Regulatory Update

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Introduction and the **World of Regulation**

Thank you for attending this session on Regulatory Update.

Rather than give you a list of agenda items, I've tried to put them into sections, to highlight how regulation impacts various work streams. Conduct and transparency, focusing here on the Global Precious Metals Code, the incident management process and trade reporting. All are key to addressing market conduct and helping to provide more transparency in the market and therefore hopefully confidence.

The other group is all the developments related to Responsible Sourcing, which includes the Conflicts Minerals Regulation, the OECD alignment assessment, the LBMA Responsible Sourcing programme and bullion bank reporting. Finally, all the regulations affecting the financial services industry, although I will be only focusing on NSFR, MiFID 2 and Benchmarks. However, there are a few others, which unfortunately I won't have the time to address.

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Fair Effective Markets Review

I thought that two years on, it would be good to start with a bit of a stock take. Back in 2015, the LBMA on behalf of the market made a commitment to the Fair Effective Markets Review (FEMR) executive that we would deliver on some of the recommendations they had provided in their report. By way of reminder, the Bank of England, the UK Financial Conduct Authority and the HM Treasury undertook a joint review of the FICC markets, which included precious metals. Since 2015, the LBMA has been successful in following through the commitment, as we work closely with the independent administrators for the benchmarks, given gold and silver are regulated. We have gone live with Phase I of the trade reporting initiative and finally we launched the Global Precious Metals Code in May of this year.

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Global Precious Metals Code – May 2017

Firstly I would like to thank everyone who took part in the development of the Global Precious Metals Code. It was certainly a challenging task to have a Code that is somewhat aligned with the FX Code Of Conduct, and yet is tailored enough to the precious metals market so it is relevant, but then also reflects the diversity of the market participants. This could not have been achieved without input from market participants.

The purpose of the Code is to promote integrity and effective functioning of the markets and to provide guidance on best practice. It is intended to provide the market with the opportunity to self-regulate, rather than wait for the authorities to provide rules on what is expected of them.

The Code applies to all market participants who are actively involved in the OTC wholesale trading markets. There are sections which apply to everyone, and sections which might not be relevant to everyone. Therefore proportionality is very important, and discretion is given to market participants to determine what is appropriate. Finally, all market participants are encouraged to use the Statement of Commitment, which can be found in the annex of the Code, to confirm they comply with the Code. This helps with transparency and, to the extent possible, should be published on websites. However, the LBMA would like to see a copy of this statement, so that they can remain a Member of the LBMA. Remember, compliance with the Code is mandatory for all LBMA Members.

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Application

Now a little bit more on the Code. The Code is divided into 5 sections:

1. Ethics;
2. Governance, compliance and risk management;
3. Information sharing;
4. Business conduct, pre trade and execution;
5. Business conduct, post trade.

At the end, some practical examples are provided to help demonstrate the application of the Code. As a general rule, we would expect that the first 3 sections would apply to everyone, no matter if you are a bank or a refiner or a producer. Everyone should have clear governance, and a compliance infrastructure in place. The Code then provides some guidance as to what that compliance infrastructure should look like. On business conduct, this would be very different from organisation to organisation. For example, a firm that has 50 traders would have a very different structure and systems in place to a firm that has 5 traders.

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Implementation

Finally, when it comes to implementation, LBMA Members have until 1 June 2018 to comply. There is an explanatory note to help primarily the non-banks with implementation, as this provides more examples and guidance on how to exercise proportionality. All firms should be carrying out a gap analysis, to understand what they already have in place, what needs to be consolidated to provide for compliance and what new systems and controls need to be put in place to fill the gaps. Thereafter, all market participants are expected to continuously review compliance with the Code, and support this by making the public statements, possibly through their websites. The LBMA Precious Metals Code Working Group will also meet from time to time to review the Code, considering whether it remains fit for purpose and to provide any updates as and when appropriate. We are not expecting to issue any substantial changes for the next 3 to 5 years, but nevertheless the LBMA will remain engaged with the market.

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Transparency: Trade Reporting

The other key development for the LBMA under FEMR is trade reporting and the need to enhance transparency. From September this year, Market Makers and some full trading Members have started to report trade data into the LBMA-i. The LBMA-i is the reporting hub that is provided by Boat and Autilla. For those of you who recall, Boat and Autilla won the request for proposal this time last year to develop the LBMA-i and to become the service provider for trade reporting. They have done an excellent job to date in engaging with market participants to define the scope, the process, and code of conduct. Several technical working groups were set up to make decisions. So today, we are reporting on all loco London and loco Zurich trades for all 4 precious metals, in spot, forward and options. No client specific data is being requested, so to protect confidentiality. Therefore, the data is sufficiently anonymous without giving away the underlying client. The data will then be aggregated and published but not until Q1 2018. This is to provide the time to analyse the data and again work with the market to understand what we need to be publishing. The data that gets published needs to be meaningful. I would strongly encourage you to visit the Boat stand over the next day or so to speak to Jamie Khurshid (CEO of Boat) and the team about the LBMA-i. Also, in particular, I would like to thank David Gornall who has been more than instrumental in getting this across the line. Please do catch him also about the detail.

Just to emphasize that reporting is mandatory for all LBMA trading Members, and failure to report will lead to fines and eventually removal from the LBMA Membership.

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Net Stable Funding Ratio

It is impossible for me to give a regulatory update without talking about the impact of NSFR. In my view, it is one of the top regulatory items affecting this market. Hence another plea to you all to help the LBMA to help the market. By way of background, BCBS adopted the NSFR standards back in 2014 and in November 2016 the EU came up with its own legislative proposal to support the implementation of the BCBS standards.

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Net Stable Funding Ratio

Although it was expected to be implemented in Jan 2018, it is now more likely to be 2020 at the absolute earliest, but probably more along the lines of 2021.

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Net Stable Funding Ratio

Why should you care? On the financing side, there are two key points: the cost of lending will increase, and banks are likely to pass that on. Alternatively and probably more importantly, the banks may re-consider their position in the market and leave. This will then potentially leave a small liquidity pool and reduce competition. This will impact the real economy. However, the most serious impact, which will affect the way this market is set up, is the impact on the settlement and clearing services provided by the London Precious Metals Clearing Limited (LPMCL). The cost of providing that service will increase significantly and, if LPMCL stops providing clearing and settlement, this will impact the entire market as London is the largest financial market in the world. For example, a Japanese trading house that transacts with an Australian bank will settle the transaction in London through LPMCL. This model is under threat because of NSFR.

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Net Stable Funding Ratio

The LBMA has produced a position paper, met with various representatives of different Member States and Members of Parliament. We also had meetings with the European Commission, but the work hasn't stopped. There are still many more Member States to meet to get support from and hope they will raise the issues facing the precious metals market at the negotiation table. We also need for the LBMA European Members to speak up, contact their representatives and support the LBMA arguments. Please speak to me after this if you can get involved, and we can provide you with all the statements and documents. Also, tomorrow at the regulatory forum, David Gornall will be going through some illustrative examples to help demonstrate the impact.

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MiFID 2

Moving onto a couple of financial services regulations – MiFID 2 and Benchmarks Regulation. Both of these regulations come into force in January 2018 and have taken up a lot of time and resources within the financial services sector to understand and implement. I don't plan to go into much detail on either, because again both these topics will be covered in a bit more detail tomorrow. Declan McKeever from JP Morgan will be providing a bit more insight to MiFID 2 and what this means, and Matt Glenville from IBA will be speaking on the introduction of the Benchmarks Regulation.

The key point from the LBMA's perspective, under MiFID 2, is what is in and what is outside of scope. This has raised a lot of questions in the market, and I have received a lot of questions on the LBMA's position on physically settled forwards. Our view is, that all physically settled forwards, whether on an allocated or unallocated basis are out of scope. A book entry takes place to effect the physical delivery. We have made our position clear, however understand that whilst some law firms and market participants agree with this position, there are others that challenge this. We remain consistent with the approach adopted by Dodd Frank, and take a firm view that global regulators need to be consistent with this approach so not to create a regulatory arbitrage.

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LBMA Precious Metals Prices

2017 also saw the consolidation of two benchmarks under one administrator, ICE Benchmark Administration. Firstly I would like to congratulate IBA for successfully managing the transition and going live with the LBMA Silver Price this month, and also to thank the CME and Thomson Reuters for all their support in helping with the transition and all the work to date. The LBMA Silver Price went live with 9 participants, and I understand there are more in the pipeline, and also saw the introduction of clearing to help grow the participation. The LBMA Gold Price saw the introduction of clearing back in April of this year, to again help increase participation. Also in January next year we will see the implementation of the Benchmarks Regulation, which introduces new requirements, and captures hundreds and hundreds of benchmarks into scope, including platinum and palladium. We are working with the administrators and the regulator to understand the impact, which even today is not absolutely clear. Broadly speaking, benchmarks will be classified into critical, significant and non-significant benchmarks, and that will determine the level of regulatory impact. I would strongly encourage you to attend the regulatory forum again tomorrow, when Matt Glenville will provide a little bit more information.

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REACH

I was asked to also briefly cover REACH, which stands for Registration, Evaluation, Authorisation and Restriction of Chemicals. The purpose of this regulation is to ensure all chemicals in an article/ raw material form must be registered with the relevant authorities in the EU by certain dates. The final registration date for all chemicals that have not be registered to date is 31 May 2018. The only precious metals that have not been addressed is Platinum and Palladium. Back in 2010, the LBMA on behalf of the market submitted a position paper to the UK Heath and Safety Executive, highlighting that Good Delivery Gold bars are finished products and out of scope of this regulation. The HSE acknowledged that a good case had been presented for the Good Delivery Gold bars. Similarly, we are finalising a position paper for Good Delivery Platinum and Palladium, and will follow a similar line of argument as we did for gold. We intend to submit this in the next few weeks, and hope to get a similar response, so to reduce the unnecessary administrative burden. If you are interested in the position paper, please get in touch.

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EU Conflict Minerals Update

Now finally onto the Responsible Sourcing programme, and the regulatory developments associated with this. Firstly, a brief mention on the EU Conflicts Minerals Regulation. This Regulation will be enforced in 2021. Everyone importing 100kg of gold or more will be expected to comply. The LBMA is lobbying against the 100kg, primarily because compliance with the regulation is important irrespective of how much you are importing, given the due diligence issues that the regulation raises. The EC will also be producing guidance on how firms can identify Conflict Affected High Risk Areas, as well as producing a list of recognised refiners, and assessing industry schemes to help with this list. Furthermore there will be reporting requirements on bullion banks. The LBMA is working on all of these aspects.

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OECD Alignment Assessment

Firstly, the LBMA volunteered to take part in the OECD Alignment Assessment, which assesses alignment with the OECD Due Diligence Guidance, and helps the EC to understand which schemes are credible to recognise. A lot of work and effort that been put into this, with various refiners being shadowed whilst undergoing an audit, various members being interviewed and a lot of the LBMA policies, procedures and governance being reviewed.

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OECD Alignment Assessment

The results have overall been positive, but nevertheless with some work still to be done. Firstly, it has been recognised that the LBMA does closely follow the OECD Guidance, has strong governance in place, clear lines of responsibility and accountability are provided, and finally that we are aligned with the public reporting requirements. The final report, to be published later this year, will highlight a lot of this positive feedback.

Nevertheless, there is still room for development. There always is. Many of these improvements have been reflected through the implementation of Version7 of the Responsible Gold Guidance. We are enhancing auditor training and oversight, as the audits are only as good as the auditors. This has involved more webinars, and more bilateral discussions with the individuals who undergo an audit. We are focused on bullion bank reporting and finally have made the use of the Refiners Toolkit mandatory, to again get refiners to focus on all the various issues, and if some don’t apply, for them to explain why.

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Responsible Sourcing Programme

This slide shows the improvements we have made and also highlights that the Responsible Silver Guidance was launched this September, after a good engagement process with the refiners. Neil will mention a little bit more on this during tomorrow morning’s session.

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Due Diligence Scope

On bullion bank reporting, we have set up a Financial Crimes Working Group, who will help the LBMA consider some of the issues linked with reporting and a potential template that can be used by the market, so no one is under or over reporting. However this Group will also be considering a number of other important issues, for example can we look at best practice on due diligence issues? Whilst we know what should be in scope, i.e. AML, terrorist financing, sanctions, conflicts minerals, fraud and many others, how do we realistically go about addressing all these risks? Are there any lessons we can learn from and share?. The Group will also help with developing the incident management process that the LBMA formalised last year.

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Incident Management Process

The incident management process is the process that the LBMA follows when there are any issues within the markets, media coverage, potential rumours, or any other issues. We have to first and foremost make sure that the rumours are credible and verifiable to the extent possible, through media searches or speaking to other members of the market. We review the Responsible Sourcing audits, engage with the auditors and the refiners, where practical. However, most importantly we engage with a number of key stakeholders. At the various institutions, we engage with compliance, legal, the business, senior managers, the LBMA committees and, if relevant, external law firms, regulators and authorities, as we did with the Homeland Security, and other third party stakeholders like exchanges. It’s a very engaged process but an important one to make sure the right decision is reached by the LBMA.

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LBMA Country Profiling

The LBMA also has a country risk profile, to help with ongoing reviews. The risk profile is primarily an internal document, which puts various jurisdictions into different categories, therefore allowing us to determine our review programme. We are working with an external law firm in trying to share this list with interested parties, such as Members of the LBMA. However, we are mindful that this list should not be taken as the LBMA standard, and whilst we might be able to share our analysis, every firm should always seek into own legal guidance when it comes to assessing the various risks.

We have established 5 categories. The first category, which in turn is divided into 4, is focused on sanctions. Is the country subject to a number of heavy sanctions, which therefore becomes a very high sanctions risk compared to countries who do not have sanctions against them directly? This would then take us to the next category. Are those countries mentioned under Dodd Frank and are there appropriate controls in addressing those risks? If not, then are those countries conflict affected areas, and if not then are there other known risks linked to that jurisdictions which is relevant to those markets? Finally, if none of the above apply, then that jurisdiction will fall into category 5, which then would be the low risk category.

This is how we have divided it, and if you would like more information, come and speak to me after.

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Brexit

And finally, a brief mention on Brexit! What impact will Brexit have on all these regulatory developments? The answer is, we do not know, but we have to continue implementing, if we want to achieve equivalence. However, there is a lot of confusion on what equivalence will look like. Nevertheless, the LBMA is taking a pro-active approach. We met with the HM Treasury to talk through some of our concerns in relation to the Terminal Markets Order, and making sure the zero-rated VAT benefit that is provided will be protected post-Brexit. Will we have to introduce a new REACH equivalence regime, and undergo the administrative burden of complying with a UK version of REACH? What will NSFR look like? There are many questions, but the positive news is, the HM Treasury welcomed our proactive approach and want us to be engaged on the various issues impacting the market so they can reflect. We want to hear from you so we can represent the market at various meetings like this.

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Regulation: A World of Acronyms

And with that, I finally take a break. There are other regulations I can continue to highlight, but the session will become an hour. Although let’s hope the feedback to today’s session isn’t that you want to hear me for an hour next year, given a lot of you highlighted that my update last year was too rushed.