Occupy the SEC

http://www.occupythesec.org

June 12, 2012

Tim Johnson, Chairman
Richard C. Shelby, Ranking Member
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C.
20510

Re: Testimony of JP Morgan Chase CEO Jamie Dimon

Dear Sirs and Madam:

Occupy the SEC[1] and OWS-Alternative Banking[2] working groups thank the Senate Committee on Finance for calling Jamie Dimon, CEO of JP Morgan Chase (JPM), to testify as to details surrounding JPM's Chief Investment Office (CIO) activities. We submit this letter to provide the Committee with our views on the matter, in an attempt to counterbalance industry testimony on the issue with perspectives from the 99%.

JP Morgan's CIO Activities Highlight the Need for a Strong Volcker Rule

On May 10, 2012, Jamie Dimon announced that JPM's CIO desk had lost at least $2 billion from a trading scheme that was ostensibly designed to mitigate the bank's risks. JPM claims that the CIO office was meant to hedge the bank's overall exposures by investing in high-quality securities. However, the CIO office was actually placing gargantuan, profit-seeking bets on risky credit default swap (CDS) indices. These bets had nothing to do with true hedging of risks. In fact, they were of such magnitude that the trader responsible for them was feared throughout the markets, receiving various monikers including "Voldemort" and

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[1] Occupy the SEC (http://occupythesec.org) is a group within the New York-based Occupy Wall Street ("OWS") protest movement. This letter represents the opinion of our group's members, and does not represent the viewpoints of OWS as a whole.

[2] The OWS-Alternative Banking working group seeks specific improvements to existing and pending financial services industry legislation and regulations, in addition to evaluating and recommending alternative approaches to banking. OWS-AB also seeks to understand and educate people about the current financial system.

the "London Whale."

This embarrassing episode for JPM highlights the extent to which major banks will engage in risky proprietary trading and try to disguise it as risk management. Indeed, the circumstances surrounding JP Morgan's CIO desk illuminate a fundamental problem in the financial system: greed. The CIO office was supposedly charged with reducing the bank's overall risk. Unfortunately, the CIO office did the opposite, taking on as much Value-at-Risk (VAR) as the entire investment banking division of the behemoth JP Morgan. Those "hedges" have not performed as expected, and now the bank stands to lose over $3 billion and counting. How could this happen?

The SEC, CFTC, the FBI and other enforcement officials are looking closely into this question. But the answer is rather straight-forward. In Oliver Stone's *Wall Street*, the flawed protagonist Gordon Gekko brazenly proclaimed that "Greed is Good." Wall Street has taken this message to heart. Forgetting that Gekko was supposed to a cautionary figure, many Wall Street bankers and traders aspire not just to Gekko's wealth but also to his tactics, reveling in high-stakes profiteering that often earns them 7, 8 and 9 figure incomes.

It is industry practice to borrow as much as possible ("leveraging") to maximize returns on equity. Therefore, the more assets are funded with debt (either on balance sheet or through credit derivatives), the higher the profits a bank will have on its stock. Unfortunately, the practice of leveraging has the potential to quickly take a bank with sufficient capital according to regulatory standards and leave it in a liquidity crisis after even minor adverse price movements. Indeed, this is what brought down Bear Stearns and Lehman Brothers: the market's unwillingness to roll over their debt due to suspected unrealized losses.

In this case, the credit derivatives traded by the CIO desk tell a similar story. While JPM "only" lost $3 billion, the loss could have been many multiples higher had there been a sharp downturn in any one asset class. When major banks such as JPM experience extreme losses, this has the potential of bringing down the entire financial system. This leads regulators to become capital providers of last resort utilizing taxpayer or public funds. For instance, after the 2008 collapse, the government had to provide major financial institutions with not only $700 billion of taxpayer money under the Treasury's TARP program, but at least $16 trillion in loan facilities through the Federal Reserve's inflationary money-printing press.[3] The end result is that banks can enjoy large returns on shareholder equity if their huge derivative bets pay off, but if they are wrong, these institutions can credibly expect to be saved by the U.S. Government for fear that the economy will collapse. The current banking model involves privatized gains, and socialized losses — a win-win deal for the banks.

JPM's CIO debacle highlights the importance of the Volcker Rule, an important part of the Dodd-Frank Act of 2010. Indeed, Dimon has admitted that "this plays right into the hands of the pundits out there" who support a strong Volcker Rule. Dimon is right.

[3] U.S. Gov't Accountability Office, GAO-11-696, Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance Needed 131 (2011).

The Volcker Rule seeks to reduce the need for financial bailouts by limiting the ability of banks to take on excessive risk. Often called Glass-Steagall-lite, the Volcker Rule restricts bank holding companies from engaging in proprietary trading, or speculating for their own profit. In theory, the Volcker Rule would force banks to re-focus on deposit-taking and loan-making, the way Glass-Steagall originally required. Unfortunately, the Volcker Rule's current form, as proposed by banking regulators, contains many loopholes that would permit egregious speculation like that undertaken by JP Morgan's CIO office.

Occupy the SEC (OSEC) has previously issued a 325-page comment letter[4] to the nation's banking regulators, asking for strong enforcement of the Rule. In our comment letter we outlined a number of ways that banks could get around the Proposed Volcker Rule, while still complying with the rule's language, and thereby continue to engage in speculative betting. For instance, the Volcker Rule creates broad exemptions for market-making, portfolio hedging and liquidity management. It also creates lucrative carve-outs for the toxic activities that actually caused the recent financial crisis, like securitizations and repurchase agreements.

JPM's "Voldemort" fiasco illustrates many of the concerns we expressed in that letter:

- The CIO office's activities may not have been booked in the Bank's trading account, which would render them to be outside the scope of the Volcker Rule. OSEC has argued for an expansive interpretation of "trading account" to cover just this type of speculation.
- OSEC has criticized the current version of the Rule for interpreting the term "hedging" to include a wide swathe of activities, whether at the desk level or the portfolio level. The Voldemort incident highlights the risks associated with such a broad interpretation.
- JPM's hedging activity may also have been inaccurately characterized as a form of "liquidity management," which is permitted in the current draft of the Volcker Rule. We argue that hedging (and "portfolio" hedging in particular) continues to be incredibly problematic from a risk management, and safety and soundness standpoint.
- It illustrates the tremendous shortcomings of metrics like VAR, internal risk management procedures, and investment principles (i.e. banks' risk plans are deeply flawed, and their metrics are largely useless.) In our letter we highlighted how many of the metrics used in the industry are inadequate for calculating risks associated with illiquid assets.

We hope this incident will raise public awareness about the dangers resulting from proprietary trading at government-subsidized banking institutions. We further encourage the Members of this Committee to pressure our banking regulators to finalize the Volcker Rule as quickly, and as strictly as possible.

[4] Comment Letter, Occupy the SEC, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in and Relationships With, Hedge Funds and Private Equity Funds (Feb. 13, 2012), *at* http://www.occupythesec.org/letter/OSEC%20-%20OCC-2011-14%20-%20Comment%20Letter.pdf.

JP Morgan can easily bear the $3 billion loss from its CIO desk. That's not the problem. The real issue is that other banks, and possibly other divisions within JP Morgan, may be replete with similarly mischaracterized and under-capitalized trades. Can we as a society rely on banks, which are private, profit-seeking entities, to do what is best for us all? The banks seem to think so. Mr. Dimon and his paid lobbyists have inveighed upon Congress and financial regulators, assuring them that the banks have sufficient capabilities to self-regulate, free from government constraint. After all, all the major banks are full of astrophysicists and mathematicians with PhD's from places like Harvard and MIT, and the job of these "quants" is to do nothing else but build esoteric financial models to manage risk. However, despite all that brainpower, banks continually and repeatedly sabotage themselves through excessive risk-taking. The Great Recession of 2008, the worst financial crisis since the Great Depression, is testament to that fact. Simply put, no amount of financial engineering can overcome that entirely mundane human foible: greed. JP Morgan's CIO debacle hammers that point home. As long as Too-Big-To-Fail banks remain profitable, there will be gross incentives for them to conjure schemes to make money in ways that put themselves and the rest of us at risk.

That is exactly why we need hard-and-fast rules, like a strictly-defined Volcker firewall that would definitely separate commercial banking from proprietary trading (along the lines of the similar Vickers ring-fencing regime that is gaining traction in Europe). In Macbeth, Shakespeare warned of "Vaulting ambition, which o'erleaps itself and falls on the other." We need a simple structural wall, like the one potentially erected by the Volcker Rule, to serve as a check on bankers' vaulting ambitions.

Suggested Questions for Mr. Dimon

Below we list suggested questions that the Committee should ask Mr. Dimon, relating to various aspects of his role as CEO of JPM.

I. Conflict of Interest

Dimon sits on the Board of the Federal Reserve Bank of New York, the most powerful bank in the Federal Reserve system. The Government Accountability Office (GAO) has recommended that Reserve Bank board members play an extremely limited role in supervision and regulation. Mr. Dimon has insisted that he does not have direct regulatory oversight over the Federal Reserve. However, he does have authority to affect the compensation of the top regulators whose job it is to supervise bank holding companies like JPM. Moreover, in a glaring conflict of interest, Dimon has lobbied fiercely against the Volcker Rule, which (if properly crafted) might have prevented the recent $3+ billion trading loss by his federally-backstopped depository institution.

Suggested Questions: In light of these conflicts of interest, Mr. Dimon will you step down from your current role as Board member even before your term expires later this year? Do you believe conflicts of interest exist amongst banks, regulators, and the Federal Reserve Bank? If so, how do you define them?

II. Sarbanes-Oxley (SOX)

In light of JP Morgan's $3+ billion dollar trading losses, Occupy the SEC and Alternative Banking steadfastly believe that there is a Sarbanes-Oxley case to be made against Dimon. That law basically says that CEOs cannot lie about the internal controls of their companies. Dimon has made it clear that he knew or should have known the risks involved in the derivative transactions that the CIO office's so-called "London Whale" was engaging in.

Suggested Questions: Mr. Dimon, how much did you know about JPM's risk controls as they related to the CIO's activities? What reports did you receive on the CIO's positions and how often did you receive them? Did they show deteriorating values? If so, why were you surprised by the loss? If not, why not? How quickly did the positions reach the reported $2 billion mark-to-market value?

III. Hedging

Jamie Dimon continues to characterize the trading positions that led to the losses at the CIO desk as 'economic hedges.' This is a term of art; it is not an accounting term. In fact, these transactions do not qualify as hedges under the accounting rules and JPM is required to report the changes in the value of these positions as they do for all their trading activities.

Suggested Questions: Why does Jamie Dimon continue to publicly mischaracterize these transactions as hedges? What are the specific positions that these 'economic hedges' are designed to offset? How many other members of JPM are engaged in this type of "hedging" activity?

IV. Schedule

Suggested Question: Please disclose your calendar and call diary so we can determine how many regulators you have met with and how frequently.

V. Compensation

We would like JPM to disclose the compensation paid to the members of the CIO desk since its inception and the supporting documentation for determining their bonuses. We would also like to know these traders' relative rank in the list of most highly paid individuals at JPM.

From what we know, it appears that these professionals were compensated like position-taking traders that work to create profits, not corporate treasury traders taking positions for the sole purpose of hedging a portfolio.

Suggested Question: Please disclose the compensation paid to the members of the CIO desk since its inception and the documentation that supported the determination of their bonuses.

VI. CIO History and Profit Reporting

Suggested Question: When was the CIO desk created?

We would like to have disclosure around the history of the trading activity undertaken by the CIO since that desk's creation.

Suggested Question: How much did the CIO desk earn for JPM since its creation?

If the CIO desk was profitable and added to JPM's bottom line, and if these were in fact 'hedge' positions, that suggests that offsetting losses on the underlying hedged positions are still sitting on JPM's books. If they were not hedges, we would like JPM to clarify its disclosures and restate prior period financial reports if necessary.

VII. Available for Sale (AFS) Portfolio

We would like clarification from JPM regarding the sale of Investment portfolio assets that are recorded as Available for Sale. The sale of profitable positions from this portfolio to cover the CIO trading desk losses indicates that the Investment portfolio was a hedge against the CIO trading portfolio, and not the reverse as JPM has repeatedly claimed. In the case that these assets were used as trading portfolio assets, JPM's financial reports should be restated to reflect that prior mischaracterization.

Suggested Question: Have any of the remaining positions that are currently underwater been moved out of the trading book, or restructured to enable JPM to transfer the positions to an Available for Sale or Held to Maturity classification to defer reporting of the losses?

VIII. Risk Controls

Suggested Questions: In light of the recent disclosures concerning the gaps in the risk control environment, do you stand by your Sarbanes-Oxley certifications to the effect that there were no material internal control gaps? How do you intend to remediate the existing internal control gaps in order to sign the next SOX Internals Control certification? If these gaps cannot be fixed, will the upcoming JPM SOX certification contain a disclosure of material weakness in internal controls?

IX. Bailout Funds

Suggested Questions: Was it appropriate for JPM to have been bailed out by the Federal Reserve, considering the evidence of how JPM's CIO desk has put depositor money at risk? What concrete changes will your firm make going forward to assure that it will not require (or request) further bailouts?

X. H.R. 2990

Suggested Question: Do you support Dennis Kucinich's Bill H.R. 2990 to support a secure economy by giving up the private bank's privilege of creating the country's money by lending it with interest to persons, corporations and the U.S. government?

XI. How Should the U.S. Government Respond?

Suggested Question: What do you think would be an appropriate government response to the clearly unorthodox and internationally destabilizing actions taken by officers of your bank, under your supervision?

Thank you for focusing your attention on this important matter of public concern.

Sincerely,

/s/

Occupy the SEC
OWS-Alternative Banking

George Bailey
Akshat Tewary
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et alia