**Testimony of Don Thompson**

**Managing Director and Associate General Counsel**

**JPMorgan Chase & Co.**

**Senate Banking Committee**

**Subcommittee on Securities, Insurance and Investment**

**May 25, 2011**

Chairman Reed, Ranking Member Crapo 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 our derivatives legal group and have been actively involved in implementation of Title VII of the Wall Street Reform and Consumer Protection Act (the "Act"). Thank you for inviting me to testify today on the opportunities and challenges of derivatives clearinghouses (CCPs).

JPMC has been an active participant in the development and management of clearing houses with direct membership in 77 clearinghouses for a variety of markets including listed and over-the-counter (OTC) derivatives, equity and fixed income securities. We are committed to clearing OTC derivatives transactions and have been clearing dealer-to-dealer OTC transactions for a decade. Today major swap dealers clear over 90 percent of eligible inter-dealer interest rate and CDS transactions. At the same time, we have also made significant investments in our client clearing franchise, which we expect to grow as the requirements of clearing under Title VII become implemented.

While there are a number of critical issues to consider in determining the appropriate market structure and governance for clearing houses, the most critical is guarding against systemic risk. Questions of membership criteria, risk committee structure and governance all implicate safety and soundness, so it is essential that regulations carefully weigh these considerations.

As the Committee is aware, the migration of products that were once traded and managed bilaterally to clearing houses will concentrate the risk from these transactions at CCPs. CCPs do not eliminate credit and market risk arising from derivatives; they simply concentrate it in a single location in significant volume. This concentration of risk combined with an increase in aggregated credit and operational risks at CCPs will result in these institutions becoming systemically important.

Since these institutions are private, for-profit entities, it is critical that regulations guard against an outcome that would privatize profits but potentially socialize losses. Attempts to increase clearing member access or lower clearing member capital requirements can be responsibly implemented only if they are coupled with requirements for sound risk management practices. These practices should include appropriate limits on the types of transactions that are subject to the clearing mandate, requirements for members of clearing houses to have capital contributions proportional to the risk they introduce to the CCP, elimination of uncapped liability of clearing members and requirements for clearing members to be able to risk manage the transactions they bring to the CCP. We strongly support open access to clearing house membership, and believe it can be achieved without compromising risk management standards.  Two critical controls must be in place at each clearing house to support open access:  a clear liability framework that caps each member's exposure, and risk limits that are real-time and proportional to each member's capital.  With this foundation, the clearing membership can be prudently expanded to firms with modest levels of capital, including the $50 million minimum proposed by the CFTC.

Absent proper oversight, CCPs are at greater risk of failure, which could have significant systemic implications. Failure could result from a number of factors, such as a member's lack of proper risk management, from clearing complex products that cannot be properly valued by the CCP, or from actions resulting from a "race to the bottom" among for-profit CCPs.

Given these risks, we believe that as long as CCPs are structured as for-profit entities, the primary regulatory focus should be to ensure that proper risk management, governance, regulatory oversight and incentive structures are in place, as discussed in greater detail below.

It is also worth noting that because derivatives trading and clearing is a global business, in order to prevent arbitrage, rigorous regulatory standards should be applied consistently in each of the major global markets, including uniform operating principles and a consistent on-the-ground supervisory approach.

**Safety and Soundness of Clearing Houses**

In considering clearing house membership requirements and their impact on clearing house safety and soundness, it is important for policymakers to keep in mind the nature of a clearing house.  A clearing house is structured to provide for mutual sharing of counterparty risk among members.  Each clearing member is exposed to the counterparty credit risk of all other members and, by extension, all clients clearing trades via other members.  Clearing houses themselves provide a very small portion of the capital which backs the performance of the clearing house, and the vast majority of the financial resources of a clearing house is provided by the members through their contributions to the guaranty fund as well as collateral posted by the clearing members.  To the extent of their liability, each member is delegating risk management of its capital to the clearing house, which in many cases is a private, for profit entity.  Each member is also exposed to the capital, liquidity and operational capabilities of other members, to the client risk introduced by every other member as well as the risk management processes put in place by those members and by the clearing house.  A clearing house that is prudently managed must have adequate margin and guarantee fund resources and must refresh its calculations daily and intraday to adjust its resources to changing market conditions.

There are additional measures that should be considered in order to enhance the safety and soundness of clearing houses:

(1) Clearing houses should have a credible resolution plan, given their interconnectedness to the financial markets and the associated systemic risk implications.  Such resolution plans should be tested regularly and reviewed by regulators.

(2) On-site inspections by regulators should be conducted at regular and frequent intervals. The sufficiency of clearing house financial safeguards should be regularly evaluated against the results of such tests, and adjusted as appropriate.

(3) The liability of clearing members to the clearing house should be clearly ascertainable and capped. Unlimited liability of members towards the clearing house to absorb clearing house losses has the effect of maintaining the solvency of the clearing house at the expense of its participants, a trade-off that likely would lead to systemic risk concentration, not mitigation. Unlimited liability is the worst of all worlds: large financial institutions will be interconnected, but will have no idea of their exposure to any other particular institution, and neither the incentive nor the means to mitigate the risk.

(4) In determining the appropriateness of a clearing house financial safeguards package there should also be an appropriate balance between initial margin and guarantee fund contributions. This balance should not be allowed to vary significantly across clearing houses. If initial margin is set too low, there will be an incentive to push risky and unbalanced positions through the clearing house as participants recognize that the risk introduced in the clearing house will be subsidized by other clearing members through guaranty fund contributions. The amount of initial margin customers are required to post, together with the degree of protection afforded such margin, may adversely affect the incentives of customers to select prudently managed clearing houses, contributing to moral hazard and instigating a race to the bottom.

**Clearing House Access**

We strongly support regulation aimed at mitigating conflicts of interest. We also support full implementation of the open access core principles set out by Congress in the Act with a risk-based framework that allows clearing members to clear client and house activity in proportion to their capital. We note that the Lynch amendment, which would have restricted equity ownership of interests in clearinghouses and swap execution facilities by swap dealers, was not part of the final text of the Act passed by Congress and signed by the President; however, proposed rules include such restrictions.

We believe that all clearing houses should provide open access to whoever meets certain minimum objective criteria. In our view, the fact that a clearing house relies almost exclusively on the capital of its members places a great emphasis on the ability of a member to absorb any losses resulting from: (a) the house and client risk that a clearing member introduces into the clearing house; and (b) mutualization of the risks introduced by every other clearing member and those clearing members' clients. Given the loss mutualization feature of clearing houses, we believe that the financial stability of clearing houses depends on the requirements that must be satisfied for a member to qualify as a clearing member. Those criteria, however defined, should require clearing members to hold a minimum amount of capital. In addition, it is our view that the way to provide open access to new clearing members while promoting the safety and soundness of clearing houses would be to provide clearing members with the ability to clear house and client risk in proportion to the amount of capital available to them as well as to funded margin and guarantee fund contributions. We do not support any exclusionary practices.

**Interaction of Corporate Governance and Risk Management**

We support regulations requiring the creation of a risk committee at all clearing houses. In addition, we believe it would be appropriate to provide for the separation of the corporate governance function (Board of Directors) from the risk management function (Risk Committee) within a clearing house.

***Risk Committee***

We believe that the Risk Committee should be comprised of a majority of clearing member representatives, with the remainder open to clearing house and client participation. We support a requirement for at least 10 percent of the Risk Committee to be composed of client representatives with relevant expertise, and the balance to be open to participation by independent representatives. We believe that the main focus of the Risk Committee should be the preservation of the guarantee fund that is utilized to safeguard the clearing house and its members against defaults, taking into account prudent risk management standards, including mitigation of systemic risk. The main focus of the Board would be to promote the commercial interests of the clearing house. We expect that in most cases the Risk Committee and the Board would be able to achieve a productive balance between those two interests. We support a requirement for the Board to consult with the appropriate regulator prior to rejecting a recommendation by the Risk Committee on matters of risk. In our view all matters relating to risk would fall within the purview of the Risk Committee. This would include all matters related to margin and the sizing of the guarantee fund, membership criteria and membership application, and the enumeration of products eligible for clearing. Regulators have identified sound risk management standards as well as open access as key factors that must be addressed in determining whether a particular type of swap is suitable for clearing.

***Board of Directors***

With respect to the corporate governance function of SEFs, exchanges and clearing houses, we support encouraging a balance of views being represented on the Board of Directors. We think that a 35 percent requirement for independent directors will be problematic to implement in practice because it will be difficult to identify a sufficient number of individuals who are not already involved in the industry and who have an appropriate level of practical market experience. In our view the desired balance between different interests can be achieved by identifying different classes of interested parties and encouraging a diverse representation of those interests in the Board of Directors. This would be done by requiring that no single class of interested parties achieves more than 65 percent of the seats on the Board. Each SEF, exchange and clearing house should be able to determine how to fill the remainder of the seats. Regulators would monitor compliance with the letter and the spirit of this provision. In our opinion, the different classes of interested parties vary depending on the type of entity: In the case of clearing houses the classes would be: (a) clearing members whose capital is at risk if another clearing member or one of its clients fails; (b) end users, who have an interest in protecting their collateral and in keeping clearing costs low; and (c) other investors and infrastructure providers (*e.g.* technology providers, SEFs, exchanges and clearing houses), who have an interest in increasing profitability.

In the case of SEFs, the classes would be: (a) liquidity providers; (b) liquidity takers; and (c) other investors and infrastructure providers (*e.g.,* technology providers, exchanges and clearing houses), who have an interest in increasing profitability.

In the case of exchanges, the classes would be: (a) liquidity providers; (b) liquidity takers; and (c) other investors and infrastructure providers (e.*g.,* technology providers, SEFs and clearing houses), who have an interest in increasing profitability.

These limitations would have the added benefit of promoting competition and discouraging vertical integration of exchanges, SEFs and clearing houses.

**All those who bring risk into the clearing house or profit from the operations of the clearing house should have "skin in the game"**

We think it is essential to the development of a sound clearing infrastructure that those whose capital is at risk can participate in the risk management of clearing houses. Clearing houses rely almost exclusively on the margin and guarantee fund contribution of clearing members to manage systemic risk and counterparty risk.

In a vertically integrated model, shareholders in a holding company that owns clearing houses and exchanges (and in the future may also own SEFs) are exposed to a fraction of the risk that clearing members are exposed to through loss mutualization. There is no current requirement for clearing houses to provide a first loss piece to the financial waterfall package and in most structures the clearing house "skin in the game" contribution is minimal compared with the overall size of the guarantee fund. For this reason the large majority of the capital at risk of a clearing house is composed of the margin and guarantee fund contributed by clearing members.

In addition to the financial resources required to satisfy the financial safeguards core principles set out in the Act we support introducing a requirement for clearing houses to carry a first-loss risk component as well as a mezzanine risk component in the waterfall of financial safeguards. This would establish a direct link between the earnings that a clearing house derives from cleared activity and the contribution of that clearing house to its own financial safeguards package. We would support regulations that require a clearing house to retain in a segregated deposit account, on a rolling basis, 50 percent of the earnings from the previous four years. We observe that this amount would represent approximately 10 percent of the clearing house enterprise value, therefore achieving a reasonable balance between risk and reward for clearing house shareholders. In addition, it would be appropriate for at least 50 percent of the retained earnings to have a first loss position in the financial waterfall. This solution would accomplish the goal of greater systemic stability, and would scale over time the contribution by the clearing house to its own financial safeguards package without large decreases or increases at any one resizing date. We recommend that the clearing house contribution be subject to a minimum floor of $50 million, to provide adequate protection and provide increased confidence in the markets while market participants ramp up access to clearing services. In our view this would incentivize clearing houses to manage risk in a prudent manner. We would also support limits on the ability of clearing houses to upstream dividends resulting from clearing fees to their holding companies when a clearing member defaults. The introduction of a first loss position and the introduction on limits on the upstreaming of dividends for clearing houses would result in significant benefits from a systemic stability point of view.

**Limitations on Voting Rights**

The best way to promote a successful implementation of the clearing requirement of the Act is to ensure that clearing houses are fully equipped to manage risk in a prudent manner, while providing open access to clients and clearing members. In order to achieve this purpose, clearing houses should be able to attract financial and intellectual capital from those who have experience in the products that the clearing house intends to clear, as well as from new participants into the market.

We note that the OTC derivatives market is sufficiently diversified at present. A market survey published by ISDA on October 25, 2010 shows that the five largest U.S.-based dealers hold 37 percent of the outstanding derivatives market (equity, rates, credit). In our view this data is more representative of the global nature of the OTC derivatives market than other data that has been quoted out of context in the debate regarding conflict of interest. That data was focused exclusively on a restricted number of U.S. institutions and was not intended to represent a survey of the OTC market, which is global. To assume that dealers would acquire shareholdings in a clearing house or otherwise gain influence over a clearing house with a view to impede or narrow the implementation of the clearing requirement would be inconsistent with the reality of today's markets. On the contrary some participants in the OTC markets have made significant investments into the capital of clearing houses well in advance of a legal requirement to clear being introduced or proposed in the U.S. or in Europe.

At this point in the development of market infrastructure, it is essential to promote competition between clearing houses, exchanges and SEFs. With respect to clearing houses, we note that in today's markets there are a maximum of three clearing houses per asset class that are able to clear OTC derivatives. In some asset classes there is no clearing house currently clearing. There is no specific reason to apply limits only to those who have the expertise and the funds to finance a clearing house and who are exposed to losses if the risk management of the clearing house fails. We believe that preventing those whose capital is at risk from acquiring the right to vote on the governance of the entities that perform a key role in the OTC markets is not necessary to achieve the policy objectives set out by Congress in the Act. For this reason we support a limit on voting rights that would apply to each class of market participants irrespective of whether they are clearing members, SEFs, exchanges, enumerated entities, or other types of entities or individuals. This would promote open access and greater competition among clearing houses.

Given that preference shares and other types of non voting shares are a way to provide liquidity into the clearing house and have no effect on corporate governance, we believe that it would not be appropriate to apply limitations on the ownership of non-voting shares.

**No Free Riding – Clearing Member Resources**

We do not believe that there should be a two-tiered approach to membership, where some clearing members are subject to loss mutualization and others are not. A clearing house will rely on the financial resources waterfall set out in CFTC proposed §39.11. This includes funded guarantee fund contributions by a clearing member. CFTC proposed §39.11 also contemplates the ability of a clearing organization to assess a clearing member for additional default fund contributions. We believe that it is important to make sure that a clearing member will have sufficient liquid capital to fund additional guarantee fund assessments, in proportion to house and client business cleared by that clearing member.

We believe it would be appropriate to require that clearing members have the ability to provide daily executable binding quotation for all points in the curve for all products cleared. Clearing houses must be able to mark to market all positions at the end of each trading day. Clearing members must provide daily prices for all points of the maturity curve rather than relying on whether the cleared product trades on an exchange or a SEF on that day.

In our view it is essential to require that clearing members have the operational ability to sustain the flow of client and house positions into the clearing house, including porting books of liquid and illiquid positions at times of market distress. In times of market stress or crisis, it is imperative that clearing members be able to act quickly in order to address the risk management aspects of defaults. By way of example, if a clearing member fails, the clearing house will conduct an auction to absorb the losses caused by that clearing member failure. The provision of liquidity by surviving members during that auction is key to the survival of a clearing house that deals in OTC instruments.

Default management is not a responsibility that can be outsourced without introducing new risks to the stability of the clearing house. We think third-party pricing and outsourced default management services can disappear quickly in a crisis, as the provider of the service may have to focus their resources on their own survival. For this reason we believe it is preferable that clearing members or their affiliates be able to participate in the default management process. In the alternative, we would support a structure that would allow a clearing member to outsource pricing and default management services to another provider so long as the third-party provider of pricing and default management services is not allowed to undertake the provision of those services to more than one clearing member (including for itself or an affiliate).

To ensure the correct incentives are in place during an auction of a failed member's portfolio, we recommend that any loss incurred by the clearing house as a result of the auction be absorbed first by the guarantee fund contributions of those members that fail to submit a bid. Any remaining loss should be distributed among the bidding clearing members in reverse proportion to the strength and size of their bid. This mechanism will ensure that all members are treated equally going in to an auction, and that appropriate financial incentives exist to provide exit liquidity to the clearing house. In addition, we believe this mechanism creates a fair outcome for all members by subordinating the guarantee fund capital of any bidder that is subject to a failed outsourcing arrangement.

**Guarantee fund assessments ensure members have appropriate liquidity to meet potential capital calls in a crisis**

We support the CFTC proposal requiring clearing houses to haircut the value of unfunded assessment and to cap the percentage of the financial resources package that can be met by the value of assessments.

We note that CFTC proposed §39.11 also refers to the own capital contribution of a clearing house as a component of the financial resources package. We believe that it would be appropriate for the Commission's regulations to provide greater granularity and require that if a clearing house enumerates its own capital as part of the waterfall, that clearing house must provide sufficient assurances that its capital will be available to meet those obligations and will not be reallocated to serve other purposes at the discretion of that clearing house.

It should be noted that a clearing member may have committed to additional assessments at more than one clearing house. We believe it would be appropriate for regulators to adopt a risk-based analysis to determine the likelihood that a clearing member will be able to meet its assessment obligations across all clearing houses.

**Systemically Important Clearing Houses**

We believe that in the new market structure landscape, that no entity should be too big to fail. In our view, this principle applies equally to clearing members, clearing houses and clients. Given the loss mutualization feature of clearing, it is only by requiring each participant to have skin in the game that we can ensure all the parties involved in bringing risk into the system have an incentive to act in a manner that is prudent, safe and sound. We believe it is appropriate for members, clients and clearing house shareholders to have skin in the game. This principle is of particular relevance for those entities that are deemed systemically important by the Financial Stability Oversight Council pursuant to Title VIII of the Act.

**Regulatory Coordination**

In our view, coordination between regulators who have authority over clearing houses will be a key component of systemic stability. One significant element will be the ability of regulators to look across clients, clearing members, exchanges, SEFs and clearing houses for any factors that could increase systemic risks. We think it is appropriate to monitor the activity of clients, clearing members exchanges, SEFs and clearing houses for undue concentration with a view to identify those that pose a systemic risk and take action to mitigate problematic situations before they exert a significant impact on the financial systems.

**Conclusion**

We believe that no institution, including clearing members and clearing houses, should be too big to fail. The policy objectives of the Act would be well served by promoting systemic stability and ensuring safety and soundness of exchanges, SEFs and clearing houses, and by requiring that these institutions have adequate capital to absorb losses and sufficient liquidity to safeguard the system. JPMC 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.