Testimony of Don Thompson

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Chairman Bachus, Ranking Member Frank, and Members of the Committee, my name is Don Thompson and I am a Managing Director and Associate General Counsel at JPMorgan Chase & Co (JPMC). I head the derivatives legal group and have been actively involved in JPMorgan Chase's implementation of Title VII of the Dodd-Frank Act. Thank you for inviting me to testify at today's hearing.

<u>Benefits of OTC Derivatives To Our Economy</u>

For the past 30 years, American companies have used, and continue to use, over-the-counter (OTC) derivatives to manage a wide variety of risks that they encounter in their day-to-day business, such as interest rate, currency and commodity risk. The role of entities like JPMC in the OTC derivatives market is to act as financial intermediaries. In much the same way that financial institutions act as a go-between with investors seeking a return on their capital and borrowers seeking to raise capital in the capital markets, we work with companies, other end users and investors looking to manage their risks and with entities looking to take on those risks to hedge the opposite exposure or earn a return. Many of the companies we work with want to hedge their risks in the OTC markets because it enables them to hedge risk in a flexible and customized manner, often in large size, in a way that is not possible in the exchange-traded markets. These same companies often prefer the flexible and customized credit arrangements of OTC derivatives rather than the rigid daily cash margin regimes necessarily imposed by clearinghouses, which can drain scarce working capital from their balance sheets. And as this Committee has heard in testimony from American companies, the use of OTC derivatives has a significant impact on their ability to compete internationally.

OTC derivatives have many benefits, but it is also the case that there were problems with their use. Through the legislative process, JPMC supported many of the provisions in Title VII that will bring needed reform to the OTC markets to ensure that the role that OTC derivatives played in the financial crisis is never repeated: mandatory registration and regulation of Swap Dealers and Major Swap Participants, mandatory clearing of standardized contracts between financial firms, greater pre- and post-trade transparency and other needed reforms enacted in Title VII. These and other reforms, taken together, will fundamentally alter the market structure of OTC derivatives—how and where these instruments are traded, the economics of transactions, the nature of products available to American companies and the liquidity and efficiency of these markets. Given these wholesale changes, it is critical that the regulations implementing them be done carefully and thoughtfully, to limit unintended consequences and ensure that American companies continue to have access to these products.

We are increasingly concerned, however, given the number of new rules to be crafted, that the deadlines set by Congress in the statute may be too aggressive, limiting regulators' flexibility to craft appropriate rules. As discussed in detail below, we are specifically concerned that some of the proposed rules, if finalized, would harm the ability of American companies to manage risks in liquid and efficient markets. For example, we believe that for some rules, such as real time reporting and block trade levels, gathering data from market participants is a necessary prerequisite to setting effective standards and that such data should inform rulemaking. And in the rush to meet statutory deadlines, there has also been insufficient focus on the statutory mandate to examine the effects of proposals on market liquidity. Another area of concern in the rulemakings is the extent to which the Swap Execution Facility (SEF) definition fundamentally changes the protocols currently in place for market participants. Currently less than 10 percent of trades in the OTC markets are executed electronically. Requiring changes to the existing platforms that serve this market, as required by the CFTC proposal, adds an additional level of complication to the already complex and difficult transition to electronified markets. Without care, there is a real risk that the current proposals will drive liquidity out of US markets and increase the cost of managing risk, if not eliminate altogether the ability to do so by making it prohibitively expensive, inflexible or burdensome. For example, the CFTC's minimum 5 quote requirement in the request-for-quote aspect of the SEF rule will inhibit the willingness of liquidity providers to quote aggressively in response to requests because their quotes will be displayed to the entire market. There are tradeoffs between the policy goals of transparency and liquidity. We believe the agencies need to carefully implement the statute to preserve liquidity and enable American companies to continue to manage their risks in an increasingly volatile, and competitive, global marketplace.

We are also concerned about the competitive harm to American companies resulting from differences in final regulations, the gap in implementation dates in Europe and other jurisdictions as well as confusion over the extraterritorial application of these provisions. While there has been significant transatlantic dialogue on areas of agreement in regulating OTC derivatives, the final shape of regulations in Europe is still unknown. The European Union is in the process of developing its proposals in its EMIR (European Market Infrastructure Regulation) and MiFID (Markets in Financial Instruments Directive) proposals. MiFID is now at the consultation stage and not expected to be implemented across the EU until late 2013 or early 2014. EMIR, which covers clearing and reporting requirements, will come into effect early in 2012. This gap has provided a significant competitive opportunity for European institutions that are basing marketing campaigns on US institutions' compliance with Dodd-Frank. The pitch is simple: "Do business with a US bank and take your chances." This problem can be addressed by a simple clarification of the intended extraterritorial reach of the Act and by harmonizing the implementation timetables between the US and the EU.

I would like to turn now to a more detailed explanation of the aspects of regulatory implementation of Dodd-Frank that are of most concern to us and, where appropriate, we have noted recommendations made by JPMC to the regulatory agencies through the comment process.

Post Trade Transparency Issues

Block Trade Definition

In order to enhance transparency in the swaps markets, Title VII of Dodd Frank requires the agencies to publish regulations providing for real time reporting of price data relating to swaps. In the statute, the agencies are required to take into account whether public disclosure will materially impact liquidity and to specify the criteria for block trades – those that are very large in size for the specific instrument being traded – and for the appropriate time delays for block trades. In the draft regulations that have been issued to date, proposed block trade size and time delay provisions risk impairing market liquidity.

The block trade definition is critical because it serves two purposes: (i) it determines what trades get the benefit of delayed reporting for purposes of post trade transparency, and (ii) it also determines what trades are exempt from the SEF execution requirement. Block trades are important for our clients because they allow them to manage their risk exposures efficiently and in size. To determine block trade sizes, the CFTC applies two tests: a "distribution" test (only largest 5 percent of trades are blocks) and a "multiple" test (takes greatest of mean, median and mode, then multiplies by 5 to arrive at minimum block size), and then defines the block size as the greater of the two tests. The SEC did not offer a proposed definition of block trade but asked for comment on the issue.

The CFTC's tests, by taking the greater of two formulations, each of which is biased toward producing a high block size, will restrict liquidity because the block size will be so high as to capture a *de minimis* number of trades. Using the highest of mean, median and mode skews the results with outliers (and in fact by the block trades themselves). One possible approach would be to use the mode because by definition it is the "social size." The purpose of a multiplier is to ensure that most trades are subject to real time reporting and any multiplier above the social size accomplishes this, though we believe that five is excessive. The distribution threshold should function as a backstop to ensure that under no circumstances can a majority of trades be block trades, so we suggest setting it at 50 percent. It is worth noting that that the concept of block trades is well established on futures exchanges and stock exchanges and that block trade sizes set in those contexts distinguish between the needs of the retail and institutional customer.

Time Delays for Block Trades

Title VII also requires the agencies to specify the appropriate time delay for reporting block trades to the public so as to avoid materially reducing market liquidity. The draft regulations promulgated by the CFTC provide for a uniform 15 minute delay for Block Trades executed through a SEF. The SEC version provides for immediate reporting of all trade details of block trades except the notional amount – the notional amount is subject to an 8-26 hour delay based upon the time of day the trade is executed. We believe that instead of a "one size fits all" solution to the time delay issue, reporting delays should be flexible and be a function of the daily trading volume of the market in question. Reporting delays are needed to avoid adverse impacts on liquidity – the problem they address is that if the market knows a dealer has taken on a large risk position, it makes it more difficult and expensive for that dealer to trade out of the risk. Therefore, without appropriate reporting delays, dealers will be discouraged from taking large positions, resulting in less liquidity in the market. From this it follows that reporting delays should be a function of the trading volume of the asset being traded, since it is easier and quicker to trade out of a risk that has a higher trading volume than one with a lower trading volume. If a dealer is able to trade out of risk more easily and quickly, then it is able to offer better pricing on risk management transactions to its customers.

Reporting of notional amounts and the "masking rule"

The SEC and CFTC post trade transparency regimes are based largely on the TRACE reporting regime, which has been successful in enhancing transparency in the corporate and agency securities markets. The principal reason for TRACE's success is its "masking rules," which report trade sizes above $5 Million as "5+" for investment grade names and trade sizes above $1 million as "1+" for high yield names. The CFTC-proposed masking rule applies only to notional amounts of $250 million or more. On a comparable risk basis to TRACE, the threshold of a $250 million interest rate swap entails far more risk than a $5 million corporate or agency bond trade. We propose setting the masking rule at the "social size" determined for block trade purposes, *i.e.*, the mode of transactions of that type, so that if the social size for a particular trade is $25 million, we propose that trades above $25 million be reported as "25+." As is the case with block trade sizes, the effect of this would be to make it easier for dealers to hedge the risk arising from risk management transactions with their customers and thus to improve the pricing and execution of those transactions.

Position Limit Issues

Title VII of Dodd-Frank authorizes the agencies to adopt position limit rules relating to OTC derivatives. The CFTC-proposed position limit rulemaking has several aspects that, if adopted, would materially harm liquidity in US markets and thus impose additional risks and costs on all market participants, including end users. Given that non-US jurisdictions are, at best, years away from imposing similar regimes, if they do so at all, it is likely that liquidity will migrate outside the US and this will adversely affect the competitive position of US entities.

In particular, the proposed rule does not allow netting of physical delivery and cash settled contracts for purposes of determining compliance with aggregate and single month limits. Netting is critical to preserving liquidity in each market and presenting an accurate picture of market positions. Because of the absence of netting, the proposed limits are set at levels so low they will dramatically reduce dealers' ability to provide liquidity to each other and to clients. The spot month limits, including those for cash-settled contracts, are based on the "estimated deliverable supply" of each commodity, as determined by the relevant exchange. Estimated deliverable supply is not relevant to cash-settled contracts and should not form the basis for setting a limit on those positions. Moreover, no systematic, rigorous process for determining estimated deliverable supply exists, and the exchanges have not made their current determinations of estimated deliverable supply publicly available. Consequently, there is significant uncertainty in the market as to how this critical concept, on which the entire spot month limit infrastructure is based, will be defined and thus how spot month limits will be set.

We believe this concept must be studied further before being implemented; otherwise there is a significant risk of market disruption. The draft rule allows financial intermediaries to avail themselves of hedge exemptions only if their counterparty is eligible for a hedge exemption. "Pass-through" of position limits should be available for *all types* of counterparties in order for financial intermediaries to be able to continue to provide liquidity to the markets. The CFTC has the authority under Dodd-Frank to permit this, but has thus far proposed not to do so.

Swap Execution Facilities

Title VII of Dodd-Frank requires swaps that are cleared to be traded on an exchange or a SEF. Block trades and swaps that are not made available for trading on a SEF are exempt from this requirement. The statute states that “multiple participants” must have the ability to interact on SEFs. By requiring all SEF trades to involve a minimum of five participants, we believe the CFTC’s proposed definition restricts customer choice unnecessarily and will result in significantly reduced liquidity. We believe the rule should lower this requirement to two participants and give clients the ability, but not the requirement, to request additional quotes. Any user of the platform could choose to request five, ten or 15 quotes if they believed it was in their interest to do so, but our clients have told us they want the flexibility to make that determination themselves, based on market conditions. That is the approach the SEC takes in its SEF proposal.

In addition, we believe that the CFTC impartial access requirement should not be interpreted to restrict the idea of dedicated liquidity pools for clients only, dealers only, or any other kind of rational self-organization that the private sector deems efficient. We believe that the CFTC should allow dedicated liquidity pools to rationally self-organize as long as the admissions criteria are not anti-competitive.

Lastly, the CFTC proposed rule requires that in order to be a SEF, the platform must support an expanded set of execution protocols that many of the existing SEF candidates do not currently support, which will result in significant transitional issues for market participants. Currently approximately less than ten percent of the market is executed electronically, and in some asset classes, that percentage is closer to one percent. Requiring market participants not only to execute electronically but to do so using protocols that don’t currently exist and are foreign to the methods they currently use decreases the likelihood of a smooth transition to electronification.

Extraterritorial Application of Title VII

Another significant concern for market participants is the extent to which regulators apply provisions of Title VII to transactions outside of the United States. Extraterritorial application not only goes beyond Congressional intent, but harms the competitiveness of US financial institutions with global businesses. Title VII explicitly provides that it "shall not apply to activities outside of the United States" unless such activities have a direct and significant connection with activities in or effect on commerce of the United States or are necessary to prevent evasion of Title VII.

One area of concern is the potential application of the Section 716 "pushout rules" to foreign branches of US banks, which we believe was neither the Congressional intent of Title VII nor consistent with US banking law. Section 716 restricts certain swaps activities such as trading credit derivatives or equity derivatives in entities that qualify for federal assistance (such as Federal Deposit Insurance). Section 716 should not be applied to foreign branches of US banks or foreign subsidiaries of US banks because those entities do not qualify for Federal Deposit Insurance and thus do not pose any risk to the US taxpayer.

Similarly, application of other provisions of Title VII, such as the mandatory clearing and SEF execution provisions, to foreign branches of US banks or foreign subsidiaries of US banks is not warranted because those activities do not have a direct and significant effect on US commerce. It is worth noting that foreign branches of US banks and foreign subsidiaries are generally subject to comprehensive regulation and examination in the countries in which they operate – for example, foreign branches of US banks which operate in London are subject to comprehensive regulation by the UK Financial Services Authority.

In addition, the European Union is in the process of enacting comprehensive reform of the OTC derivatives markets, and so applying US rules to activities conducted in European jurisdictions runs the risk of inconsistent regulations ultimately applying to the same activity and harming the competitive position of US financial entities operating overseas.

Regulatory coordination

Title VII of the Dodd-Frank Act requires agency consultation and cooperation in their rulemaking activities. Despite this stated requirement, certain proposed regulations are treating very similar products differently in a way that is difficult to justify from a public policy perspective.

An example of this is in the post-trade transparency rules, which require the capture at point of trade of many trade details for eventual reporting. The trade details to be captured under the CFTC proposed rule and the SEC proposed rule, however, are not the same. This will make implementation of the rules very difficult for market participants who are subject to them. These differences will require different systems and workflows and largely duplicative but separate training and compliance regimes, all of which will result in widespread confusion among trading, operations and compliance personnel employed by market participants.

For example, at JPMC we employ traders who enter into both credit default swap index transactions, which are "Swaps" and thus subject to the CFTC proposed rule, and single-name credit default swap transactions, which are "Security Based Swaps" and thus subject to the SEC proposed rule. Just as it makes no sense to regulate salmon differently depending upon whether they are in fresh water or salt water, it makes no sense to treat very similar OTC derivatives activities differently depending upon whether they are subject to CFTC or SEC jurisdiction. The existence of two separate post-trade transparency regimes that will need to be implemented differently at the trader level will make such implementation difficult and will make the information that is ultimately reported less useful to the public. The result is likely to frustrate the post trade transparency objectives of the rules.

Another example is the definition of SEF. There are significant differences between the regulatory agencies' proposed regulations that will require two distinct trade execution infrastructures. We urge the Commissions, to the maximum extent possible, to conform their regulations and eliminate any differences which are not absolutely necessary in order to eliminate these negative consequences.

We are also concerned about the increased costs and burdens that our clients, many of which are mainstream US companies, will incur as a result of Title VII implementation. The mandatory clearing requirements, even if the client is an exempt end user, will result in increased costs because JPMorgan Chase's hedge transactions will be cleared, and we will have to pass on those costs. To the extent that the post trade transparency and SEF rules materially reduce liquidity, dealers' impaired ability to hedge will mean less competitive pricing for clients. The business conduct rules will result in much more extensive documentation at point of trade, and clients will have to bear the costs of reviewing and negotiating that documentation. Finally, the costs of complying with the extensive rules under Title VII, which will impose significant costs on dealers that will be passed along to clients, will be exacerbated by Section 716 which will require JPMC to maintain three swap dealers instead of a single legal entity, significantly raising compliance costs.

JPMorgan Chase is committed to working with Congress, regulators and industry participants to ensure that Title VII is implemented appropriately and effectively. I appreciate the opportunity to testify before this Committee and look forward to answering any questions you may have.

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
DON THOMPSON	JPMORGAN CHASE & CO. SIFMA
3. Business Address and telephone number:	
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4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
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