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Founded 25 years ago in 1987, this special edition of the Alchemist celebrates the LBMA's Silver Anniversary. It features an article by the first Chairman of the LBMA, Robert Guy, who looks back at the inception of the association as well as an Editorial feature by the current Chairman, David Gornall.



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All the metals – all the angles – all the time

Reinterpreting Gold's Price Behaviour

By Daniel Brebner, Head of Metals Research, Deutsche Bank



Gold is not just money, it is 'good' money. In this article Daniel Brebner argues why Gresham's Law is so relevant in understanding gold and how it behaves.

Gold is widely misunderstood. Many investors don't understand how it is valued and why it behaves the way it does. Some are uncomfortable that gold is not 'consumed' like other commodities – it is not eaten, or burned or forged, as food, energy or industrial metals would be.

Gold has no use, according to many. But then gold is not really a commodity at all. While it is included in the commodities basket it is in fact a medium of exchange and one that is officially recognised (if not publicly used as such). I would argue that gold is an officially recognised form of money for one primary reason: it is widely held by most of the world's larger central banks as a component of reserves.

I would go further, however, and argue that gold in fact could be characterised as 'good' money as opposed to 'bad' money which would be represented by many of today's fiat currencies. In describing gold as such I refer to Gresham's Law: when a government overvalues one type of money and undervalues another, the undervalued money (good) will leave the country or disappear from circulation into hoards, while the overvalued money (bad) will flood into circulation.

Support for this assertion comes from my interpretation of US government action at the end of dollar convertibility in 1971 (the end of the Bretton Woods system). The US ended convertibility because it did not want to send its gold to France or Britain who were demanding gold (or about to) rather than dollars; this in response to the decline in perceived value of the dollar due to profligate government

spending during the 1960s. The US government valued its 'good' gold money more than its 'bad' paper money and therefore set about hoarding it – officially. Thereafter the USD, the bad money, became the world's reserve currency (with immense benefits for US government funding, in our view).

This 'good' money assertion holds from this point, but for a short window during the late 1990s when several western governments (Britain, Canada, Switzerland, etc) decided to convert their gold to other (presumably more valuable?) fiat currencies – most likely the US dollar. I would suggest that the US government did not object.

Characteristics of 'good' money

The ideal medium of exchange must balance the paradox of representing value while having

little intrinsic value itself. There are very few media which can do this. Fiat currencies physically have no use other than that which is prescribed to them by government and accepted by the public. That fiat currencies cost little to produce is of secondary concern and, I believe, quite irrelevant to the primary purpose. Gold is neither a production good nor a consumption good. Jewellery, I view as a form of storage or hoarding (the people of Portugal have all but exhausted their personal gold stores, hoarded in the form of jewellery, having converted it to survive the crisis). If gold did have a meaningful commercial use, I believe that it would make the metal less attractive as a medium of exchange, as the value of the metal in whatever market it was used in could periodically interfere with its medium-of-exchange role.

That gold is fairly costly/difficult to obtain is of secondary relevance to the value that it is used to represent. The fact that this characteristic has throughout history continuously frustrated governments reliant on a gold-standard and therefore unable to expand their spending at will is, again, secondary. Nevertheless I do believe that scarcity could be an important factor in ensuring the longevity of a currency. Scarcity may create some stability in the value that it represents and in turn influence the confidence with which the public regard it.

Other characteristics are important in fulfilling the requirements for 'good' money: indestructibility, divisibility, transportability and universal acceptability.

The conclusion from my overview of gold functionality is that the key difference between good and bad money is scarcity (imposed supply discipline could be another way of describing this). Fiat currencies can be scarce but this scarcity may change on a whim which may both impact its tenure as currency and/or relegate it to being characterised as bad money.

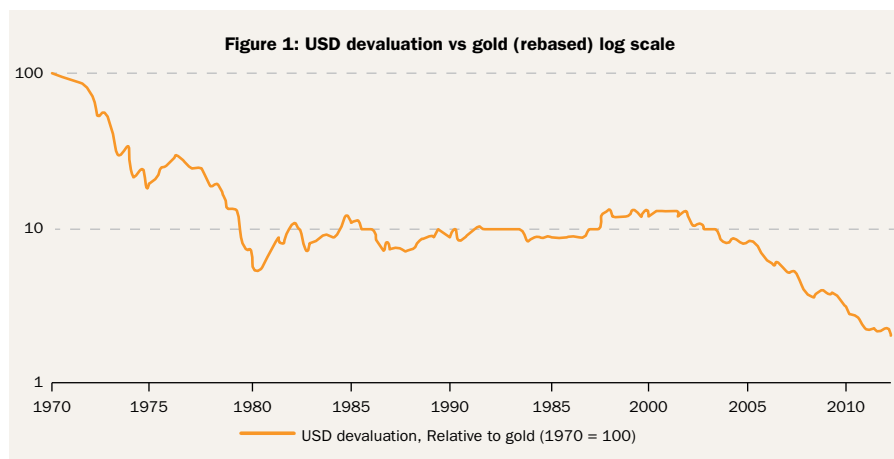
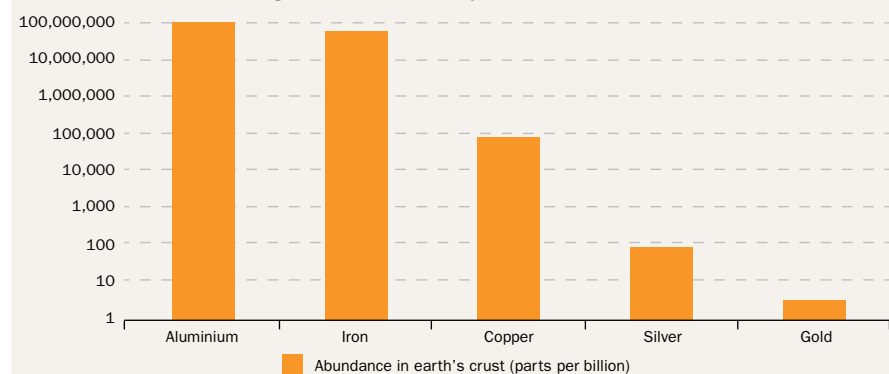


Figure 2: Relative scarcity - selected elements

Some economists would argue that it is not sufficient to look only at money supply, that demand for money is also important. I would disagree with this assessment; money is not a production/consumption good as I have previously discussed. What is the marginal demand for money? The question itself is a non-sequitur. There is constant demand for money whatever the economic condition. The important question is how this money is used once it is acquired.

The conventional metric to view money supply is to look at M2, for both the US and China. In my view it is important to use both regions given the RMB peg, creating a kind of USD axis

Gold is truly scarce, having a concentration of around 3 parts per billion in the Earth's crust (see Figure 2). If all the gold ever mined were to be put in one spot it would consist of a cube roughly 20 metres per side. Furthermore and equally important, the rate of gold supply growth is normally quite slow and reasonably predictable.

Gold's price behaviour

To describe it in the simplest of terms, gold's value depends in large part on the degree of 'badness' of bad money. Following on from the previous discussion this factor is significantly reliant on relative scarcity.

If bad money becomes less bad (supply growth constrained and interest rates at appropriate levels), then one would expect that the desire/incentive to hold good money becomes less obvious. Hoarding of good money would, according to theory, fall. Gold's utility in this case would decline and prices would fall relative to the US dollar; the degree of this fall would likely be determined by the required supply contraction and therefore gold production costs (this secondary pricing factor becoming more important in determining value as the primary currency element diminishes in my view).

If however, as seems to be the case currently, bad money becomes increasingly bad, then one would expect that the desire/incentive to hold good money should increase coincident with the perceived deterioration in functionality of the bad money as a currency. In short this is why the gold price has been appreciating over the past 10 years – coincident with the growing overvaluation or increased 'badness' of the US dollar.

Throughout history there has been one consistent factor which has contributed to the overvaluation of fiat currencies versus gold: excessive borrowing (often associated with war). In the past 100 years alone the US has experienced this twice: in 1934 and 1971. In 1934 the dollar was devalued by 42% versus gold and in 1971 the dollar was initially devalued by 8% and then by considerably more as the market pushed gold prices higher when inflation took hold into the late 1970s (a function of the easy monetary policy of the 1960s, war and a supply shock in oil).

Figure 3: US Fed B/S and China FX reserves

History now appears to be repeating itself with excessive borrowing resulting in a new phase of devaluation for the dollar although the current situation may be unprecedented in modern history for the breadth and scale of the value adjustment that may be necessary.

Monetary factors

I would argue that the gold price is highly price sensitive to two monetary factors: 1) excessive fiat money supply growth (ie, a rate above that justified by population and unlevered productivity growth combined); and 2) money velocity. Velocity is an important factor given the higher the money velocity (greater transactions) the greater the accuracy in the relative pricing of economic goods, particularly during environments of changing money supply. Nevertheless I attach primary importance to supply.

which dominates the global economy. Figure 3 combines the Fed balance sheet and China F/X reserves. This is a potentially superior representation of incremental money supply. Note that much of this expansion is backed by credit – credit fuelled spending by the US consumer for Chinese products resulting in increased China reserves combined with the Fed bailouts.

There may be some double counting in the combination of this data but I don't believe that it is significant.

Figure 4 below then shows the relationship between the growth in USD supply and appreciation in the gold price. By association of course I imply causation which should always be treated with caution (as Hume would advise). I previously argued however that by using historic

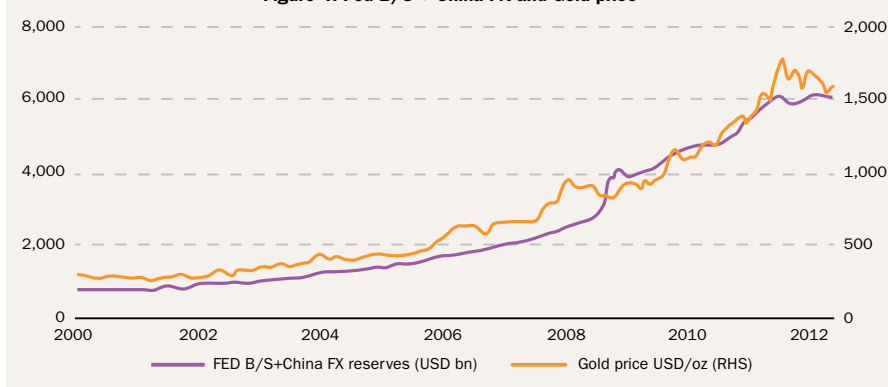
Figure 4: Fed B/S + China FX and Gold price

Figure 5: Gold price vs money stock*



precedent excess supply can be associated with overvaluation; I make this assertion here.

Taking the ratio between the two data series I derive Figure 5. The ratio between gold and money supply remained fairly stable until late 2008, coincident with the collapse of Lehman and a peak in the intensity of the financial crisis at that time. Interestingly the expansion of the Fed balance sheet at that time actually resulted in an initial de-rating of gold against the supply of dollars. Yet this is opposite to what I have argued; instead we should have expected to see gold's price move higher coincident with the increase in supply. What happened?

“ While I believe that the US Fed could continue to expand its balance sheet further in the future, the extent of money expansion is difficult to determine. ”

Figure 6 takes this analysis a step further by including US CPI (I admit that is a poor gauge of inflation but it serves its purpose sufficiently here). In late 2009 deflation emerged in the Western economies as consumption contracted and money velocity sank. On this basis I believe that while the supply of money grew considerably, valuations in US dollar terms were impacted by the constraints on the flow

of money through the economic system at the time. Much, if not all, of the new money created by the Fed went to banks which then purchased US short-term bonds. I would argue that this hoarding occurrence temporarily inverted the good/bad money dynamic between gold and the dollar. There was not increased hoarding of gold at this time as the principal beneficiaries of the increase in money supply must operate within the confines of the fiat regime and do not have the flexibility that the public and the state do.

Implications for forecasting

How does one go about forecasting gold prices? Implied in the above argument is the necessity to forecast future central bank action with respect to monetary policy, and also how additional money would subsequently flow through to the rest of the economy. The latter aspect – effectively, how will the individuals receiving this new money spend it – has important implications for inflation. In the case of 2008, the new funds were used by financial institutions to bolster their liquidity requirements, resulting in inflation in a particular asset class benefiting from such purchases: US treasuries.

In a future quantitative easing (QE) scenario the question is not only who will receive this incremental money but also, how it will be spent, given this could lead to selective price inflation with repercussions for gold price performance.

While I believe that the US Fed could continue to expand its balance sheet further in the future, the extent of money expansion is difficult to determine. But even more challenging is predicting how (or even if) this money will move through the broader economy.

For example, if the Fed were to announce a QE of a magnitude of USD1 trillion then the gold price would likely move to USD1,900/oz ± 100 /oz, assuming perceptions of inflation remained the same. If, however, inflationary fears escalated, a price of USD2,500/oz could be justified. In this latter scenario, I expect that this excess money would need to be more broadly distributed. It is possible that this could occur if the commercial banks which are principal beneficiaries of the Fed's balance sheet expansion in turn expanded their balance sheets to the benefit of consumers and/or corporations.

For gold to react to its maximum potential new 'bad' money needs to be created and subsequently disseminated efficiently into an economy where a sufficient frequency of transactions results in a wholesale repricing of production/consumption goods.

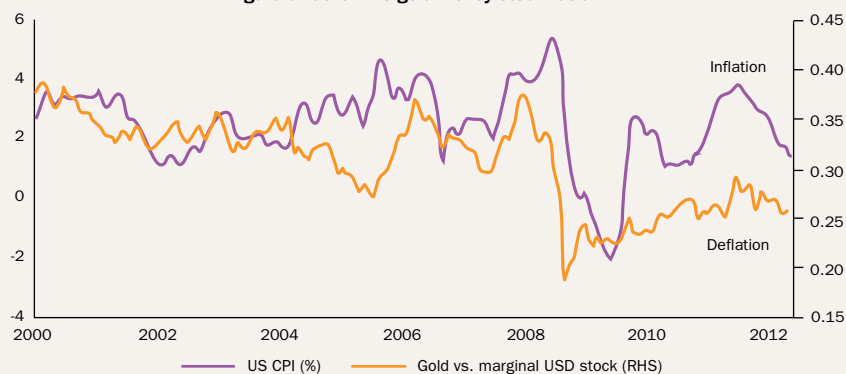


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Prior to joining Deutsche Bank, Daniel spent 10 years as an analyst at UBS where he held various positions, the most recent as co-head of Commodities Research. He was a geologist with Buenaventura Ingenieros in Lima Peru before working in the banking industry. Daniel has an honours BSc in Geology (University of Toronto) and an MSc in Mineral Exploration (Queen's University). He is also a CFA charterholder.

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Figure 6: US CPI vs gold:money stock ratio





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London or New York: Where Does the Gold Price Come From?

By Brian Lucey, Professor of Finance at Trinity College, Dublin, Charles Larkin, Lecturer in Economics at Cardiff Metropolitan University and Fergal O'Connor, current holder of the LBMA bursary, PhD Student at Trinity College and part-time Lecturer at Preston University



Dr Brian Lucey, Charles Larkin and Fergal O'Connor consider a number of key questions about trading activity in the gold market. They present an academic perspective to questions such as where is the gold market price made, whether one market location has a predominant influence on the others and whether the price-making process is diffused.

The gold market worldwide is itself diffuse, with trading taking place on organised exchanges in dozens of locations. And yet, it remains in many ways bipolar.

Table 1 shows the dominance of London as a trading centre for gold with 86% of business occurring there, approximately 90% of which are spot transactions. While more than eight times smaller, America's options and futures exchanges are vastly more transparent with a constant flow of prices and daily volumes; information inherently lacking in the London OTC market. And while the other main markets are growing they still account for just over 3% of turnover. Thus, analysis of the 'gold market' can be reduced, in so far as that is possible, to analysis of these two markets.

From this it is clear, first, that the main markets remain London and New York and second, that it is unclear who 'leads the dance'. Although larger, the dominance of spot OTC trading in London makes its influence harder to grasp. Mere volume alone does not in and of itself make a market dominant.

This is not a phenomenon unique to gold. Equity and bond analysts have had to grapple with the issue of what market leads what for decades. There are a vast number of papers and analyses on which markets lead and which follow, at a macro level. More recently there have been advances in both economic and statistical methods that have allowed a degree of light to be shed on this issue at an individual asset level.

Consider for example 'Siamese twin' shares, where the same claim on asset is traded on two markets. Examples would include Royal Dutch-Shell or Unilever Plc/NV, or more generally cross-listed shares. Evidence is overwhelming that even when the shares should move together in a predetermined manner they do not. These shares therefore suggest that markets make prices not just on the basis of asset returns but also on the basis of some 'local' information.

If we think of gold we can imagine two spot markets, and see immediately that abstracting from travel and related costs, the price of an ounce of gold in one market should be approximately equal to the price in the other. With some modification we can see a similar

argument for gold futures and gold cash markets.

Two approaches and a host of later alternatives and improvements to these have been developed to determine, statistically, the extent to which one market informs the price in another market. Hasbrouck (1995) and Gonzalo and Granger (1995) both use statistical techniques to look at a system of interrelated prices (such as the Siamese twin share prices) and to deconstruct these into what are called information shares.

They use two quite distinct approaches: the Hasbrouck (1995) methodology gives us upper and lower bounds for these shares while the Gonzalo and Granger (1995) model provides a unique level. Both rely on the concept that the prices of the two assets being investigated must share a common trend or a steady state to which they return. This is economically sensible, because if there were to be a long-term deviation from a stable relationship an arbitrage opportunity would emerge, and even without wishing to consider the market as being more than moderately efficient, such arbitrage would eventually act to bring the prices back into line. We can then, to simplify the matter considerably, consider these information shares as being the percentage of this fair or stable price that each market contributes.

We ran these models on two gold assets: the closing price of one month gold futures traded on COMEX and the London AM fix. We chose these as they are benchmark gold prices, and crucially the London AM fix always happens before COMEX closes. As such, any information that the fix conveys will, we assume, be largely incorporated into the price formation process leading to the COMEX close. Similarly the previous COMEX close price is well known and digested by the London bullion market prior to the auction that sets the fix.

We looked at the prices from January 1986 through the end of July 2012, giving more than 6,500 observations. We subdivided the data into non-overlapping windows of 100 days, approximating four months' trading. The work of Tully and Lucey (2007) suggests that shocks to the gold price decay relatively slowly, but would be well dissipated within that period.

Figures 1 and 2 on page 9 show the estimated information shares from the two methods. If we define the dominant market as being that which contributes more than 50%, then the two methods agree more than 90% of the time. The broad message, in terms of which market is dominant, is very similar across the two

Table 1: Gold spot, futures and options trading volumes 2011

	2011 ('000 ounces)	% of Total volume
UK	43,775,704	86.75
America	4,991,604	9.89
China	697,002	1.38
India	494,547	0.98
Japan	488,502	0.97
Dubai	12,507	0.02
Total volume	50,459,865	

Source: UK data annualised from Murray (2011), all others from GFMS (2012)

approaches. For simplicity, we concentrate on the Gonzalo and Granger findings.

The initial analysis of the data does not show direct linkages to particular economic or routine political events causing switches between the London and New York markets. The transitions of prime ministers, presidents, Fed chairmen and Bank of England governors do not have any apparent impact on the switching between locations. Interestingly, changes in the Fed Funds rate and the Bank Rate of the Bank of England have no clear impact. There is a shift to the London market that coincides with the slow collapse of the Eastern Bloc beginning with the protests in the summer of 1989, which also coincided with the peak of the Japanese asset price bubble.

The interesting aspect of the 1990 switch from New York to London is that it happens around the time of the National Bureau of Economic Research (NBER) US business cycle change from expansion to contraction. The move to London remains for a series of important European political events related to the reunification of Germany, the fall of Thatcher and the move of the US business cycle towards expansion. Gulf War I does not seem to have any impact on the switching between London and New York, despite the traditional assumption that wars and other destabilising political events have profound impacts on the gold markets.

The switch back to London from New York happens again at the time of the 1992 exchange rate mechanism (ERM) crisis and the clear pressures being brought to bear on sterling. The brief switch to New York was reversed and dominance returned to London. Outside of the ERM crisis and the wave of devaluations across European monetary events, prior to the eurozone crisis, do not seem to have any impact on the switching of markets.

Global economic crises may have an impact on switching depending on their location and implied political implications. The switch from the London markets to the New York markets occurs at the start of the ruble crisis and the bailout of Long-Term Capital Management (LTCM) as opposed to the start of the Asian crisis. This may reflect the active discussions happening during the ruble crisis of the so-called 'loose nukes' problem that could be engendered by Russia becoming a failed state and the surprise to the US markets of the collapse of LTCM. By the time you enter the new year (and the Time magazine cover of 'The Committee to Save the World' has been published) the markets have switched back to London.

There is some active switching between markets between the dot-com bubble peak in March 2000 and the beginning of the dot-com bust recession in March 2001. Following the 9/11 attacks the New York market becomes dominant.

The New York market remains dominant throughout the downturn and into the expansion phase in the US economy before switching to London.

New York becomes dominant at the start of the global financial crisis just following the open concerns about US Treasury bonds. It remains dominant until August 2008. Interestingly London is dominant throughout the collapse of Lehman Brothers, with the market switching to New York only as the NBER contraction period comes to a close and the US begins its anaemic expansion. The final switch to New York in April 2011 does not seem to have been triggered by any geopolitical or economic event and must therefore be driven by the gold market itself.

The interesting aspects of the moves between New York and London are that they appear – except in examples of globally important phenomena – to be *sui generis*. The next question will be to try to understand, possibly via a behavioural or ethnographic study, what are the key decision triggers for gold market actors in switching the locus of 'price maker' from one market to another.

Figure 1: Hasbrouk Information Shares

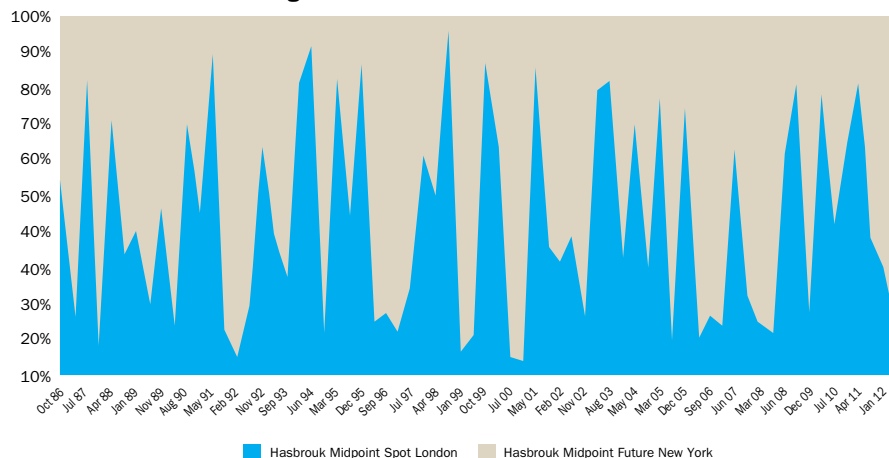
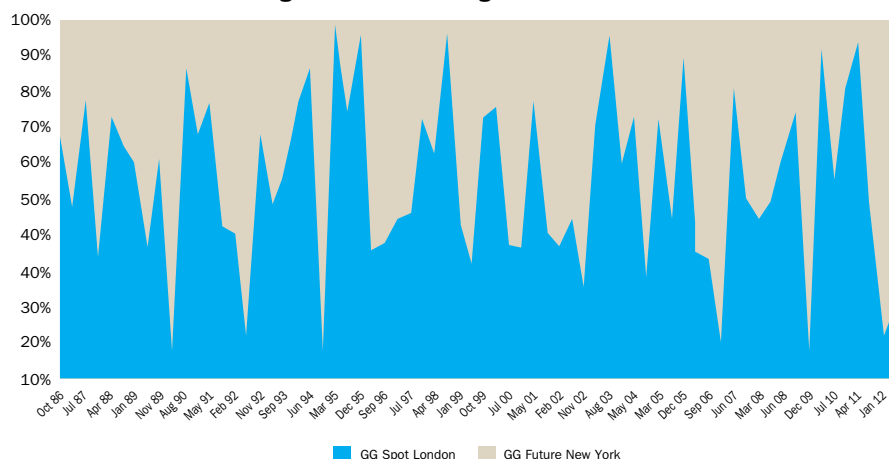


Figure 2: Gonzalo-Granger Information Shares



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Fergal O'Connor is a PhD student at Trinity College and part-time Lecturer at Preston University.

He holds a MA in economics from University College Cork and is the present holder of the LBMA Bursary.

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GFMS, 2012, Gold survey 2012

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Visit to Malca-Amit's New Vault

By Aelred Connelly, Public Relations Officer, LBMA

Malca-Amit became a member of the LBMA in March 2012 and shortly afterwards completed the building of a new vault facility close to Heathrow airport. Stuart Playford, Emma Attridge and Aelred Connelly from the LBMA visited the facility recently. Here Aelred describes their visit.

Malca-Amit is a Hong Kong-based company established in 1963 with offices in more than 30 countries, providing a range of solutions for corporations, wealth managers, banks and high-net-worth individuals looking to source, transport and store gold, silver and other precious metals and jewellery. The new secure storage facility was opened in April 2012 near Heathrow airport to complement the vaulting facilities at other secure sites in Singapore, New York, Zurich and Bangkok.

Similar facilities are being developed at airports in Hong Kong and Beijing, and are scheduled to be completed by the end of 2012, shortly after the LBMA Conference. Plans are also afoot to double the vault space at the Singapore Freeport which will add three vaults to the two that are already in operation.

It was a balmy day when we arrived at Feltham station where we were warmly greeted by our host for the day, Allan Finn, Global Commodities Director for Malca-Amit. Allan told us that the location of the vault was top secret so he deviously drove his car round in circles until we were so disorientated we had no idea where he had taken us.



Figure 1: Silver bars being held in storage.



Figure 2: The method of warehouse racking for storing gold bars.

When we eventually arrived at our destination only the sound of planes overhead gave any indication as to where we were. That many planes could mean one of only two things: we were either near Heathrow or we were witnessing a flypast for the Queen's Jubilee celebrations. Before we went in to the building Allan explained that the perimeter fencing can withstand a 7.5-ton vehicle at 50 mph and the internal shutter anti-ram barrier which is located behind the entrance gates can withstand a 7.5-ton vehicle at 30 mph. So that's Jonah Luma thwarted then.

Built above ground, the Malca-Amit vault is one of a number of new facilities that either have been built or which will be opened shortly within the perimeter of the M25. Gold vaults are usually located within the M25 to keep transportation costs and journey times to a minimum. Proximity to an airport is an advantage. Silver can be stored in areas further away from London due to its comparatively low value.

Contrary to popular belief, the LBMA does not approve new vaults – it only approves or accredits the refiners who produce the bars which are stored in them. But the vaults in London perform a very important role as gatekeepers to ensure that the bars which are delivered into the London market meet the standards laid down by the LBMA in the Good Delivery Rules. The vaults not only physically check the quality of bars they receive, but they weigh them too.

There are lots of considerations to take into account when building a new facility, to which I am sure that Allan could testify. As well as the construction of a secure site, a vault will need high tech security equipment, a system to record bars, scales and trained staff to check and weigh them. In order to be able to weigh bars a company can apply to the LBMA for status as an 'Approved Weigher' so that they are authorised to check the weights of bars entering London for

the first time on behalf of the market.

As you can imagine no chances are taken with the level of security. The thing I noticed most of all when wandering around the facility was the plethora of cameras, which seemed to take up all the available space on both the walls and ceilings. Allan explained that some have 29 megapixels (equivalent to 95 conventional cameras) which allow staff to zoom in to view the most minuscule objects or details. All images or recordings are retained for a period in excess of 90 days.

The alarm system is linked to a guaranteed police armed response unit with direct communication to the police control room. If an alarm is triggered the immediate area is automatically sealed off from the rest of the building. Doors into and out of that area will not open. So woe betide any member of staff who sets one off accidentally!

During the tour I noticed the traditional beam balance scales as well as the electronic Sartorius scales which are currently being trialled by the London vaults. But the thing that strikes you most is the vault. Allan explained that it is a Chubb safe grade XII which offers the highest possible level of security and provides capacity for more than 300 metric tonnes of gold and 1,000 tonnes of silver. The bars themselves are stored on pallets, not your conventional wooden ones, but heavy duty capacity warehouse racking which can hold 80 gold bars on a single layer (see figure 2). This facilitates easy checking for auditors as they don't have to de-stack the bars to inspect them. Gold and silver are not the only precious items in storage: there are also diamonds and other precious stones and jewellery which are kept in storage on behalf of clients.

Our tour came to an end. Allan drove his car round in circles again until we were so disorientated that we didn't know where we had come from. But he made up for it by taking us for a nice lunch on the river at Richmond.

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A Day in the Life of a GDL Officer

By Rebecca Adamson, Good Delivery List Officer, LBMA



Gold bars being examined at a recent bar inspection.

6.00 am

My alarm is a gentle recall back to reality.

7.00 am

After a light breakfast, I feed the cat (it's better fed than I am!) before leaving on my bike to go to the station.

8.15 am

I'm off to a bar inspection this morning so I drop into the office to collect a camera and the documents I will need and head straight to the vault.

9.00 am

Meet with the appointed bar inspectors, who are representatives of other London vaults or who sit on the Physical Committee. As is to be expected, security is always very tight when visiting the vaults. We sign in and meet the vault manager, who escorts us through several security layers before we reach the lift and down we go into the vault. We are to view a set of 11 gold bars today that have been submitted by a gold refiner who is applying for Good Delivery status. This is a standard stage of a GDL application. We must check that they correspond with the photos and

technical drawings submitted previously with the application as well as ensuring that the bars meet the specifications set out in the GDL Rules. I measure the bars and take lots of photos. Following the inspection, the inspectors conclude that the bars are acceptable, which means we can proceed with the application and send the bars to be assay tested by the referees. If the bars were rejected at this stage, there would be a lot more work to be done arranging the removal of these bars from London and discussing with the PC how this application should now proceed.

9.45 am

We leave the vault and I return to the office. It's raining – it always seems to be raining when I leave this vault! Or snowing..

10.30 am

I check my emails. It's my job to facilitate all GDL applications for gold and silver accreditation, and I am the first point of contact throughout the process. An application can take around six months to complete, from submitting the first documents through to the bar testing stage and final acceptance, and has been known to last much longer than that if further information is

needed. For my own interest, I once counted the action points I complete during each application – they amount to over 100 separate stages! At the moment, we have an unprecedented number of GDL applications at various stages of completion, as well as several more applicants who have approached us to indicate their interest and are just finalising their application documents. Sometimes it can be quite frustrating for refiners who would like to apply for accreditation but fail on one or two of the minimum requirements.

“ We have an unprecedented number of GDL applications at various stages of completion. ”

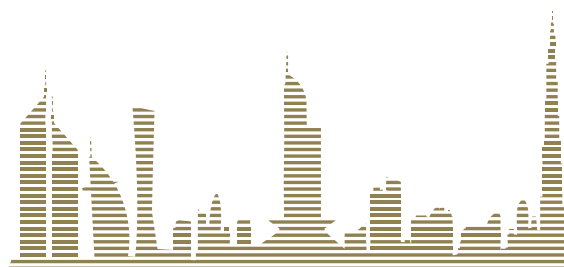
11.00 am

I also manage the proactive monitoring of all current Good Delivery refiners. All GD refiners are tested once every three years. We have a batch of refiners who are taking part at the moment. Each batch takes approximately two to three months in total, from preparing the initial letters of notification, through to receiving results back from the referees who have checked assayed the dip samples submitted by the participants. We have received some results back from one of the referees today, so I am able to compare the assay results against those submitted by the participant. We look at the mean assay results and if the difference is outside of the acceptable range, we then start to analyse a little more closely for any disparities.

Save the date

For registration details,
write to register@dpmc.ae

www.dpmc.ae



2013

DUBAI PRECIOUS METALS CONFERENCE

6 - 7 April 2013, Dubai

11.30 am

A meeting with the Bank of England, with whom we are working closely to develop a new Vault Accreditation scheme for London vault operators. This is followed by a conference call with our design consultants, with whom we are working to upgrade the LBMA website, as well as the Visual Guide to bar defects which will assist Good Delivery refiners in understanding what is, or not, acceptable in the market.

12:30 pm

I begin to receive the completed bar inspection reports from the inspectors at this morning's visit. As soon as I have received all three, I can circulate them to the Physical Committee.

1.00 pm

I'm taking a short lunch today, because we have a Physical Committee meeting this afternoon. Our office is located behind the Royal Exchange and so there are lots of historic buildings to look at. Today I walk across the highwalk to the Barbican Centre to have a look at their current programme of shows.

1:30 pm

I have to arrange a shipment of gold reference samples to another GDL gold applicant. During Stage 1 of the technical assessment, an applicant receives a set of 24 gold reference samples for assaying. Essentially we are testing the ability of the applicant to assay to GDL standards. Assaying means that the refiner's laboratory tests the samples to

determine the fineness, e.g. 999.99. They use various methods to do this, some of which have changed very little in the last several hundred years. I prepare all of the shipping documentation, including a weight list. I then ask a colleague to shadow me whilst I pack the samples to ensure that there are no errors. Once the package is ready to go, I arrange for a secure courier to collect it.

2.00 pm

I maintain the current Good Delivery lists, including the database that the vault managers use in order to view details of bars that are on the current list. I have received an email from one of the GDL refiners requesting a change to the specifications of their bar on the current list. I check that the drawing they have submitted meets all specifications and prepare it to be tabled at the meeting this afternoon.

2.30 pm

We are currently in the process of introducing new media software to store all GDL related images, which will make it easier to access and retrieve photos. I spend some time editing the catalogue. I then have a meeting with the Chief Executive of the LBMA to update him on any recent Good Delivery matters and to discuss with him the draft programme for next year's Assay and Refining Seminar.

3.00 pm

The Committee members start to arrive for the Physical Committee meeting. Agreement

is reached on a number of issues that will have a direct influence on the operations of the physical London bullion market. As well as presenting several of the meeting's papers, I also produce the minutes and ensure that all action points are followed up.

5.00 pm

I am arranging for the team to visit a GDL refinery to learn more about the refining process. I email the refinery to make some final adjustments to travel arrangements and to find out what we should wear – most refineries are quite specific about what you can and can't take with you – mobile phones and cameras are often off limits and some don't allow you to wear any metal at all (better have that gold filling removed!).

5.30 pm

Time to leave. I put my handwritten notes of today's meeting in my intry ready for me to write up first thing tomorrow.



Rebecca Adamson
GDL Officer, LBMA

Rebecca is the LBMA's GDL Officer, and is primarily responsible for the administration of the LBMA

Good Delivery System, including applications and Proactive Monitoring. Rebecca joined the Executive in 2010, having previously worked as a consultant to the LBMA since 2008.

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2012 also marks the silver anniversary of The London Bullion Market Association. TD extends its congratulations to the LBMA on achieving this significant milestone.

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The Silver Anniversary of the LBMA

By Robert Guy, the Founder Chairman of the LBMA



Robert Guy (seated left) with the current Chairman of the LBMA, David Gornall.

To mark the silver anniversary of the LBMA, the very first chairman, Robert Guy, looks back with affection at the events which led to the formation of the LBMA in 1987.

This was not going to be the easiest meeting. It was October 1974. My boss at Rothschild's dealing room had just resigned and the bank had chosen me to be his successor. This affected not only Rothschild, but also the London Gold Market. Rothschild had chaired the Gold Fixing since it started in 1919, and had been broker to the Bank of England for more than a century. I was on my way to chair a meeting of the other members of the Fixing: Samuel Montagu, Mocatta and Goldsmid, Sharps Pixley and Johnson Matthey. Or was I? There was no alternative but to open the meeting by asking my new colleagues: "Is it your wish that Rothschild should continue to act as chairman of the Fixing?"

They knew that my dealing experience was in foreign exchange, not bullion, and I knew that my peer group was up to 20 years older than I (a mere child at 30) and that they had recently discussed the possibility of the chairmanship being rotated. Was I out of a job before I had even started?

Fortunately for me, although it was not with the greatest show of enthusiasm, the other members gave their consent that day in 1974 and I continued to chair the meetings. But only until 1993!

In those early days there was certainly a great deal to concern us. We were struggling to regain a portion of the gold sold by the South African Reserve Bank (at that time South Africa produced around 1,000 tonnes a year, now down to around 200 tonnes) which we lost completely when the British government closed the gold market for two weeks in 1968. We were also facing the threat of new competition from the US futures market, due to open in January 1975. We were beginning to take advantage of the

liberalisation of the market in Hong Kong where we opened new trading subsidiaries. But the going was tough.

Gradually things got better. More subsidiaries followed in Singapore, New York and Sydney. The IMF and US Treasury gold auctions, far from depressing the gold price, stimulated fresh investor demand. Central banks returned to the market (as buyers). Gold production rose. Turnover increased and so did profits. London was back. Some years later the head of the Soviet Union central bank asked me how we had planned our recovery – no surprise in such a question from a country which lived (and died) by its five-year plans.

“ The IMF and US Treasury gold auctions, far from depressing the gold price, stimulated fresh investor demand. ”

But, in truth, it was not planned. Apart from the external factors, I think the success of those years can be attributed to ethos and competition. The five firms were extremely competitive and watched each other's activities like hawks. But, at the same time, they knew the importance of working together.

And that is why, whatever the state of the market, they would meet, in turn, in each other's offices, at 4pm on a Wednesday afternoon every month. Naturally we began with tea and biscuits; an hour or so later the waiter would appear with the drinks trolley.

We were an eclectic bunch. The group included Guy Field of Samuel Montagu (at that time the leading house in the market), French émigré, brought up in Liverpool, with an idiosyncratic turn of English phrase – “Don't make my goat boil” – and his young assistant, my longstanding

friend Robert Beale (a fellow historian, albeit from Cambridge). There was Keith Smith of Mocatta and Goldsmid, the oldest firm in the market, for whom he had worked, man and boy, save for National Service in the RAF, and Jack Spall of Sharps Pixley, father of Jonathan (now at Barclays Capital), who, unusually for the market (but to its benefit) started his city career in the softs market and had been a broker with Merrill Lynch. Irascible might be the word for some of them; goodness knows what their word was for me.

There were occasionally some unusual issues to address (were the bars from North Korea radio active? Had the makers of counterfeit sovereigns in Beirut been working overtime?) but a typical agenda at the meetings of the fixing members would include performance at the Fixing and market making throughout the day; clearing and good delivery; imminent legislation in the UK and the EEC; VAT. And indeed all those other similar issues which face the LBMA today. Except there was no LBMA: no central secretariat. We split the work between ourselves and colleagues in our respective firms. The Bank of England did not attend our meetings but I regularly reported to it on developments. (“I expect my broker to keep me informed,” said one official when I had forgotten to do so. Oh!)

One issue that we had particular need to discuss with the Bank was the application of Derby and Co (to which Guy Field had moved) to become a member of the Fixing. The Bank had granted Derby the status of ‘authorised dealer’ – a necessary qualification to deal in gold in the days of exchange control – and now the company wanted to enhance its status further.

What did the Bank of England itself think? “It's not within my gift” came the official reply, and Derby was denied. But later, by which time he was at JP Morgan, Guy (“too many Guys?” asked one distinguished commentator) made a very significant contribution to the creation of the LBMA, particularly in the drafting of the constitution.

The early 1980s, the rise to the then record price of \$850, the explosion of western investor demand, the dramatic dishoarding from Asia, the birth of bullion banking (as we then called mine finance) – these were indeed good years for the market. As a result, a number of foreign banks sought to open their own bullion trading rooms in London – Morgan Guaranty, Credit Suisse and Nova Scotia among the earliest. Negotiations with Customs and Excise resulted in their becoming associate members of the market, which meant that their wholesale trades could benefit from exemption from VAT under the Terminal Markets Order. They were in the ‘Black Box’. Yes, this meant more competition but at the same time it only enhanced the position of London in the international market. That's why we had an ‘open door’ policy.

In retrospect, we then got a bit carried away. After much debate and protracted discussions with the London Metal Exchange (LME), in 1982 representatives from the gold market formed their own company, the London Gold Market Ltd, which became joint owner with the LME of the London Gold Futures Market (LGFM). A trading floor was built in Plantation House and the shareholders, particularly the members of the Fixing, provided good order flow and price support. The Achilles heel, however, was the lack of domestic investor and speculator interest, without which no futures market can survive and, following an excellent report by John Wolff, the market closed within three years.

(There was a useful side-benefit from the closure of the LGFM. The market, as an entity, had enjoyed the benefit of the Terminal Markets Order and, on its closure, we negotiated with Customs and Excise the right of individual companies to become, if they so wished, associate members of the London Gold Market. The majority did so.)

In the early days of the LGFM it appeared that solid progress was being made. The marketplace generally was relatively quiet, not as exciting as earlier in the decade, but there did not seem much to worry about.

And then came the collapse of Johnson Matthey.

On Friday September 28, 1984, I flew back from Washington where I had been attending the annual meeting of the IMF. Bleary-eyed, I arrived back home in Kew on Saturday morning to be greeted by my wife Diana (a constant source of support throughout my career) with the words: "The deputy governor of the Bank of England has just rung. He wants to speak to you. But don't ring him, he'll ring you."

The hours passed. I had no idea what this was about. I tried to ring my closest and most trusted colleague at Rothschild but without success. Eventually the deputy governor did indeed ring. 'Opaque' is, I think, the right word (and in the circumstances totally understandable) but the instruction was quite clear. I had to contact the other four members of the market and tell them to meet (accompanied by a colleague who could 'deliver') at the Bank of England at 9am on Sunday morning.

Easier said than done – I didn't have all their home telephone numbers. (You didn't in those days and, of course, there were no mobiles.) I surprised one member by suddenly and surreptitiously (another banker lived next door) appearing on his doorstep in a Chelsea square. Another I tracked down via a phone call to a pub in deepest Surrey. High drama is often accompanied by moments of sheer farce.

The simple fact of the matter was that Johnson Matthey Bankers, a Recognised Bank and supervised as such by the Bank of England, was insolvent. The cause was not JMB's bullion trading activities but the bank's commercial loan book. The exposure of the Fixing members to JMB was small and manageable – we had strict trading limits on each other which varied according to our relative size – but many

international banks were not as prudent and had very high exposures. JMB's failure, in my view, would threaten the whole London market, rebound very badly on the city and be particularly damaging to the Bank of England.

The full story of what happened over the next 24 hours will not be told until the Bank releases the relevant papers, but the outcome was that at 8:30 on the Monday morning the Bank announced that it had bought JMB.

“If today's members of the LBMA look through the minutes of the early AGMs they will recognise many subjects which concern them now.”

The Fixing took place, as usual, two hours later with the representative of JMB at his desk. JMB was eventually sold to Mase Westpac (which bought it only on condition that it was invited to join the Fixing) in June 1986.

Other changes were well underway by then, however. Work had already started at the Treasury on the drafting of the Financial Services Bill which led to the creation of the Securities Investment Board and the various self-regulating organisations which were later subsumed by the Financial Services Authority. (The story continues!) The members of the gold market were already concerned about the possible repercussions this would have for them.

Much more important for us, however, the Treasury, headed by a very angry Chancellor of the Exchequer (Nigel Lawson) was demanding a new approach to banking supervision following the JMB debacle. Nobody had sought his views on the rescue plan for JMB and he was not pleased. Something must be done. And, dreadful phrase, lessons must be learned.

The eventual outcome was that the Bank assumed formal supervision of the foreign exchange and bullion markets. Discussions took place with the Bank which now needed a formal body to represent the bullion market. A small group of associate members drafted their own proposals and came to discuss them. Our response was that they were pushing at an open door. The gold market had to take account of the new responsibilities of the Bank and it recognised that the market as a whole was suffering from a democratic deficit. The open door policy, our creation of associate members, had proved so successful that there were now more than 50 of them. Liaison was proving increasingly onerous and time-consuming. In October 1986 I wrote to all the associate members informing them that I had "been asked by the Bank of England to give some thought to the organisation of the market in the light of the forthcoming enactment of the Financial Services Bill". I then formed a steering committee (drawn from associates as well as members) to assist the Bank in its drafting of a Code of Conduct. In February 1987 I wrote again

to everyone: "We are now turning our minds to the creation and constitution of the London Bullion Market Association" and invited all to give us their views. The LBMA was incorporated on December 14, 1987, and we held the first Extraordinary General Meeting on May 12, 1988.

If today's members of the LBMA look through the minutes of the early AGMs they will recognise many subjects which concern them now, just as they did the old gold market. But I perceive a greater professionalism and innovation, which reflect the strong commitment of a large number of people.

The clearing arrangements were revamped. Standard terms and conditions were published, guidelines on options were produced. Building on the initiative of a number of dealing rooms (Martin Stokes of JP Morgan and John Bishop of Rothschild to the fore), the LBMA took responsibility for developing the Gold Forward Offered Rate (GOFOR), which did much to help develop mine finance. A new market agreement was made with Customs and Excise.

A public relations firm was hired and a newsletter published; it was nowhere near the standard of *the Alchemist* but at least it was a start. In it we were able to announce victory in a battle with Brussels. The EEC wanted us to go metric. We wanted to keep the troy ounce. Together with the Bank of England and the refining industry we won the day. The troy ounce was saved.

There were few arguments and a strong collegiate approach prevailed. I was particularly pleased that we kept to our original ambition and supported charitable causes such as the provision of a bursary for students from the developing world at Imperial College and the Camborne School of Mines.

We opened an office in Fredericks Place and for the first time we had an executive secretary, Inga Brereton, to support us. We tried hard not to be over-bureaucratic and to keep our costs down but it's fair to say that we did not have the vast number of regulations, domestic and international, with which those in the market today now have to deal. As a regular reader of *the Alchemist*, I cannot fail to be impressed by the range of activities which are now undertaken.

Looking back at my time in the City and at Rothschild, I have many good memories. But my greatest satisfaction is in being one of those who created the LBMA in 1987 and I send my warmest congratulations to all of you on making it such a success today.

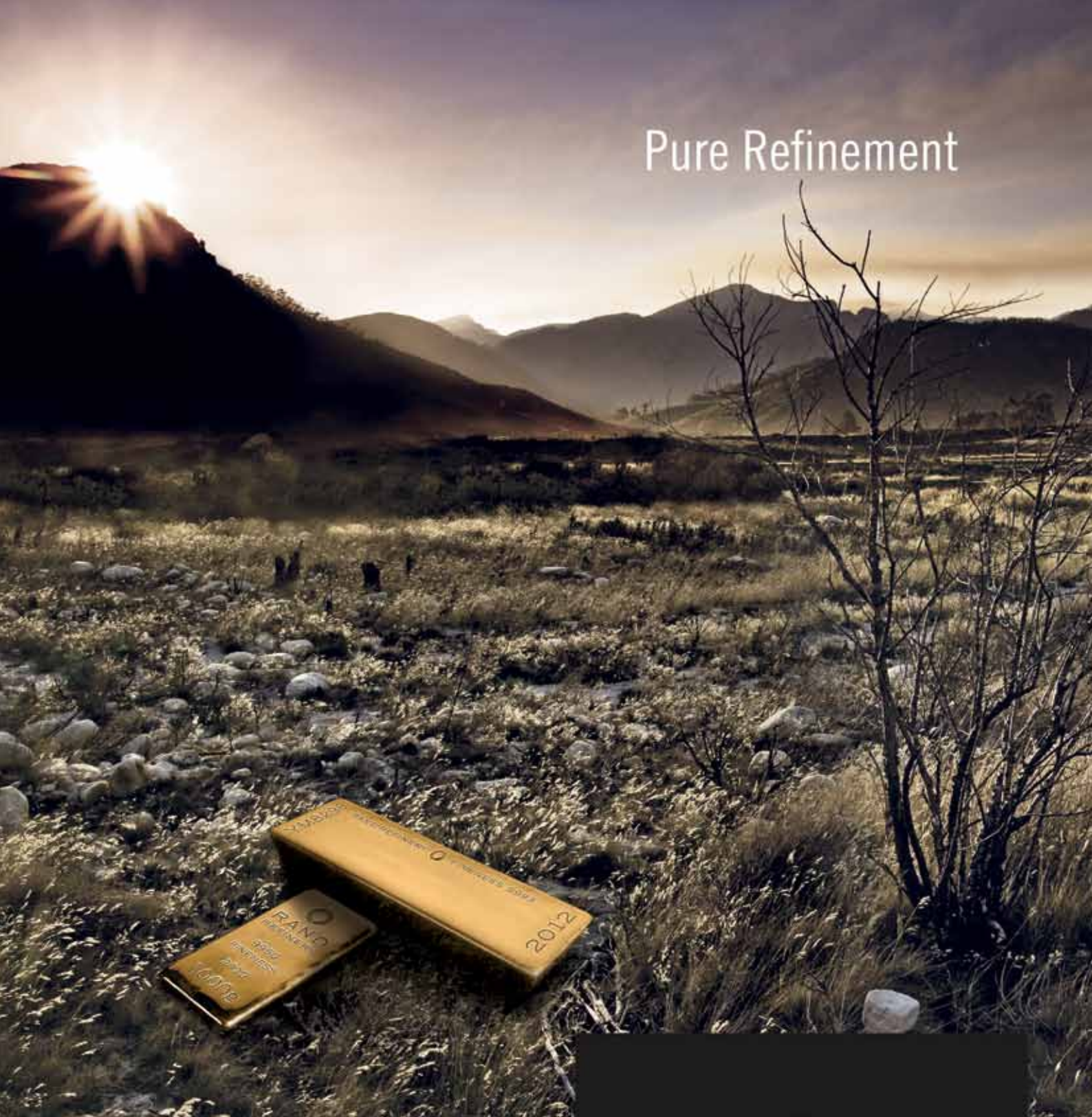


Robert Guy, was the Founder Chairman of the LBMA.

He read history at Balliol College, Oxford and joined N.M. Rothschild and Sons

in 1967. He was a member of the Main Board for 26 years and, following his retirement in 2003 was a Non-Executive Director of the Royal Mint. He and his wife, Diana, now divide their time between Kew and Provence and their grandchildren in Sussex and New Orleans.

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**The
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The Growing and Evolving Gold Retail Investment Market in China

By Albert L.H. Cheng, Managing Director, Far East, World Gold Council



Jinhangjia, a spot trading product for private investors, thereby accelerating the development of China's retail gold market. In December 2006, with marketing support from the World Gold Council, China Gold Group issued its first two-way trading gold bullion product – the China Gold Investment Bar – traded at the prices listed on the SGE with a tight margin for domestic investors.

Since the Shanghai Futures Exchange (SHFE) launched the gold future in January 2008, gold futures trading volume has significantly increased; in 2011 alone 14.4 million contracts were traded. This gold futures market together with the spot trading of SGE form the basis of the Chinese gold market.

A ripening retail investment market

In the recent context of rising inflation, stagnation in domestic equities and government attempts to curtail a real estate bubble, individuals are exploring other alternatives to preserve their wealth. Gold is becoming an increasingly popular investment vehicle and the industry is responding rapidly by introducing more gold-related financial products.

Even with an uncertain global economic recovery, China's gold market remains resilient and promising, as Albert Cheng, Managing Director, Far East, World Gold Council, reports.

The World Gold Council's 2012 Q2 *Gold Demand Trends* report puts China's gold jewellery and investment half-year demand at 400.1 tonnes, making it increasingly likely that China will overtake India to become the largest consumer of gold.

China's gold retail investment market has tripled in size since the establishment of the Shanghai Gold Exchange (SGE) 10 years ago in 2002, with ongoing growth suggesting that the country will remain a major player in the international gold market.

Golden tradition jolted by modern history

China has been infatuated with gold for thousands of years. This auspicious element has always been associated with Imperial China and represented good fortune. Shanghai also has a particular history with gold: in the 1930s and 1940s, Shanghai was already a renowned financial centre in the Far East and was home to the largest gold trading centre in the region.

In the new Chinese republic, the government decided gold was an important strategic resource and assumed management of it. In 1950, the People's Bank of China introduced measures to control gold and silver trading. In 1983, the State Council issued new regulations that placed the control of all purchasing and distribution of gold and silver under the central government.

Two decades passed before controls on the domestic gold market were loosened. On October 30, 2002, SGE was opened as part of a range of market-oriented financial reforms. The World Gold Council played an important role by sharing expertise and knowledge in the formation of this spot exchange gold market in China¹.

In 2004, China classified gold for investment and permitted individuals to invest in the precious metal. In late 2005, the SGE and the Shanghai branch of the Industrial and Commercial Bank of China (ICBC) launched the

“ China's gold retail investment market has tripled in size since the establishment of the Shanghai Gold Exchange (SGE) 10 years ago in 2002. ”

In our survey² conducted in February 2012, 57% of the 1,407 interviewed investors had gold as an investment at that time, and 71% planned to invest in gold during the coming year. Around 70% of existing gold investors found gold investment to be the preferred investment to achieve both capital appreciation and wealth preservation, which were the two most prominent investment drivers. Not surprisingly, investment demand in China is growing at a staggering rate: 117%³ since 2007.

1 World Gold Council commissioned reports from renowned think tanks in China in 1999 and 2000 with the blessings of the Peoples' Bank of China to understand international practices and the benefits and practicalities of opening the gold market for its financial institutions. These two reports continue to serve as a major reference for Chinese decision-makers.

2 WGC commissioned Ipsos to conduct a survey to investigate the investment behaviour with emphasis on gold in February 2012.

3 Growth rate is based on change of full year investment demand in China from December 2007 to December 2011.

Major commercial banks, investment firms and gold jewellery companies are the primary sellers of investment gold products specifically for Chinese investors. The likes of ICBC's *Ruyijin*, China Construction Bank's *Longdingjin* and China Gold Group's *Investment Gold Bullion* are investment bars priced at a small premium to SGE's quotes and they are sold across a broad network of bank branches and outlets across the country.

“ Against the backdrop of a global economic downturn, the longer-term growth of China's economy remains healthy, supported by the continual income growth of an emerging middle-income class. ”

Observing the rapid development of the China gold market, the World Gold Council formed a strategic partnership with ICBC to develop a specific gold investment product to echo investors' needs, while stimulating new demand. In December 2009, the World Gold Council and ICBC launched China's first Gold Accumulation Plan (ICBC GAP) catering to investors who want to accumulate gold on a daily basis over a long investment horizon. ICBC GAP has been a huge success. As of June 2012, ICBC GAP has achieved sales of 15 tonnes in half a year and accumulated 4.2 million accounts since its launch, exceeding many expectations and prompting other banks to introduce similar products.

The success can be attributed to two main factors. Undeniably, the market is going through a high growth stage. An equally important element of success lies in its product design. ICBC GAP is designed to answer investors' needs to handle the often difficult market timing decision. The product won the 2011 Shanghai Financial Innovation Award conferred by Shanghai municipality. In addition, ICBC and the World Gold Council have been very active in advocating the long-term strategic asset allocation of gold to support market education.

Taking its rightful place in the gold market

In the last 10 years, China has emerged as both the largest consumer and the largest producer of gold. Building on this foundation, we believe the retail gold market will continue its expansion under the favourable conditions of continual income growth, widening retail reach via commercial banks and product proliferation under market liberalisation.

Against the backdrop of a global economic downturn, the longer-term growth of China's economy remains healthy, supported by the continual income growth of an emerging middle-

income class. *China Consumer Daily*, a popular newspaper, forecast that by 2015, China would have 75 million families, up from 15 million in 2005, with an annual income averaging US\$4,300. Household savings are expected to triple in the same period.

Under such a scenario, investment as well as gold products will benefit. In the survey referenced earlier, 71% of the respondents voted to include gold in their portfolio allocation in the coming one year; gold also overtook equity as the top choice by investors.

Of all the retail channels currently available in China, banks represent the principal avenue. Commercial banks have responded to increasing demand for gold by developing resources and capabilities for physical gold, trading, financial and wealth management as well as reinforcing internal controls and risk management. New gold-related products are constantly placed on the market and distributed throughout the Big Four Chinese commercial banks' extensive networks, which by the end of 2011 exceeded 50,000.

Some of the large and medium-sized banks have begun specialising in the gold business by establishing precious metals subsidiaries and franchises. Banks with branch network advantage will dominate the distribution of retail investment products. As the bullion business continues to develop, banks will build a broad range of gold products tailored to different investor needs.

“ China has the foundation, means and will to achieve its aspirations. To enhance the process of this development, the World Gold Council will continue its initiatives in market liberalisation, product and channel development as well as investors' education. ”

In August 2010, the People's Bank of China, the National Development and Reform Commission and China's Securities Regulatory Commission co-authored a report entitled *Opinions on Promoting the Development of the Gold Market*, which set out the blueprint for the further development of the gold market in China. Following the announcement, we saw numerous examples of government initiatives to support the development of the gold market.

In January 2012, the National Development and Reform Commission released *The Development of Shanghai as Financial Centre in the Period of the 12th Five-Year Plan* and set a target to maintain world number one ranking in gold trading. In January 2011, the Shanghai

municipal government announced plans to launch a gold exchange-traded fund (ETF) on the Shanghai Stock Exchange in collaboration with the SGE. In August 2012, the SGE and Foreign Exchange Trading Center had moved forward with interbank over-the-counter (OTC) gold trading as part of broader reforms to modernise the sector.

These steps are part of China's ambitions to become a major gold trading centre on a par with London and New York. This is also the natural evolution of the market as increasingly sophisticated investors look for the right product structure for gold allocation. This will ultimately support the growth of the institutional gold market in China.

China has the foundation, means and will to achieve its aspirations. To enhance the process of this development, the World Gold Council will continue its initiatives in market liberalisation, product and channel development as well as investors' education. By unleashing this potential, we see universal gold recognition in this market going forward and we anticipate that the annual investment demand will show a tremendous increase and exceed 600 tonnes by 2016. This road is indeed paved with golden bricks.



**Albert L. H. Cheng,
Managing Director, Far
East, World Gold Council**

Albert Cheng joined the World Gold Council, Singapore regional office in

March 1993 as a Regional Manager, Planning and Business Development, Far East, becoming Managing Director, Far East in 2003 with responsibility for operations in the entire region.

Prior to his many years in gold marketing, he was with Dentsu, Young and Rubicam, Hong Kong in the early 80's, where he was responsible for a number of popular and durable consumer products. He was Account Director when he left.

His career in gold marketing began in July, 1985 when he joined the Royal Canadian Mint as the Regional Manager in charge of sales & marketing in the Asia Pacific region.

Mr. Cheng is widely consulted on the development of the gold markets in Asia throughout the past 27 years with both the Royal Canadian Mint and World Gold Council. He is one of the international advisors of the Shanghai Gold Exchange.

A graduate of the Chinese University of Hong Kong, Mr. Cheng holds a degree in Business Administration with a major in Marketing.

Where the World Trades Gold

The importance of gold in the global markets, combined with its responsiveness to world events, have made our COMEX Gold Futures and Options contracts accepted around the world. They are used extensively as a hedge against inflation, and they provide a safe haven in times of financial uncertainty. These contracts are available on the CME Globex electronic trading platform, on the trading floor in New York and for over-the-counter (OTC) clearing through CME ClearPort. Our benchmark 100-oz. Gold Futures contract is complemented by 50-oz. e-miNY and 10-oz. e-micro contracts, as well as a cleared-only solution for OTC London Gold Forwards. Referenced the world over, these contracts provide market users with liquidity, ease of access and unparalleled price transparency.

For more information on our suite of Gold products, please contact Michelle Zhang, michelle.zhang@cmegroup.com, or visit cmegroup.com/metals.

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 CME Group



LBMA Silver Anniversary Celebrations

10 December 2012, London

**A Bullion Market Seminar will take place at Mansion House,
10 December from 14:00 to 16:00,
followed by a black tie cocktail reception at 18:30 and dinner at 19:00.**

Welcome Remarks,
David Gornall, LBMA Chairman and Global Head
of Metals Trading, Natixis London.

With speeches from
Dr Brian Lucey, Associate Professor in Finance, Trinity College Dublin
Dr Olivier Ledoit, Permanent Research Fellow in the Department of
Economics at the University of Zurich
Suki Cooper, Precious Metals Analyst, Barclays

LBMA Members, Associates and their guests are invited to attend.
See the LBMA website for further information
on the events.

DIARY OF EVENTS 2012-2013

OCTOBER 2012 25-26

The Silver Summit
Spokane, USA
The Davenport Hotel
www.cambridgehouse.com

NOVEMBER 2012 2-3

International Precious Metals
& Commodities Show
Olympiapark, Munich, Germany
www.edelmetallmesse.com/en/index.html/

9

World Gold Mining Forum
Park Hyatt,
Toronto, Canada
www.worldgoldminingforum.com

11-13

LBMA /LPPM Precious Metals
Conference
Grand Hyatt Hotel
Hong Kong, China
www.lbma.org.uk

12-13

MEI Precious Metals 2012
Cape Town,
South Africa
www.min-eng.com/preciousmetals12/index.html

22

8th Heraeus Precious Metals
Forum
Hanau, Germany

DECEMBER 2012 5-7

7th China Gold & Precious Metals
Summit
Shanghai, China
www.chinagoldsummit.com

10

LBMA Silver Anniversary Dinner
(For Members, Associates and
Invited Guests)
Mansion House
London, UK
www.lbma.org.uk

APRIL 2013 6-7

Dubai Precious Metals
Conference 2013
Dubai, United Arab Emirates
www.dpmc.ae/

16-19

Denver Gold European Gold
Forum 2013
Zurich, Switzerland
www.denvergold.org/gold-forums/egf-2013

MAY 2013 13

Johnson Matthey Platinum 2013
Launch
London, UK

AUGUST 2013 5-7

Diggers & Dealers Forum 2013
Kalgoorlie, Australia
www.diggersnddealers.com.au/

SEPTEMBER 2013 22-25

Denver Gold Forum 2013
Hyatt Regency, Denver, CO, USA
www.denvergold.org/gold-forums/

26-29

World Gold 2013
Hilton Brisbane, Queensland,
Australia
www.ausimm.com.au/worldgold2013/

OCTOBER 2013 7-10

LME Week 2013
London, UK
www.lme.com/lmeweek.asp

27-31

Conference of Metallurgists 2013
Québec, Canada
www.metsoc.org/com2013.asp

Regulation Update

By Ruth Crowell, Deputy Chief Executive, LBMA

Industry organisations announce cross-recognition of gold refiner audits

In September, the LBMA, EICC-GeSI and RJC announced their mutual cross-recognition of gold refiner due diligence audits. The cross-recognition means audit efficiency for gold refiners as well as the industry as a whole. All three organisations have developed audit and certification programmes that aim to increase conflict-related due diligence and responsible practices in the gold supply chain for their respective sectors.

All three programmes focus on independent third party audits of refiners' due diligence in compliance with the OECD Due Diligence Guidance, which recognises refiners as a key "choke point" in the gold supply chain. The SEC final rules for conflict minerals (Dodd-Frank Section 1502) also indicate that manufacturers can meet US requirements by relying on refiners who have been certified by "industry groups' 'conflict-free' designation programmes" such as those of the EICC-GeSI, LBMA and RJC. While all three programmes have common features, each of these programmes are tailored to serve their specific supply chains.

In practical terms, this recognition means if a refiner goes through any of the three auditing processes, all three organisations will recognise this audit as meeting the conflict-free audit requirements. For example, if a refiner passes an RJC or LBMA audit, this process will not have to be repeated for EICC to recognise them as conflict-free and vice versa. However fulfilling EICC-GeSI requirements only meets the LBMA & RJC conflict-free audit requirements to avoid duplication. There are additional requirements for refiners to achieve LBMA & RJC certification.

The LBMA's Responsible Gold Guidance is a mandatory due diligence policy for all Good Delivery gold refiners in order to maintain their LBMA accreditation. This programme is tailored for refiners delivering into the London Bullion Market and other financial gold markets around the world. The 63 LBMA Good Delivery gold refiners include the pre-eminent refiners of gold internationally, with an annual production making up between 85% and 90% of world gold production. Compliance with the guidance is reviewed annually by independent auditors and results are submitted to the LBMA, as well as being made available to the public.

The guidance formalises and extends the existing due diligence in the refining industry by incorporating a risk-based approach to avoid sourcing gold from areas subject to conflict. The guidance is based on the OECD Due Diligence Guidance, as well as existing practices in Good Delivery refiners aimed at combating money laundering and terrorist financing.

	LBMA	RJC	CFS
Common features: Third party audit, OECD DDG & SEC compliance			
Tailored focus	London Bullion Market	Jewellery supply chain – mine to retail	Manufacturers
Audit outcome	Continued Good Delivery accreditation	CoC certification	Validated smelter/refiner list
Mutual recognition	RJC CoC and CFS audits = Responsible Gold requirement	LBMA and CFS = conflict-sensitive sourcing only.	RJC and LBMA audits = CFS
Disclaimer: Fulfilling CFS requirements only meets the LBMA & RJC conflict-free audit requirements to avoid duplication. There are additional requirements for refiners to achieve LBMA & RJC certification.			

The EICC-GeSI's Conflict Free Smelter (CFS) Program

The CFS Program is a voluntary initiative developed by the GeSI and EICC extractives group, in which an independent third party audits smelters' and refiners' procurement and tolling activities and determines whether the smelter or refiner has demonstrated that all the minerals they processed originated from conflict-free sources. The CFS Program publishes the list of smelters and refiners who have been found compliant to the CFS Program protocol, on the CFS Program website (www.conflictreesmelter.org). The CFS programme is tailored specifically for the electronics industry supply chain.

The RJC Chain-of-Custody (CoC) Standard

enables responsible sourcing of precious metals for businesses in the jewellery supply chain. RJC's CoC Standard was launched in March 2012 and is a voluntary standard applicable to gold and platinum group metals (platinum, palladium and rhodium) in addition to the mandatory RJC Code of Practices for RJC members.

RJC CoC-certified entities, including gold refiners, are audited to ensure that CoC precious metals are conflict-free as a minimum, and to ensure systems are in place to assure provenance claims of mined, recycled and/or grandfathered gold. RJC CoC-certified entities must also meet a range of requirements for human rights, labour standards, environmental impact, and business ethics, as set out in the RJC Code of Practices. Certified gold refiners must implement conflict-sensitive sourcing practices in line with the OECD Due Diligence Guidance for all sources of gold to the refinery. RJC has recognised the LBMA and CFS audits

as fulfilling relevant requirements of Section 10 of the CoC Standard. As per the other programs, RJC's Certified Refiners are publicly listed at <http://www.responsiblejewellery.com/chain-of-custody-certification/chain-of-custody-certified-members/>

The industry programmes are aligned with the recently issued SEC final rules as well as the OECD Guidance and Gold Supplement. Industry programmes, such as those developed by the GeSI and EICC Extractives group, LBMA and the RJC, were implicitly recognised as compliant with the SEC rules.

“ The LBMA's Responsible Gold Guidance is a mandatory due diligence policy for all Good Delivery gold refiners in order to maintain their LBMA accreditation. ”

The CFS, LBMA and RJC audit programmes aim to ensure that the global gold market can continue to function smoothly supported by market participants' efforts to demonstrate that their gold-containing products are 'conflict-free'.

The LBMA, EICC-GeSI and RJC are committed to continuing to work together for industry efficiency and sharing of lessons learned as programmes are implemented.

LBMA Responsible Gold Guidance enables gold industry to meet SEC final conflict minerals rules

In August the US Securities and Exchange Commission (SEC) adopted final rules that implements Section 1502 of the Dodd-Frank Act. These rules require companies to publicly disclose their use of conflict minerals that originated in the Democratic Republic of the Congo (DRC) or an adjoining country.

The LBMA has played a leading role in ensuring that once these rules are in place, the global gold market will be able to continue to function smoothly while at the same time allowing market participants to demonstrate that their gold-containing products are 'conflict-free' for the purposes of the SEC rules.

This has been achieved by the development of the LBMA's Responsible Gold Guidance, with which all Good Delivery gold refiners must comply in order to maintain their LBMA accreditation. Compliance with the guidance is reviewed annually by independent auditors and results are submitted to the LBMA, as well as being made available to the public.

The SEC final rules repeatedly endorse the OECD guidance as a "nationally or internationally recognised due diligence framework" for fulfilling Dodd-Frank requirements of conflict mineral due diligence. The SEC says that it "satisfies our criteria and may be used as a framework for purposes of satisfying the final rule's requirement that an issuer exercise due diligence in determining the source and chain of custody of its conflict minerals".

In addition, the SEC endorses the OECD Gold Supplement as such a framework for gold. The gold industry has worked diligently with the OECD to make the Gold Supplement a sound and workable guidance, with representation from the LBMA, the World Gold Council (WGC) and the Responsible Jewellery Council (RJC).

“ The LBMA has played a leading role in ensuring that once these rules are in place, the global gold market will be able to continue to function smoothly. ”

Gold industry programmes for refiners, such as those developed by the LBMA and the RJC, were implicitly recognised as compliant with the SEC rules. "An issuer would have reason to believe representations were true if a processing facility received a 'conflict-free' designation by a recognised industry group that requires an independent private sector audit of the smelter, or an individual processing facility, while it may not be part of the industry group's 'conflict-free' designation process, obtained an independent private sector audit that is made publicly available."

The final SEC rules make a number of changes from the proposals they announced in December 2010 to improve its practical implementation, which are beneficial for gold supply chains. The LBMA Gold Guidance goes beyond the requirements of the SEC rule and is therefore already well positioned to more than fulfil the expectations of this rule and of comparable international standards.

At the 2011 LBMA Conference in Montreal LBMA Chairman, David Gornall announced that the issue of conflict gold was the LBMA's number one priority. Since then the LBMA has worked diligently with other bodies, particularly the WGC, the RJC, the Electronic Industry Citizenship Coalition-Global e-Sustainability Initiative (EICC-GeSI) and the OECD over the past two years, to prepare itself for these rules. The outcome reflects favourably on the effective work undertaken by the LBMA and these other industry bodies with which it has been working closely.



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LBMA News

By Stewart Murray, Chief Executive, LBMA

MEMBERSHIP

Members

On 1 July, 2012, WestLB AG changed its name to Portigon AG.

On 26 September, 2012, Jewellers Trade Services Partners (JTS) was admitted as an Ordinary Member.

Associates

On 1 August, 2012, Gerald Metals Inc changed its name to GT Commodities LLC.

On 10 August, 2012, Alex Stewart International was admitted as an Associate.

On 26 September, 2012, Sunshine Minting Inc was admitted as an Associate.

On 9 October, 2012, Stewart Group Inspection & Analysis changed its name to ALS Inspection.

These changes brought the membership to a total of 139 companies, comprising 69 Members (of which 11 are Market Makers) and 70 Associates.

GOOD DELIVERY LIST

Doduco GmbH of Pforzheim, Germany was added to the Silver List on 9 August, 2012.

There are currently 63 refiners listed on the Gold Good Delivery List and 73 refiners on the Silver Good Delivery List.

COMMITTEES

Management Committee

The committee met in July and September to review reports from the various sub-committees and provide guidance on a number of current activities. In addition, the committee held a meeting in September to focus on longer-term issues including the optimum way of communicating to the membership as well as getting feedback from Members and Associates about the Association's activities and future direction. Another topic discussed was the need for increased due diligence on the admission of Members, Associates and Good Delivery refiners. It goes without saying that the Executive welcomes comments, feedback and criticism

at any time from the membership as well as from the wider bullion market. If you have any strong opinions on what the LBMA is doing, don't wait to be asked for them. Email me at; stewart.murray@lbma.org.uk.

One particular item of discussion in recent months, both within the Management Committee and at meetings of the Market Makers, has been a review of the arrangements for compiling GOFO and SIFO, particularly since the advent of the daily forward curves for these metals which were introduced last year. The committee has accepted a recommendation from the forward Market Makers that their GOFO submissions should include both dealable bids and offers in the half-hour before the GOFO means are calculated at 11:00 am each day. At present, only dealable bids (the rates at which they will lend called to other Market Makers) are submitted. In addition, in future, submissions will have to be made by 10:45 am.

GOFO will continue to be based on the submitted bids, and the Reuters GOFO page will be essentially unchanged. While GOFO is a well-established benchmark for the forward gold market, SIFO – its near equivalent – has always been purely indicative in that it is based on submitted mid-rates. As the information in the daily forward silver curve is also based on mid-rates (though covering an extended period from spot to three years forward) it has been agreed that SIFO will be discontinued with effect from 5 November, 2012.

Regulatory Affairs Committee

The RAC met in July and August to discuss a variety of regulatory issues. The most important of these continues to be the LBMA Responsible Gold Guidance but as this work moves from development to the implementation phase, the committee is increasingly looking at other regulatory issues. The RAC's main goal is to provide members with timely and relevant information about forthcoming regulatory developments which will have an impact on the

bullion market. Part of this work involves the Executive improving contacts and communications with regulators and related associations. The RAC has also contributed to the discussions in the LBMA about how the optimum level of due diligence can be practised when admitting companies to the membership.

Physical Committee

The committee met in July and September to review the work of the Executive in its maintenance of the Good Delivery system. A very large number of refining companies are currently in the process of applying for accreditation or are already going through the technical assessment procedures. The current phase of proactive monitoring, which primarily involves refiners in the former Soviet Union, is particularly demanding for the Executive because of the logistical challenges of moving assay samples into or out of the successor countries.

A new version of the Good Delivery Rules was posted on the website in September. The changes since the previous version are described in the preamble. One of these is the inclusion of Alex Stewart International in the list of LBMA Approved Supervisors.

Weighing has been a particular focus of the committee's discussions at the two most recent meetings. Topics included the agreement on 12 September to list Barclays Bank's new vault as an Approved Weigher and the initiation of a review of the London vaults' experience of using the Sartorius gold scale over the past year.

The committee reviewed progress in the development of a new version of the visual guide to Good Delivery bars (which will help refiners to understand what is acceptable to the London vaults in relation to the physical imperfections in Good Delivery bars). The basic website structure has now been developed. Due to pressure of other work, little progress has been made with the project to provide a scheme

for accrediting vault staff but it is expected that work on this project will resume by late October. The committee also took part in a joint meeting with the Membership Committee which focused on the due diligence to be applied to applicants for Good Delivery accreditation.

Finally, the committee has continued to discuss bullion market VAT, taking account of the views of the VAT group which has received feedback on the memorandum of understanding on VAT that was issued to Members and Associates earlier in the year.

Public Affairs Committee

At its meetings in July and September, the PAC applied what might be called the finishing touches to the plans for the annual conference, which is being held this year in Hong Kong, 11 to 13 November. It looks as though there is going to be another record attendance. The committee is now turning its attention to future events and examining possible venues for the 2013 and 2014 conferences.

However, in the immediate future the most exciting event is of course the Silver Anniversary Dinner for Members, Associates and guests which will be held in the splendid surroundings of the Mansion House in the City of London on 10 December. Reservations of places should be made through the LBMA contact for each member company (see below for more details).

Membership Committee

Apart from its detailed consideration of the applications for membership, the work of the committee in its recent meetings has focused on a particular issue, namely how the LBMA should treat applications from related companies. If two related companies share a single trading desk, the LBMA allows both of them to be Members but it requires that one of them must have the status of an Affiliate membership and thereby waive certain rights, such as voting at the AGM and sponsoring applications if the other company is making use of these rights.

The same requirement applies if two sister companies wish to become Members. If these companies have separate managements and trading desks, however, then both may be admitted as Members, provided that only one of them will exercise the above-mentioned rights at any one time.

Finance Committee

The Finance Committee increasingly plays a proactive role in the administration of the LBMA, rather than simply drawing up a budget and approving the annual accounts. For instance, at its meeting in September, the committee examined a proposed entertainment and travel policy for the LBMA which was subsequently approved by the Management Committee.

The Finance Committee also has to perform the Treasury function of ensuring that the cash balance from the Association's ordinary activities is effectively and securely invested. Because of the seasonal nature of LBMA cash flow, this cash balance shows very distinct peaks

and troughs. The Executive and the Finance Committee both strive to ensure that these funds generate some return, even in these days of minimal interest rates.

Executive Meetings and Travel

In September, the Chief Executive and Deputy Chief Executive took part in the second 'PlatforM' meeting, organised by the European Precious Metals Federation, which was attended by a number of associations representing the precious metals markets in Europe and North America. These included the International Platinum Group Metals Association (IPA), the London Platinum and Palladium Market (LPPM), the Silver Institute and the World Gold Council. All participants agreed that it would be useful to hold such meetings on a biannual basis to allow an exchange of information about a range of topics and to avoid a wasteful duplication of effort. The next meeting will be organised by the LBMA and will be held in London in March 2013.

Silver Anniversary Dinner

All Members, Associates and Good Delivery refiners have been invited to apply for tickets for the Silver Anniversary Dinner to be held in the Mansion House in the City of London on 10 December, 2012. This is going to be a very special occasion with many of those who were involved in the early days of the LBMA attending as guests. An initial allocation to the various grades of membership will be:

Market Makers: 10
Ordinary Members: 6
Associates: 4
Good Delivery refiners: 2

Contacts at all Member and Associate companies have already been asked to reserve places for their colleagues who wish to attend. After receipt of the initial reservations (which should be submitted by the end of October), additional places can be reserved by application.

All staff members and associates who are involved in the bullion market may attend. To ensure a place at the dinner contact Varsha

at varsha.peiris@lbma.org.uk without delay. In addition, taking account of the needs of central bankers who are attending the dinner as guests of the LBMA, a Members' Seminar is being held on the afternoon of the same day. See page 23 for programme details.

Market Moves

Janet McCarthy to Metalor Technologies SA

Janet joins Metalor Technologies SA on 12 November, 2012 as the company's Group General Counsel and Compliance Manager. Janet will be responsible for all legal issues in the Group. Janet joins the Metalor team from Mitsui & Co. Precious Metals, Inc. located in New York, where she worked for more than 4 years as a General Counsel and Chief Compliance Officer.

Valerie Chan joins Natixis

Valerie joined Natixis on 1 October as a senior Precious Metals Trader. Valerie's career began at Citigroup in Singapore before she moved to London as a Precious Metals Trader.

Florian Richardt joins Heraeus Metallhandels-gesellschaft mbH

Before joining Heraeus as Manager, Sales & Marketing, Florian worked for five years as specialist for interest, currency and commodity derivatives at Commerzbank AG. In his new role at Heraeus, he will be responsible for strengthening and further developing precious metals sales activities. Florian holds a Master's degree in Finance and Capital Markets from the Frankfurt School of Finance and Management.

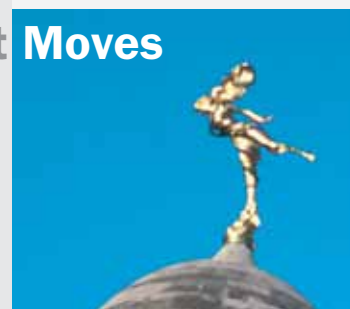
Andrew Silver joins Triland Metals Limited

Andrew moved to Triland in mid-September as part of its sales team. He brings more than 20 years of customer-facing LME experience and extensive knowledge of metal industry customers.

Edgar Geister to Commerzbank

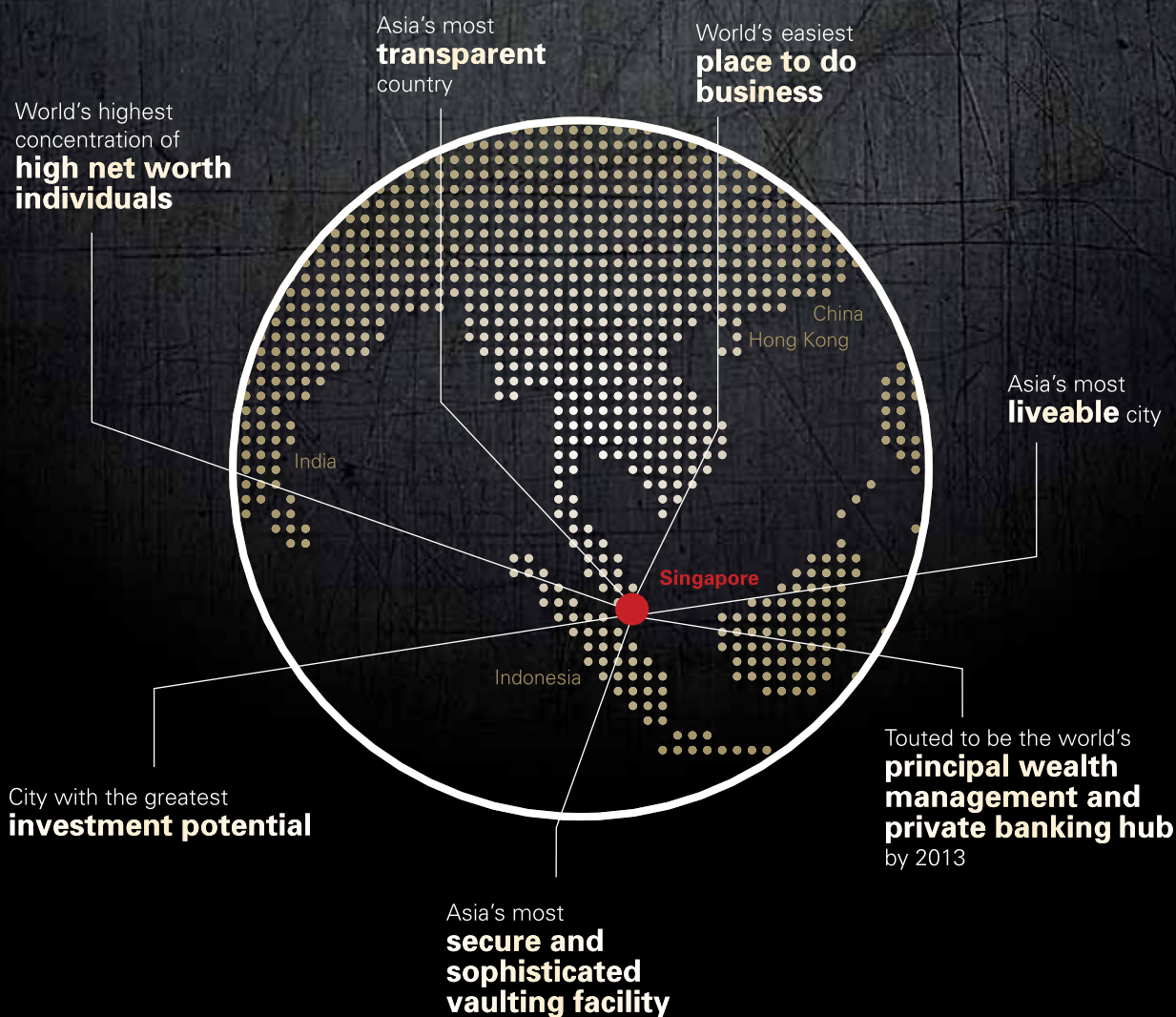
Edgar joined the Luxembourg based precious metals team of Commerzbank on 1 August, after having served more than 15 years in the international corporate credit business. In his new role, Edgar will focus on expanding the physical business.

Between 1997 and 1998 he worked as a credit administrator and credit analyst for Westdeutsche Landesbank (Ireland) plc before moving to Luxembourg and taking over responsibility as a Senior Credit Analyst for Commerzbank's credit department and becoming a group head at the beginning of 2011.



Singapore

Asia's global precious metals trade hub



Make Singapore your global precious metals trade hub

From 1 October 2012, all investment precious metals¹ will be exempt from 7% VAT; Refiners based in Singapore with the intention to be LBMA/ LPPM-accredited can take advantage of the Approved Refiner and Consolidator Scheme (ARCS)².

Visit www.iesingapore.com/preciousmetals for more information.

¹ Investment precious metals are defined as gold of at least 99.5% purity, silver of at least 99.9% purity or platinum of at least 99% purity; they must be produced by LBMA/LPPM-accredited refiners.

² ARCS persons can enjoy the following benefits: (a) VAT suspension on importation of goods; (b) Waiver of VAT payment on goods supplied between ARCS persons; and (c) Special input tax recovery for ARCS persons, as compared to the input tax claims allowable under normal VAT rules following the VAT exemption of IPM.



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Bloomberg CBGL<GO>
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Direct contact +352 477 911 2540

Achieving more together

Goals Set, Goals Achieved

Editorial comment, by David Gornall, Global Head of Precious Metals Trading at Natixis and LBMA Chairman

At our conference in Montreal in September 2011, I announced the LBMA's two major goals for the coming year. These focused on the vitally important regulatory issues which were confronting our market. It is not just a matter of good fortune that we have had the necessary resources (an experienced Executive and the then new Regulatory Affairs Committee) to rise to the resulting challenge. Indeed it is a testament to the prescience of the previous Management Committee that we were able to achieve so much.

Goal number one was to ensure that the Good Delivery List did not become a two-tier version as a result of pending US legislation. The efforts that our Executive made on behalf of the broader industry were aimed at explaining our approach and then positively influencing the numerous stakeholders of Dodd-Frank section 1502 relating to conflict minerals in the Great Lakes area.

Following the appointment of our Deputy Chief Executive, Ruth Crowell, as the co-facilitator of the OECD gold supplement drafting committee, Ruth made new contacts in governmental, corporate and NGO circles that helped us to achieve the best possible result for all concerned. The goal of retaining a level playing field for the whole market, based on a single Good Delivery List – rather than one that is used in the US and another that is not – has been achieved.

Through further cooperation with the Responsible Jewellery Council, the World Gold Council and the EICC-GeSI in the US, we have created a protocol for refiners that operationalises the OECD guidelines. Of course some of our most important conversations and meetings were with the Securities and Exchange Commission (SEC), which was required by Congress to develop rules to implement the measures in the Act.

“ Through further cooperation with the Responsible Jewellery Council, the World Gold Council and the EICC in the US, we have created a protocol for refiners that operationalises the OECD guidelines. ”

The resulting rules were a lot less onerous than many had anticipated and broadly practical to the industry.

As a result of this publication of the SEC rules, the Executive has revised the LBMA Responsible Gold Guidance which, together with the associated Audit Guidance, has now been circulated to Good Delivery Refiners and other interested parties for comment.

“ The combined result of all these efforts furthers our ongoing aim of reinforcing our role as the competent authority for OTC gold and silver. ”

The second of the goals, a better treatment of gold within the Basel III bank capital ratios, remains in the midfield area. These subjects and other regulatory issues have now become prime topics for the LBMA and its members.

We have responded to these challenges in various ways, including the organisation of two short seminars on both subjects, where experts have presented to the LBMA on their findings. It is of course our intention to continue this work.

The combined result of all these efforts furthers our ongoing aim of reinforcing our role as the competent authority for OTC gold and silver.

At the last Management Committee meeting, we decided to start work on an educational suite whereby we will use webinars and other forms of electronic information to help educate new entrants to the bullion market within the Membership. This is financially possible due to the success of past conferences and support from Members, Associates and Good Delivery Refiners.

The forthcoming conference in Hong Kong has already outstripped previous conferences in terms of delegates, with more than 565 delegates registered so far. I would like to thank the PAC in advance for the way they developed

the programme and the many new initiatives that participants will enjoy at the event.

In other areas of the LBMA's work I have to mention the Market Makers group, which has recently reviewed the terms of reference for all the services that they provide to the market. This has included a review of GOFO and SIFO in the light of the introduction last year of the daily forward curves compiled on the basis of their contributions. Details of the new arrangements will be communicated to the Membership shortly.

Not long after our conference, many of us will meet again at a very special event for Members and guests of the market, to be held at the Mansion House on 10 December. The LBMA's 25th Anniversary Dinner will be a unique opportunity for past and present members of the market to meet and compare the state of play today with how things were in the early days of the LBMA (and earlier).

Many thanks to our first Chairman, Robert Guy, for scribing his first article in *the Alchemist*. He is, of course, correct in saying that we continue to grapple with challenges similar to those he and his colleagues faced in the late 1980s, but there are a great deal more of them now than in 1987 – all of which keeps us all healthily busy. It is an honour to read that he congratulates the LBMA for its continued success. The period that Bob refers to hold fond memories for me, as I worked with him, John Bishop, Martin Stokes and Guy Field!



David Gornall, Global Head of Precious Metals Trading at Natixis and LBMA Chairman.

David Gornall started his career in 1979, trading silver at Lonconex Limited, part of the Primary Industries/Golodetz commodity trading group. After a spell at Morgan Guaranty Trust of New York, he moved to Sogemin, trading in the LME ring and heading the bullion and FX desk. In 1992 he joined NM Rothschild to start their LME base metals operation, before returning to Sogemin's successor, Natixis Commodity Markets – where he was a main board director until 2009.

David is currently the Global Head of Metals Trading at the French Investment Bank, Natixis.

David is Chairman of the LBMA and has been a member of the Management Committee since August 2005.



facing facts

Paul Burton,
Senior Equities Analyst
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The recent Denver Gold Forum brought together some 160 precious metal development and mining companies with the world's top fund managers and analysts. This annual get-together is the premier event in the sector – it's much like the LBMA conference of the gold investment world.

This year's conference was probably the largest and most diverse gathering I have witnessed in the 16 years I have been attending. The gold price performed its customary pre-Denver spike, which to a degree helped soothe some nerves in an industry under severe pressure through operating and capital cost inflation, project delays and missed production targets, and lack of significant discoveries.

What a torrid time the gold industry and its investors have endured over the course of this year so far. Who would have thought even two years ago that with a gold price close to US\$1,800/oz as I write, a number of gold producers would be taking the dramatic step of firing chief executives for poor operational performance?

To compound things, company share prices have fared badly in the equity markets, although it would perhaps be harsh to blame the company executives for the full extent of the decline. That is due more to reduced investor risk appetite since the economic crisis of four years ago.

The gap between anticipated performance and sober reality has exposed poor management techniques and ability, or at least the wrong emphasis in strategic

planning. If the gold price were still in a rampant phase of the bull market we would not be having this discussion as the healthy profit margins would have diverted attention and helped paper over the cracks. But with gold in a sideways trading range for much of this year, the focus has been on how companies are managing the pressures of cost inflation – both operating and capital.

The boards of a number of major gold producers, most notably Barrick Gold and Kinross Gold, have taken the dramatic step of firing their chief executives.

What has been going wrong? It seems that company boards have had enough of project delays and cost overruns that have not only threatened growth and profitability but have, more significantly, led to an exodus of investors.

In Barrick Gold's case, the company's shares have underperformed those of its peers and the gold price, and the recent disclosure that the massive Pascua-Lama project would now be delayed by a year and cost up to US\$8 billion to complete (against US\$3 billion just three years ago in the feasibility study) prompted the board to act and dismiss Aaron Regent and install an accountant, Jamie Sokalsky, in his place.

Mr Sokalsky has already imposed a more conservative fiscal regime on to the company by stating in the Q2 results that the company will adopt a more disciplined capital allocation approach focusing on the two key metrics of free cashflow and risk-adjusted return. The new mantra will be "Returns will drive production; production will not drive returns".

As a result, the company has effectively put on hold two of its large capital projects (Cerro Casale and Donlin Creek) as they "do not currently meet our investment criteria". The company will continue with permitting activities at reasonable costs and evaluate options to improve the economics of both projects.

This is good news. I have suggested in the past that there should be a greater concentration on measures of financial performance throughout the industry rather than the 'rock factory' mentality and metrics, such as non-accretive reserve and

production growth, without any consideration of costs.

What shareholders want now is security, and producers should offer both growth in earnings and net cashflow, on a per share basis, and provide better returns in the form of dividends to compensate for poor capital appreciation.

One of the areas where these considerations are particularly significant is in merger and acquisition (M&A) activity which, as readers may remember from my last Facing Facts, is very much in the news. Indeed, there have been a number of new announcements in recent months that indicate that there is a significant consolidation wave in the intermediate sector of the industry.

It is interesting to analyse the latest deals to find out how much companies are willing to pay for an ounce of gold in the ground. Based on 13 of the largest deals either completed or announced this year so far, our calculations show that the weighted average price of an ounce of resource (Measured & Indicated) is US\$119/oz. The range, however, is wide – one deal was completed at a miserly US\$8/oz (Pan African Resources buying Evander from Harmony Gold Mining) and, at the other extreme, IAMGOLD paid US\$654/oz for its acquisition of Trelawney Mining & Exploration (while on the face of it, this looks extremely expensive for a non-producing asset, Trelawney's main gold project has a huge inferred resource that IAMGOLD will hope to upgrade to Measured and Indicated category).

Although the price paid for 'in-ground' ounces is a simple and easy valuation method, it has a major drawback in that it assumes that all resource ounces are created equal, whereas in reality we know that some ounces are more expensive than others to exploit.

A more complete analysis takes into account the capital investment required to buy an existing operation or to put into production a development asset, plus the sustaining capital over the life of the mine as well as average life of mine operating costs to determine more realistically what it will cost to bring that ounce in the ground to the bullion market. For example, Pan African's US\$8/oz becomes US\$1,300/oz when all costs of extraction are taken into account.

If you do this analysis on the M&A deals previously mentioned, the average total cost comes out at just over US\$1,150/oz, a discount of 35% to the spot gold price. This demonstrates the low valuations afforded by the market at the moment. When the gold price was US\$330/oz the implied discount was zero.

Finally, if you turn the equation around, it suggests that the long-term gold price implied from acquisition valuations this year is just US\$1,150/oz, a rather bearish forecast.



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Paul Burton graduated as a mining engineer from the Camborne School of Mines in 1975 and spent almost twenty years working in the South African gold mining industry before becoming editor of World Gold Analysts in 1996, a position he still holds. In 2008 he became Managing Director of GFMS World Gold until the company was acquired by Thomson Reuters last year and is now Senior Equities Analyst, Thomson Reuters GFMS. He is an established speaker on the international conference scene and is Chairman of the FTSE Gold Mines Index Committee. He holds an MSc in Mineral Economics and an MBA from the University of the Witwatersrand.

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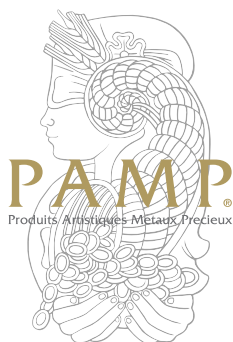
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