HJ TALK BEFORE CFTC March 25, 2010

Good morning. My name is Henry Jarecki. I am Chairman of Gresham Investment Management, a firm that provides investment advice and execution services to pension funds, insurance companies, sovereign wealth funds, and others who wish to diversify their stock and bond portfolios by adding a diversified pool of commodities to them.

I thank the Commission for inviting me to appear before it again, and I presume you have all brushed up on your Latin in preparation for my testimony. I have, however, come here to offer a deal. If the Commission will agree to the ideas I propose, I promise not ever to use Latin in my testimony again. That's an easy promise for me to make, for it was indeed the Ancient Greeks who spoke most profoundly about risk, and I may turn to them for the odd phrase in the course of these remarks.

The questions put by the Commission are both thoughtful and thought-provoking, and I would not want in a talk limited to five minutes to address them all. I will therefore in the next week or two present material in response to the Commission's inquiry on price discovery in the metals markets, on the impact of index trading on physical market prices, and on the best way to ensure competitive trading. Not surprisingly, I will express my confidence in the commodity market's ability to prevent manipulation and corners, and I will express the hope that the Commission will approach position limits in the metals markets as it has suggested doing in the energy markets, namely, as a percentage of the futures open interest.

It is, however, worth emphasizing first off that the futures markets have over the past two years proven themselves to be immune from the troubles and especially the risks that afflicted the over-leveraged stock, bond, real estate, and insurance markets and their derivatives. What has made these markets so immune? I think that it is because they have avoided artificial constraints that have unforeseen consequences; instead they deal with leverage in a rational way, namely, they mark all customers big or little, commercial or speculator to market and they do so on a constant basis. This practice prevents balance sheet fiddles and the multiple liabilities and hidden indebtnesses that ultimately let everyone down. Such fiddles are meant to hide the amount of leverage being used; all broad market dramas derive from the fiddle-hidden excessive leverage. The futures markets structure, and it alone, was what protected the futures markets and its customers and those who rely on it for price discovery. Simultaneously, it protected the economy against the commodity crises that typically come in the wake of a credit crisis.

I know quite a bit about this for, as some of you may remember, the bulk of my experience in trading commodities was gained some thirty years ago when I was the Chief Executive of The Mocatta Group, which was, both during my tenure and for most of the 300 years preceding it, the largest precious metals dealer in the world. In this capacity I witnessed first hand one of history's most notorious commodity price manipulations, namely, the time that the Hunt Brothers attempted to corner the physical silver market. It was a time when this Commission and its then equally courageous Chairman joined with New York's Commodity Exchange of which I was for sixteen years a Board member, to let the American public rather than Federal regulation foil the Hunts' attempt.

Jim Stone was the Chairman of the Commission in those days and, as the silver price moved up and up, any number of brokers granted the Hunts more and more credit on their physical holdings. Fear gradually emerged that a bursting of the silver bubble and a subsequent failure by the Hunts might take down large brokerage houses and lead to a domino panic similar to what was recently seen. Jim Stone was leaned on by the most powerful figures in that era's Administration, by the Treasury Department and even by the Federal Reserve Bank. They wanted him to intervene in the market, to "settle" the contracts to stop trading, or to set a ceiling price. Chairman Stone said that the markets had the ability to right and to regulate themselves and that the best thing to do was nothing at all. Perhaps he had heard of the ancient Greek who said, "τῆς εὐανδρίας τὸ οὐδὲν ποιεῖν ἐν συμφοραῖς", which is to say, "It takes great courage in a time of crisis to do nothing."

As the price of silver over very few months rose from $7 to $17 and then to $30, 40, and 50, the American public took its rings off, sold its silverware, and some even took their silver teeth out of their mouths. People lined up, two hundred deep, to sell silver. The smart people laughed at them. The market price of silver was $50 and the yokels were selling it for $30 to the scrap dealers who were selling it to the bullion dealers for $40 who were hedging it in the futures markets at $50. But when these billions of dollars worth of new silver got refined and came on the market and the Hunts, in an effort to keep the supply-induced price drop from causing margin calls that would bankrupt them, had to buy it up, the corner failed. It was not by an act of the Federal Government, but because the market itself corrected the imbalance between supply and demand and thus ultimately bankrupted the Hunts. It is here worth mentioning, of course, that it was the little guy who made the big profit and that it was he, through the market, that foiled the Hunts' attempt.

As I say, I will comment on all this in my written submission. Here, today, I want only to mention once more the importance of disaggregating positions of firms like ourselves who, each January, tell our customers (and indeed the world at large) just what mix of commodities is most likely to enable a customer, by mixing a long-only diversified commodity fund position with the rest of his stock and bond portfolio, to diminish his risks. We buy the mix of commodity futures for a customer only when that customer (who knows just what he will get) instructs us to do so and deposits with us all of the money all those commodities would ultimately cost if he were to take delivery of them. His investment is thus fully funded. We do not trade for ourselves and do we not use or enable our customers to use the leverage to which I have a few moments ago attributed the credit crises.

It is for this reason that we consider ourselves passive mechanics of our customers wishes, and we think it is irrational, anti-competitive, and against the public interest to aggregate our dozens of customers' fully-funded positions as if they were our positions. The concept of the passive mechanic was taken up by Chairman Gensler at the recent energy hearings, and he went so far as to say that it was, "at the core of our difference", and that he didn't, *"see a Goldman Sachs swap desk or a J.P. Morgan swap desk as a passive mechanic. It is a highly sophisticated risk business, and not a passive mechanic component."*

I was relieved to hear these words of the Chairman and to discover that he and I have no argument at all. I agree with him that the opaque swap books of the big banks have a machinery that is so complex, and a netting of positions that is so complicated, that it is difficult to say whether or not they are, in fact, passive mechanics. But despite this, these banks have in the past and continue to this day to assert the swap dealer hedge exemption, which allows them to take as large a futures position as they claim they need to "hedge" the exposures they claim they have. Gresham, on the other hand, recently had its limited relief from position limits revoked by the Commission, despite the fact that we trade transparently and on exchanges, and that our traders do not have complex exposures to offset. Still, by capping our ability to grow, the Commission has put us at an extreme competitive disadvantage to the giant investment banks that are our competitors.

The Commission has claimed that it is less concerned about classic manipulations, such as the one attempted by the Hunts, than about what it calls "excessive speculation", but it is impossible to conceive of excessive speculation occurring without the use of leverage, and as I have already said, Gresham does not employ leverage in any of the strategies it implements for its clients nor does it permit its clients to do so. The big banks that offer swaps, however, can -- like the banks of the Hunt era -- offer their customers almost unlimited leverage.

For these reasons, I say again that we think it is irrational, anti-competitive, and against the public interest to aggregate our dozens of customers' full-funded positions as if they were our positions. The continuation of such action will force us, if we want to grow to use the OTC markets, despite the fact that many of our customers invested with us for the very reason that, for the 23 years we have traded TAP, we have exclusively used exchange-traded futures. We must now use swaps because we are close to exhausting the options available to us in regulated US markets. It would be ironic for us to be forced on to the opaque OTC market at a time when the Obama Administration is looking for ways to bring as much business as possible onto the far more transparent and far safer exchanges; doing so would introduce new risks for our customers as well.

But it is not only the move to OTC markets that should trouble the Commission, not when we hear that commodity futures contracts that trade on foreign exchanges, such as Paris wheat, are trading at multiples of their recent past volume. Such a flight to Europe is especially bad news for the only industrial metal futures contract that trades with any volume on an American exchange, COMEX copper, for the most liquid copper market, by a factor of ten, is today on the LME. Position limits will simply shift the remaining volume to the LME, removing the trading from the oversight of the CFTC and further impeding a contract that is struggling to remain relevant.

Consider as well, that commodity investors who are limited from taking an interest in precious metals through futures will, instead, gain their exposure by purchasing the physical; this may take the acquired metals out of commerce for long periods of time, if not for good. This, of course, would be much more likely to increase the volatility and cause the price rises that the imposition of position limits seems intended to prevent. The foreign gold and silver markets are already in large measure physical markets and many Europeans prefer the ownership of physicals in bullion dealer vaults to positions in futures markets. It is not hard for one market to replace another. After all, the trading, in gold and silver that moved from Spain and Portugal to Antwerp moved next to Amsterdam, and thereafter, with the movement of my former firm's principal Moses Mocatta, to London, where it has remained ever since. The possibility that gold, silver, and copper trading might well, perhaps in the wake of position limits, move from the futures market to the physical markets is foreshadowed by the recent news that two large investment banks are buying metal warehouse. At the same time, Standard & Poors has announced that, in response to anticipated new regulations, it is launching an all-non-US commodity futures.

It is moreover astonishing to us that a firm as small as we are, perhaps 2 or 3% of the size of the large investment banks who are our competitors, may be forced off the markets while they remain on. Here, too, it was Solon the Athenian who said, "laws are like cobwebs: if any smaller creature falls into them, they hold it fast; while something weightier can break through the web and run off."

Indeed, continuing to aggregate all futures positions at the level of the intermediary would leave open what I call the "aggregation loophole" where an individual customer could buy parts of many different futures funds and thus acquire a position far larger than is good for the market.

To sum up, I would make four recommendations to the Commission:

1. Position limits on metals futures must not be so low as to force such business into alternative channels such as the over-the-counter markets or physical storage.

2. The CFTC should continue to collect trade data from all commodities markets' participants so as to have the most complete picture possible of who is implementing the trades but also who is controlling and benefitting from them.

3. Once you identify that an entity is merely the implementor of a fully-funded passive strategy and not the beneficiary, you should attribute the positions implemented by that entity to the ultimate beneficiary and impose any position limits upon that beneficiary. Only in this way can you close what I have described as the aggregation loophole.

4. Do not, finally, be afraid of identifying the end user. It is administratively trivial to identify those who control large positions.

Thank you again for allowing me to offer my remarks on this important subject.