Why Regulate Precious Metals

By Joel Cook, Global Head of Commodities Compliance, Standard Chartered Bank

Regulation in financial markets is in focus now more than ever. The succession of crises that has plagued global financial markets from 2007 right up to the present has placed pressure on governments and regulators to impose stricter controls on participants in financial markets.

In such a climate increased regulatory burdens may seem inevitable. But it is still worth taking a step back to consider whether regulation, and in particular regulation of precious metals markets, is a good thing.

Why do we choose to regulate financial markets at all? The basic driver is a perception that financial market forces, if left completely unchecked, would not always operate in a fair and equitable manner. The assumption therefore is that some sort of framework of rules is required to guide and restrict the activities of the various participants in those markets, so as to prevent any undesirable forms of conduct and promote both certainty and fairness.

In most financial markets there are imbalances in the level of information, skill or sophistication of the various participants in a market. This is particularly the case where there are both wholesale and retail participants. Regulations create levels of investor 'protection' so that less sophisticated participants can access the market safe in the knowledge that their lack of knowledge and experience will not be exploited. This is seen in the form of disclosure obligations, rules that require products or services to meet suitability and appropriateness standards, requirements on firms to manage internal conflicts of interest, etc.

Regulations may also increase certainty for participants operating in a market. For example, bullion market participants want to know that in a Loco London gold transaction the bullion they can expect to receive in settlement of a purchase will conform to certain minimum standards as to weight and fineness. The London Bullion Market Association (LBMA) Good Delivery Rules set out minimum specifications for Good Delivery Bars, and these rules help provide participants with certainty in their bullion transactions.

Similarly participants on a futures exchange want to be able to rely on the fact that all other participants are bound by rules of conduct that for example prohibit behaviour which may distort the market price for the futures contracts traded on that exchange. This helps to create certainty that the price 'discovered' through the exchange trading mechanism is reasonably reflective of prevailing market conditions and can be seen as a true market price.

Recent enforcement action in relation to NYMEX precious metals derivatives contracts highlights the importance placed on regulations to ensure that markets are free from manipulation. In April 2010 the US Commodity Futures Trading Commission (CFTC) ordered a US hedge fund manager to pay a fine of USD 25mn for attempting to manipulate the settlement prices of NYMEX platinum and palladium derivatives contracts, by engaging in a behaviour known as 'banging the close'. The CFTC also imposed restrictions on the hedge fund manager's trading around the closing period of the NYMEX platinum and palladium contracts. (http://www.cftc.gov/PressRoom/PressReleases/pr5815-10.html)

It is worth noting that although rules are typically imposed through legislation or directives (such as statutes or regulations which a firm must comply with) or through some sort of contractual arrangement (such as the rules of a trading exchange, platform or industry association, which a member firm contractually agrees to be bound by), rules may also be imposed through some sort of voluntary self-regulatory framework.

The London Code of Conduct for Non-Investment Products (NIPs) code is an example of such a voluntary framework. The NIPs code was drawn up by industry bodies representing the foreign-exchange, money and bullion markets, in conjunction with the Bank of England and with input from the FSA. It sets out the standards of conduct, and professionalism expected of participants in terms of their interaction with each other and with their clients.

Most rules, particularly those imposed through legislation, are backed by a threat of sanctions. In the event of improper conduct regulatory bodies may take enforcement action and impose censures, fines or other penalties. In recent times, possibly as a result of political pressure on regulators, fines imposed by regulatory bodies have become considerably more penal, with both the amount of fines and the number of disciplinary actions increasing.

In self-regulatory regimes the mutual self interest of the parties involved and simply the desire to avoid negative publicity and damage to reputation can be enough to ensure compliance with the regulations. Compliance with the NIPs code for example is essentially on a voluntary basis. It relies on the professional and wholesale nature of the market and the broadly similar levels of knowledge and sophistication of its participants, to ensure that market conduct conforms to the required parameters. Allegations of breaches of rules or improper conduct are bilateral matters to be decided between the two participants and there is no body that will impose sanctions for breaches of NIPs code provisions, although arbitration may be sought for dispute resolution.

The simple fact of having regulations does not in itself create complete certainty for market participants. While a regulatory regime can offer a degree of certainty as regards the quality of a commodity being delivered under a contract or the acceptability of various forms of conduct, markets also appreciate longer-term certainty. Participants will want to be comfortable that regulations will not be subject to frequent or arbitrary change so they can make long-term plans accordingly. Concern over whether current regulations will still be in force in a year, or perhaps whether a change in government will lead to the introduction of new regulations, can impact strategic planning within firms.

It is also beneficial that any changes to regulations will be subject to some sort of industry consultation process so that market practitioners have the opportunity to make comments on regulatory proposals and contribute to the process of forming regulations. Furthermore it is preferable that proposed regulations are subject to some sort of cost/benefit analysis to ensure that regulations are not unduly restrictive and allow financial markets the scope to develop new products and risk management solutions.

Some regulatory regimes seek to address these issues and the broader question of why regulation is a good thing, through terms of reference and operating principles. The UK for example has five statutory objectives set out in the Financial Services and Markets Act 2000 (FSMA), which its regulator, the Financial Services Authority (FSA), must seek to achieve. These are: to maintain confidence in the financial system; to promote public understanding of the financial system; to secure the appropriate degree of protection for consumers; to reduce financial crime and to contribute to the protection and enhancement of the UK financial system. This last objective concerning financial stability in the UK is a very recent addition and a direct response to the recent financial crisis.

In addition the UK FSA also has principles of good regulation which include the requirement that any restrictions imposed on financial markets must be proportionate to the benefits resulting from those restrictions, and the need to minimise adverse effects on competition that may arise from regulations.

There is also a political dimension to the drive to regulate. Regulations may be influenced by popular viewpoints or reactions to contemporary market events. This is particularly the case recently where in many western jurisdictions, there has been a public perception that existing regulatory regimes failed and that this failure was a material contributor in the global financial crisis. In both the US and the EU, considerable amounts of new regulation have been proposed and are at various stages of implementation.

Such regulatory 'knee-jerk' reactions may even fail to achieve the desired objectives. The CFTC's proposals to introduce position limits in energy contracts and potentially even metals contracts in order to curb supposedly harmful speculation have attracted much criticism, both for their argued negative impacts such as increasing uncertainty and driving trading on to less transparent venues such as the OTC market, but also for being too large and potentially ineffectual.

The direct benefits of new regulations to the actual market participants may not always be completely clear. The various regulatory proposals in the US and EU calling for increased transparency in OTC derivatives markets for example, are arguably more

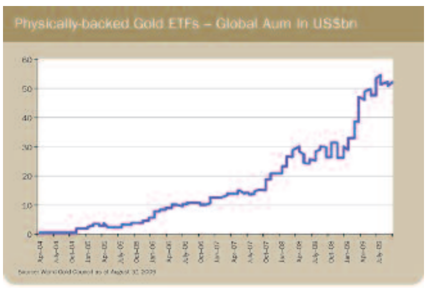

Figure 1: Source: ETF Securities – 'Setting the Gold Standard – An investor's guide to the gold market and gold ETFs/ETCs'.

beneficial to the regulators themselves and the wider public to whom governments and regulators are ultimately responsible, than to those transacting in OTC derivatives where the desire for contractual flexibility or confidentiality may have driven the decision to utilise the OTC market in the first place.

In some developing financial markets, regulations are used to restrict access to certain types of market participants and to allow domestic markets to develop in a controlled and sustainable manner. Such limitations may be in the form of restrictions on memberships of domestic exchanges or trading platforms, foreign exchange controls or import / export licence requirements. This can frustrate the attempts of international firms to get involved in these markets.

Regulation is therefore generally a good thing, adding certainty as well as 'levelling the playing field' for market participants, by addressing imbalances in the relative sophistication of the various participants in a market.

Why though is this relevant to precious metals markets? Although the majority of gold production is used for jewellery, retail investment in precious metals has typically been confined to a consumer market, with a distinct wholesale market in which banks, central banks and industrial producers and consumers make up the bulk of the participants.

Recent concerns over the stability of traditional forms of investment such as shares, bonds and currencies have however led to increased retail participation in the wholesale precious metals markets. Over the last 8 years a considerable number of precious metals Exchange Traded Funds (ETF) or Exchange Traded Commodities (ETC) products have been set up. Since 2004 the total value of the assets under management for physically backed gold ETFs has increased from zero to around USD 50 billion (see Figure 1). As well as ETFs or ETCs in gold and silver which have traditionally been attractive to retail participants, more industrial metals such as platinum have recently become the subject of ETFs. In addition new forms of access product which allow retail investors to gain exposure to precious metals prices such as dual currency deposits where gold is the second 'currency', have also been developed.

Some have argued that increased financial activity in commodity markets has resulted in increased commodity prices and the amplification of commodity price volatility. Investment demand for gold for example has increased dramatically with the demand coming from ETFs representing a larger proportion of overall annual demand. Between 2004 and 2010 annual gold demand contribution from ETFs increased from around 150 tonnes to around 600 tonnes

Figure 2

while overall annual demand has remained relatively unchanged (see Figure 2).
At the same time there has been significant correlation between this increased demand for gold from investment sources, with the underlying price of gold (see Figure 3).

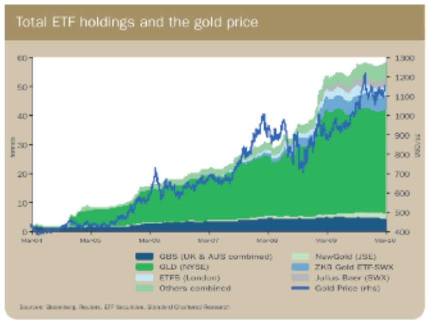

Figure 3:

These new forms of retail participation in wholesale precious metals markets add to overall liquidity, but at the same time bring a greater responsibility to ensure fairness and certainty for all market participants. Those investing in precious metals ETFs must be comfortable that the price of the underlying metal is not subject to manipulation. Regulations are critical in giving all participants, including retail investors, that level of comfort.

So despite being restrictive and often complex, regulation is generally a positive force. The challenge however is to ensure that regulatory frameworks are equitable, proportionate, consistent, tied to clear objectives and promote a stable environment in which to conduct long-term business. In an ideal world, regulations would be consistent across all jurisdictions. While the harmonisation of financial regulations across the European Union and the recent attempts by the G20 nations, to promote consistent regulations are certainly positive developments, this is a long way off. There will always be a political dimension to regulation and while there are still multiple independent nations there will always be separate national agendas and priorities.

Prior to the global financial crisis, some regulatory regimes had begun moving towards what is known as 'principles-based regulation' whereby a set of broad outline principles forms the foundation of the regulatory regime, with specific regulations and guidance supplementing and expanding upon the basic principles. Greater focus is placed on qualitative values, desired outcomes for customers and modifying participants' behaviour, rather than quantitative prescriptions and the imposition of punitive sanctions for breaches.

Because they are less prescriptive, these regulatory regimes also tend to be less adversarial in nature. The UK FSA is perhaps the most well-known exponent of such an approach. A possible consequence of the global financial crisis and the FSA's perceived failure to anticipate and prevent the crisis in the UK, is that this will be seen in part as a failure of less prescriptive and less adversarial principles-based regulatory systems. This may in turn lead to a move toward more detailed regulations, a more adversarial approach and more stringent sanctions for breaches.

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