Testimony of Don Thompson

JPMorgan Chase & Co.

Subcommittee on Capital Markets and

Government Sponsored Enterprises

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Chairman Garrett, Ranking Member Waters, and Members of the Committee, my name is Don Thompson and I am a Managing Director and Associate General Counsel at JPMorgan Chase & Co. I provide legal advice with respect to the full range of J.P. Morgan's OTC derivatives businesses and have been leading J.P. Morgan's implementation of Title VII of the Dodd-Frank Act. Thank you for inviting me to testify at today's hearing.

The extraterritorial application of Title VII to JPMorgan Chase's swaps activity is an issue of critical importance to our firm, American banks' competitiveness internationally and market integrity. Simply put, the unnecessary harm cannot be overstated. An overreaching application of Dodd-Frank would severely impact U.S. competitiveness and actually increase risk when a robust regulatory framework already exists and there are other safeguards that could be adopted without creating an unlevel playing field for our banks.

Background

The question of the degree to which the many reforms affected by Title VII will apply to activities outside the United States is an essential one. Congress addressed the issue in Section 722 of Dodd Frank, which states that Title VII should not apply outside the United States unless foreign activity has a "direct and significant connection with activities in, or effect on, commerce of the United States." If an expansive approach to extraterritorial application is part of the Title VII framework, the effect on U.S. financial institutions would be to put those firms at a severe competitive disadvantage relative to their overseas competitors.

Since Dodd Frank passed in July of 2010, the question of how this provision would be applied has loomed as one of the most important issues facing the OTC swaps markets. The reason this issue is so important is that swap markets and the activities of swap dealers are global, as I describe below. Although there has been no definitive pronouncement on this issue by the CFTC or SEC to date, there are reasons for concern.

Statements by Chairman Gensler and CFTC staff in public forums have indicated that the CFTC intends to take an expansive, aggressive approach in applying Title VII's provisions to the overseas activities of U.S. swap dealers. These views have been confirmed in meetings in which many market participants have participated. In particular, the CFTC has indicated that for firms

that conduct swap activity through their foreign branches, such as J.P. Morgan, they will likely consider the firm as a single legal entity and will apply all of Title VII's requirements to all of the foreign activity of the firm, even those activities with entities that have no nexus to the United States.

The CFTC has indicated that it will propose a rulemaking or interpretation on the extraterritorial application of Title VII at some point in the regulation writing process, but it has not yet indicated when it will be published.

Competitive Disadvantage

J.P. Morgan is a diversified financial institution that competes with other investment banks in all markets around the world. When we compete outside the United States, a big part of the value we provide to our clients is that we bring global capabilities and scale. Equally important is being able to compete on a level basis with local competitors in local markets. The importance of U.S. firms to compete on a level playing field in the global marketplace has been long recognized in U.S. banking regulation (Regulation K of the Federal Reserve Board is an example), which has generally provided financial institutions with powers sufficiently broad to enable them to compete effectively with their foreign competitors outside the U.S.

A good example of this is our securities powers. Historically our ability to transact in debt and equity securities through bank entities was circumscribed by regulation in the U.S., but outside the U.S. we are authorized to engage in securities underwriting and trading. This approach works because, among other things, the banking regulators, the Federal Reserve Board (the "Fed") and the Office of the Comptroller of the Currency (the "OCC"), have broad powers to regulate our foreign branches, subsidiaries and affiliates to ensure that all of their activities, including derivatives activities, are conducted in a safe and sound manner, which I describe later.

Applying all of the Title VII provisions to all our foreign activities would (1) violate this longstanding principle of competitive equality, (2) would directly conflict with the requirement that overseas application is only warranted when the "direct and significant effects" test is met and (3) would place U.S. firms at a severe competitive disadvantage to foreign banks.

The best example of how extraterritorial application of Title VII will place U.S. firms at a competitive disadvantage in the global marketplace is contained in the proposed margin rules for uncleared swaps. If a French pension fund, a Dutch company or an Asian sovereign wealth fund wishes to enter into a derivatives transaction, European or Asian banks will not require them to post margin; if Dodd-Frank is read to require U.S. banks to do so, we will simply lose this business, which will ultimately have a negative impact on U.S. jobs and the economy. Furthermore, since most companies seeking debt underwriting require a derivative as part of their funding plan – for example, a German firm may wish to issue debt in dollars and swap to euros – we would also be unable to compete in those markets.

The competitive impact of applying the margin rules to our swap activities overseas is exacerbated by very prescriptive and restrictive rules governing what types of margin are eligible under the proposed regime. By restricting eligible margin to U.S. dollar cash, Treasuries and Agencies, the proposed rules will not only put U.S. banks in the position of demanding margin from our overseas clients when our competitors do not, but we would not even be permitted to accept margin in the form of, for example, Euro Cash and G7 Sovereign Debt, which are common forms of permitted collateral in European markets. The effect of this will be to eviscerate our ability to serve clients overseas and cede the global market to foreign competitors, who would not be subject to these rules.

Congress could have passed a law prohibiting U.S. banks from operating an overseas derivatives business, but it did not. In fact, it has never even considered doing so, given the vital importance of this business to U.S. financial firms and their ability to serve U.S. multinational corporations. And yet the interplay of a CFTC/SEC registration requirement and a margin proposal from the bank regulators risks the same result. Under the terms of Dodd Frank, which include a specific mandate against extraterritorial application of rules in this area, the CFTC should not require a foreign branch or subsidiary of a U.S. bank to register as a U.S. swap dealer unless it is doing business in the United States.

In fact, in gauging Congressional intent on this issue, many Members of Congress, including those who supported and led the passage of Dodd-Frank, have subsequently expressed concerns about such an approach. Chairmen and Ranking Members of the House and Senate Agriculture and Financial Services Committees, the New Democrat Coalition, bipartisan members of the New York Delegation and many others have expressed concerns that the needle be threaded carefully given the negative impact on American competitiveness.

In short, if Title VII applies only to international branches of U.S. banks serving European or Asian clients, but not to our European or Asian competitors, we will lose much of this business. The impact on J.P. Morgan would be severe; although this varies from quarter to quarter, we often derive as much of our revenues from our global operations as from those in the United States. Moreover, losing our non-U.S. customers would deprive us of valuable diversification in our credit exposures and would increase risk to our firm rather than reduce it.

Harmonization Isn't the Answer

As one would expect, we have raised the problem of competitive disadvantage to regulators and policy makers whenever we have the opportunity to discuss this issue. The answer that we often hear is that global harmonization of rules will solve the problem. While we understand that various groups of regulators are attempting to harmonize the rules relating to derivatives globally, and we agree that these efforts are important to ensure against regulatory arbitrage and adverse competitive impacts, practical impediments to harmonization will make it unreliable as a solution.

First is that most harmonization efforts are focused on harmonizing U.S. regulation with that in Europe. While this is of course critically important, it is equally important to recognize that we operate globally, in every non-U.S. jurisdiction of commercial importance. Even if U.S. regulation relating to derivatives were to be perfectly harmonized with Europe's (which we think is highly unlikely as we will explain in the succeeding paragraph), the issue of competitive disadvantage would still be a problem for us in Asia, Latin America and many other important markets around the globe.

As experience with other attempts to harmonize commercial law shows, it is likely that only the broadest set of principles can be adopted on a global basis. There still will be the need to implement and interpret those principles at the national level, and it is likely that differences will arise in such implementation and interpretation, highlighting the need for regulations that enable entities to compete locally on a level playing field.

Second, we think it is highly unlikely that harmonization of derivatives regulation between the United States and Europe will be perfect: it is much more likely to result in significant differences on many important issues.

The CFTC and SEC acknowledge this in their Joint Report on International Swap Regulation, published last week, in which they stated that with respect to harmonization efforts "it is still too early to determine precisely where there is alignment internationally and where there may be gaps or inconsistencies."

For example, it is not at all clear whether other G20 regulators will adopt either the Volcker rule prohibition on proprietary trading or the so-called "Swaps Pushout" rule contained in Section 716 of Dodd Frank. To date, global regulators are taking a significantly different approach to the rules relating to requiring margin for uncleared swaps than the approach taken in the U.S. by the CFTC and the prudential regulators.

Harmonization with Europe will be at best imperfect, and thus extraterritorial application of U.S. rules to U.S. swap dealers' activity in Europe – which we believe Congress never intended in the first place – will leave U.S. swap dealers at a significant competitive disadvantage compared to European competitors.

Third, harmonization will not fix the timing problem. The U.S. Congress and regulators have made needed reforms to the OTC swaps markets much more quickly than their counterparts in Europe and Asia. The U.S. regulatory framework will be largely set and in the process of being implemented in 2012. In contrast, the European approach is on a much longer timetable and may not be concluded until 2014 or even later, and the rest of the world is even further behind. If harmonization is used as the solution to the extraterritorial application of U.S. rules, there will be a period of at least two years where U.S. firms will be operating at a significant competitive disadvantage to their overseas competitors, and during that time many customer relationships will be lost.

The Existing Prudential Supervision Framework for Bank Activity Outside the U.S.

The stated rationale for an aggressive, expansive application of the Title VII framework to the foreign activities of U.S. banks with non U.S. clients is that this activity has the potential to import excessive risk back into the United States, much as the swap activity of AIG's London based financial products subsidiary did. There are a number of reasons why this rationale is not valid with respect to U.S. banks in the current regulatory environment.

- **First, it is important to note that the activities of U.S. banks outside the U.S, including their swap activities, are already subject to a robust prudential supervisory regime that is administered by the Fed and the OCC.** For example, every national bank that operates foreign branches must furnish information concerning the financial condition of those branches upon demand by the OCC. These prudential regulators already have broad supervisory authority over the foreign activities of banks (including foreign branches), their subsidiaries and their affiliates. U.S. banks conducting international operations under Regulation K are required to supervise and administer their foreign branches and subsidiaries in such a manner as to ensure that their operations conform to high standards of banking and financial prudence. Branches must have effective systems of records, controls and reports to keep management informed of their activities. The systems must provide, in particular, information on risk assets, exposure to market risk, liquidity management, operations, internal controls, legal and operational risk, and conformance to management policies. All such reports, as well as any additional reports required by the Fed, must be available to Fed examiners. Moreover, Fed and OCC examiners can and do regularly examine the foreign branches and subsidiaries of U.S. banks. Unlike the case with AIG Financial Products, the foreign swap activities of U.S. banks, affiliates and subsidiaries are already subject to a comprehensive regulatory regime that is designed to ensure that those activities are conducted in a safe and sound manner. Pursuant to this authority, for example, prudential regulators could require branches or subsidiaries of U.S. banks operating overseas to provide periodic reporting of their significant credit and market risk exposures.

- **Second, the regulatory regime for swaps has dramatically and fundamentally changed since AIG.** Under Title VII, major participants in the swaps market are now required to register as swap dealers or major swap participants. Once registered, they are subject to a comprehensive, "entity level" regulatory framework that includes requirements for sound risk management practices and minimum capital standards. Had these entity level regulatory requirements been applicable to AIG Financial Products, it would not have been able to incur the exposures that it did and would not have had to be bailed out.

Proposed solutions, such as the Himes-Garrett Bill discussed below would maintain these aggressive new Dodd-Frank mandates, while keeping U.S. banks subject to the comprehensive entity level regulatory regime of Title VII with respect to all foreign swap activities of swap dealers and major swap participants.

The Himes-Garrett Bill is a Sensible Solution

The application of the entire Title VII regime to all the foreign activities of U.S. banks, creating a severe competitive disadvantage for U.S. banks, is not necessary to achieve the protection of the U.S. financial system. The Himes-Garrett bill is a sensible and workable bipartisan solution that protects the U.S. financial system without making U.S. banks uncompetitive in the global marketplace.

The Himes-Garrett Bill, by recognizing that there are two types of regulation imposed by Title VII, achieves this dual goal of protecting the U.S. financial system and placing U.S. firms on a competitive footing for global business:

- "Entity Level" regulation, which applies to the totality of entities' swap activities, include the requirement to register as a swap dealer, to maintain minimum capital standards, to have in place sound risk management practices and a robust compliance program.

- "Transaction Level" regulation, which applies to each individual swap entered into by an entity, includes the requirement to submit a swap for mandatory clearing, to execute swaps on a Swap Execution Facility under certain circumstances and to provide certain risk disclosures in connection with certain types of swaps. The bill redefines the term "swap" to exclude transactions between foreign branches, subsidiaries or affiliates of U.S. banks and their non-U.S. clients, but permits regulators to require those foreign entities to register as swap dealers or major swap participants.

The Himes-Garrett structure—by maintaining the tough "entity level" regulation imposed on these entities under Title VII but exempting individual transactions from Title VII requirements, such as margin requirements—removes the competitive disadvantage aspect of applying Title VII to foreign activities but continues to protect the U.S. financial system against the importation of excessive risk from that foreign activity.

Conclusion

In conclusion, J.P. Morgan is committed to working with Congress, regulators and industry participants to ensure that Title VII is implemented appropriately. The consequences of getting it wrong are very significant for the competitiveness of U.S. banking institutions and the effective functioning of U.S. and global markets. I appreciate the opportunity to testify before this Committee and look forward to answering any questions you may have.

United States House of Representatives
Committee on Financial Services

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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.
3. Business Address and telephone number:	
[redacted]	
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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