Precious Metals Regulation

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Preamble

I cannot remember another time when your market has been so in the news as it is these days. However, as most of you probably realise that is not necessarily a good thing. Increased visibility usually brings increased scrutiny and that is what I am here to talk about today.

I have been asked to give you an overview of the regulatory changes that you should be aware of as they may affect your business and how you do it. It was notable that David spoke as much as he did about this topic. I suspect that it is the first time in the Chairman's introductory remarks at your conference that there has been this amount of attention paid to regulatory issues. I am a little worried about this because I first spoke in front of an LBMA audience last autumn, when I felt pretty certain I knew more about my subject than you did. This year, I am not quite so sure because you have had to go up the learning curve on regulation very quickly, and you know – as you saw from Pierre's talk – so much more about your industry than I do. I can give you some heads-up on the regulation, but I am going to expect you to give me some help on how it will actually affect your industry. So let us think of this as a collaborative effort.

I am going to talk about the changing regulatory landscape and particularly focus on Dodd-Frank more than the European environment, because for the moment Dodd-Frank has a much more direct implications. Europe has been relatively easy on gold to date and I will explain why I think that is the case. I will talk a little bit about what David mentioned on the Basel Committee and whether gold should be included in the list of liquid assets, together with a little bit on how those changes will affect the market and the lessons we will have learnt from our first year of being involved in the regulatory process.

The Changing Regulatory Landscape

You may have noticed paying attention over the last few years that there has been an increasing sense that the efficient market hypothesis, as it is called in economics, and the consequent light touch regulation did not really produce the desired effect of financial stability. You might also have noticed in the last few months, particularly in Europe and in the US, that legislators and politicians do not necessarily seem to be doing a much better job at getting financial stability in place. We do not have the optimal solution about who should be doing that and how, but that is really quite a different topic.

Traditionally, your markets have functioned very well, and I think it is important to mention this. I do not think there are very many regulators present in the market but there have not been any identified significant market failures. Particularly with regard to some of your organisations, including the host of this conference, self-regulation has proven to be very effective in the bullion markets. However, you have been caught in the regulatory net almost entirely by association with other markets post the 2008 crisis. There has been an effort to extend regulation to new markets, to any market perceived as opaque, and to try to work particularly on the transmission of information. For those of you who lived through Lehman Brothers either there or in one of their counterparties, one of the reasons the markets froze in the summer of 2007 and into 2008 was that no-one was quite sure what anybody else's exposure looked like. You could argue that this is a crisis of financial reporting, which I would, or transaction reporting, but the truth is that it was very hard to know who owed money to whom at any given time. This is really what

Dodd-Frank, more than anything going on in Europe, is trying to change. By accident or by design, your markets are going to be hit.

The Dodd-Frank Act

Overview

The biggest single piece of legislation, in every sense of the word, is the US Dodd-Frank Act that was signed into law in July 2010. It is the biggest in the sense that it is 2,000 pages long, compared with something like the Federal Reserve Act, which was 31 pages, and Sarbanes-Oxley, which was about 100 pages. There has been a certain amount of paper inflation in US legislation for years, but this one beats all of the previous records. In particular, for fun facts to know and tell, this is 2,000 pages without any implementation or regulation. Most of the actual work was left to subsequent regulation by the authorities responsible for putting it in place, in your case largely the SEC and the CFTC. It is what is called an omnibus act. The good side of that is it is trying to cover everything at once which permits it to consider possible interactions within the Act. The bad side is that you could call it a "kitchen sink act" and we will get to that when we talk about the conflict minerals. Everybody threw in their own amendment for something that they wanted for their district or their constituents. The EU tends to regulate by chapter or theme. Dodd-Frank tries to cover everything at once.

With the rule making still in process, one of the things that has become very difficult to follow, for anybody in your industry or any other, is the state of play at any given time. There were very clear deadlines, which in most cases were 12-18 months, for putting in place all of Dodd-Frank. The problem is that there were no sanctions for not meeting those deadlines, so almost everything has been extended. For most industry participants, this is actually a very good thing. It means you have time to make your voices heard, to consult on some of the regulations and to try to affect change where change makes sense. It does make it a very unwieldy process to follow, and it is not clear for any of you exactly when you have to start being in compliance. In most cases, it is one year after the regulations have been passed, but the regulations are now in large measure a moving target. The only advice I can give on that is to make sure, whether through the LBMA's Regulatory Affairs Committee or your own counsels, that you are up to speed on those parts of the Act that affect you.

Issues

Basically, there are three big issues within Dodd-Frank and one that comes from the Basel Committee which will affect your industry. OTC derivatives, such as forwards and options, will affect you; conflict minerals, which I will talk about at some length; and actually something that is more philosophical, which is that US rulemakers – and the only way I can put it is as someone at the FDIC put it to me – are kind of down on consumer access to commodity trading. They think this stuff is dangerous and individuals probably should not touch it. If you think about this, it is important in the philosophy of rule making to know this because the SEC's remit is to make sure that the consumer is informed and safe when it enters into an investment. It is not a buyer-beware mandate. So you need to think about how they are framing their thoughts about some of these consumer issues. Obviously for most of you who are wholesale players, that is irrelevant but it will hit some of you.

In OTC derivatives, they are most concerned about central clearing and trading on exchanges so people can track where a transaction is and who owes what to whom. However, the scope of this is still currently a bit of a movable feast. The other good news for those of you in the room that are producers is that in most cases and for most OTC derivatives, hedging done in the gold market by end users is exempted. If you can argue that you are doing what you are doing as part of the normal course of business but that you are not a major market participant, you do not get caught up in a lot of these problems. This was due to a very strong lobby by manufacturers and service providers, not in your market but generally in derivatives, who said that they only use swaps to hedge their exposure and they are responsible for providing jobs to the market. They argued that, if you make their ability to protect themselves more expensive, you would cut their ability to provide profit, business and jobs to the market. They were listened to much more actively, understandably in the sense of the crisis, than financial players. There are possible implications for gold forward rate agreements and gold interest rate swaps. It may be clear to some of you in the market, but it is not yet clear to me to what extent you get caught up more in forex or more in commodities. You fall right smack in the middle and sometimes are not defined in either, and so your position is much more ambiguous than what is clearly a foreign exchange position or what is an agricultural commodity.

I have mentioned that the US has concerns about individuals, and there was an infamous blow-up this summer on the email traffic about something called Section 742a, which caused a flurry by saying that nobody could ever sell to consumers again and you have got to stop on July 15th. That proved to be erroneous but still scared a lot of people. The idea is that, to my understanding – and keep remembering that I know regulation and you know your market so I may get this wrong – the CFTC did not want retail commodity transactions and it was not entirely clear whether gold fell into this. It was only going to be allowed if you had actual physical delivery within 28 days. They kept pushing the 28 days forward and nobody quite knew how that was going to be affected. These are the kind of things you are going to have to start paying attention to. Obviously there are very clear decisions under US law about who is an eligible counterparty and who is an individual. They want to stop individuals transacting on the margin or with leverage, but just about anybody doing a forward is transacting and anybody with margin payments is doing something with leverage. This is still a very ambiguous area with rules still to be fully developed.

The third point is conflict gold and I will talk a little more about this later. This is the infamous section 1502, which requires additional reporting requirements for companies with SEC filings or suppliers to companies with SEC filings, where you must be able to attest to the fact that none of the gold in your production chain has come from the Democratic Republic of Congo or any of the neighbouring countries. It holds for what is called three Ts and G – tin, tantalum, tungsten and gold. I will talk a little about the resulting unintended consequences that David mentioned, because I think they are very important.

Now, if you are all completely depressed, there is some good news coming.

Europe

In the EU, gold has largely been out of scope and I think that is a good thing. There is a very clear reason for this. It is partially because government instruments are not as liquid in Europe, as in the US, and there is an issue about being able to have access to good quality liquid instruments and collateral that is much more compelling, I am afraid to say, in the EU than it is in the US. It is probably more compelling in Asia as well but I will come on to that.

Gold as a Liquid Asset

A completely different area of regulation is whether gold should be included in the liquid assets definition. The World Gold Council has been lobbying heavily to get gold included as a high quality liquid asset. You do not really want to know too much about this, but the Basel Committee on Bank Regulation is responsible to the G20 for designing new capital liquidity requirements to keep banks safe and to lower the likelihood of a future crisis and its future severity. Currently gold does not get any kind of preferential treatment, but the World Gold Council argues that its low credit and market risk, ease and certainty of value, lower correlation with risky assets, and the fact that it is listed on developed and recognised exchanges means it meets the four criteria that need to be met to be considered a liquid asset. They have had considerable success, and this is one of the lessons to learn: talking to regulators actually helps.

The European clearing houses are likely to include gold as collateral under EMIR, which is the market infrastructure rule. They have already had agreement for ICE Clear Europe, JP Morgan, CME and LCH Clearnet to go forward with the use of gold as acceptable collateral for margining. As I said, this is still somewhat less likely in North America due to both deep markets in treasury bonds and the need to fund that US Government deficit. In Asia, there is still probably a good opportunity because there is also a problem with adequate availability of liquid assets, so there may be a positive resolution here as well. More generally, there is something on our website for completely different reasons about the liquidity requirement – it is called LCR – which means that it is almost humanly impossible if you do the calculations to fill that LCR without massive shrinking of banks' balance sheets. Once regulators actually realise the implications of having to do that, they may be much more amenable to accepting other instruments such as bullion in their liquidity requirements.

It is interesting that in 2008 and currently that gold has been heavily used to get dollar funding, which was highlighted in *The Financial Times* last week. This is a development that we have not often seen. Where dollars are short, people are increasingly trying to use gold lending to get dollars. This is also going to highlight the importance of gold as an alternative. I am not here to push gold generally speaking but I think in this case, with some of the dollar shortages in Europe, this alternative has to be something that does arise.

Resolved Issues

Another piece of good news is that there are some resolved issues and there are some things that we need to think about very quickly concerning changes to the market. My favourite resolved issue is that we know for certain that bullion does not come under the Volker amendment of Dodd-Frank. This is about the only thing I can say with certainty. The Volker amendment was designed to take private equity and proprietary trading out of the banks' balance sheets. They have to spin them off and capitalise them separately. It is very clear that bullion does not fall into that category.

Supply Chain Management

I am really not going to spend much time on the supply chain management issue. Just two things: it is a focus on the audit trial on where the gold comes from as a result of Dodd Frank. And it demonstrates the value of a collective effort by most of the major players in the market to make progress on the issue. For those of you who can stay, you are going to have a Tuesday afternoon specific session on responsible gold that will tell you much more about this than I can.

Open Issues

So what are the open issues that are left? One is how consistent the US and the EU law on derivatives will be. At the moment, we hear that they are about 70% consistent, but that remaining 30% can be pretty expensive. We also hear that there is a very good dialogue between the SEC and the EU Commission on achieving consistency. Sadly there is not quite such a good dialogue between the SEC and the CFTC, so there is still a problem within the US. The second issue is whether the French presidency of the G20 and the Cannes summit in early November will be inclined to make a statement about gold. They have put a real emphasis on commodities. Personally, I am doubtful that it will represent any major change because their interest is on agricultural commodities and particularly on the price of food to the emerging markets, so I think that this is probably not on the agenda, but whenever you hear commodities you need to pay some attention. Will Dodd-Frank prohibit or discourage US residents from trading over the counter precious metals including gold and silver? In particular, how are they going to feel about these gold ETFs for individuals in the future, and can they distinguish these ETFs from the infamous ETFs that got UBS in so much trouble last week, which were not about gold?

Business Strategy and Lessons

So I will close with thinking a little about the business strategy and the lessons for you. Financial institutions are all going to be thinking about which businesses they keep and which they discard in light of the new rules and the new costs. They are going to be managing under uncertainty for some time to come, and they are going to have increased costs of compliance. Frankly I thought that the fact that you were all here was a very good sign because I would have expected them to cut budgets on things like conference travel already, so I think that is probably a sign that it is a little less draconian than I expected.

I am conscious of the time so I will just finish with the general lesson, which is to beware of the unintended consequences. Sadly for Africa, the conflict minerals resolution has effectively created an embargo against African minerals for many of those countries, which is doing them no good. I would also argue that, for countries that are less interested in ethical behaviour, it has given them the market for free, which is probably not what the US intended and is a shame. However, I do not know that you are going to change anybody’s mind on this at this stage, so the trick is to mitigate the impact.

Last of all, there are specific lessons for the bullion market. I think that you have all found that selective engagement, so that authorities feel comfortable with what is going in, is important. Access to data and producing as much fact and data-based work as you can to back up your opinions is critical in helping them to keep up-to-date with what is going on, and basically maintaining a dialogue wherever you can. One of the saddest consequences of the crisis is that regulators have been terrified of talking to the markets, and without that conversation no-one is really going to understand what the other is doing. Thank you very much.