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## **Legal Aspects of Hedging in the Gold Industry: Current Issues**

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### SUMMARY

*This paper will discuss the legal aspects of hedging in the gold industry (concentrating primarily on hedging of the gold price) in the context of the changed market and circumstances of the last two years.*

*The first part of this paper will provide a brief summary of the way hedging is commonly used in the gold industry, the types of instruments available, and discuss the hedging strategies of some of the major global gold producers.*

*The second part of this paper will consider some of the more significant legal issues encountered by industry participants (primarily gold producers rather than banks) and which have arisen over the last two years including: risk management; corporate governance; commercial and legal risks; changes in the regulatory environment; disclosure and reporting requirements, and where applicable, will provide past examples of how these issues have arisen. It will conclude with a review of likely future trends for gold industry hedging activities.*

### BACKGROUND

Derivative use sky-rocketed through the 1990s, as innovation in the range and type of financial products available increased markedly. Derivative use globally stood in excess of US\$70 trillion at the end of the 1990s – a tenfold increase during that decade.<sup>1</sup>

In the gold industry, low commodity prices saw Australian gold producers turn to financial products to hedge against commodity

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<sup>1</sup> J Kleck, "Hedging: An old Practice Goes Global", University Publications, [http://www.uwosh.edu/departments/news\\_bureau/c.../hedging.html](http://www.uwosh.edu/departments/news_bureau/c.../hedging.html).

price, interest rate and exchange rate risk to protect their cash-flow. Although gold hedging has always had vehement critics in the gold industry, towards the end of the 1990s Australian gold producers were among the most heavily hedged in the world.<sup>2</sup> Despite many high profile financial losses from derivative use, gold hedging techniques and structures became ever more important to company finances, and increasingly sophisticated.

Hedging in the gold industry was reassessed at the end of 1999, as huge, widely publicised losses hit heavily hedged gold producers such as Ghana's Ashanti Goldfields (Ashanti). A brief spike in the gold price threw hedging programs developed in the context of a consistently falling gold price into disarray, and left companies fighting for survival. Although this raised awareness in the gold industry of some of the risks of hedging, and led to the redesign of many hedge programs, hedging activity continued at a substantial level whilst gold prices remained low.

In the last two years however, both in the gold industry in Australia and globally there has been a gradual change in hedging activities and a reduction in the level of hedging in the gold industry. The gold market has strengthened as countries' economies and equity markets have faltered, and corporate confidence has been diminished as a result of high profile corporate collapses such as the collapse of Enron Corporation (Enron). These factors, together with a consolidation of industry participants and increasing shareholder preference for unhedged producers, has led to a review by many companies of their own hedging strategies, and has resulted in what has been termed a "sea change" in the local industry.<sup>3</sup> Cuts in United States interest rates over that period have also proved favourable to gold, and less favourable to gold hedging.

In Australia there was an 8 percent decrease in hedging to December 2001,<sup>4</sup> and this trend looks likely to continue. Many producers who have previously sold gold forward, are now delivering into hedge contracts without renewing these contracts, sometimes for the first time in a decade or more.

## OVERVIEW OF GOLD HEDGING

In order to consider some of the legal issues related to hedging, it is necessary to provide a simple summary of the concepts.

<sup>2</sup> T Jin and V Fang, "An Empirical Study of Derivatives Usage in the Australian Gold Mining Industry" Monash University.

<sup>3</sup> JP Morgan Securities of Australia Quarterly Review March 2002.

<sup>4</sup> Australian Gold Council Press Release, "Drop in Gold Hedging", 13 March 2002.

## **What is Hedging?**

Hedging is a technique for reducing or eliminating the risk caused by price, interest rate or foreign currency exchange rate fluctuations, the primary objective of which is to manage cash flows.<sup>5</sup> In its most simplistic form, hedging is a means by which a trader in a commodity protects itself against changes in the price by taking a position which will compensate for adverse price moves. When used in this way, hedging is a form of insurance against loss resulting from price changes.

Although hedging involves the use of derivatives, it is generally associated more with the management of risk, than with the speculative aspect of many other derivatives. However, as will be discussed in this paper, there are risks, and the opportunity for speculation, in hedging activities.

## **Hedging by Gold Producers**

Hedging by gold producers may be done in a number of ways. Because gold is a store of wealth, central banks hold considerable stocks of gold bullion, and this allows gold hedgers to utilise a unique form of hedging with forward sales, which works as follows:

- a gold producer (Producer) agrees, usually through its dealer or merchant bank (Dealer), to sell a quantity of gold which the Producer does not currently have, at the current spot price;
- the Dealer borrows the quantity of gold from a major central bank such as the Bank of England (Bank), with a promise to repay the quantity (not the value) of gold after a certain period of time, usually 12 months or less, and sells that gold into the spot market;
- the Dealer immediately invests the cash raised from the sale of the gold on the spot market, in the cash interest rate market;
- the Producer repays the borrowed quantity of gold to the Bank out of its production after the time specified in the agreement;
- the Dealer then pays the Producer the cash raised from the gold sale onto the spot market 12 months earlier, plus the interest earned on the cash interest rate market, less the interest charged by the Bank (the gold lease rate) and the Dealer's fee (usually around 0.25 percent).

## **Different Types of Hedging**

There are a number of different types of hedges. The main types used by gold producers in addition to forward sales are as follows:

<sup>5</sup> Jin and Fang, op cit n 2.

- (a) *Spot deferred*: This type of hedge is a forward sale which can be converted, at the Producer's option, into a spot sale if the spot price is higher. Typically such sales can be deferred for a set period of time.
- (b) *Purchase of puts*: A put gives the Producer the right to sell the gold to the other party at a specified price and time. A put purchase costs money, but it protects the down-side without limiting the upside.
- (c) *Sale of calls*: When a Producer sells a call, it is committing to sell future production at a specified price and date in the future – it has an obligation to sell at that price if the other party demands, but not the right to sell. In return it receives a premium. Many Producers that purchase puts (as per (b) above) choose to pay for them with the premiums received from the sale of calls – a more speculative move.
- (d) *Purchase of calls*: Producers which have otherwise hedged production, may buy calls – which give the Producer the right to buy gold at a pre-determined price regardless of the prevailing price in order to allow participation in a much higher market.<sup>6</sup>

Hedging for Producers, as for the producer or consumer of any commodity, can range from prudent to aggressive, or even reckless. As well as there being different forms of hedging, there are also different objectives. Hedging can be defensive – to ensure survival in the case of high cost Producers – or it can be offensive – to generate a premium or to speculate on the price of gold.<sup>7</sup>

As the gold price falls, it is common to see an increase in hedging by companies. In a falling price environment, an increasing number of companies see the need to protect their falling profits, and the longer the price decline goes on, the more “riskless” hedging appears.

Risks involved in different hedging strategies are discussed below.

#### KEY INDUSTRY PLAYERS

To understand the current legal issues which arise in gold industry hedging in Australia, it is useful to consider the hedging strategies and positions of some of the major global gold producers, not least because these players are almost all now heavily involved in the Australian industry. It is particularly worth considering the dichotomy between hedgers and non-hedgers that has developed in the industry.

<sup>6</sup> For further details see, “Gold Derivatives: The Market View – the Products”, at <http://www.sharelynx.net/papers/Goldhedging.htm>.

<sup>7</sup> Adrian Day, “Adrian Day rates Miners by their Hedge Books” *Coin Magazine*, 22 November 1999.

If hedging was simply a risk management tool to manage commodity price and other risks, you would expect to see some similarities in the hedging practices of the major gold producers. However this is not the case, as there has developed an extreme difference in views and practices between the hedgers and non-hedgers.

## **Global Gold Producers**

### **Unhedged**

#### ***Newmont Mining Corporation (Newmont)***

Newmont generally takes a non-hedging position on the basis that hedging limits possible profits as well as losses, making gold stocks less attractive to investors. Newmont nevertheless elects to enter selective hedging transactions to achieve strategic objectives.<sup>8</sup>

As a result of the February merger with Normandy Mining Ltd, Newmont has a considerable hedge book at present. Newmont recently announced that Normandy's hedge book would be substantially reduced to allow 70 percent of reserves and 87 percent of resources to be exposed to the spot price of gold.<sup>9</sup>

Commentators have suggested the one of the reasons that Newmont's bid for Normandy was successful over that of AngloGold was due to shareholder preferences for Newmont's anti hedging policy.<sup>10</sup>

#### ***Gold Fields Limited (Goldfields)***

Gold Fields claims it is "totally unhedged"<sup>11</sup> and has a similar position to Newmont.

### **Hedged**

#### ***Barrick Gold Corporation (Barrick)***

Barrick is one of the most successful and heavily hedged gold producers in the world, having hedged the gold price for the past 15 years. Barrick hedges using a spot deferred contract where the delivery date and forward price are not fixed. This enables the company to sell at the spot price if it is higher than the forward price, and roll the contract forward for up to 15 years. Barrick is able to negotiate favourable terms such as these due to its strong credit rating and substantial reserves.

<sup>8</sup> Newmont Financial Report 2001.

<sup>9</sup> Shaw Stockbroking, "Normandy Reduces Gold Hedging", 17 January 2002.

<sup>10</sup> John Hathaway, "O Brother Homestake, Where Art Thou", The Tocquville Funds, 29 May 2002.

<sup>11</sup> Gold Fields Limited website as at 5 July 2002, <http://www.gold-fields.com>.

Barrick is reported as making additional US\$2.1 billion in revenue over the last 14 years due to hedging. Given the recent recovery in the gold price, Barrick is reported to be modifying its overall hedge position, and for the first time in 14 years has not hedged, or locked in prices in advance for its entire output, and instead plans to sell half of its 2002 production on the spot market.<sup>12</sup>

It has been speculated that if the gold price rises to US\$350/oz Barrick's mark-to-market losses on its hedge book would be in excess of US\$1 billion.<sup>13</sup> These recent predictions have led some commentators to speculate whether Barrick could have a fate similar to derivatives dealer Enron, if the gold price rises steeply.<sup>14</sup> In view of the nature of Barrick's hedge program, this would seem unlikely.

### ***AngloGold***

AngloGold is reported to have made US\$820 million of hedge gains in the past four years.<sup>15</sup> Although its overall hedging policy is unchanged, AngloGold has recently announced that it is cutting back its hedge book to allow maximum exposure to rises in the price of gold.

### ***Placer Dome Inc (Placer Dome)***

Placer Dome CEO Jay Taylor has recently<sup>16</sup> stated that they are pleased with their forward sales program and have no intention of changing course.

## **Australian Gold Industry**

Consolidation in the Australian gold mining industry has had an influence on hedging patterns. In Australia, just five years ago foreign owned gold producers accounted for only 19 tonnes of Australia's recorded output of 313 tonnes.<sup>17</sup> The only foreign companies active here were Homestake and Placer Dome.

In 2002, foreign companies now control half of Australia's gold production of around 285 tonnes, and all of the global majors are represented here. Of the major acquisitions of gold miners in Australia recently, three of the four were foreign non-hedgers buying hedgers, whilst Barrick bought Homestake (which was foreign owned already),

<sup>12</sup> Geoff Breen, "To Hedge or Not to Hedge or Is Hedging Really Dead?," JP Morgan Securities Australia Limited, Australian Gold Conference, 15-16 April 2002.

<sup>13</sup> David Vaughn, "Gold is Free!", 8 May 2002, [www.kitco.com/ind/vaughn/may82002.html](http://www.kitco.com/ind/vaughn/may82002.html).

<sup>14</sup> Ibid.

<sup>15</sup> Breen, op cit n 12.

<sup>16</sup> February 2002 (Breen, op cit n 12).

<sup>17</sup> Breen, op cit n 12.

which resulted in a hedger buying a non-hedger.<sup>18</sup> Increasing consolidation and consequential strengthening of balance sheets is also likely to impact on the type of terms producers can negotiate in their hedging contracts (for example, margin triggers), and means that such companies are less likely to be forced by their bankers to forward sell.<sup>19</sup>

Other Australian gold producers such as Sons of Gwalia and Newcrest, are heavy hedgers<sup>20</sup> and are reported to have suffered heavy hedging losses in the last year. Commentators have suggested that if gold goes above US\$330/oz Australian producers will need to start to cover short positions and may take massive losses.<sup>21</sup> As at April 2002 only 32 percent of Australian production is reported to be unhedged.<sup>22</sup>

### **New Projects**

Irrespective of changing trends in hedging practices, the certainty which hedge cover brings is likely to continue to be required by banks financing new or existing projects.<sup>23</sup> Banks want cover to know funds are in place to repay loans before gold is produced, and have little interest in the up-side benefits to the company of a rise in the price of gold.

Hedging has, and will continue to allow producers to raise money at a low cost, off balance sheet, for the purpose of developing new lower priced gold supply.<sup>24</sup>

## **RISK MANAGEMENT**

Derivatives have been the fastest growing risk management method in the last two decades.<sup>25</sup> In turn, risk management is at the core of any consideration of the legal aspects of gold hedging. As was shown in the case of Ashanti in 1999, hedging can introduce its own set of risks that also need to be managed.

In structuring a hedging strategy, it is important for companies to know what risks can be controlled, what risks can be limited, and what risks can be safely left to run. They need to identify all possible

<sup>18</sup> Ibid.

<sup>19</sup> Wayne Longeran, "Today's Gold, Tomorrow's Profit", JASSA Spring 1997.

<sup>20</sup> Sons of Gwalia has not delivered to spot market since 1985 (Breen, op cit n 12).

<sup>21</sup> Robert Chapman, "Gold and Silver Potpourri", [http://www.gold-eagle.com/gold\\_digest\\_02/chapman060402pv.html](http://www.gold-eagle.com/gold_digest_02/chapman060402pv.html).

<sup>22</sup> Breen, op cit n 12.

<sup>23</sup> Dalrymple at Thunderbox, Kingsgate in Thailand and Western Areas in South Africa have all recently used hedging facilities to fund project development. Newcrest is also forecast to add hedge protection when funding the expansion of Telfer (Breen, op cit n 12).

<sup>24</sup> Jim Sinclair, "The Gold Market is sitting on a Time Bomb", Miningweb 4 October 2000.

<sup>25</sup> Jin and Fang, op cit n 2.

risks, model the exposures to the company and ensure that adequate controls are in place to limit potential losses.<sup>26</sup>

Surveys relating to gold mining companies in North America indicate that companies have very different risk management strategies and different levels of hedging. This reflects the balance management strikes between profit maximisation for shareholders, and maintaining financial health. Many corporations engaged in risk management hedged down-side exposure whilst pursuing opportunities to take advantage of up-side volatility, or used "selective hedging" rather than fully hedging to trade off cash flow stabilisation provided by hedging against speculative gains.<sup>27</sup>

Whether hedging is used for insurance against a falling gold price, or as part of a more speculative strategy, the risks a company is exposed to and seeks protection from, or the volatility in the market it hopes to take advantage of, must be ascertained to ensure a company's hedge program is properly structured to achieve its objective. Companies such as Pasmaico, Ashanti and others seem to have failed to do this, and their hedging practices led those companies to the brink of collapse.<sup>28</sup>

#### CORPORATE GOVERNANCE

The lack of internal controls and/or management's imprudent attitude to market risks inherent in derivatives, have been the direct cause of most of the major losses attributed to the use of derivatives.<sup>29</sup>

Companies need to ensure that adequate corporate governance mechanisms are in place to prevent the company from entering into derivatives contracts which are inappropriate to the company's needs or strategic direction, and to ensure that hedging activities are both within developed guidelines and subject to appropriate board supervision and control. Management needs to be well informed about the range of financial instruments available to safeguard the company's revenue, and that hedging is undertaken where it is prudent to do so.

#### **Directors Duties**

The responsibility for implementing an appropriate hedging policy, with appropriate safeguards and procedures to protect the company's

<sup>26</sup> Susan Campbell, "A Safe Bet" Australian CPA Vol 71 (11) Dec 2001.

<sup>27</sup> Jin and Fang, *op cit* n 2.

<sup>28</sup> *Ibid.*

<sup>29</sup> Andrew Booth, "Legal Aspects of Commodity, Currency and Power Derivatives" [1997] AMPLA Yearbook 348.



interests, rests with the board of directors. Directors have a duty of care and diligence, to manage and conduct the business of a company in the best interests of the company. In *AWA Ltd v Daniels (t/as Deloitte Haskins & Sells)*<sup>30</sup> the court held that this duty included overseeing the plans of managers in the acquisition and organisation of financial resources towards the attainment of the company's goals. This duty is confirmed by the *Corporations Act*.

In order to exercise sufficient care and diligence to satisfy this duty, directors must sufficiently inform themselves about appropriate financial tools and to ensure that those responsible for the day-to-day management of the corporation also possess that knowledge. Directors must also consider whether the correct tools are being used appropriately and direct day-to-day management to amend their actions if they are not.

The careful design and development of a hedging policy, and due supervision and monitoring of the implementation of the policy will certainly assist directors in discharging their fiduciary obligations.<sup>31</sup> The type of management framework will vary between companies, and will depend upon the various risks and circumstances facing the company.

In the case of *Powercor Australia Ltd v Pacific Power*<sup>32</sup> the court made a number of comments about the need for companies to have efficient and transparent monitoring and record keeping systems, and to put in place a risk management program to reduce the probability of poorly managed outcomes when dealing with derivatives. This case has been the subject of detailed discussion in the AMPLA Journal.<sup>33</sup>

Directors need to be mindful of the balance between the maximisation of wealth and prudent management. There will be limits to the extent to which a company's production can be hedged. Imprudent use of derivatives for speculation may not show the exercise of due care and diligence and may create liability for directors.<sup>34</sup> Ashanti and its directors are reported to have been the subject of litigation by stockholders in the United States as a result of its hedging practices.<sup>35</sup>

Interestingly, in North America, the hedging practices of gold miners has been found to be largely influenced by the form of compensation management received (for example, stock versus options).<sup>36</sup> No similar association was found in Australian gold mining companies.<sup>37</sup>

<sup>30</sup> (1992) 7 ACSR 759.

<sup>31</sup> Campbell, op cit n 26.

<sup>32</sup> [1999] VSC 110.

<sup>33</sup> Charles Birch and Tresna Tunbride, Comments (2000) 19 AMPLJ 121.

<sup>34</sup> Raj Vaswani, "A Duty to Hedge", 22 March 2002, <http://www.gtnews.com/articles6/4395.html>.

<sup>35</sup> Sinclair, op cit n 24.

<sup>36</sup> Peter Tufano, Harvard Business School, "Who Manages Risk" (1996) *Journal of Finance* (September).

<sup>37</sup> Jin and Fang, op cit n 2.

It has been suggested that one of the safest way for directors of companies to meet their duties in addition to good corporate governance practice, is to ensure that the direction of the hedge is the opposite of the company's underlying exposure, and that the company hedges only a sufficient amount of its production to protect against the down-side risk, whilst leaving some upside available.<sup>38</sup>

### **Duty to Hedge?**

It is also becoming evident that companies cannot just simply not hedge because of the highly publicised losses and perceived "dangers" of hedging. This is especially true for gold producers. Because gold is an actively traded and volatile commodity, and most gold producers have a large exposure to gold price risk, their financial performance will be strongly influenced by the price of gold. In such circumstances, hedging gold price risk becomes an important part of a company's management activity<sup>39</sup> and it is possible that an Australian court could find that there is a duty on gold producers, or their directors, to hedge or to at least consider hedging.

Whilst there is no Australian authority on this proposition, nor does the *Corporations Act* impose such a duty, the decision of the Indiana Court of Appeals, United States, in *Brane v Roth*<sup>40</sup> indicates that such a duty is possible.<sup>41</sup>

In *Brane v Roth* the shareholders of a grain cooperative successfully recovered trading losses from the directors on the grounds that they had failed to adequately protect the cooperative's revenues by hedging. The court held that because the cooperative derived 90 percent of its revenue from trading in grain, it was a reasonable business expectation that reasonable managers would have hedged to protect the revenue from the sales of grain. The board was not protected by the business judgment rule because it had failed to inform itself adequately of hedging tools in order to make a business judgment.<sup>42</sup>

This decision, while not imposing an absolute duty to hedge, suggests a duty on corporate fiduciaries to inform themselves of the appropriate risk management tools and to implement them according

<sup>38</sup> Michael Hampton, "Golden Rules for Mining Company Gold Hedging", 27 July 2000 [http://www.minesite.com/archives/features\\_archiv.../hedging.html](http://www.minesite.com/archives/features_archiv.../hedging.html).

<sup>39</sup> Matthew Callahan, "To Hedge or Not to Hedge... That is the Question", 10 April 2002, The Leonard N Stern School of Business.

<sup>40</sup> 590 NE 2d 587 (1992).

<sup>41</sup> Paul Ali, "Weather Derivatives, Hedging volumetric risk and Directors Duties" (2000) 18(2) CSLJ and Randall Borkus, "A Trust Fiduciary's duty to implement capital preservation strategies using financial derivative techniques" (2001) *Real Property, Probate and Trust Journal*, Chicago Spring.

<sup>42</sup> Ali, *ibid.*

to the needs of the business. If the business derives the majority of its revenue from trading in commodities then hedging is likely to be a major risk management tool.

Both the heads of negligence considered in that case are consistent with Australian law on duty of care.<sup>43</sup> It is possible that a court in Australia would require the directors of a company that derives the majority of its revenue from trading in commodities to ensure that its trading revenue has an appropriate degree of protection from price fluctuations.<sup>44</sup>

## KEY COMMERCIAL AND LEGAL RISKS

If companies are to minimise the extent to which hedging itself creates risks, close consideration is required of the treatment of risks within the hedging contract itself. The following is a snapshot of some common legal, commercial and operational risks that need to be addressed. Particular attention is paid to risks which have actually resulted in losses to companies in recent years.

### **Legal Risks**

#### **Counterparty risk**

An important feature of gold hedging is that a large amount of hedging is done using over the counter (OTC) contracts rather than exchange traded contracts. Whilst exchange traded contracts have the benefit of an exchange clearing house which effectively guarantees the settlement of the contract, OTC contracts do not have this protection. Although an OTC contract can be individually negotiated and tailored to the individual circumstances required by the parties, each party will be reliant upon the other to perform its obligations, and not to default on its obligations.

Therefore it is important that each party assess the reliability and credit-worthiness of the other parties before entering into a transaction, and ensures that the documentation adequately deals with such credit risk. This risk must be assessed carefully. A contract to sell gold at a set price on a set date is only valuable if the other party to the contract is able to buy the gold at that time.

#### **Margin requirements in hedging documentation**

Many companies of lesser credit standing than the global majors have in the past been forced by their lenders and hedge counterparties to accept margin requirements in contracts. The way

<sup>43</sup> Ibid.

<sup>44</sup> Ibid.

margin requirements work is that if there is a loss on the gold hedge, then some or all of that loss must be paid to the counterparty in order to keep the hedge in force. In such a case the lender is not willing to simply trust the gold producer and wait months or years for the gold they have hedged to be produced.<sup>45</sup>

The presence of margin calls in a forward contract adds an additional layer of risk to the contract in the event that the gold price rises above that locked into the contract. This is a significant risk for a heavily hedged producer with substantial forward sales if the gold price spikes.

After many years of falling gold prices in the 1990s, many producers appear to have been lulled into a feeling of complacency over the risk of leaving margin triggers in the hands of their lenders. However this can be an extremely risky situation if the lenders demand that their clients pay more margin money, or force them to cover the hedges at very unfavourable prices, as appears to have been the case with Ashanti in late 1999.

In that case, it is reported that as the rising price of gold exceeded the prices Ashanti had contracted to sell at, and its hedge book saw huge losses, the banks that lent the money to buy those hedging contracts on margin demanded cash as collateral. In addition, since the gold the subject of the hedge books was still in the ground, Ashanti could not sell gold to pay the cash needed to cover the futures positions. Ashanti suffered a US\$570 million dollar loss on its hedge book, of which nearly half was owed immediately to creditors.<sup>46</sup>

It is reported that the margin has to be covered on Ashanti's hedge book in December 2002. If gold is high at that time, it is speculated that this may be fatal for Ashanti.<sup>47</sup>

### **Documentation**

For OTC contracts, the documentation which effects the transaction is of fundamental importance. The standard documentation which has been developed by the International Swap Dealers Association (ISDA) is the most widely used form for documenting gold derivatives transactions. This paper does not consider the details of ISDA documentation as this documentation has been in place for some time relatively unchanged and has been considered in detail at previous AMPLA conferences.<sup>48</sup>

The fundamental point to be aware of is the risk that the standard ISDA document will be used for a transaction for which it is

<sup>45</sup> Hampton, *op cit* n 38.

<sup>46</sup> Callahan, *op cit* n 39.

<sup>47</sup> Chapman, *op cit* n 21.

<sup>48</sup> Booth, *op cit* n 29 and D Brown, "Financial Risk Management" and J O'Sullivan "Financial Risk Management: Commentary" [1993] AMPLA Yearbook 99.

inappropriate. Each time the ISDA standard documentation is used, it should be approached as a unique transaction, and the appropriateness of the terms reviewed from the outset. Cross default clauses, treatment of credit risk, and break clauses should be particularly carefully reviewed in the context of acceleration provisions and defaults under other agreements.<sup>49</sup>

The increase in the size and complexity of derivatives transactions has in the past led to poorly documented transactions which are in effect time-bombs which companies have had little chance of comprehending or controlling.<sup>50</sup>

### **Complexity**

Throughout the 1990s gold and other derivatives became increasingly sophisticated, and complex. As hedging strategies and structures became more difficult to understand, and more inaccessible to company business managers, risk exposure increased.<sup>51</sup>

The complexity and diversity of derivative products has, and will continue in the future to test the bounds of companies' corporate governance practices. Companies need to closely monitor and supervise all aspects of their hedging activities.

The case of Ashanti is again an example where this appears not to have happened. In March 1999, Ashanti was being praised for its sophisticated and successful strategies which had resulted in financial engineering becoming as important as gold production.<sup>52</sup> After Ashanti's highly publicised hedging losses at the end of 1999, questions were asked as to how the finance director at Ashanti convinced his fellow Ashanti directors and the auditors that he was a derivatives expert and should be allowed to keep the full details of the Ashanti hedging program to himself. It is reported that he locked all documentation of hedging in a room to which only he had access on the grounds that it was too complicated for anyone else to understand.<sup>53</sup>

## **Commercial Risks**

### **Currency**

Currency has proven to be a major problem in the past for Australian commodity hedgers who are reported to have hedged

<sup>49</sup> Booth, *op cit* n 29.

<sup>50</sup> Brown, *op cit* n 48.

<sup>51</sup> *Ibid.*

<sup>52</sup> Bill Shepherd, "The Art of Hedging Gold", *Global Finance*, March 1999.

<sup>53</sup> "Auditors should monitor hedging programmes and ensure shareholders are fully informed", [http://www.minesite.com/archives/features\\_archives/2002/Feb-2002/hedging040202.htm](http://www.minesite.com/archives/features_archives/2002/Feb-2002/hedging040202.htm).

commodity prices, but have remained exposed to unfavourable currency movements. By locking in long-term hedging contracts, a significantly worsening currency has the same effect as a significantly strengthening gold price. A strongly hedged producer may be locked into a situation where its forward production is already sold at a lower price based on an inflated currency.<sup>54</sup>

In any analysis of risks, a company must consider all aspects of that risk and how factors which may be secondary to the primary objective (for example, to lock in a set gold price), may impact on the management of that risk.

### **Timing issues**

Most hedgers hedge more than a year forward – and some five or 10 years forward. This can create a timing issue if a company which has hedged a modest amount of its annual production (say one third) for the next six years, has a total hedge well in excess of any single year's production. In such a case a small movement per ounce above the hedge price, puts a large loss in the hedge book. Although this loss is on paper only as long as gold is extracted as scheduled, clauses in hedging contracts which allow banks to seek additional collateral before actual production dates in such circumstances can cause problems for companies.<sup>55</sup>

### **Committed v uncommitted hedging**

The make-up of the hedge book is as important as the level of hedging, as it is necessary to distinguish between commitments and protection. The purchase of puts, rather than the entry into forward sales contracts means that if the price of gold rallies strongly, the puts can expire worthless and will not lock in a rate lower than the spot price.

Although protection has to be purchased, and therefore is more expensive at the time than commitment, it allows the most flexibility whilst protecting against down side risk. Directors have in the past been reluctant to pay that "insurance premium", but after the experience of many gold producers who committed to forward sales, and lost much of the recent gold up-side following the gold price rise, this is likely to change.

<sup>54</sup> Most recently, currency losses are reported to have impacted companies such as Pasmenco and Sons of Gwalia. Pasmenco is reported to have taken forward A/US\$ contracts and locked into a currency position which proved to be too high when the unhedged US\$ zinc price fell. In this case, it appeared that management felt it could forecast the direction of both the A\$ and the zinc price, hence they did not take out policies for the worst case situation and relied on being able to predict the market. In this case the decision was fatal for the company (Campbell, op cit n 26). Sons of Gwalia is reported to have committed to a \$US tantalum price for six years (to 2006) locked in at a A/US\$ rate of 69c. This has caused substantial losses in the hedge book (reported to be \$650 million) which is still in negative territory.

<sup>55</sup> Hampton, op cit n 38.

More recently, the trend in Australia appears to be changing in favour of a reduction in commitments and an increase in protection.<sup>56</sup>

### **Asymmetrical hedging**

Falling gold prices in the 1990s encouraged a dangerous strategy of selling two or three times the volume of calls as a company buys puts.<sup>57</sup> The cost of the puts, is paid for by the premiums received from the sale of the calls. If the price of gold moves down, the put kicks in and compensation is paid. However, if the price rises, the call will be exercised by the counterparty and the company has to cope with twice as much hedge loss for every further dollar of price protection.

In the context of price volatility, asymmetrical hedging becomes particularly dangerous where calls sold are subject to margin requirements. A producer may be forced to buy-back the calls at a high premium and realise a substantial loss.

### **Naked call options**

The sale of calls is one of the most speculative and reckless of hedging practices, because although it earns the seller a premium, it limits the upside whilst doing nothing to protect the down side as it gives the buyer the right (but not obligation) to require the sale of gold to the buyer at a strike price. The motivation for the sale of calls whether by a producer or a bank, is purely profit – the premium received is a source of easy profit for the seller, whilst the spot price stays below the strike price. The seller does not have to do anything, and retains the premium. Such call options can be written in unlimited numbers.<sup>58</sup>

From the point of view of a gold producer who sells calls, risk of loss when the spot price exceeds the call option strike price, can be minimised if gold can be produced to be delivered into the contract. However, if a gold producer has insufficient gold available to deliver into the contract, or it is a bank which is selling the call and it doesn't have the physical gold (naked call option), it must purchase gold on the spot market to deliver into the contract, and losses can be huge. It was reported in December 2000 that banks were writing hundreds of thousands of naked calls, each representing 100 ounces of gold.<sup>59</sup> Any increase or spike in the gold price consequentially leads to substantially increased risk exposure.

<sup>56</sup> Breen, *op cit* n 12.

<sup>57</sup> Hampton, *op cit* n 38.

<sup>58</sup> Adrian Hamilton, "Gold Delta Hedge Trap" December 2000 The Guilded Opinion, at <http://www.usagold.com/guildedopinion/Hamilton.html>.

<sup>59</sup> *Ibid.*

A type of hedge known as a delta hedge, developed using the Black and Scholes Option Pricing Model, is used as a means of reducing the risk of the sale of naked call.<sup>60</sup> A failure to use the delta hedge in this circumstance has been described as criminally negligent on the basis of the huge losses it could expose the company or bank to.<sup>61</sup>

However, even the use of delta hedges and pricing models has risks. Long Term Capital Management (LTCM), the hedge fund which in 1998 was the subject of a highly publicised US\$3.6 billion dollar bail-out by the United States Federal Reserve in order to prevent the collapse of the entire global system, was engaged in highly leveraged, speculative derivatives, including the sale of naked gold calls. It is rumoured that LTCM was short 400 tonnes of gold when it collapsed, and that the United States Government arranged for the gold to be supplied to counterparties very quietly and forbade LTCM principals ever to discuss it.<sup>62</sup>

It has recently been speculated in the context of the most recent gold price rally, that if gold goes above US\$330/oz that producers, and banks exposed to complex financial derivatives as part of their gold trading may run into financial disaster like the collapse of LTCM in 1998.<sup>63</sup> The recent fall in the gold price from highs of US\$330/oz to just over \$300/oz in late July, has raised suspicions about a massive intervention to help an important institution which had massive gold derivative positions exposed by the price rises.<sup>64</sup>

## **Operational Risk**

So long as the hedge program does not exceed future production, generally (irrespective of opportunity losses compared with the spot price of gold) the gold will be produced to enable the gold producer to meet its hedging related obligations under forward sales contracts. Accordingly, an operational or other problem at the mine or elsewhere (including sovereign risk issues), which may result in the gold producer being unable to produce sufficient gold to meet its obligations can have substantial ramifications for both the producer and the banks.

Where gold production is not sufficient to cover the hedge losses, the company will be liable to fund any shortfall. This type of problem may lead to more than just liquidity problems for the company, and

<sup>60</sup> For more information on delta hedges and the Black and Scholes Option Pricing Model, see *ibid.*

<sup>61</sup> *Ibid.*

<sup>62</sup> *Ibid.*

<sup>63</sup> Robert Chapman, "Gold and Silver Potpourri", [http://www.gold-eagle.com/gold\\_digest\\_02/chapman060402pv.html](http://www.gold-eagle.com/gold_digest_02/chapman060402pv.html).

<sup>64</sup> Robin Bromby, "Miners run for cover", *The Australian* 30 July 2002.



may lead to the risk of insolvency depending upon the severity of the problem.<sup>65</sup>

In these circumstances, banks will often rely upon margin requirements for out-of-the-money hedges, which as set out above, can themselves cause major problems for gold producers.

Companies need to ensure hedging levels or provisions allow them some level of comfort in the case of an operational problem (or use a combination of committed and uncommitted hedging), and ensure that the hedging contract adequately provides for this situation.

## REGULATION OF GOLD DERIVATIVES

### **Industry Regulation in Australia**

This paper will not discuss in detail the regulation of gold derivatives in Australia, because as set out below, gold hedging in general, remains largely unregulated. The current regulatory regime for derivatives, although applying to instruments used for gold hedging, is not likely to have significant impact upon gold producers engaging in OTC trades for hedging purposes.

Andrew Booth discussed current and likely future regulation of derivatives in detail in his 1997 paper.<sup>66</sup> Many of the amendments to the *Corporations Act* he foreshadowed as a result of the 1997 Wallis Committee's inquiry into the financial services sector became effective in March 2002. Chapter 7 of the *Corporations Act* replaces the old Chs 7 and 8 of the *Corporations Law* pursuant to the *Financial Services Reform Act* 2001. The new provisions broadly incorporate new disclosure and licensing requirements for financial products offered by persons carrying on a financial services business. The old provisions dealing with "futures contracts"<sup>67</sup> have been repealed and replaced with the general concept of a "derivative" as a "financial product".<sup>68</sup>

There is now no doubt that OTC derivatives are included within this regulatory regime. However, the licensing and disclosure requirements should only have implications for those persons carrying on a financial services business which includes persons such as investment advisers, futures brokers, futures advisers. Exchange traded contracts will also fall under this regime and will be governed by the rules of the relevant exchange.

<sup>65</sup> Hampton, op cit n 38.

<sup>66</sup> Booth, op cit n 29.

<sup>67</sup> Section 72(1)(d) and Ch 8, *Corporations Law* 1997.

<sup>68</sup> Chapter 7, *Corporations Act* 2001.

### **Post-Enron Legislation**

Unlike in the United States, there are no current moves in Australia to introduce legislation to specifically deal with derivatives post Enron, other than in a general disclosure and audit regulation context (see below).

In the United States, various bills have been put forward in what has been described as a knee jerk reaction to the Enron collapse.<sup>69</sup>

In February 2002 proposed derivatives legislation was re-introduced into the United States Senate<sup>70</sup> which would regulate and require transparency and disclosure by eliminating exemptions granted by the *Commodity Futures Modernisation Act 2000* which excluded OTC metals commodities from regulation by the Commodities Future Trading Commission (CFTC) under the *Commodity Exchange Act 1974*.<sup>71</sup> In July 2002, an additional Bill was introduced into the Senate amending the *Commodity Exchange Act 1974* for the same purpose. Both these bills have been referred to a Senate committee for review.<sup>72</sup>

In March 2002, a separate bill was introduced into the House of Representatives to regulate all OTC derivatives, and to combine the Securities Exchange Commission and the CFTC into a single entity.<sup>73</sup> Debate on this bill is still open.

Alan Greenspan and others have publicly stated their opposition to extending federal regulatory supervision of derivatives.<sup>74</sup>

## DISCLOSURE

### **Is there Adequate Disclosure of Hedge Transactions?**

Many criticisms have been made of the lack of adequate disclosure requirements for hedge transactions from government, industry and investors. One obvious fact is that accounting and disclosure standards have not kept pace with innovations in financial markets and the growth of derivatives.<sup>75</sup> The lack of disclosure makes it difficult for

<sup>69</sup> Platts, "Mark-to-Market Accounting under Investigation Post-Enron", 10 April 2002, at <http://www.platts.com/features/energyderivatives/index.shtml>.

<sup>70</sup> It was first introduced in 2000 but was defeated.

<sup>71</sup> Platts, *op cit* n 69.

<sup>72</sup> "A Bill to Provide Regulatory Oversight over Energy Trading Markets and Metals Trading Markets, and for other Purposes" (S 2724).

<sup>73</sup> Platts, *op cit* n 69.

<sup>74</sup> *Ibid*.

<sup>75</sup> "Overview: Accounting and Disclosure", May 2000, <http://risk.ifci.ch/134940.htm>.

shareholders and investors to draw accurate conclusions on real profit as opposed to apparent profit from company's financial statements.<sup>76</sup>

This is an extremely contentious and topical issue following Pasmenco's highly publicised hedge book losses, and Enron and other recent corporate collapses. Criticisms arise primarily because OTC gold derivatives are largely unregulated, and disclosure of derivatives is essentially off-balance sheet, subjective and often overly complex and confusing. The comment has been made that nothing is black and white when it comes to accounting for derivatives – only large areas of grey.<sup>77</sup>

Although a firm can substantially change its financial risk profile by acquiring options or forward contracts to hedge or take positions on future price movements, at the current time no accounting system comprehensively and satisfactorily addresses the accounting and reporting of transactions in all kinds of derivative transactions. Different accounting treatments are allowed for transactions which are essentially the same and there are no uniform international standards.<sup>78</sup> In the context of the gold price reaching close to US\$330/oz in June, when many companies have hedge books in negative mark-to-market territory, disclosure is of critical concern to shareholders concerned about accounting fraud scandals and collapsing share prices.<sup>79</sup>

Concerns about disclosure and accounting for and reporting hedge positions have caused many investors to turn away from investments in hedged companies due to the lack of disclosure by companies regarding their hedge positions.<sup>80</sup> The details which are disclosed often have analysts perplexed by their complexity. It is important not only that details are provided, but that they are meaningful in expressing how a company assesses and manages risk, and easily understandable, verifiable and comparable.<sup>81</sup>

<sup>76</sup> Geoff Breen gives the following recent example from an Australian gold producer which illustrates the problem with current disclosure of hedging activities. In their March 2002 quarterly the company reported: a foreign exchange loss of A\$13 million by delivering US\$22 million at 73c average; a previous unrealised A\$8.9 million gain from surplus gold hedging contracts was reduced to A\$4.7 million, again unrealised; and loss on gold loan of \$4.7 million. In contrast, the off balance sheet mark-to-market value of the three hedge books was negative A\$923 million, with contingent calls over 50% of production applying well below the spot price at A\$500-520. There is no indication of the operation of the derivatives referred to, what likely exposure the company has to commodity and foreign exchange price movements, and the impact on the company as a whole. Profit declared by this company was a mere \$1.3 million, with the magnitude of the hedging losses totally overshadowing improved mine performance.

<sup>77</sup> Ibid.

<sup>78</sup> "Overview: Accounting and Disclosure" op cit n 75.

<sup>79</sup> Robert Chapman, "Gold, Silver, Platinum, Palladium and Diamonds" (2002) *The International Forecaster*, 1 June.

<sup>80</sup> "1999 Gold Mining Industry Year in Review", <http://www.kiac-usa.com/1999GSYR.html>.

<sup>81</sup> "Overview: Accounting and Disclosure", op cit n 75.

It has been suggested that companies need to provide adequate disclosure as to delivery dates on hedge contracts, delivery ounces, and prices to allow investors to estimate profit or loss contribution per period. For some time there have also been calls for the mark to market valuation to appear in balance sheets, and hedging policies to be disclosed so that investors know exactly what is happening.<sup>82</sup>

Demands by counterparties under hedge contracts are also items which should be disclosed. In November 2001 Narvan Mining, which was listed on London's AIM market, was ordered by its hedge counterparty to close off its base metal hedges. This action is generally thought to have hastened its demise which occurred the following month. Shareholders were not informed of this action, despite the fact that it was price sensitive information. The question is raised whether the company's auditors were informed of this change in policy, and why shareholders were left out.<sup>83</sup>

It is likely that in the post Enron corporate environment, auditors of gold producers will be expected to monitor hedging programs on an ongoing basis.<sup>84</sup>

As is obvious from the above, some major changes are required in this area. Equally clear, is the fact that many of the problems identified above are now being appreciated and action is slowly being taken to address concerns. The collapse of Enron and its misuse of accounting practices relating to derivatives, and the general concern about inadequate accounting, have finally prompted a self-regulating industry, to recommend changes to existing standards. Each of the United States, International and Australian Accounting Standards Boards are now considering different improvements and changes to the current accounting standards to tighten disclosure and reporting requirements. Companies themselves also appear to be making greater effort to provide adequate disclosure to satisfy investor concerns.

In the near future hopefully we will see significant changes in this area.

## **Accounting Techniques Employed**

### **Hedge accounting**

Hedge accounting permits a company to defer the gains and losses on the hedge until the time when the hedge transaction is

<sup>82</sup> "Has gold hedging switched from being a blessing to a curse", 17 January 2000, <http://www.minesite.com>.

<sup>83</sup> Ibid.

<sup>84</sup> Ibid.

completed.<sup>85</sup> In the case of gold hedging this would be when the gold or futures contract is actually sold. Until the time when the hedge is complete, any gains or losses in the value of the hedge instrument are not recorded, which can lead to abuse of the system and a lack of disclosure.

The practice of hedge accounting has led to the complicated disclosure requirements for hedge instruments in international standards IAS 39 and FAS 133, which both recommend the use of mark-to-market accounting.

### **Mark-to-market (MTM) accounting**

MTM accounting has become standard practice in the United States, United Kingdom and Australia. MTM accounting requires companies to estimate the fair value of their outstanding futures contracts at the end of each quarter. This method is useful as it gives investors an idea of the current value of the futures contract and allows them to track changes over time. However, there is no independent standard of “fair value”, which leaves valuation susceptible to creative accounting.<sup>86</sup>

A key variable in calculating MTM is market volatility, because the value of derivatives can fluctuate rapidly during the life of a contract. This is especially true for gold futures contracts due to the rapidly fluctuating spot price of gold. Therefore, MTM accounting is useful for two-three year futures contracts but not 10-20 year futures contracts, because estimation of forward curves differs in longer term contracts as it is harder to predict the marketplace.

MTM accounting allowed Enron to count profit it expected to earn from futures contracts as current earnings, meaning that it was able to boost its earnings and demonstrate quarter by quarter growth and rapid expansion.<sup>87</sup> Enron used inflated prices of the futures contracts which hid substantial debts, thereby abusing the MTM system. However, it is generally accepted MTM is an effective accounting technique when applied properly.

### **Current Disclosure Rules**

The following is a brief summary of the nature of current disclosure requirements, both in Australia and internationally, both at a general level, and specific to derivatives.

<sup>85</sup> D M Chance, “An Introduction to Derivative and Risk Management”, Harcourt College Publishers, Florida, 2001, at p 728.

<sup>86</sup> Platts, *op cit* n 69.

<sup>87</sup> *Ibid*.

### **Australian accounting standards board (AASB) standards**

Specific disclosure requirements are contained in the accounting standards set by the AASB. AASB 1034 "Financial Report Presentation and Disclosure" prescribes what a company must disclose in its financial report. Although there is no specific requirement for a hedge transaction to be recorded as a hedge, a financial report must disclose additional information that is not presented in the financial statements and that is necessary to enable an assessment of the company's financial position to be made.<sup>88</sup>

AASB 1033 "Presentation and Disclosure of Financial Instruments" specifically requires information on hedge transactions to be disclosed<sup>89</sup> but leaves substantial latitude in the hands of a company both as to how it describes such matters and what matters are described. Proposals to amend AASB 1033 and other standards to be consistent with the international standards on the issue (which are also subject to review, see below) are currently being considered. The proposed changes could have significant financial reporting implications for Australian reporting entities<sup>90</sup> as currently, there are no requirements in Australia dealing with the recognition and measurements of financial instruments. The AASB recommends that IAS 39<sup>91</sup> be adopted, which will mean the inclusion of derivatives in a company's balance sheet.

Other relevant standards which require disclosure of assets and liabilities do not require a hedge instrument to be classified as an asset or liability.

### **International accounting standards**

International accounting standards set by the United States Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB), although currently not legally binding in Australia, are also relevant.

The IASB has issued two standards governing disclosure requirements for hedges in financial accounting. IAS 32 and IAS 39 require derivatives to be measured at fair value. IAS 39 provides that hedge accounting can be applied where the hedge relationship is clearly defined, measurable and effective, and requires that hedges be included as assets or liabilities on the balance sheet and be measured at a fair value. IAS 39 requires hedges to be classified and adopts the

<sup>88</sup> Clause 5.2.

<sup>89</sup> Clause 5.8.

<sup>90</sup> AASB Media Release, "IASB Improvements of Financial Instruments Standards", 21 June 2002 and AASB Invitation to comment, "Proposed Improvements to International Accounting Standards IAS 32 and IAS 39", June 2002.

<sup>91</sup> See above the subheading "International accounting standards".

same classification of hedges as FAS 133. Improvements to IAS 31 and IAS 39 have been proposed and are currently being considered.

FAS 133<sup>92</sup> establishes accounting and reporting standards for derivative instruments and hedge transactions and requires a company to recognise all derivatives as either an asset or a liability in the statement of financial position and to measure those instruments at a fair value. The MTM accounting technique is employed to account for the gains or losses in the value of the derivative. This standard is also currently the subject of proposed amendment. ISDA is critical of the proposed amendments, and claims that the changes proposed add an unnecessary layer of complexity to an already complex standard without apparent improvement.<sup>93</sup>

### **Urgent Issues Group (UIG) standards**

Prior to the recent activity in amending proposed standards discussed above, the lack of specific disclosure requirements for gold hedging transactions was identified by the AASB. UIG Abstracts were formulated as a response to concern that the absence of authoritative guidance on the disclosure requirements for gold hedging would lead to diverse or unacceptable accounting practices which undermine the reliability and relevance of financial reporting. However UIG Abstracts are not binding.

Abstract 33 “Hedges of Anticipated Purchases and Sales”<sup>94</sup> requires hedge transactions to be accounted for as hedges, provided certain criteria are fulfilled, and requires the identification of anticipated purchases and sales intended to be hedged. Additional regulation is contained in Abstract 18 “Early Termination of Gold Hedges”<sup>95</sup> which requires gains or losses from hedges which are terminated early to be accounted for. Abstract 25 “Redesignation of Hedges” issued at the same time, also requires gains and losses from the hedge before it is redesignated to be accounted for.

### **Australian Gold Council (AGC) standards**

In recognition that the extent of disclosure of hedge transactions by gold producers has varied greatly around the world, the AGC released a standard intended to be a uniform minimum standard of disclosure in order to maintain investor confidence.<sup>96</sup> The new standard was designed to improve the format and level of disclosure of hedging of

<sup>92</sup> Produced by the Financial Accounting Standards Board.

<sup>93</sup> Letter dated 1 July 2002 to Financial Accounting Standards Board, published <http://www.isda.org.com>.

<sup>94</sup> May 2000.

<sup>95</sup> December 2000.

<sup>96</sup> AGC Media Release, “AGC Launches Hedging Derivatives Standard”, 3 October 2000, <http://www.australiangold.org.au>.

precious metals and foreign currency by gold producers, and to formalise the disclosure of gold producers' revenue management activities and positions in financial reports.<sup>97</sup>

Information such as A\$ and US\$ denominated ounces the subject of forward sales, call options sold, put options purchased and other hedging, estimated net realised price, strike price and other relevant information including total committed ounces and total hedged ounces are required to be disclosed.

This standard formalisation of hedge transactions is estimated to have been adopted by over 90 percent of Australian gold mining groups in their financial reports.<sup>98</sup>

### **Australian Stock Exchange (ASX) listing rules**

As most gold producing companies are listed on the ASX they must also comply with the ASX listing rules for financial reporting and disclosure. The ASX requires half-year and annual reports (in the format of Appendix 4B) to be lodged with the ASX and distributed to shareholders. Appendix 4B does not specifically require hedge transactions to be disclosed as hedges in the report. However, under r 3.1 once a company becomes aware of information that a reasonable person would expect to have a material effect on the value of the company's securities, the company must inform the ASX immediately. It is questionable whether this requirement is enough to ensure that gold companies disclose their hedge transactions, although such a requirement would be highly desirable.

### **Corporations Act and Corporate Economic Reform Program (CLERP)**

Companies have obligations under the *Corporations Act* to prepare financial reports which must give a true and correct view of the financial position and performance of the company.<sup>99</sup>

In June 2002 CLERP 9 was announced, with an Issues Paper covering audit regulation and corporate disclosure due for release this month. Final legislation is expected in 2003, and will take into account current events in the United States with respect to disclosure.<sup>100</sup>

### **Future Directions**

Changing accounting standards will clearly have some impact upon how derivative transactions are reported. Whether they will address

<sup>97</sup> Ibid.

<sup>98</sup> Australian Gold Council, "After 'conflict diamonds' could we have 'guilt free' gold?", [http://www.minesite.com/archives/features\\_archive/2001/Sept-2001/agc10.htm](http://www.minesite.com/archives/features_archive/2001/Sept-2001/agc10.htm).

<sup>99</sup> Chapter 2M, *Corporations Act* 2001.

<sup>100</sup> Michael Dulaney and Sharon Wilson, "Crisis in Corporate Confidence: The Regulatory Response" (2002) 21(2) AMPLJ 162.



the issues concerning equity markets and investors all over the world remains to be seen.

The Australian Securities and Investment Commission (ASIC) has recently warned the boards of all listed companies to sign off on accurate accounts, after the wave of dubious reporting revelations in the United States. ASIC has launched a new crackdown on company reporting, forming a taskforce to analyse the issues that have dented investor confidence across global markets. Certain AASB standards are reported to be under scrutiny. ASIC has stated that companies who have doubts about the correct accounting treatment of transactions should contact auditors, or even ASIC itself prior to finalising their financial reports.<sup>101</sup>

## CONCLUSION

In conclusion, recent developments have seen a lot of attention given to hedging activities by shareholders, companies and regulatory bodies, which has been reflected in the financial press.

Companies are generally reducing their hedge books and increasing their exposure to upwards movement in the gold price, sometimes for the first time in over a decade. This is not only because of the more positive outlook for the gold price, but because of the greater understanding companies have of some of the risks inherent in the use of derivatives, and what is emerging as a global investor preferences for stocks in less heavily hedged companies. The problem of investor confidence as a result of Enron and other highly publicised hedging losses and the lack of adequate disclosure standards in this preference should not be underestimated.

From a regulatory position, the collapse of Enron and other major corporations has focused attention both on general disclosure issues relating to off-balance sheet liabilities, and on specific issues relating to derivatives. It is hoped that recent reviews of accounting standards and legislation will make the situation clearer for investors and curb some of the excesses of the derivatives market. It is also to be hoped that gold producers themselves increase their disclosure to shareholders and meet, and exceed disclosure requirements. It is only by increasing such disclosure that investors will again become comfortable with heavily hedged stocks, and investor preferences swayed.

<sup>101</sup> Bill Pheasant, "ASIC urges closer check on company reporting", *The Weekend Australian Financial Review* 13-14 July 2002.

Despite all this, hedging is likely to continue to be an important part of the gold industry, both for risk management and speculation purposes. This will particularly be the case if some of the issues raised in this paper can be satisfactorily addressed. Many Australian and global gold producers have recently confirmed their commitment to hedging,<sup>102</sup> although some reductions or changes in strategy may occur.

To conclude, it is clear that if hedging is carefully managed and used with due regard to the risks being hedged against and the risks inherent in derivatives use, it can be an important financial tool and an effective way for companies to manage the risk they face in a volatile market. If this is done, and appropriate disclosure standards are set, maintained and enforced, it is likely that hedging in the future will be more readily accepted by both regulators and shareholders and will gradually stop being associated with the risky practices and losses of the past.

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<sup>102</sup> Sons of Gwalia most recently.