmoil over the past few years was initially triggered by concerns about securitized mortgage securities backed by subprime mortgages, leading to a very rapid shut-down of the broader market for securitized instruments. Only recently has the securitization process, frozen for almost two years now, finally begun to thaw. Yet these instruments still face a narrow market, largely because it can be very difficult to decipher what the underlying assets are or how they are performing. If we used XBRL standards to make these issues much more transparent, we might be able to speed up the revival of the securitization process.

You may think this is a very technical matter best left to financial institutions, but that’s a misperception. Thawing this market is important—and here’s why. For the last six years or so, more than half the lending to individual households in the US and elsewhere has flowed NOT from bank balance sheets but from the securitization market. Economists who complain that consumer credit remains too restricted because banks aren’t lending are, in my opinion, only half right. They’re not taking account of the lending generated by securitized assets. And if the idea is to spur economic recovery through consumer spending, then we need to make it much more viable to resume securitizing assets.

This hasn’t happened, unfortunately, because there’s still major uncertainty that securitized instruments are going to be sufficiently transparent. As we know, however, there’s a solution for this problem. XBRL would go a long way toward making the instruments and the performance on their underlying assets more understandable, more easily analyzed, and thus more marketable. Again, the goal here is to take information that’s already been provided and make it clearer and easier to find. In the case of securitized assets, use of appropriately designed XBRL tags would make it much more easy for financial analysts to identify the relevant numbers in a portfolio performance report, correlate them to the original assets, and manipulate the data to develop an accurate evaluation of the security itself.

By this time, some of you probably think I am such an apostle for XBRL — that I believe we can use it to spur economic recovery, save the whales and stop global warming. If only it were that easy. What is easy, though, is to demonstrate how useful and practical XBRL can be, and how it can clarify and demystify financial language and financial instruments. And that’s what we want to do.

Conclusion

Let me again thank you for coming today. I’m delighted to see so many of you here because, the more we get the word out about XBRL, the more confident I am that we can persuade people to use this tool to clarify shareholder communications and distil the information in other financial documents. As we work with XBRL US and SWIFT, we want to be sure that the XBRL processes we develop will meet the needs of your companies, your institutions and your stakeholders—here and around the world. This is really a conference about illumination and transparency, and whatever guidance you can give us in pursuing those goals will be most welcome.

Again, my thanks.