AQS QUADRISERV

Prepared Comments, SEC Roundtable

September 29, 2009

SEC Securities Lending and Short Sale Roundtable

Panel 3: *Improving Securities Lending for the Benefit of Investors: Transparency; Electronic Platforms; Central Counterparties; Accountability*

Written Statement of Gregory W. DePetris, Co-Founder, Quadriserv, Inc.

Ms. Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Dear Ms. Murphy:

Pursuant to the Commission's invitation to speak at the SEC Roundtable on September 29th, I appreciate the opportunity to submit a few brief thoughts on Quadriserv's[1] role in the securities lending market as it relates to the panel entitled, "Improving Securities Lending for the Benefit of Investors: Transparency; Electronic Platforms; Central Counterparties; Accountability." We have discussed this topic in detail in prior comment letters submitted by the company which address the broader potential benefits of a modernized market structure for securities lending[2].

AQS is a regulated, automated, centralized marketplace for securities lending transactions. Through its ownership structure and operating principles and in partnership with The Options Clearing Corporation ("OCC") which acts as central counterparty ("CCP"), AQS operates as a for-profit industry utility focused on delivering improved price transparency, risk management, automation, access, operating and capital efficiencies to market participants.

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[1] Quadriserv is a leader in delivering transformational market structure changes to the securities lending industry. Quadriserv, through its wholly owned subsidiary, Automated Equity Finance Markets, Inc., has developed the AQS® platform for securities lending. AQS, through its relationship with The Options Clearing Corporation, has created a centralized marketplace for securities lending transactions in the U.S., and plans to expand into the European market through its relationship with Eurex Clearing. As a FINRA member broker-dealer and a SEC regulated alternative trading system, AQS aims to maximize liquidity, access, credit and transparency, while mitigating systemic risk, through a fully automated trading environment. For more information about Quadriserv, please visit www.quadriserv.com or www.tradeaqs.com.

[2] File Nos. S7-30-08 and S7-08-09

AQS has been designed in collaboration with Member firms, including leading broker-dealers, custodial lending banks, agent lending banks, market-making firms and asset managers, with the goal of creating a strong central market structure for securities lending and borrowing. Importantly, the platform and its operating standards continue to be refined through the active involvement of firms representing each AQS Member category, system vendors and industry operating partners, who contribute their collective views through committees that advise on topics such as the Quality of Markets, Innovation, Technology and Operations, and Regulatory and Compliance issues. This practitioner input is further enriched by the formal involvement of select individuals and academics focused on securities lending, short selling and market structure in their respective areas of expertise and research.

The AQS infrastructure is comprised of four primary components: price discovery, clearing, settlement and open contract maintenance. These disparate functions are linked together by connectivity between the AQS matching system, the AQS Middle Office system, The OCC[3], the Depository Trust & Clearing Corporation ("DTCC")[4] and SunGard Loanet[5]. The resulting straight through processing framework provides clear transaction history and detail at the most granular account level, from loan initiation, toloan guaranty, to loan settlement and finally to ongoing loan maintenance and back office accounting, nearly all of which is overlaid on an existing communication network that connects the vast majority of securities lending and borrowing participants.

Clearing[6] and Non-Clearing Members[7] currently use the AQS market to facilitate securities lending and borrowing in an exchange-like, CCP environment. Through the CCP risk management and membership

[3] The OCC, founded in 1973, is the world's largest derivatives clearing organization, and was the first clearinghouse to receive a 'AAA' credit rating from Standard & Poor's Corporation.
[4] The Depository Trust & Clearing Company provides clearance, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives; the Depository Trust & Clearing Company processes the cash and securities movements for all securities loans processed through AQS
[5] SunGard's Loanet is a multifaceted solution for equity finance, serving broker-dealers, custodian banks, agent lenders, and other participants in the securities lending markets. Loanet provides a real-time interactive platform across which these participants can communicate and complete transactions, as well as software systems for order routing, order management, and accounting. Organizations use Loanet to automate securities borrowing and lending activities, helping to handle large transaction volumes efficiently. For more information, please visit SunGard at www.sungard.com/securitiesfinance.
[6] AQS Clearing Members are Clearing Members of the Options Clearing Corporation (OCC). There are two types of Clearing Members: * Typical Clearing Members (CM) will provide market access and clearing services to Non-Clearing Members (NCM) * Competitive Liquidity Providers (CLP) are Clearing Members who borrow and lend for their own account and do not sponsor market access or clearing services for NCMs.
[7] Non-Clearing Members (NCM) are not Clearing Members of The Options Clearing Corporation (OCC) and are required to transact and clear through a registered AQS Clearing Member. There are two classes of Non-Clearing Members: * Primary Liquidity Providers (PLP) typically include custodial lenders, third-party agent lenders and direct lenders of securities * Electronic Participants (EP) include borrowers and/or lenders of securities, such as 130/30 investment managers, option market makers, hedge funds and proprietary trading firms.

structure, counterparty default, mark-to-market payments, cash dividend payments and rebate settlements are all guaranteed to and from borrowing and lending counterparties. Through AQS policies and procedures, as well as the specific messaging protocols between AQS, OCC and DTCC, borrowing and lending interests are electronically matched, cleared and settled more efficiently, more quickly and with a far higher degree of certainty than with conventional processing standards.

It is important to highlight two key issues that should be considered in the discussion of how to improve the securities lending process for the benefit of investors: transparency and the role of a central counterparty. Our views on both are discussed in greater detail below.

Defining Transparency

Much has been made of the concept of transparency as it relates to securities lending markets. As a basis for discussing transparency, we assume agreement on the central market ideal and economic principle that the more supply and demand that congregates in a single place, the more efficient the price setting mechanism that venue will offer. We believe that this same principle – so effective in increasing efficiency and improving market quality in other areas of the capital markets – also applies to securities lending markets.

Transparency is a concept easily obscured without a clear, common understanding of what is being made transparent. The simplest form of transparency is pre-trade and post-trade information regarding trading interest – quotes and trade reports. A central market has the ability to make available both quote and trade information derived from the activity on the market. In a broader sense, however, transparency includes a common understanding of the products and the participants in the market. In a sense, this transparency can be provided by standardization rather than individual investigation of counterparties. From the perspective of a centralized market, transparency regarding participants and products arises from a single, standard definition for the following reasons:

1. All investors have equal access to price discovery in the central market
2. Credit is universally and equally provided through the CCP mechanism
3. The product being traded is standardized among all participants
4. All participants are margined on equal terms based on their actual mark-to-market ("MTM") risk
5. All participants are held to the same code of conduct, enforceable at the market center

An organized market can provide transparency on both levels by enabling individual lenders and individual borrowers to trade in a common instrument in a common credit environment for the benefit of all participants. To quote Arthur Levitt in an address on this very topic, "we should never lose sight of the underlying essence of a market -- a place where buyers and sellers come together. Every other feature of the marketplace -- whether crafted by tradition or technology -- exists *only* to serve that primary purpose."

We strongly believe that public investors benefit from increased transparency, and that each market participant stands to experience improvement from a more organized market.

For beneficial owners of securities, price transparency allows for:

- Reliable performance benchmarking
- Improved understanding of risk-adjusted return from securities lending
- Increased investment returns
- Reduced overall systemic risk through the CCP structure

For securities lenders, a centralized market structure allows for:

- Increased price transparency that can positively affect lender performance
- Reduced cost of counterparty indemnification
- Reduced trading friction

For broker-dealers, a centralized market structure allows for:

- CCP cross-product and margin netting
- CCP transactions receive a lower risk-weighting under Basel 2
- CCP membership is the gateway to the central market, preserving the role of broker-dealer as intermediary in the value chain
- Equal, automated access to borrowable inventory to facilitate settlement
- Through the CCP, one credit relationship provides access to an entire universe of CCP counterparties
- Improved operational and technology efficiencies

- A robust, time-tested margining and risk management framework
- Although some broker-dealers have expressed concern about the potential for reduced profits, we believe that the effect of reduced capital costs and more efficient balance sheet usage will enable firms to do more business at lower costs and with reduced risk, while “growing the pie” and increasing market liquidity overall

For borrowers of securities, a centralized market allows for:

- Upgraded counterparty credit across the securities lending value chain
- Increased price transparency
- Reduced trading costs

For securities markets generally, a centralized market allows for:

- Improved regulatory oversight
- Reduced fails to deliver which, in turn, can help address short sale concerns
- Improved trading efficiencies across securities markets
- Application of robust, risk-based margin that properly collateralizes risk

For securities issuers and listed companies, a central market provides:

- Information about the supply and demand for stock borrowing, an important consideration in analyzing how that activity affects the trading market for issuer securities
- Reduced fails to deliver, improved short sale compliance and reduced likelihood of naked short selling

The Role of a Central Counterparty for Securities Lending

There exists an operating central counterparty marketplace for securities lending transactions. Quadriserv believes that the central counterparty model executed through a transparent electronic trade system is a complementary structural alternative to existing OTC business practices. The historical success of this market structure has had a universal, unambiguously positive impact on investors in nearly all other areas of capital markets. More importantly, we also believe that such a structure, while new to securities lending, is consistent with the stated objectives of policymakers. These objectives include:

1. Prevent risk to the financial system

- A CCP imposes robust margin requirements in addition to numerous other widely accepted risk controls
- Through the mark-to-market and individual margining process, a CCP guarantees counterparty risks, including counterparty default, rebate payments and mandatory corporate action payments
- A CCP can clear other derivative contracts that are highly correlated with securities lending, leading to improved risk reduction at the CCP through multi-lateral, multi-product risk netting

2. Promote efficiency and transparency

- Efficiencies
    - Capital efficiencies result from position and margin netting at the CCP
    - Operating efficiencies result from straight through processing – automated execution of the securities loan integrated with clearance and risk management at the CCP linked to other CCPs
    - Technology efficiencies result from the potential for complete integration of the technology platform of a central market with existing industry standard stock loan processing companies (e.g. SunGard)
    - Settlement efficiencies result from improved STP, strict participant delivery standards and look-ahead accounting process at DTC
- Transparency

  Price transparency allows for:

    - Reliable performance benchmarking
    - Improved understanding of risk-adjusted return from securities lending
    - Increased investment returns due to lower costs resulting from competition and transparency

3. Prevent market manipulation, fraud and abuse

- Daily mark-to-market CCP conventions uncover potential fraud or abuse resulting in immediate Clearing Member default
- Centralized pricing generates important trade data that can be used by regulators in conjunction with other information sources to identify manipulative or abusive trading behavior

4. Protect unsophisticated parties

- OCC membership is limited to qualified broker-dealers. Non-OCC member are provided access by member firms, providing all participants the benefit of efficient, reliable, and regulated stock loan transactions through the system

5. Improved Market Dynamics

- Provides clarity and greater analytical capability for all participants in the stock loan market
  - ATS processes and controls are consistent with the operation of a registered national securities exchange
  - Clearing processes can be monitored and audited
- Enhancing market transparency
  - Trading activity is published to a market data feed
  - Trading activity can be monitored by supervisors
- Limiting collateral exposure/risk
  - Robust CCP margin conventions and risk management frameworks can be easily audited
- Governing potential conflicts of interest in the stock loan and borrowing process
  - While governing any perceived conflicts would not be considered a market function, a standardized, regulated, exchange-like market that facilitates competitive price formation leads to a common understanding among market participants about best execution and best practices

Again, I thank you for the opportunity to provide these comments. We at Quadriserv look forward to the continuing discussion about the important issues surrounding securities lending market structure, and remain committed to supporting the industry and regulatory community in whatever capacity we can to continue moving the market toward a more efficient, reliable structure.

Sincerely,

Gregory W. DePetris
Co-Founder
Quadriserv, Inc.