U.S. Securities and Exchange Commission
Securities Lending and Short Sale Roundtable
September 30, 2009
Statement by The Depository Trust & Clearing Corporation

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Background

For nearly 36 years, The Depository Trust & Clearing Corporation's family of companies has helped automate, centralize, standardize and streamline post-trade clearing and settlement processes that are critical to the safety and soundness of the capital markets. As a result, we've helped our customers increase their operational efficiency, reduce risk and lower cost. DTCC's primary mission is to protect and mitigate risk for its members—and safeguard the integrity of the U.S. capital markets. As part of this mission, we are closely following discussions with regard to potential new regulations that may affect DTCC directly but also those that would affect our customers, with an intention to, where feasible, develop central tools that can support regulatory objectives while helping minimize the costs of compliance for our customers.

DTCC, through its subsidiaries, provides clearing, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and OTC derivatives.

DTCC operates through six subsidiaries and two joint companies, three of which I will mention with regard to the discussion today on short sales.

DTCC's joint venture company Omgeo, which is jointly owned by DTCC and Thomson Reuters, has 6,000 customers in 45 countries and plays a critical role in electronically linking counterparties to the institutional post-trade process. Omgeo acts as a central information management and processing hub for brokers, investment managers and custodian banks. Omgeo's offerings address challenges mainly to do with manual, error-prone processes you may encounter throughout trade lifecycle events. In the case of hedge fund transactions in U.S. equities, including short sales, the customer side trades between the hedge funds and executing brokers are generally confirmed and acknowledged between those parties and the hedge funds' prime brokers, using Omgeo's TradeSuite service. Once each individual trade is affirmed by the prime broker, it is handed off by Omgeo to NSCC's Continuous Net Settlement System (or CNS) where it is novated, guaranteed and netted with all other buy/sell transactions received from the various U.S. trading marketplaces and become part of the executing broker's and prime broker's single net obligation to settle in that security with NSCC.

DTCC's subsidiary, NSCC, nets down or reduces the total number of trade obligations requiring financial settlement by an average of 99% each day. On an annual basis, more than $315 trillion in trading obligations entered our CNS system in 2008, but with a 99%

netting factor firms only had to make payment of $2.9 trillion to complete settlement. Netting significantly reduces market risk. NSCC generally clears and settles trades on a T+3 basis. Once netted down, broker-to-broker trades are combined with single broker institutional trades for settlement at The Depository Trust Company (DTC), another DTCC subsidiary, and the movement of all securities and money takes place at DTC. There is no netting of institutional trades that do not go through NSCC. If securities are not available, no exchange of money or securities occurs. The trade will pend in DTC's system for the day until securities are available, or if no securities are made available, then settlement will be cancelled and the trade must be resubmitted the following day for settlement.

Tools NSCC employs to mitigate the risk include continuous trade netting, capital adequacy standards, a daily mark to market, and a common clearing fund. DTC operates a fully collateralized settlement system. Both subsidiaries use ongoing operational risk assessment, business resiliency exercises, the wide geographic dispersion of operating and data centers, a variety of advanced quantitative analytical methodologies such as back and stress testing, and a special focus on regulatory and compliance issues.

In addition, DTCC's principal regulated subsidiaries, including NSCC and DTC, all consistently maintain the highest credit ratings. By operating as a central counterparty and thus taking the risk onto itself, NSCC helps the industry reduce the risk associated with trading, while freeing up available capital. It does this by stepping in between the seller and buyer of each trade to assume the counterparty credit risk and the responsibility to deliver the securities to the buyer and payment to the seller. This is the principal function of a central counterparty (CCP). But a central counterparty also reduces the financial obligations requiring settlement, and reduces the necessary movement of securities, through the netting processing, thereby also lowering operational risks.

Fail Statistics

It is our understanding that today's panel regarding short selling is, to some extent, motivated by concerns some in the market have expressed about naked short selling (NSS). Those who believe that naked short selling is a severe problem in the U.S. markets often cite fail to deliver statistics as a supposed indicator of naked short selling activity, notwithstanding the SEC's own cautionary statements on its own Web site noting that there can be any number of reasons for fails to deliver, including administrative errors (such as failing to sign a certificate properly), and that the existence of fails cannot automatically be construed to be evidence of NSS activity. Even bearing that caution in mind, however, recent trends in fails can suggest some conclusions about what is happening in the markets.

NSCC makes fail statistics available to the SEC and other regulators on a daily basis and the SEC currently makes that data available to the public via its web site periodically. This fail data relates to the net NSCC obligations produced by NSCC's CNS system. DTCC, in comment letters to the SEC, has been a strong advocate for the more timely disclosure of information regarding fails to help add transparency. These aggregated statistics do not reveal fails on individual trades. Since fails that may be related to potential NSS would be embedded in such overall statistics many feel that the trend in overall fails is suggestive of possible trends in fails that may be related to NSS.

For the Commission's consideration, many in the industry believe a measure of the efficacy of Commission Rule 204T (and now Rule 204) in combating "naked" short selling may be the impact it has had since its implementation in October 2008 on persistent fails to deliver in CNS. Thus, a look at the fail rates over the past year, before and after the introduction of Rule 204T, may be relevant to the discussion of whether NSS is a problem in the U.S. equity markets. Clearly, these statistics suggest that the regulations have had a dramatic impact on the number of fails to deliver:

- Fails during July 2008 in CNS averaged 1.09 % of total daily value processed in CNS. Following the implementation of Rule 204T, fails dropped precipitously – averaging about 0.23% of value over the last three months of last year. This number has been maintained at this much lower level – for example, fails were at 0.16% in July 2009.

- Further, even in this percentage we believe that factors other than short selling are causative of a substantial portion of the remaining fails. For example, in July 2009, 42.5% of the remaining fails were in Exchange Traded Funds, and many in the industry believe that many of those fails may be due to latency in the creation/redemption process, not NSS.

- The remaining 57.5% in July 2009 include both short and long sales. Even if short sales were half the volume, the fail rate relating to non-ETF shorts would be well below the fail rates quoted in the first bullet above.

- Many in the industry feel that this low fail rate combined with Rule 204's requirement to clean the fails up on T+4, place appropriate back-end controls on fails including any resulting from NSS.

Current Discussions

DTCC has regular discussions with the SEC staff on a wide range of issues, pertaining to our role in the industry and insights we might offer regulators about the trade process, including concerns about short selling and NSS. Omgeo has been working with SIFMA's Prime Brokerage Committee for several years with regard to the industry's proposed amendments to the SEC's No Action Letter on Prime Broker Arrangements and has held out a particular component of its TradeSuite system for use in identifying any remaining short selling abuses by going well beyond simply relying on customer representations regarding locates in three areas:

- Notification of Order Making Discrepancies, where the executing broker and prime broker have a different understanding of whether a customer's sale order was long or short. A TradeSuite Confirm field allows executing brokers to identify prime broker trades as either sell long or sell short. In addition, for clients using Omgeo's Advice of Cancellation/Correction (AOCC) product, the prime broker can send a message to the executing broker with reason codes.

- Notifications when customers execute long sales with the executing broker but the securities are not in the customer's prime brokerage account at the prime broker making the delivery. For clients using Omgeo's Advice of Cancellation/Correction (AOCC) product, the prime broker can send a message to the executing broker with reason codes.

- Notifications when the Prime Broker determines that it did not provide a locate and it cannot uncover evidence of a locate from the source the customer identified as providing the locate. For clients using Omgeo's Advice of Cancellation/Correction (AOCC) product, the prime broker can send a message to the executing broker with reason codes.

In DTCC's recent discussions with industry members on these and related issues, including a concept put forth by a company named Global Locates Services that calls for a phased approach to enhancing the locates process, there has been initial industry reaction in three areas. The industry feedback is better detailed by industry participants, but the concerns are:

- The statistics described above suggest to many, that the requirements of Rule 204 and other recent regulatory initiatives have addressed whatever remaining issues there may be in terms of abusive short selling. Many in the industry believe that, at minimum, additional time is needed to assess whether abusive short selling is still a problem after studying the combined effects of all these recent regulatory initiatives.
- If abusive short selling remains a problem -- a conclusion, as noted, that many in the industry don't accept – then work is needed to identify whether locate practices contribute to it.
- Even if this determination is reached, industry members feel that the enhanced procedures called for in the draft amended No Action Letter which Omgeo is prepared to work with the industry on, should be implemented and monitored.
- Then, if it is determined that there is still a residual problem, there may be a basis for considering additional proposals. As we have reviewed with the Commission staff, there are detailed technical concerns with certain aspects of other concepts that would have to be addressed if we reach this outcome.

In conclusion, DTCC stands ready to assist our customers with automated and centralized solutions that can help them meet any new or enhanced regulations including any with regard to NSS or short selling in general, in a cost-effective implementation manner. We are also committed to working with regulators, as we have throughout our history, to safeguard the integrity of our financial markets, whether from abusive practices or the threat of terrorism. By the nature of our mission and governance, we will look for guidance from both the Commission and industry before embarking on the development and implementation of any such tools. We hope that we can provide information and expertise to the Commission and industry as it continues exploring various aspects of short selling practices.