



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

Keynote Address by Donald Donahue, Chairman and CEO

The Depository Trust & Clearing Corporation

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Conference Overview

How will the recent government intervention, forced mergers and the proposed increase in financial regulation impact the global market structure?

Thank you, Richard (Mitterando).

It's certainly a pleasure for us at DTCC to sponsor this conference with our good friends at J.P Morgan Chase. They've long been a formidable presence in the global marketplace. They also know as much as anyone these days about the challenge of managing abrupt mergers arranged by the federal government – a skill set it looks like we'll all have to be developing!

The dramatic changes we've seen in the industry during 2008 certainly suggest that this is a good time to ask some questions about our industry. It's necessary to take stock of where we are, of what's changed, and of what endures. It's time to make some assumptions about the shape and structure of the markets, so we can plan for the future. And it's certainly time to rethink how we can capitalize on the inherent strengths and risk management capacities of the industry's infrastructure. That's what this conference is about, and those are the themes I want to talk about today.

After all, we've certainly been moving through a very savage financial storm—or maybe earthquake is a better metaphor, because we continue to feel aftershocks throughout the financial system. In the last two weeks alone, the Fed has stepped in—yet again—to bolster Citibank with additional capital, and is preparing to lend another \$800 billion to bolster consumer and mortgage financing.

But we can't afford to wait until all the dust and debris have settled to see what's happening to the global market structure. Strong economic and regulatory pressures are coming to bear—and the structure and oversight of the markets will be a critical issue.

We don't have to look any farther for an example than the often-misunderstood market for credit default swaps. The rapid growth of that market, coupled with misperceptions about how the market functions and how traders hedge their positions, led many observers to suggest that there were astronomical sums involved which couldn't possibly be managed. The result was an exaggerated fear about exposures in the market, its lack of regulation and the risks involved.

Some analysts, for example, were predicting that the money owed to buyers of credit protection on Lehman Brothers would be in the \$400-billion range. The reality was starkly different. After we netted down all the Lehman contracts in our Trade Information Warehouse, the final figure was \$5.2 billion.

Can we strengthen the infrastructure for this market in order to reduce risk? Yes, and we should. We should also make it more transparent. But did the market malfunction? Absolutely not. And yet it's certain to be held up as "Exhibit A" of what can go wrong when there is supposedly inadequate regulatory oversight of financial markets, especially new and supposedly untested markets.

Basic Questions

In the wake of all that's happened and the response it will spark, we obviously need to ask ourselves some questions. Perhaps the most basic question we should be examining is how we

preserve the principles of free trade, free markets and the free flow of capital, especially when they're increasingly under attack in the very countries that gave rise to them.

When our financial system is stressed, as it most certainly is right now, people tend to forget that the innovation, integration and intermediation created by the global securities industry are as crucial to progress everywhere as the advance of science or the stability of political systems.

The second question I'd raise involves exchanges and market structures. We've certainly seen market functions becoming increasingly global and increasingly moving away from traditional exchanges – what's the endpoint of that? How will that evolve, and what role will and should the regulators play to channel that evolution in desired directions?

The third question I'd ask is how can we utilize the inherent strength of the industry's infrastructure to help the industry navigate through this time of unprecedented turmoil and regulatory pressure? How can the infrastructure continue to help the industry to reduce risk, lower cost and support innovation throughout the markets?

As I think many of you know, DTCC played a major role in helping to stabilize the industry following the Lehman Brothers' bankruptcy. In the course of six weeks, we were able to close out more than \$500 billion in exposure to Lehman trades across the markets and asset classes, with no meaningful market impact and absolutely no loss to the industry – a staggering illustration of the benefits a resilient infrastructure can bring to the industry.

The more global our industry becomes, the more important it is to maintain that resilient and interconnected infrastructure and to evolve that infrastructure in the ways needed to support the ever-increasing globalization of the markets that we serve. As the industry continues to change and expand, the issue is not so much whether there will be new financial instruments and new ways to trade them – there's clearly no way to turn off the spigot of innovation. The issue is how we ensure that the creation and trading of new instruments stay in synch with the growth of the infrastructure needed to sustain them and gauge the risks involved. When those things get out of

synch, the risks involved can morph exponentially and very quickly – so how do we make sure that that doesn't happen?

What's Changed

Let's begin by tallying up what's changed in the financial scene. The first piece of the new "common wisdom" is that liquidity is king, and – the corollary – that leverage is in the dog house. Once proud investment banks are now converting themselves into bank holding companies, and busying themselves trying to figure out how to attract retail bank deposits. Stable sources of funding – such as retail bank deposits – are now gold, and business models dependent on short-term or overnight funding strategies are, at best, moribund if they're not dead already. The "object lessons" provided by the fates of Bear Stearns and Lehman have driven that understanding home very forcefully.

In the near term, business models relying on leverage will have to curtail their ambitions to reduce the level of leverage they're using or move into unregulated spaces by adopting a corporate form that averts regulatory scrutiny. In the longer term, I suspect the possibility of avoiding regulation is likely to be lost – that the option that an institution conducting major activity in the financial markets and offering financial services to investors can still avoid being registered with and overseen by a financial supervisor will be closed off, and a very "bright line" rule followed about who does and who does not have to be regulated.

Similarly, the current decline of the "bulge bracket" investment bank model will open space for other market participants, including private partnerships and so-called "second-tier" or regional institutions, not to mention hedge funds and other "buy side" institutions. Yet even among hedge funds, the ranks have been thinned. Now that there are fewer deep-pocketed banks in the capital markets, there are also fewer prime brokers for the hedge funds to rely on. In addition, as part of more active risk management programs, many institutions are implementing tighter capital standards. Consequently, although hedge funds face less competition, many are not able to command the short-term liquidity they were accustomed to, and, as I said, I think they do face the likelihood of mandatory regulation. The clear demarcation between a securities professional

and a “buy side” firm – one that has certainly been eroding for years – will soon vanish completely.

Greater Transparency

Another fallout we can expect from the crisis we’re enduring is a much greater emphasis on the transparency of traded instruments. The need for greater clarity about how the instruments are assembled and how they function is already high on the regulatory agenda. The structure of some collateralized debt obligations, for example, has proven to be so opaque that unraveling them begins to look like a job for the scientists who decoded the human genome.

But I don’t think this is an issue the industry should just hand off to regulators. And here’s why. I’m very concerned that, in the regulatory response to the market crisis, the handling of the transparency issue and the standards for transparency that regulators may set could end up crippling the securitization process itself. To sustain the flexibility and usefulness of these instruments, we need to simplify them ourselves. Otherwise, we may end up seeing the baby thrown out with the bath water, and that would leave capital markets throughout the world without a financing technique that, properly handled, is extremely valuable.

As some of you may know, in recent years the SEC has been very avidly pushing the use of the “Extensible Business Reporting” mark-up language – XBRL – by companies required to file reports with the Commission under the various Securities Acts. XBRL also is very commonly used in bank financial reporting, both here and in Europe. DTCC is a participant in the XBRL consortium here in the States, and we and others are working to develop a way of using XBRL to promote transparency in reporting on structured securities – getting the data on the performance of the portfolios underlying those issues to be much more readily available in “structured data” form, so that it can be more easily manipulated and analyzed. We believe that will contribute significantly to promoting transparency for these instruments, and will be key to making securitization viable again as a technique for financing assets.

Regulation

Another major hallmark of the coming years, we all recognize, will be a strong push for a broad overhaul of regulatory policies.

It's clear that the existing regulatory model has been recognized over the past several years as being seriously flawed – for a whole host of reasons. Studies in the past several years have pointed out the anti-competitive effects of the U.S. regulatory model, and the comparative advantages afforded by other regulatory models. The failures of the past year have damaged the reputation of some of our regulatory agencies, and have shifted regulatory power considerably. And, unfortunately, I think the failures of the last year have also seriously damaged the credibility of industry self-regulatory efforts – and by that I don't mean the work of the Financial Industry Regulatory Authority, but the credibility of voluntary standards for liquidity management, for the reliance on internal risk management models under Basel II, and other regulatory approaches that placed greater reliance on the industry's policing itself.

As a result, the likelihood is that we could end up with a much more “broad brush,” top-down approach than we now have. It's easy to imagine, for instance, that the Securities and Exchange Commission and the Commodity Futures Trading Commission could be consolidated into a single agency – I think that has to be viewed almost as a given. And the Federal Reserve is unquestionably going to assume much greater regulatory authority and power, likely as the designated “market stability” regulator under a model very similar to that outlined in the Treasury Department's Blueprint for regulatory reform issued this past March.

As the industry prepares to face this inevitable regulatory restructuring, there are two points I think we ought to keep focused on. The first is that there is still value in the “self-regulatory” model, and the industry needs to focus on restoring its credibility. Did parts of it fall short, and does it need to be strengthened? Absolutely! But in any number of ways that model worked and continues to work without requiring a heavy hand or heavy regulatory spending. It's another baby I'd hate to see thrown out with the bath water, and we have to understand how we can help to restore its credibility.

The second point is we need to keep legislators thinking about is the value of an international approach to the crafting of regulations. In today's world, where finance is such a global industry, this would seem to be a given—and the fact that what began as a problem in this country with sub-prime loans rapidly tripped off a huge credit crunch elsewhere in the world is clear evidence of just how international our business has become.

People and institutions invest globally. But most of the regulations under which we operate were devised chiefly for the domestic market. We need to ensure that the impending changes in regulation, as they come, take into account the need to align regulatory standards across all of the markets seeking to interact in trading financial assets, and create mechanisms to ensure ongoing cooperation among financial regulatory bodies in other parts of the world. It will be extremely difficult to maintain U.S. leadership in the global financial arena if we don't act in the coming "re-regulatory" wave to adopt and implement standards that recognize the increasing integration of the global financial markets.

What Hasn't Changed

Because, despite the global financial crisis and the changes it has brought, there are two trends in our industry that don't show much sign of change at all. One is precisely that increased globalization of markets. The other is the expansion of trading off exchanges and onto other platforms of liquidity. At a glance, these trends don't appear to be linked. But they are.

Stock exchanges around the world have been linking up to handle international investment flows. This is what prompted the New York Stock Exchange to join Euronext, the London Stock Exchange to buy Italy's Borsa Italiana, and Nasdaq's link-up with the OMX Group, which includes the Scandinavian exchanges

Nor is the rush to marry limited to U.S. and European markets. The largest merger between exchanges this year took place in Brazil, where the new, combined Bovespa is now the third largest exchange in the world. And let's not forget the New York Mercantile Exchange's move to the CME.

And yet, even with this consolidation of exchanges and exchange functions, the market value of exchanges (like so many companies these days) is down sharply. With fewer major participants in the markets, and the cutback in trading by hedge funds, exchange volumes are not growing as expected. In Europe, where the established exchanges face competition from the new electronic trading platforms, competition is very stiff. What this suggests is the possibility of even more consolidation.

One of the defensive moves we see exchanges making is the switch to a more self-enclosed vertical structure. Not only will they handle trading, but they also want to handle the clearing. It's a totally enclosed business which, as you may know, is the model in U.S. futures markets, and has been a standard business model in some European markets for a long time.

Now Nasdaq is talking about instituting the same kind of model in the U.S. equities market. It would like to execute your trades on its trading platform, and then clear your trades through its clearing platform. One-stop shopping, so to speak, which the Intercontinental Exchange is likewise planning to make its business model in London.

At DTCC, we shake our heads when we see these proposals. This suggests a return to the 1970s, when each of the U.S. regional markets maintained its own clearing and depository business, and the task of clearing trades was a very fractured business. Our model at DTCC is totally different.

We're user-owned and governed, and we operate on an at-cost basis. Rather than serve any specific exchange, we accept trades for clearing and settlement from all of the exchanges. In fact, we supply centralized risk management and oversight of trading activities across some 60 exchanges, ECNs and alternative trading systems.

This does two things. It provides us sufficient trading volume to generate enormous economies of scale. We now clear each side of an equities trade for less than three-tenths of a penny. It also gives us the opportunity to look at trading positions and volume across numerous trading platforms, so that we can see the shape and direction of participants' portfolios and apply risk management techniques as needed.

We are, after all, the product of nearly 25 years of competition and consolidation in the clearing business. Years ago, trading firms grew tired of having to post collateral at each exchange and, by the late 1990s, as many of you probably recall, all the regional U.S. exchanges had opted out of the clearing and settlement business. That business came to us in search of a centralized infrastructure that can reduce risk and lower costs through economies of scale.

But in the face of slower growth in trading volumes, Nasdaq and other exchanges are deciding they want to return to the practice of yesteryear – of the last century, actually. The larger question, it seems to me, is whether exchanges and other trading venues have given adequate thought to the infrastructure they need in order to function.

Just as the arrival of more and more trading platforms tends to drain liquidity away from more established exchanges, the creation of alternative clearing and settlement systems tends to reduce potential economies of scale, increase collateral costs and limit the scope of longstanding, centralized risk management systems. Central counterparties can no longer look across all markets—and diverse asset classes—to evaluate risk on a system-wide basis because they're not seeing all the trading activity taking place. And yet, as far as I'm concerned, that is the most powerful risk management weapon in the industry's arsenal. Just imagine the chaos that would have ensued if the task of liquidating Lehman's positions that I mentioned earlier had had to be undertaken in a world where those positions were split up among several clearing organizations – there's no way it could have been resolved as successfully on behalf of the industry.

As the exchange landscape has evolved, so has the over-the-counter landscape. Quite a number of new financial instruments, such as credit default swaps, which have seen explosive trading growth, are traded entirely over the counter. Among other things, OTC derivative markets tend to be more flexible and more accommodating to hybrid instruments and new asset classes such as carbon emission permits. Unless new regulations throw up huge roadblocks, I think we'll continue to see new derivative instruments and asset classes springing up in the relative freedom of OTC markets.

What are the challenges that such a development would have to meet? The nay-sayers argue that over-the-counter trading of many of these instruments can't provide many of the benefits of a traditional, exchange-listed market – the operational resiliency and the transparency that traditional markets offer. And these criticisms have become perhaps the number one issue for the OTC markets.

But in considering them, let me go back to the example of the CDS market, which I mentioned earlier. Quite a few regulators, politicians and members of our industry have voiced concern about the operational risks associated with this market. And yet, in my judgment, the CDS market actually is supported by an infrastructure that is among the most highly developed for any OTC derivative asset class...thanks to DTCC's automated Deriv/SERV matching platform as well as our Trade Information Warehouse.

Working with our customers, we built an infrastructure for this market that works. We handled the final disposition of hundreds of billions of dollar in credit default swaps that referenced Lehman, Fannie, Freddie Mac, WaMu—and even the three major banks in Iceland. We held these swaps contracts in our Trade Information Warehouse, the central registry we built specifically to serve this market. The Fannie and Freddie contracts were a particular challenge because the agencies were part of virtually every credit default swap index out there—and we had to account for all of them. By the time we were done, we had netted some \$7 billion in swap contract payments going through settlement down to \$429 million.

Earlier this year, we also took charge of moving Bear Stearns' CDS dealbook of about 150,000 open contracts worth hundreds of millions of dollars to various subsidiaries of JP Morgan Chase. Given the values involved, and the scrutiny this market was under, it would have been a nightmare if every one of these contracts would have had to be modified individually—and manually. The industry would probably still be sorting it out. But because we've automated this process, we were able to complete most of the swing in just 48 hours, and it was transparent to our customers. Proof positive – in both of these examples – that the OTC market infrastructure can provide the necessary level of operational resilience.

Last month we began publishing data from the Warehouse, to provide a better picture of what actually is going on in the CDS market and, frankly, to puncture some of the wilder fantasies about how the credit default swap market was going to bring about the end of the world. Since the beginning of November we've been publishing data on the amounts of CDS outstanding. So the OTC market infrastructure can also deliver the necessary level of trading transparency as well.

None the less, many observers wonder why this market does not have a central counterparty. In fact, for many months now, regulators in both the United States and Europe have been urging the creation of a central counterparty for this market. In response, the Clearing Corporation, which is now a part of ICE, has announced it wants to build one. NYSE-Euronext and other exchanges have noted that they're interested in creating a Central Counterparty too.

At DTCC, we've been working with all these parties on this project, and we're examining the possibility of creating central counterparties for other sectors of the OTC market as well.

A central counterparty in these markets would do what it does in all markets. It would help to reduce risk. Central counterparties, as we know, require their participants to put up collateral in case there are problems with a trade. Central counterparties are also in a position to monitor their members' trading positions. If a participant's trade book exceeds the central counterparty's risk guidelines, the participant will have to put up more collateral. And this process would certainly help render some of the risk from the CDS market. It would be prohibitively expensive to place big, wild bets. We certainly expect that you'll be seeing one or more live central counterparties in the CDS market by the end of the year.

The Role of Infrastructure

The story of the CDS market is one of many that underscores the vital role played by the industry's infrastructure. While we would not wish the financial crisis we're in on anyone, one of the things to come out of it has been the opportunity for us at DTCC to demonstrate how well we protect our members, how much value our robust structure brings to the market, and how much work we've already done to buttress the expansion of markets globally. In a period of

unprecedented volatility and shaken confidence, we've been able to ensure safety and mitigate risk across the industry to the relief of our customers and government agencies.

And that's exactly the role an infrastructure should play. Our mission is geared toward generating value for our member-customers, reducing risk, lowering cost, and ensuring the integrity of the financial system. As the markets globalize, it will become more and more critical that the infrastructure globalize as well, to continue to deliver the same benefits on the global scale in which the markets are now operating.

For that reason, a bit more than a month ago, we announced a ground-breaking proposed merger with LCH.Clearnet. This will create the world's largest clearing organization and, for the first time, customers operating in both U.S. and European capital markets will have the support of a common infrastructure for the cash equity markets and the cash fixed income markets that are becoming so interlinked. We're also excited about some of the possible new products and services we may be able to build on that LCH.Clearnet will be bringing to the combined organization. They have clearing services for futures and commodity products that, for example, include support for trading in carbon emission permits, something that we believe will expand rapidly in the States when Congress acts next year. They have experience in other areas where the industry is looking to expand as well.

And that's just what we have in mind. We want to make the resilience, the experience and the risk mitigation qualities of the infrastructure as widely available as possible to the industry. As I recently said to a group of our customers: you have an enormously powerful infrastructure—an enormously powerful engine—that's prepared to take you where you need or want to go. The industry is undergoing a difficult and thorough restructuring. More regulation is on the horizon. And markets are changing. Through all of that, our goal is to keep your infrastructure in place so that you can resume growing your businesses and continue to bring innovation and value to the marketplace.

Thank you.