PROPOSED TESTIMONY OF DR. HENRY JARECKI AT THE CFTC, July 29th, 2009

My name is Henry Jarecki and I'm the Chairman of Gresham Investment Management, a company I formed to implement TAP, a conservative long-only tangible asset portfolio I developed more than 20 years ago. (Portfolio composition chart) We've been managing this strategy for ourselves and others since 1987 and we have over that time provided better returns than the S&P 500 with less volatility and have improved the performance of the stock and bond portfolios into which it has been introduced (Charts 1, 2, and 3). We do these diversified commodity investments by buying futures for our customers, not by engaging in commodity swaps and we applied for and got a "No Action Letter" when we got near position limits. I have been in the futures industry for over 40 years. During that time I have seen one market drama after the other and indeed was on the Board of the Commodity Exchange when it had to address one of our markets' greatest manipulations, that of the Hunt brothers, who bought large quantities of physical silver which they hoped, after moving the market upwards, to sell.

What we do is not only good for diminishing an investor's global portfolio volatility but also for protecting him or her against the ravages of inflation, a matter of increasing importance to those who want their pensions to keep pace with the cost of living. (Charts on Return v. CPI) Our clients currently include numerous state, Fortune 100, and union pension plans, insurance companies and a host of foreign enterprises as well. (Chart) Our customers are stable, well financed entities that decide to take part only after they study the idea for a year or two. They do not any of them use leverage or speculate or take delivery of physical commodities. They maintain their core positions even when markets fall and they provide stability and trading liquidity to the market in general. What better market participants can there possibly be? (Chart showing Customer Composition)

Our activities are tiny compared to the size of our two big competitors, the Goldman Sachs and UBS indexes. We undertake trading in accord with simple rules we established over 20 years ago and articulate afresh to our clients annually. I'm naturally fearful that our business will be throttled in the false understanding that commodity futures index purchases can cause prices to rise. People talk of the high open interest but do not understand that for every long there is a short. Indeed, there must be a balance. When the open interest is high, there are not only more long positions than there have previously been but also more short positions. Does this mean that a high short position causes prices to rise? The idea is of course absurd, but no more absurd than the idea that high open interest causes high prices. To compare what we do with what our competitor, the index swap exemption users, do, I can say that the cost to our customers is lower, or to restate it, that the returns of our customers' portfolio are higher. (Chart comparing us with other two)

Given my 40 years of experience in these markets, I am surprised to think that high prices are attributed to commodity futures acquisitions. The futures markets, proud though they may be of themselves, are not where the world's prices are made. Prices are made on the factory floors and at the gas pumps, and at the level of the farmers who grow wheat, the consumers who eat bread, the oil companies that take oil out of the ground and the car owners who buy it at their gas stations. The amount of buying and selling that is done in the <u>real</u> physical markets is typically 10 or 20 times as much annually as the open interest is. (Chart)

There is a fear of high prices and a notion that the high price of food or gasoline is due to the futures markets. This is more than improbable. We live in a time where the U.S. Fed has had an accommodative monetary policy and where enormous amounts of money have been spent on a war that would, if taxes had been raised to support it, have been even more unpopular. When more money chases the same quantity of goods, prices rise. That is what causes inflation and that is what caused real estate and equity prices to go up as well. (Chart)

Harmonisation

It is, however, a mystery to me how futures prices (or even inflation) can be said to cause a lack of convergence in wheat prices. How can long-only folks like ourselves be the cause? We, for our part (and most other index providers as well), are typically out of the nearby positions many weeks before the first notice day. How, then, can those activities be affecting convergence? How, moreover, can the lack of wheat price convergence be explained by index participants when their participation in the soybean market is at least as great as their participation in wheat. Why, then, is there not a similar lack of convergence in soybeans? Those who understand warehouse rules see that there are insufficient warehouses articulated in the contracts. This causes the lack of convergence. And, by the way, that's what the Wheat Report says as well.

This hearing, however, has been called on the topic of position limits in the energy markets. This seems to me to be a euphemism for what we can do to make sure that Crude doesn't trade over $140 again. Oil prices were indeed remarkably high last year. But, such high prices were also found in steel, coal, and cobalt, and they don't trade on futures markets at all. (Chart) How is that to be explained? Equally interesting, those who probably know the most about oil, who can afford the most high priced oil economists, and who have the largest available stock of oil, namely, the rich Middle Eastern oil operators, were presumably equally puzzled by high prices. Why, if it was clear that the prices were too high, did they not sell many years' worth of production when the price hit 147? Indeed, if the U.S. Government thinks that oil prices are too high and that they are being artificially held there, why does it not just sell some to lower the prices for the benefit of consumers? Similarly, if it is so easy to manipulate oil prices upwards, why does OPEC not simply raise the prices whenever it wants to by acting in the futures markets?

Finally, it is obvious that the flows into index funds (see chart) do not correlate with oil price increases. In some periods, for example, the correlations are indeed negative. This is relevant because the CEA talks about "causing fluctuations in the price" of a commodity, and the flow data shows that this causative element does not exist.

For all these reasons, therefore, I think it is inaccurate to believe that index providers are the cause of high oil prices. Money-printing and money-spending is one cause; fears of shortages and of inflation are others. Special circumstances, like state subsidies in China and India and the high cost of new production are further elements. What we know in any case is that if the cause were speculation and manipulation, the long-only investor is absolved. Every manipulation I have ever seen or heard of has been undertaken in physicals and almost always by commercials.

I appreciate, however, that the idea that commodity futures purchasers cause high physical market prices is superficially appealing. And I accept that the Commission may, in response to public concern, decide that something should be done. *Ut aliquid fiat*, we used to say when I practiced medicine: "In order that something be done." When the relatives were pushy and asked us to do more, we gave large and very colorful pills. *Ut aliquid fiat videatur*: "In order that it be <u>seen</u> that something is being done."

The position limits "something" that the Commission may well do should, however, be directed at those who would engage in excessive speculation or undertake large purchases. It is illogical to apply position limits at the level of firms like ours that passively implement the investor's decisions and it is actually counterproductive for many reasons. In the first place, one should want to disaggregate so that one knows who the final long position holder is. It is obviously possible for someone who would want to acquire a larger position by using indexes, to own three or four different indexes at a time. Without disaggregation, how could that be prevented? Even more, when firms such as ours announce clearly, openly, visibly and one year in advance just what our position mix is intended to be, it is irrational to think of us as something other than the passive machinists of implementation. It is the customer, not we, who decides to purchase the commodity index and it is thus at the investor level that all position limits should be placed and enforced. Obviously, with disaggregation, each individual customer will have to identify his position if he is anywhere near position limits. He could otherwise buy five wheat-directed funds, own a billion dollars worth of wheat futures and yet not be subject to position limits. Making the investor not the aggregator responsible closes a giant unintended loophole.

It is, moreover, counterproductive and manifestly unfair to have long-only diversified commodity funds such as ours disadvantaged in any way when we are openly identifying our intended proportions a year in advance and openly trading and registering our positions on each exchange and its clearing house and fully showing the prices of every trade that we do on the long side, on the short side, and on the hedging side to anyone who looks. If people like us aren't permitted on exchanges, and only swap exemption folks are called hedgers, it would encourage secrecy and that is not what the exchanges, the regulators, or the public want.

Indeed, before thinking about position limits themselves, the regulatory body should revisit the question of swap exemptions and, if necessary, require all those currently enjoying such benefits to request the position limit exemptions that firms like ours have asked for and been granted for many years. It would, in any case, be grossly anti-competitive and would put out of business small enterprises like ourselves if what we do were banned or limited in any way before the same effective constrains are placed on those who assert swap exemptions.