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United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510–6250

April 23, 2013

VIA U.S. MAIL & EMAIL (DLeslie@CFTC.gov and JRiley@CFTC.gov)

The Honorable Gary S. Gensler
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: RIN No. 3038-AD57, Proposed Guidance on Extraterritorial Application of Certain Swap Rules; RIN No. 3038-AD85, Exemptive Order Regarding Compliance with Certain Swap Regulations; and RIN No. 3038-AD85, Final Exemptive Order Regarding Compliance with Certain Swap Regulations

Dear Mr. Chairman:

In the fall of 2008, the world financial system nearly collapsed as many large financial institutions failed or faltered. American taxpayers and governments around the world were forced to bail out a number of these financial institutions.[1]

In the aftermath of this collapse, Congress worked to overhaul regulation of U.S. financial markets and key market participants. Principal among those objectives was restoring regulation to the swaps markets.[2] Title VII of the Dodd-Frank Wall Street Reform and

[1] For example, according to records released by the Board of Governors for the Federal Reserve System, Bank of America, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Royal Bank of Scotland, and American International Group received significant financial support during the financial crisis. U.S. Gov't Accountability Office, GAO-11-696, Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance 131, 162 (2011). Overseas banks accounted for about 70 percent of the Federal Reserve's discount window loans during the peak of the financial crisis. See "Foreign Banks Tapped Fed's Secret Lifeline Most at Crisis Peak," Bloomberg News, Bradley Keoun & Craig Torres (April 1, 2011), http://www.bloomberg.com/news/2011-04-01/foreign-banks-tapped-fed-s-lifeline-most-as-bernanke-kept-borrowers-secret.html.

[2] See, e.g., 156 Cong. Rec. S5870-02 (July 15, 2010) (statement of Sen. Dodd: "[W]e tried to deal with exotic instruments that had caused so much of the difficulty. The derivatives market was a $90 billion market, and it mushroomed in less than a decade to $600 trillion, putting our Nation at risk because of a lack of transparency and accountability to determine what was occurring in those markets. To consider it a radical idea that we might want to have accountability and transparency I find remarkable considering what our country has been through."); 156 Cong. Rec. S3569-08 (May 12, 2010) (statement of Sen. Dodd: "[T]he market in which these companies operate will become safer and less expensive because of the new rules for big players: the swap dealers and major participants."); 155 Cong. Rec. H4498-01 (Apr. 2, 2009) (statement of Rep. Barney Frank: "And we will see this when we bring the bill up, that we won't have any more unlimited credit default swaps and collateralized debt obligations."). Prior to 2010, Congress was prohibited from regulating the swaps markets by the Commodity

Consumer Protection Act (the "Dodd-Frank Act") established a comprehensive regulatory regime for the swaps markets and their key participants, with the Commodity Futures Trading Commission (CFTC) overseeing the swaps markets, and the Securities and Exchange Commission (SEC) overseeing security-based swaps markets.[3]

These regulatory reforms were enacted to reduce systemic risk, increase transparency, and promote market integrity by, among other things:

1) providing for the registration and comprehensive regulation of swap dealers and major swap participants;
2) imposing clearing and trade execution requirements on standardized derivative products;
3) creating recordkeeping and data reporting regimes with respect to swaps; and
4) enhancing regulators' rulemaking and enforcement authorities over all registered entities, intermediaries, and swap counterparties.[4]

One central issue in this new regulatory regime has been to what extent it will apply to U.S.-based affiliates of foreign firms and foreign affiliates of U.S.-based firms. While crafting the legislation, Congress and financial regulators were acutely aware of "how the stability of a large financial institution could be undermined by its activities abroad and how the entire U.S. financial system could be threatened as a result."[5] In order to protect U.S. taxpayers and U.S. markets from those types of derivatives trading risks, Section 722 of the Dodd-Frank Act gave the CFTC authority over cross-border swap activities that "have a direct and significant connection with activities in, or effect on, commerce of the United States."

On July 12, 2012, the CFTC proposed guidance regarding the cross-border application of various swap provisions.[6] That same day, the CFTC also proposed an exemptive order for certain entities that would grant market participants temporary conditional relief from certain provisions of the new swaps regime.[7] On January 7, 2013, the Commission issued a final exemptive order that allowed a non-U.S. person that registers as a swap dealer or major swap

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Futures Modernization Act. See Commodity Futures Modernization Act of 2000 (Appendix E of the Consolidated Appropriations Act, 2001), P.L. 106-554, 114 STAT. 2763A–452-453 (2000) ("The Commission is prohibited from registering, or requiring, recommending, or suggesting, the registration under this title of any … swap agreement … The Commission is prohibited from—(A) promulgating, interpreting, or enforcing rules; or (B) issuing orders of general applicability[.]").

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), P.L. 111-203, codified at 15 U.S.C. § 8301 et seq. (2010).

[4] See "Final Exemptive Order Regarding Compliance With Certain Swap Regulations," 78 Fed. Reg. 858, (1/7/2013) ("Final Order").

[5] "Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act," 77 Fed. Reg. 41214, 41215 (7/12/2012) ("Proposed Guidance"). See also, e.g., 156 Cong. Rec. S5828-01 (July 14, 2010) (statement of Sen. Dodd: "Derivatives are vitally important if utilized properly in terms of wealth creation and growing an economy. But what was once a way for companies to hedge against sudden price shocks has become a profit center in and of itself, and it can be a dangerous one as well, when dealers and other large market participants don't hold enough capital to back up their risky bets and regulators don't have information about where the risks lie. AIG was the classic example, of course, where that happened.").

[6] Proposed Guidance, 77 Fed. Reg. 41214 (7/12/2012).

[7] "Exemptive Order Regarding Compliance With Certain Swap Regulations," 77 Fed. Reg. 41110 (7/12/2012).

participant to delay compliance with certain entity-level requirements of the new swaps regime, and non-U.S. swap dealers and major swap participants and foreign branches of U.S. swap dealers and major swap participants to delay compliance with certain transaction-level requirements of the new swaps regime for a specified period.[8] That Final Order essentially provides a transitional period leading to compliance with the Guidance, once it is finalized.

Some members of the financial industry have filed comment letters urging the CFTC to weaken its proposals so that many of the Dodd-Frank safeguards will not apply to a wide variety of cross-border swaps and key market participants. The purpose of this letter is to urge the opposite: that American families and businesses deserve strong protections against the risks posed by derivatives trading, including from cross-border swaps, and that the Proposed Guidance should be strengthened rather than weakened.

In particular, this letter recommends: (1) applying derivative safeguards to U.S. financial institutions and their foreign branches and agencies on an entity-wide basis; (2) applying the same derivative safeguards to foreign affiliates and subsidiaries that are under common control with a U.S. financial institution; (3) rejecting suggestions to exempt derivatives trading conducted between the non-U.S. offices of U.S.-based financial institutions; (4) expanding the description of guarantee arrangements considered relevant to determining whether a foreign affiliate or subsidiary should be treated as a U.S. person to include, at a minimum, arrangements involving total return swaps, credit default swaps, and customized options; and (5) ensuring that the foreign offices of U.S.-based financial institutions, when conducting derivatives trades that have a direct connection to the United States, comply with the same capital, clearing, margin, recordkeeping, and reporting safeguards and business standards that apply to their U.S.-located counterparts.

JPMorgan Whale Trades. Recent events in the financial markets have bolstered the rationale for strong cross-border swaps protections and oversight of overseas derivatives trading. The U.S. Senate Permanent Subcommittee on Investigations, which I chair, recently completed a bipartisan investigation into a complex set of synthetic credit derivatives trades, known as the whale trades, which caused a loss of at least $6.2 billion at JPMorgan Chase in 2012. Those derivatives trades illustrate the type of swaps trading activity by a large, federally insured bank and its foreign office that must not be exempt from comprehensive U.S. derivatives regulation and oversight.

To ensure those trades are subject to the CFTC's cross-border application of the new derivatives reforms, please find enclosed a copy of our bipartisan Subcommittee staff report entitled, "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses," which was released in connection with a Subcommittee hearing on March 15, 2013.[9] I request that both the Levin-McCain report and all related hearing materials be considered as included in the administrative record for the Proposed Guidance and related orders.

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[8] Final Order, 78 Fed. Reg. 858.

[9] "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses," before U.S. Senate Permanent Subcommittee on Investigations (3/15/2013).

The JPMorgan Chase whale trades provide a variety of fact patterns and policy issues that are relevant to the regulation of overseas derivatives trading and critical to the overall effective implementation of the derivatives title of the Dodd-Frank Act. Key issues include:

1) the integration of U.S. and non-U.S. derivatives trading operations;
2) the magnitude of risks to a large U.S. bank that may arise from derivatives trading by a relatively small non-U.S.-located office;
3) the challenges facing regulators seeking to detect, measure, and track derivatives risks and losses affecting the U.S. financial system; and
4) the need for strong derivatives safeguards to prevent banks from understating or disguising the risks and losses associated with a complex derivatives portfolio.

Integration of U.S. and Non-U.S. Derivatives Trading. The JPMorgan whale trades demonstrate how some major U.S. financial institutions have so closely integrated their U.S. and non-U.S. derivatives trading operations that they function as a single global enterprise, often using the same funds, information systems, risk management, and financial reporting results. The details of how the whale trades were conducted and reported strongly support the CFTC's application of its derivatives safeguards to the non-U.S. offices of U.S. financial institutions.

The JPMorgan whale trades involved swaps referencing either synthetic credit indices or credit index tranches; they functioned as bets on the creditworthiness of various corporations around the world. They were undertaken in connection with an investment program called the Synthetic Credit Portfolio (SCP) and recorded in an SCP trading book. The SCP and its trading book were created and run by JPMorgan's Chief Investment Office (CIO).

The CIO is a division of JPMorgan Chase Bank. It is headquartered in New York City, its offices are within the bank, and it is overseen by the bank's primary regulator, the Office of the Comptroller of the Currency (OCC). It is headed by a Chief Investment Officer, who is one of the most senior executives at the bank. Among other activities, the CIO invests the U.S. bank's excess deposits, a portion of which are federally insured by the Federal Deposit Insurance Corporation (FDIC).

In addition to its U.S. operations, the CIO operates a relatively small branch office in London, sometimes referred to as "International CIO," which conducts derivatives trading, among other activities. The CIO's senior personnel in New York hire and supervise the CIO personnel in London, who operate in the same office space as JPMorgan's London banking and investment operations. All of the whale trades, as with other SCP trades, were executed by CIO traders employed by the London office, using money from the U.S. bank's excess deposits, a portion of which was FDIC insured.

Although London CIO traders conducted the whale trades on a day-to-day basis, the bank formally attributed the trades to JPMorgan Whitefriars Inc.,[10] a Delaware corporation with a

[10] See, e.g., Hearing Exhibit 4, "Chief Investment Office New Business Initiative Approval Executive Summary," (Nov. 2006), at page 9 (explaining that the SCP trades would be performed through the "London Branch (trades back-to-back through the branch)," the "New York Branch (trades back-to-back through the branch)," and then assigned to "JPMorgan Whitefriars Inc. (ultimate repository of the risk).").

London branch office that acts as JPMorgan's "primary legal entity to book and manage certain equity and credit security and derivative products."[11] The CIO's use of a U.S. corporation, operating through a London office, to record its trades was standard practice in JPMorgan's credit derivatives trading operations.

To execute, record, and track the whale trades, the CIO's London office used JPMorgan's software systems and back office personnel, which administers both its U.S. and U.K. derivatives trades. To analyze the trades and establish appropriate risk limits, the CIO's London office used JPMorgan's Value-at-Risk (VaR) and other risk management models and software which, again, are used for both its U.S. and U.K. derivatives trading operations. In addition, to analyze the trading risk, the CIO's London office used, not only its own risk management personnel, but also risk management personnel in New York. To determine its capital requirements, the CIO's New York and London offices used JPMorgan's standard models and software.

The derivative positions resulting from the CIO London's whale trades were valued or "marked-to-market" on a daily basis. The daily values attributed to the derivative positions were included in the CIO's internal daily profit and loss records, which combined its London and U.S. trading operations. The CIO's daily profit and loss records were routinely rolled up into JPMorgan's overall daily profit and loss records, which were maintained internally, and reported publicly on a quarterly and annual basis in JPMorgan filings with the U.S. Securities and Exchange Commission (SEC).

The CIO London office entered into the whale trades with a relatively small number of counterparties, including major U.S. banks such as Bank of America, Citigroup, Goldman Sachs, and Morgan Stanley.[12] In some of the whale trades, the CIO's counterparty was JPMorgan Bank's own Investment Bank.

The facts surrounding the JPMorgan whale trades provide solid support for the CFTC's assertion that "large financial institutions effectively operate their businesses as a single business, by virtue of the relationship with the parent company and to each other, with the constituent parts inextricably linked to each other."[13]

Increasing Risk. On December 21, 2012, in connection with the Proposed Guidance, in your role as CFTC Chairman, you observed: "[R]isk has no geographic boundary and money can move in and out of markets and jurisdictions in milliseconds. For the public to be protected, swaps market reform must cover transactions of overseas branches and overseas affiliates guaranteed by U.S. entities." The JPMorgan whale trades, which saw rapid trading and equally rapid losses, prove this point.

The whale trades took place over a three-month period, from January to March 2012, after which the Chief Investment Officer, Ina Drew, ordered all Synthetic Credit Portfolio

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[11] JPMorgan Chase & Co.'s Resolution Plan (7/1/2012), at 4, http://www.federalreserve.gov/bankinforeg/jpmorgan-chase-20120703.pdf.

[12] See, e.g., Hearing Exhibit 35, JPMorgan email identifying SCP counterparties in the context of ongoing "Collateral Disputes," (April 20, 2012).

[13] Proposed Guidance, 77 Fed. Reg. 41216.

trading stopped. During those three months, the notional size of the SCP trading book tripled, from about $51 billion to about $157 billion. The London traders conducted credit derivatives trades on a daily basis, sometimes conducting hundreds of trades in a day. By March 2012, the SCP trading book contained a high risk mix of over one hundred different credit instruments, referencing investment grade and non-investment grades corporations in the United States, Europe and Asia; specifying a variety of maturity dates; and extending from one to ten years in duration.

JPMorgan's Chief Investment Officer in New York oversaw the CIO's London office and exercised ultimate control over its trading strategies which were actually carried out by a handful of CIO traders in London. At the end of each business day in London, a CIO trader in the London office marked the value of the derivative positions in the SCP trading book, used JPMorgan software to derive a total profit or loss for the day, and sent an email to CIO headquarters in New York with the resulting daily profit or loss estimate. CIO personnel in New York reviewed the data and provided a final profit or loss figure to the bank for inclusion in the bank's overall daily profit-loss report.

In January 2012, the SCP trading book began incurring sustained losses. While many of the reported daily losses totaled less than $10 million, on some days the portfolio incurred massive losses totaling as much as $319 million, $415 million, even $570 million in a single day. At the end of the quarter, in March 2012, JPMorgan reported internally that the SCP trading book had lost a total of $719 million. Fourth months later, in July 2012, after it was determined that the London traders had been mismarking the SCP book to understate losses, JPMorgan restated its first quarter earnings and increased the SCP losses by $660 million, a 70% increase, to a total of more than $1.4 billion. In addition, although CIO headquarters had ordered a stop to new SCP trades on March 23, 2012, the losses from the existing derivative positions continued to mount through the second and third quarters of 2012, eventually reaching at least $6.2 billion, all in a relatively benign credit environment.

The SCP losses incurred by the London office directly impacted JPMorgan's overall balance sheet and earnings. In addition, the whale trades and their related losses triggered an in-depth review by JPMorgan's regulator, the OCC, which found that the London office had engaged in unsafe and unsound derivatives trading activity, and that the New York CIO, as well as JPMorgan itself, had inadequate internal controls and exercised inadequate oversight.

Together, the facts behind the JPMorgan whale trades provide incontrovertible evidence that swaps executed by a non-U.S. office of a U.S. financial institution can cause sudden, massive losses for the U.S. parent corporation, can put federally insured deposits at risk, and can directly affect the U.S. financial results of a major bank. This evidence provides additional support for the CFTC's determination that U.S. derivatives safeguards should be applied to non-U.S. offices of U.S. financial institutions in order to protect the U.S. financial system.

Foreign Branches and Agencies. One key issue is who should be considered a "U.S. person" for purposes of requiring compliance with the derivatives safeguards established by the Dodd-Frank Act.

The Proposed Guidance and Final Order each provide a definition of "U.S. person."[14] The definition appropriately includes, among other provisions, corporations which are organized, incorporated, or have their principal place of business within the United States. The Proposed Guidance also makes it clear that a U.S. person includes a "foreign branch or agency of a U.S. person … by virtual of the fact that it is a part, or an extension, of a U.S. person."[15]

The JPMorgan whale trades provide strong factual support for an inclusive definition of "U.S. person," in particular when it comes to the foreign branch or agency office of a U.S. corporation, since the London branch office of the CIO clearly functioned as an extension of the CIO office in New York. The London office's funding, management oversight, information systems, risk management, and financial reporting were fully integrated with JPMorgan's U.S. operations, and its financial results directly altered JPMorgan's financial results. To protect U.S. taxpayers and the U.S. economy from the derivatives risks incurred by JPMorgan, it is logical and of critical importance that the London office of JPMorgan's Chief Investment Office follow the same capital, margin, risk management, trade execution, recordkeeping, and reporting requirements and the same business conduct standards as the U.S. bank itself. The Proposed Guidance would achieve that result by taking the position that it "would apply the Dodd-Frank Act registration requirements to a U.S. person and its foreign branches and agencies on an entity-wide basis."[16] The final Guidance should surely do the same.

Foreign Subsidiaries and Affiliates. In contrast to the provision on foreign branches and agency offices, one of the more misguided provisions of the Proposed Guidance states: "By contrast, a foreign affiliate or subsidiary of a U.S. person would be considered a non-U.S. person, even where such an affiliate or subsidiary has certain or all of its swap-related obligations guaranteed by the U.S. person."[17] The Proposed Guidance would apparently view a foreign affiliate or subsidiary as a non-U.S. person even if it were fully integrated with its U.S. parent, operated as a wholly owned shell operation with no offices or employees of its own, and functioned in the same way as a branch or agency office. That approach makes little economic sense, given the insubstantial reality of many foreign affiliates and subsidiaries in the financial industry. The provision is also at odds with other portions of the Proposed Guidance which assert that foreign affiliates or subsidiaries that enjoy "guarantees" by a U.S. person effectively transfer their swaps risks to that guarantor and should be subject to U.S. derivatives safeguards.[18]

Under the Proposed Guidance, a foreign affiliate or subsidiary of a U.S. financial institution would not be treated in the same manner as a foreign branch office – where derivative

[14] Compare Proposed Guidance, 77 Fed. Reg. 41218, with Final Order, 78 Fed. Reg. 865. The Final Order definition is substantially and unduly more constricted. The Final Order fails to include, for example, corporate entities in which the direct or indirect owners are responsible for the corporate liabilities and one or more are U.S. persons; and commodity pools or collective investment vehicles with a majority of U.S. investors. The Final Order does not adequately explain why these categories were dropped from the definition of U.S. person in the Proposed Guidance.

[15] Proposed Guidance, 77 Fed. Reg. 41218.

[16] Id. at 41221.

[17] Id. at 41218.

[18] See, e.g., id. at 41218 ("In the Commission's view, the concerns regarding risks associated with the affiliate group structure are heightened where a U.S. person guarantees (or provides similar support) to a foreign affiliate or subsidiary. In such situations, the risk of the swaps executed abroad are effectively transferred to or incurred by the U.S. person.").

safeguards are applied to the parent corporation and its foreign office on an entity-wide basis – but would have to be treated as an independent, non-U.S. entity that must be analyzed as to whether it is subject to the CFTC's derivatives safeguards. That language is deficient and confusing. The whale trades case history suggests that setting up a system that initially excludes foreign affiliates and subsidiaries of U.S. financial institutions from the CFTC's derivatives safeguards as non-U.S. persons, and then requires a case-by-case analysis of whether they should be made subject to those safeguards, would be overly complicated, resource intensive, and lead to uncertainties and gamesmanship.

For example, JPMorgan could take the position that its whale trades were not conducted by the CIO's London branch, but instead by JPMorgan Whitefriars Inc., which is not a branch office, but a Delaware affiliate. JPMorgan booked the whale trades through JPMorgan Whitefriars by arranging back-to-back trades through its London and New York offices, paper exercises that moved the trades from the CIO in London to the CIO in New York to JPMorgan Whitefriars.[19] While JPMorgan Whitefriars happens to be a Delaware corporation with a London office, JPMorgan could have easily used the same means to move the trades to a U.K. or Cayman affiliate or subsidiary. If it had, under the Proposed Guidance as now drafted, JPMorgan may have been able to treat the whale trades as those of a foreign affiliate that, at least as a starting position, would be outside the CFTC's derivatives safeguards. Other provisions would then have to be employed to determine whether the foreign affiliate should be subject to CFTC regulation, focusing on such factors as whether the affiliate's operations were integrated with those in the United States, its financial results are consolidated with the parent corporation's U.S. financial results, or it has U.S. counterparties: a resource-intensive and complicated analysis.

While financial institutions today devise and employ a wide range of foreign affiliates and subsidiaries, it is far from clear that many allow those engaged in derivatives trading to operate as independent actors. To the contrary, it appears more typical that such foreign affiliates or subsidiaries are closely integrated with a parent corporation which has the financial backing needed for derivatives trades and which exerts close supervision over their derivatives trading books. Rather than treat all foreign affiliates and subsidiaries as non-U.S. persons, the final Guidance should consider starting with the presumption that a foreign affiliate or subsidiary engaged in derivatives trading will be treated as an extension of the parent corporation in the same manner as a branch or agency office, unless the parent corporation presents evidence as to why the affiliate or subsidiary should be treated independently. At a minimum, it is essential that an additional test be added to the final Guidance which would include as a U.S. person any foreign affiliate or subsidiary under common control with a U.S. person. In determining common control, the Commission should identify such objective factors as common management, funding, information systems, risk management, and financial reporting, including whether the affiliate or subsidiary's finances are consolidated with those of the U.S. person.

No Exemption for Foreign Offices of U.S. Financial Institutions. Some comment letters have urged the Commission to ignore the legislative history of the Dodd-Frank Act,[20] and

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[19] See footnote 2, supra.

[20] See, e.g., 156 Cong. Rec. H5223-02 (June 30, 2010) (statement of Rep. McMahon: "In particular, I applaud the effort to bring greater transparency, accountability, and oversight to our derivatives markets. This bill will make sure

exempt derivatives trades conducted between the foreign office of one U.S. financial institution and the foreign office of another U.S. institution, arguing that because such trades take place completely outside of the United States, they should be exempt from CFTC regulation. The JPMorgan whale trades demonstrate why that approach is ill advised.

In today's market, the vast majority of derivatives trading is conducted by a small number of large financial institutions, virtually all of which have both U.S. and foreign derivatives trading operations and virtually all of which could cause major damage to the U.S. economy if they were to fail or lose substantial value.[21]

The four largest whale trade counterparties were Bank of America, Citigroup, Goldman Sachs, and Morgan Stanley, each of which had pending credit derivatives trades with JPMorgan totaling between $3 trillion and $4 trillion in notional value.[22] The next three largest whale trade counterparties were Deutsche Bank of Germany, Societe General of France, and UBS of Switzerland, each of which had pending credit derivatives trades with a total notional value of between $2 trillion and $3 trillion.[23] The list does not indicate whether the whale trades were conducted with a U.S. or foreign office of those financial institutions; the trades could have been with either or a mix of the two.

Given the interconnectedness of global financial institutions internally and with their counterparties, if a key foreign office involved with derivatives trading experienced a default or insolvency, it would almost certainly directly affect the U.S.-based entity, and, if large enough, the U.S. financial system and economy. This direct impact on the United States is easily seen in the JPMorgan whale trades, where the financial institution consolidated the financial results of its global derivatives trading operations, including its foreign losses, in its U.S. filings with the SEC. Even without a consolidated financial statement, an insolvency experienced by a foreign office of a global financial institution could directly impact its U.S. operations by causing a loss of confidence in the institution, increasing the cost of its financing, or causing investors to withdraw funds from the institution or sell its stock. If the institution were to fail or lose substantial value, it could trigger related negative financial consequences in the United States. As explained in the Proposed Guidance:

> "The interconnected nature of the relationships among the affiliated entities within a corporate group means that a risk in any part of this group, whether in the

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that our regulators in the private sector understand that **outstanding swap exposures** for individual companies will never be allowed again to bring about a situation like what happened with AIG. This legislation also recognizes the important role that derivatives play in actually reducing systemic risk for our end user companies and in increasing the flow of credit throughout our economy.")(Emphasis added.)

[21] See, e.g., OCC Quarterly Report on Bank Trading and Derivatives Activity Second Quarter 2012, at 1, Graph 4, http://www2.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq212.pdf ("Derivatives activity in the U.S. banking system continues to be dominated by a small group of large financial institutions. Four large commercial banks represent 93% of the total banking industry notional amounts and 81% of industry net current credit exposure.").

[22] Subcommittee Hearing Exhibit 35.

[23] Id.

> United States or abroad, can quickly spread throughout the organization and jeopardize the financial integrity of the entire group."[24]

In the case of JPMorgan, the losses caused by its London office were substantial and caused a 24% drop in the bank's stock price, but fortunately did not jeopardize the integrity of the entire group. The same might not have been true if the $6.2 billion in losses had taken place at a different financial institution with a U.S. presence.

Still another problem is that, if derivatives trades conducted between the foreign offices of U.S. financial institutions were exempted from the U.S. derivatives safeguards, that exemption would itself encourage U.S. financial institutions to move their derivatives trading operations abroad, to London or elsewhere. By voluntarily surrendering regulation of that category of derivatives trading, the CFTC could find itself with the ability to police only a small fraction of the derivatives market, even when the trades being conducted in London or elsewhere involve major U.S. financial institutions, and the risks arising from those trades would have a direct and significant effect on the United States.

The better approach would be to acknowledge the global nature of derivatives trading, the dominance of a relatively small number of global financial institutions in the derivatives markets, and the impact that any of those global financial institutions would have on the United States if its derivatives trading were to cause the financial institution to fail or lose substantial value. Given the current state of derivatives markets, the CFTC must not exempt derivatives trades conducted by the foreign offices of U.S. financial institutions.

Guarantees. Another key issue involves the CFTC's proposed reliance on the concept of "guarantees" to determine whether an entity should be subject to U.S. derivatives safeguards. The Proposed Guidance does not define the term except in a footnote, when it states:

> "[R]eferences to a guarantee are intended to refer not only to traditional guarantee of payment or performance of the related swaps, but would also include other formal arrangements to support the non-U.S. person's ability to pay or perform its obligations, including without limitation, liquidity puts and keepwell agreements."[25]

The broad concept of "guarantee" is central to concerns with cross-border swaps and should be addressed in the text rather than in a footnote. If a U.S.-based parent company provides an implicit or explicit guarantee, regardless of the form of the guarantee, to a non-U.S. subsidiary or affiliate, the risk is effectively transferred to the U.S. person. In such circumstances, the exact form of the guarantee should not prevent the CFTC from demanding compliance with the CFTC's derivatives safeguards. The final Guidance should expand the list of guarantee arrangements that would be considered relevant to determining whether a foreign affiliate or subsidiary should be subject to U.S. derivatives safeguards to include, at a minimum,

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[24] Proposed Guidance, 77 FR 41216.

[25] Id., 77 Fed. Reg. 41221, footnote 47.

arrangements involving total return swaps, credit default swaps, or customized options.[26] It should state explicitly that the term is intended to encompass any guaranty arrangement in which the foreign affiliate or subsidiary's activities create a material on or off balance sheet liability for a U.S. person.

Clearing, Margin, and Trade Execution Requirements. Still another key issue has to do with the applicability of clearing, margin, recordkeeping, and trade execution requirements to foreign branches, agencies, affiliates and subsidiaries of U.S. financial institutions. In the case of the whale trades, the majority of the credit derivatives trades executed by the CIO traders in London during the first quarter of 2012, were cleared through exchanges with margin requirements. Given the large number of trades, numerous credit instruments, and losses that were magnitudes greater than anyone at JPMorgan had projected, the margin requirements turned out to be critical safeguards that helped ensure JPMorgan maintained sufficient funds to cover its losses. Further, disputes with counterparties over the adequacy of the collateral for the trades helped bring the whale trades to the attention of senior JPMorgan management.

In addition, the use of standard trade execution procedures and recordkeeping procedures helped ensure that all of the complex and quickly changing trades were properly booked and recorded, enabling bank managers and regulators to reconstruct those trades later to understand what happened. The JPMorgan whale trades provide ample proof of the importance of the clearing, margin, recordkeeping, and trade execution requirements and the utility of applying them to the foreign branches, agencies, affiliates and subsidiaries of U.S. banks to protect the U.S. financial system as well as U.S. counterparties.

In contrast, if the CFTC were to excuse non-U.S. offices of U.S. financial institutions from complying with U.S. derivatives clearing, margin, recordkeeping, and trade executive requirements, it would encourage U.S. financial institutions to conduct their derivatives trading solely through their non-U.S. offices. The result would be to dramatically narrow the reach of the derivatives title of the Dodd-Frank Act. In addition, by exempting the foreign offices of U.S. financial institutions from the Dodd-Frank safeguards, the CFTC might find itself with the ability to police only a small fraction of the derivatives market, even when the trades being conducted involve major U.S. financial institutions, and the risks arising from those trades could have a direct and significant impact on the United States.

Derivatives Detection. The JPMorgan whale trades also illustrate the challenges that regulators face in detecting unreported derivatives trading and ensuring that large financial institutions prudently manage their derivatives trading risks. As with the JPMorgan whale trades, the magnitude of financial and other risks associated with derivatives trading is often shrouded in secrecy, may be poorly understood by a financial institution's senior management, and may too easily go undetected by regulators. An understatement of risk is particularly likely given the often relatively poor documentation of derivatives trades, often inadequate hedging

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[26] In the case of Enron, for example, the parent corporation used a wide variety of arrangements that created off balance sheet liabilities for the company, including through the use of total return swaps and oral agreements to buy back assets that had been sold to an affiliate or subsidiary. See, e.g., "The Role of the Financial Institutions in Enron's Collapse," before the U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 107-618 (July 23 and 30, 2002), at 163, 178-79.

documentation, the prevalence of variable and easy-to-manipulate valuation practices that can be used to hide losses, and the often insufficient disclosure and testing of models and metrics used to measure risk.

Despite billions of dollars in losses piling up, JPMorgan effectively dodged oversight by its primary regulator, the OCC, until forced by the media to disclose the massive whale trades it was conducting. Months after the losses peaked and the derivatives portfolio was largely shut down, OCC issued six supervisory letters with 20 Matters Requiring Attention (MRAs), as well as a cease and desist order directing JPMorgan Chase to correct the unsafe and unsound practices related to the high-risk derivatives trading executed by the bank's London branch. To prevent that type of below-the-radar derivatives trading, foreign offices like JPMorgan's CIO office in London should be required to report all trades to a swap data repository and to use effective portfolio reconciliation and compression procedures to ensure an accurate depiction of the size and nature of their derivative holdings.

Business Conduct Standards. In response to the Dodd-Frank Act, the CFTC has developed a set of external business conduct standards that, in essence, require swap dealers and major swap participants to treat their counterparties with integrity. They must verify that the counterparty is eligible to enter into the swap being proposed and that the swap is suitable for that counterparty, disclose all material information about terms of the swap, and provide a daily mid-market mark for any uncleared swap.[27] History has shown that without these standards, derivatives dealers may mislead or cheat their counterparties.[28] While the Subcommittee did not examine those issues in connection with the whale trades, the fact that those trades were conducted with virtually every major financial institution, including those organized in the United States and those with a major U.S. presence, indicates that the better approach would be to apply those counterparty protections standards widely. In the end, they will protect not only U.S. counterparties, but also U.S. derivatives and financial markets.

Regulatory Coordination. Finally, the CFTC has recognized the critical role of international cooperation and coordination in the regulation of derivatives.[29] The CFTC should, to the extent possible, seek to harmonize and coordinate its requirements with those of other U.S. financial regulators, particularly the SEC. However, the CFTC should not unduly delay implementation of these critical reforms in the interests of still additional regulatory input. Effective regulation of the rapidly evolving derivatives markets is an iterative process. After reforms are implemented, they will undoubtedly be revised. Do not let the perfect be the enemy of the urgently needed.

Our financial system nearly collapsed as a result of inadequate regulation of derivatives. As we saw from JPMorgan's whale trades, those same derivatives risks still exist today. For that reason, implementation of Title VII of the Dodd-Frank Act should be finalized without delay and

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[27] Proposed Guidance, 77 Fed. Reg. 41227.

[28] See, e.g., "Wall Street & the Financial Crisis: The Role of Investment Banks," before the U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 112-675 (April 27, 2010); "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 112-675 (April 13, 2011)(Report and Appendix), Vol. 5, Part 1, at 385-764.

[29] Final Order, 78 Fed. Reg. 860.

must include regulation of cross-border swaps. Exempting derivatives trades conducted by the foreign offices of U.S. financial institutions from U.S. derivatives safeguards would ignore the lessons taught by JPMorgan's high risk whale trades.

Thank you for the opportunity to submit these comments.

Sincerely,

Carl Levin
Chairman
Permanent Subcommittee on Investigations

Enclosure