SECTION II: EXECUTIVE SUMMARY AND RECOMMENDATIONS

In order to place this Report's "Recommendations" and "Guiding Principles" in perspective, this section of the Report will begin with an overview of the causes, triggers and dynamics of contemporary financial shocks which have the potential to take on systemic characteristics.

As a starting point, a distinction must be drawn between financial disturbances and systemic or potentially systemic financial shocks. Financial disturbances arise with some frequency and can have their origins in a number of factors ranging from a geopolitical event such as September 11 to a failure of a specific financial or non-financial corporation. However, financial disturbances do not exhibit the very rapid contagion effects present in financial shocks as discussed below. The absence of rapid and far reaching contagion effects may be due to any number of factors including: (1) the event was widely discounted in the first place, (2) public or private policy responses are swift and decisive, and/or (3) the event does not raise broad-based concerns about potential or actual credit losses that could compromise the ability of financial counterparties to perform in a manner consistent with their obligations. Credit-related problems, as discussed below, are of special concern because — as we have seen on many occasions — financial markets have a remarkable capacity to cope with financial disturbances so long as widespread credit problems are not seen as an imminent threat. Experience also shows that the fact or the fear of large credit losses is often the key variable through which financial disturbances become financial shocks.

With that distinction in mind, it is fair to say that the past twenty-five years have witnessed dozens of financial disturbances, but only a very small number of financial shocks having potential or actual systemic consequences that caused major damage to the financial system and the real economy. In fact, over the past twenty-five years there were probably only three financial shocks that, by most counts, achieved the "red zone" characteristics of systemic risk. They were:

- The LDC debt and banking crisis of the early to mid 1980s;
- The stock market crash of 1987; and

- The Asian, Russian and LTCM crises that culminated in the late summer and early fall of 1998.

There were also a number of "near misses," centering on situations that had the potential to become very serious, but did not. One example of such near misses was the seriously weakened financial condition of a number of very large banks and non-bank financial institutions in the late 1980s.

With the benefit of hindsight, it is not difficult to draw distinctions between financial disturbances and financial shocks. Unfortunately, in real time it is virtually impossible to draw such distinctions. Indeed, neither financial market participants nor policy makers have a good track record of anticipating the specific triggers — or their timing — that will cause financial disturbances, much less distinguishing in advance which disturbances have the likelihood of taking on shock-like features with systemic properties. In fact, even when the threat of a major financial disturbance is recognized by many — as for example, recent concerns about a dollar crisis or a significant rise in credit spreads — such awareness of a threat provides little assurance that the marketplace in general will anticipate whether, when and with what degree of severity such a disturbance will actually occur, much less anticipate whether the fact of the disturbance will have potential systemic implications.

In other words, while great progress had been made in containing financial disturbances, rare but potentially virulent financial shocks may occur with little, if any, warning. Thus, while the specific triggers and precise timing of these very low probability events cannot be anticipated, it is possible to look at after-the-fact experiences with such events and to draw lessons which may be helpful in order to avoid future problems or at least limit their adverse consequences. For example, the recent history of both financial disturbances and shocks tells us something about their behavioral characteristics which may be relevant for the future. At the risk of gross oversimplification, for example, there are three traits that seem to have been associated with major financial shocks in the past. These traits are as follows:

- First, the triggering event or events cause sharp and sudden declines in one or more classes of asset prices. The decline in asset prices is sufficiently steep to raise questions about the creditworthiness of major counterparties or institutions such that the analytical distinction between market risk and credit risk blurs as market risk and credit risk feed on each other.

- Second, the combination of falling asset prices and the erosion of creditworthiness causes market participants to commence risk mitigation efforts such as position liquidations which — while perfectly reasonable at the micro level — add to macro pressures on asset prices which in turn trigger the initial evaporation of market liquidity for one or more classes of assets. The evaporation of asset liquidity aggravates both market and credit risk and begins to call into question balance sheet liquidity for some institutions. Investor position liquidations intensify these pressures.

- Third, in these circumstances, once seemingly generous amounts of margin or collateral are rapidly called into question, thereby dramatically elevating credit concerns. The escalation of credit concerns further influences the defensive behavior of financial market participants, all of which acts to reinforce the cumulating adverse market dynamics. Hence, a financial crisis with potential systemic risks is at hand.

In reality, the dynamics discussed above are not sequential but are virtually simultaneous in that they interact quickly to form a financial “perfect storm.” The financial perfect storm has certain traits in common with its meteorological cousin in that its exact timing and severity cannot be predicted with any precision. However, as with the meteorological perfect storm, we do know something about the preconditions that can influence the severity of the financial perfect storm and we can take steps in advance that will help to limit its damage. For example, in thinking about the simplified dynamics of financial shocks outlined above, it is not difficult to identify a number of factors that lie beneath those dynamics and may help to better understand and anticipate gathering financial storms and thus limit their prospective damage. The Policy Group believes that better anticipating financial shocks and being better positioned to limit their severity centers on the following ten fundamentals:

- First, credit risk, and in particular counterparty credit risk, is probably the single most important variable in determining whether and with what speed financial <u>disturbances</u> become financial <u>shocks</u> with potential systemic traits.

- Second, the evaporation of market liquidity is probably the second most important variable in determining whether and at what speed financial disturbances become financial shocks with potentially systemic traits.

- Market liquidity will be importantly influenced by the presence of "crowded trades" in the financial marketplace in circumstances in which crowded trades are inevitable. The hard reality is that individual financial institutions will never be able to anticipate the order of magnitude of such crowded trades even if it is true that the most sophisticated market participants are able to develop a sense of gathering crowded trades.

- In periods of acute market stress, market liquidity can largely evaporate even in what is normally the most liquid of markets. When this occurs, a downward pressure on asset prices intensifies.

- Third, the value of many classes of complex financial instruments can change very rapidly even in a matter of hours or days. Rapid changes in value can be especially pronounced for instruments having "embedded leverage."

  - The risk of rapidly changing prices can be of particular consequence with highly complex instruments in an environment in which investor behavior is influenced by the "reach for yield" phenomenon.

- Fourth, even in normal circumstances, determining the value of many classes of financial instruments is very difficult and often heavily dependent on complex proprietary models.

  - The fact that many financial institutions use broadly similar analytical tools to model price changes in response to external events heightens the risk of precipitous price changes in the face of crowded trades

  - Because of this, final authority for valuations must be vested in a business unit that is fully independent of the revenue producing businesses.

- Fifth, most statistically driven models and risk metrics such as value at risk calculations fail to capture so called "tail events." As such, their use must be supplemented by a wide range of complementary risk management techniques, such as stress tests and hybrid VaR measures that take account of market liquidity.

  - For example, model-driven correlation estimates between the properties of various classes of activities — or even between measures of creditworthiness of individual companies or counterparties — can change very rapidly and in ways that statistical measures cannot anticipate.

- Sixth, the integrity and reliability of all elements of financial "infrastructure" including, for example, payments, settlement, netting and close out systems — as well as the smooth functioning of back offices, especially in times of stress — are critical risk mitigants and must be managed and funded accordingly.

- Seventh, many classes of financial institutions including banks, investment banks, hedge funds and private equity funds now have sizeable investments in assets that are highly illiquid even in normal market conditions.

    - The valuation of such assets is very difficult.

    - Stress tests are one of the few risk management tools that can provide insight into the downside financial risks associated with such investments.

- Eighth, the day-to-day costs of comprehensive risk management and control-related functions for financial intermediaries are very substantial. Indeed, for the largest and most complex intermediaries, such costs can run into the tens or even hundreds of millions of dollars per year. While such costs are related to size and complexity, for smaller intermediaries and users the costs associated with core risk management capabilities are substantial and may outweigh the potential of higher returns associated with higher levels of risk tolerance. Thus, while smaller intermediaries and end-users of complex financial products may appropriately look to outside experts for advice and guidance in the use of these complex instruments, they should also recognize that they themselves must ultimately accept responsibility for their decisions. If the operating costs of effective end-to-end risk management are seen as too high to bear, the logical conclusion may be that the risks are too great — a judgment that can only be made at the highest level of management.

- Ninth, in the past, one of the great strengths of the financial system has been its capacity to organize and execute restructurings for troubled but viable companies and countries. Such restructurings typically occurred through groups of primary creditors having a major financial interest in the outcome. To the extent such primary creditors now use the credit default swap market to dispose of their credit exposure, restructuring in the future may be much more difficult.

- Tenth, since we know that financial disturbances and even financial shocks will occur in the future, and we know that no approaches to risk management or official supervision are fail-safe, we also know that we must preserve and

strengthen the institutional arrangements whereby, at the point of crisis, industry groups and industry leaders, as well as supervisors, are prepared to work together in order to serve the larger and shared goal of financial stability.

A central and recurring theme to every aspect of this Report is, in a word, complexity. Indeed, there is literally nothing about the subject matter of the Report that is simple, straightforward and one-dimensional. For example, even the seemingly mundane — but critically important — back-office operations of all classes of financial institutions are now enormously complex and entail sizeable elements of financial, operational and reputational risk.

The reality of complexity gives rise to an apparent paradox. Namely, at first blush, it would seem that complexity gives rise to the need for ever more detailed "Rules of the Road" in order to manage and control the risks inherent in such a complex business environment. However, while rules have their place, the fundamentals of managing financial risks in today's complex environment are not to be found in excessive reliance on a rules-based framework for risk management.

Thus, the fundamentals of managing risk in the face of heightened complexity point not to the need for more rules but rather to the time-honored basics of managerial competence, sound judgment, common sense and the presence of a highly disciplined system of corporate governance. The stress placed on these fundamentals is not a substitute for needed rules but it is a forceful reminder that the cause of financial stability is more rooted in these fundamentals than it is in highly prescriptive rules. Thus, a central feature of the underlying philosophy of this Report is the Policy Group's belief that still more effective financial risk management calls for striking a better balance between principles and rules.

Reflecting that philosophical tilt, the Report includes both "Recommendations" and "Guiding Principles." The distinction between "Recommendations" and "Guiding Principles" is narrow but meaningful. The term "Recommendation" as used in this context points to a reasonably specific and well-defined course of action the Policy Group believes should be followed. In contrast, "Guiding Principles" are typically more directional in nature and less specific in content.

In using this approach, the Policy Group is mindful that some might suggest that reliance on such Guiding Principles is seriously flawed in that these principles frustrate the cause of accountability on the part of individual institutions. Recognizing the legitimacy of that

concern, the Guiding Principles are framed in language and sufficient detail that auditors, accountants, senior management, board audit committees and official supervisors should be able to determine with relative ease whether individual institutions are adhering to the intent of the Guiding Principles.

While the Report contains a relatively large number of Recommendations and Guiding Principles, this relatively large absolute number should not be interpreted as symptomatic of widespread evidence of shortcomings on the part of individual institutions. To the contrary, financial institutions have made great progress in strengthening their practices in the areas covered in this Report. Moreover, the Report is very broad in its reach and most of its Recommendations and Guiding Principles are distinctly forward-looking. Because they are forward-looking, the Policy Group strongly believes that widespread support for and adherence to these Recommendations and Guiding Principles will make a significant and ongoing contribution to the universally accepted goal of financial stability.

The Recommendations and Guiding Principles which follow are classified into one or more of the following categories:

- Category I are actions that individual institutions can and should take at their own initiative.
- Category II are actions which can be taken only by institutions collectively in collaboration with industry trade groups.
- Category III are actions which require complementary and/or cooperative actions by the official sector.

In the summary presentation that follows, the Recommendations and Guiding Principles are presented in the order in which they appear in the Report. The page numbers listed below are the pages in the Executive Summary in which each section of Recommendations and Guiding Principles appear. In turn, individual Recommendations and Guiding Principles are referenced to the page numbers in the full text where the subject matter is discussed.

Section III:	*Risk Management and Risk-Related Disclosure Practices*	Pages 13 to 18
Section IV:	*Financial Infrastructure: Documentation and Related Policies and Practices*	Pages 18 to 24
Section V:	*Complex Financial Products: Risk Management, Risk Distribution and Transparency*	Pages 24 to 34
Section VI:	*Emerging Issues*	Pages 34 to 40

A. Recommendations and Guiding Principles: Risk Management and Risk-Related Disclosure Practices (Section III, pages 41 to 68)

1. Improving Transparency and Counterparty Credit Assessments

1. *Recommendation, Category I (pages 45 to 46)*

Where market participants lack sufficient relevant information prior to making a credit decision, CRMPG II recommends that they seek entity-level portfolio and other data from counterparties on a private and confidential basis, to the extent such information is needed to accurately assess credit quality. CRMPG II further recommends that market participants attempt to periodically review the risk metrics, stress test methodologies, behavioral characteristics of models and other analytics used by their counterparties' risk managers in assessing the entity's overall risk profile; that they assess both the quality of the processes and systems that generate the counterparties' data, as well as the details of the associated market scenarios; and that they run their own sensitivities on the institution-specific portfolio, when required. Where appropriate, additional information should be requested from counterparties based on the results of running these sensitivities. As part of the due diligence process, CRMPG II recommends that credit providers also obtain disclosure of contingencies that may have a material impact on the credit quality of the counterparty (e.g., increases in collateral requirements due to rating triggers, etc.). The scope of requests for information may depend on the quality and availability of data on a given counterparty in the public domain, as well as the size and nature of exposure. Where satisfactory information is not available, market participants should adjust their credit parameters accordingly.

When determining how much information to provide on a confidential basis to their counterparties, market participants should recognize that provision of relevant credit data increases the level of the counterparties' comfort and improves the likelihood that access to credit will remain during periods of systemic and institutional stress. CRMPG II recommends that credit users and OTC market participants seek a proper balance between preserving proprietary information and providing information that will enable their counterparties to gain an appropriate level of understanding of their management, investment process and philosophy and material risks.

2. *Recommendation, Category I & II (page 47)*

   CRMPG II recommends that trade associations, such as the Global Documentation Steering Committee, continue efforts to attract widespread acceptance of documentation standards for the treatment of confidential information. Individual firms should also continue to independently develop and refine their internal policies and procedures for managing sensitive client data and endeavor to address confidentiality issues raised by counterparties by disclosing and following such policies and procedures with regard to confidential materials. CRMPG II further recommends that firms evaluate and understand the operational risks associated with customized legal documents that deviate from the firm's existing procedures for the handling of confidential counterparty information and take such risks into account when considering such agreements.

3. *Recommendation, Category I (pages 48 to 50)*

   CRMPG II recommends that market participants continue to work to improve their understanding of their own portfolios, and to identify portfolio concentrations to a security or a market factor. Credit and market systems should be enhanced to better approximate directionalities across clients and products by risk factor. Credit systems should isolate the key risk factors that drive exposures, including exposures arising from complex transactions, and ensure that risk metrics fully reflect the impact on performance, based on movement of the underlying factors. Those key risk factors should be aggregated across the portfolio to assess the degree to which concentrations exist. This information is useful in assessing the credit quality of counterparties, in addition to providing some insight into crowded trades.

2. Improving Risk Measurement, Management and Reporting

4. *Guiding Principle, Category I (pages 51 to 52)*

   Investment in risk management systems should continue to be a high priority and will almost certainly require greater resources in the future. Full testing and validation prior to use is essential, keeping in mind that model verification should be performed independently of the business units. Market participants should avoid over-reliance on any one model or metric when analyzing risk; rather, a portfolio of analytics including stress tests, scenario analysis and expert judgment should be employed. Special attention should be paid to the

assumptions underlying these models and on understanding the impact on the results if inputs and assumptions turn out to be incorrect. The resiliency and reliability of such models should be regularly reviewed through independent periodic verification of both pricing and risk models, given that the former often provide multiple inputs for the latter.

5. *Recommendation, Category I (pages 53 to 56)*

   5a. CRMPG II recommends that collateral be used as a tool to address material differences in transparency and credit quality of counterparties, as well as to reflect asymmetry of exposure profiles. Credit terms, including margin arrangements, should be established at levels that are likely to be sustainable over time. The Policy Group believes that initial margin is an important credit risk mitigant and that the establishment of prudent initial margin requirements at the commencement of a trading relationship can play an important role in promoting financial stability during periods of stress. In addition, CRMPG II recommends that market participants continually review their collateral policies, practices and systems, and where necessary formulate remediation plans.

   The development of model-based portfolio margining programs is useful in mitigating counterparty risk by relating the amount of initial margin to the underlying risks. However, because the amounts of required margin may increase with changes in volatility, users should fully analyze the liquidity and risk management impact of potential margin requirements during times of market stress.

   5b. CRMPG II recommends that financial institutions be alert to the potential for overall leverage in the system to increase (arising from a liberalization of credit terms, increased utilization of credit facilities under pre-existing terms, or the development of new structures that facilitate the taking of leveraged positions in new forms); that financial institutions carefully monitor their resulting actual and potential credit exposures; and that in determining what actions are appropriate they take into consideration both individual counterparty and sectoral risk issues. CRMPG II recommends that financial institutions understand how counterparties analyze their own funding liquidity and leverage

levels, and consider whether collateral levels are appropriate relative to funding flexibility.

5c. CRMPG II recommends that financial institutions ensure that their risk measures and analyses comprehensively capture a full range of actual and contingent exposures, such as committed funding arrangements. As further discussed in Section IV, market participants should ensure that netting and collateral enforceability are appropriately reflected in risk measures. Dealers should also make certain that in the context of term commitments and similar arrangements, their credit policies appropriately reflect the creditworthiness of the counterparty. These commitments, as well as collateral policies and practices, should be reported periodically to senior management.

6. *Recommendation, Category I (page 57)*

CRMPG II recommends that financial institutions implement robust credit pricing models, as recommended by CRMPG I, and measure and report returns adjusted for credit costs. Firms should expand their models to incorporate the risk of counterparty default and portfolio volatility and carefully evaluate the correlation of exposures to the likelihood of counterparty failure. The impact of collateral should be considered, such that increases in collateral reduce expected counterparty loss and therefore the implied credit cost.

7. *Guiding Principle, Category I (pages 58 to 60)*

The sophistication of stress tests, scenario analyses and liquidity-adjusted metrics as alternative and sometimes more appropriate measures for credit exposures should continue to be enhanced, and the exposure information that they contain should be carefully and regularly considered by risk practitioners and senior management, with additional elevation of stress test findings to senior management when appropriate. Whether based on historical events or hypothetical events, scenarios used for stress testing should be plausible, so as to resonate with the users and senior management. When analyzing exposure measures, institutions should consider the status and adequacy of trade-related documentation.

8. *Guiding Principle, Category I (pages 61 to 62)*

   Financial market participants should re-emphasize recruitment, training and retention of skilled credit analysts and market risk managers who understand their clients and the strategies clients employ, as well as the dynamics of complex portfolios under stressed circumstances. Firms should ensure adequate staffing levels, independent of the trading units, to allow credit analysts to spend sufficient time with clients in order to obtain and maintain a comprehensive understanding of their business and credit characteristics. Additionally, operations and risk management areas need to be staffed so that they can function adequately through periods of market stress.

3. Prime Brokerage

9. *Recommendation, Category I & II (pages 63 to 67)*

   The volume of prime brokerage business continues to grow substantially. While properly executed prime brokerage activities have the potential to reduce overall systemic risk, they are also subject to a variety of legal, operational, credit and other risk challenges. To mitigate those issues, CRMPG II recommends that significant industry participants intensify industry-sponsored efforts to define the important relationships among hedge funds and other customers, executing dealers and prime brokers across all product areas and business lines. In addition, each participant in the prime brokerage market, whether executing dealer, client or prime broker, should on an ongoing basis maintain a full and clear understanding of the risks (e.g., credit, market, contractual and operational) that it incurs in this market, its internal controls and its contractual relationships, taking into account the credit, market and operational factors that can arise in these three-way arrangements. As a component of this Recommendation, prime brokers should ascribe a high priority to actively monitoring the credit quality of each of their counterparties, including conducting regular due diligence calls and/or meetings.

   Participants should consider the development of cross-product prime brokerage and netting agreements that would comprehensively address credit, commercial and risk issues. Such agreements could incorporate by reference each underlying master trading agreement that may have been entered into, and serve to harmonize disparate credit and other material

commercial terms such as events of default, cure periods and close-out procedures.

As derivative prime brokerage products develop further, market participants should continue to work with industry groups to standardize terms and agreements that govern give-up arrangements. Participants need to ensure that they have the operational capability to monitor and track transactions executed pursuant to those arrangements. The magnitude of current and prospective prime brokerage trading volume is such that systems and processes must be automated further through solutions like straight through processing.

B. Financial Infrastructure: Documentation and Related Policies and Practices (Section IV, pages 69 to 118)

1. Documentation Policies and Practices

10. Guiding Principle, Category I (page 72)

Market participants should look to the GDSC publication, "How to Improve Master Agreement and Related Trading Agreement Negotiations — A Practitioner's Best Practice Guide," for guidance in negotiating master agreements. The Best Practice Guide suggests certain time frames for completing the negotiation of master agreements, and market participants should also prioritize the negotiation of unsigned master agreements by assessing portfolio exposure; evaluating unsigned master agreements in combination with unsigned confirmations; looking to collateral, counterparty type and counterparty jurisdiction in assigning risk to unsigned master agreements and confirmations; and identifying which ongoing negotiations are with prospective versus live counterparties.

11. Recommendation, Category I (page 73)

CRMPG II recommends that market participants also ensure that credit, legal and documentation departments and the relevant businesses have access to master agreements themselves and an understanding of their content, and should consider developing a process to identify agreements in need of updating.

2. Operational Efficiency and Integrity

12. Recommendation, Category I & II (pages 74 to 75)

Market participants recognize the immediate need to address the backlog of unsigned confirmations on an industry-wide basis and are currently committing substantial resources to its resolution. CRMPG II recommends that, as a matter of urgency, market participants apply additional resources to this task, take part in and strongly encourage the development of electronic trade matching and confirmation generation systems and work together as well as cooperatively with trade associations to identify and implement solutions. In addition, market participants should make use of one or more of the following: using master confirmations, circulating drafts of structured confirmations pre-trade, pre-negotiating short form confirmations pre-trade, signing or initialing term sheets pre-trade and orally verifying material trade terms promptly after trade date. Moreover, individual institutions should periodically inform senior management and their primary regulator about progress being made in reducing confirmation backlogs. In extreme cases, senior management should be prepared to consider whether trading volumes need to be reduced until the backlog is normalized. CRMPG II endorses the convening of an industry-wide roundtable in the near term to focus on aggressively reducing confirmation backlogs by working toward further technological and operational enhancements, and by strengthening back-office operations.

13. Guiding Principle, Category I & II (page 76)

In addition to the pressing tasks outlined in Recommendation 12, market participants should also engage in industry initiatives to identify and develop effective methods of monitoring and addressing backlogs and compliance with policies, use internal audit or other independent mechanisms to identify shortcomings and measure progress and foster vigorous governance and management controls.

14. Guiding Principle, Category I & II (pages 77 to 79)

Electronic trade assistance services promote efficiency and confidence in the markets, and both market participants and trade associations should strongly encourage automation in the processing of OTC transactions. Automation, including electronic trade affirmation and matching and straight through

processing, is a key risk mitigation device, at least in part because most risk metrics assume the existence of an underlying, undisputed transaction. Automation must be pursued whether or not it presents any short-term economic benefit.

15. Recommendation, Category I & II (pages 80 to 84)

CRMPG II recommends that trade associations and market participants must pursue and develop straight through processing of OTC transactions, a critical risk mitigant in today's high volume markets. As a fundamental matter, disputes over the existence or the terms of a transaction have the potential for enormously increasing risk, since each party to the disputed transaction hedges and risk manages the disputed trade based on certain economic assumptions. STP reduces the number and frequency of trade disputes and maximizes market efficiency, opportunity and access. STP therefore fosters legal, credit, market and operational certainty.

3. Netting, Close-out and Related Issues

16. Guiding Principle, Category I, II & III (pages 85 to 100)

16a. Market participants should decide bilaterally which of the three ISDA close-out methodologies would be most appropriate in the context of their trading relationship. As market participants gain experience in the use of Close-out Amount and as products and portfolios change, market participants should continue to evaluate the efficacy of the three ISDA methodologies against the objective of achieving close-out valuations that benefit both from the transparency and objectivity obtainable through market quotations for liquid products during normal markets, and the flexibility necessary to determine close-out valuations across the range of products they trade and the conditions of market stress they are likely to confront over time.

16b. Market participants should pursue opportunities to facilitate payment netting. This may mean continuing to develop systems and operational capabilities. Equally important, where industry standard documents provide for payment netting as an option, more parties need to make this election and put it broadly into practice to take better advantage of this settlement risk-reducing mechanism.

Market participants and trade associations should also review the Group of Thirty's Monitoring Committee on Global Clearing and Settlement interim report, published in April 2005, which discusses progress made since the January 2003 publication of the G30's *Global Clearing and Settlement: Plan of Action*. The G30 Plan of Action and interim report provide excellent guidance in the areas of interoperability, risk management and governance with respect to global securities clearing and settlement, and should be considered in the OTC derivative context.

16c. Rules governing capital computations have a major impact on the breadth and depth of financial markets and financial product trading activity. It is essential that those rules favor the use of risk-mitigating tools such as cross-product netting and not restrict their use through regulatory requirements unrelated to the goal of systemic risk reduction. Intraproduct, cross-product and cross-affiliate netting and collateral arrangements should be recognized and given full netting benefit when there is a well-founded basis for believing that they are legally enforceable. Supervisory regulators should not impose additional requirements that restrict the use of such netting arrangements.

16d. Trade associations and market participants should adopt as a best practice the pursuit of cross-entity and cross-product netting and cross-default provisions in master agreements governing OTC trading relationships. Increased use of such provisions will achieve greater efficiency and reduce market and counterparty risk in default scenarios by ensuring the swift and consistent termination of transactions across-product lines.

16e. To the extent industry documentation does not already include such provisions, trade associations and market participants should make it a best practice to define clearly the termination rights of parties to OTC transactions upon the occurrence of changes in law, changes in tax rules, regulatory changes or governmental actions. A termination "road map" is particularly important in circumstances where performance would otherwise be substantially more difficult or expensive, or be subject to substantial uncertainty.

16f. Recent occurrences, perhaps most notably the events of September 11, 2001 have served as a reminder of the need for force majeure provisions in trading documentation. Market participants should clearly address the consequences of force majeure events, including any delays in performance, in their master agreements to minimize disruption and uncertainty in the markets. While force majeure provisions in trading documentation may allow for delays in performance, in no circumstances should any party able to walk away from its obligations as a result of the occurrence of a force majeure event.

16g. Market participants should continue to harmonize and centralize counterparty credit risk assessment, and should strive for speedy and efficient identification of counterparty exposure across-product lines. To achieve such goals, market participants should develop systems and operational enhancements, utilize the internal audit function or other independent mechanisms and foster strong corporate governance, as appropriate. Trade associations should work with their membership to identify common concerns in this area and seek solutions.

17. Guiding Principle, Category II (pages 101 to 105)

The productive discussions in the markets in relation to the 1999 recommendation of CRMPG I on documentation harmonization should intensify. The fundamental mission of the GDSC, which was created as an outgrowth of CRMPG I, was to harmonize documentation standards and reduce documentation basis risk, and market participants should accordingly make it a <u>best practice</u> to facilitate harmonization and consistency in documentation standards. To that end, new standards should be incorporated in existing documentation to the extent possible, and new documentation should be used on a forward basis. Market participants should work cooperatively with trade associations to achieve greater harmonization.

18. Guiding Principle, Category II (page 106)

Collateral managers and other market participants should explore the development of standardized, automated processes for clearing, settlement and portfolio reconciliation of high volume ”vanilla” OTC products.

4. Credit Derivatives

19. Recommendation, Category I (pages 107 to 109)

CRMPG II recommends that financial intermediaries and end-users of credit derivatives redouble their efforts to ensure that they fully understand the nature of their credit derivative transactions and the similarities and differences between those transactions and other credit positions and exposures. In this regard, it is very important that market participants be thoroughly familiar with the terminology used to document credit derivatives, and the nuances surrounding various terms.[1] Market participants should be aware that credit derivative transactions may intentionally or unintentionally give rise to other risks, including retained credit risk, counterparty credit risk, legal risk, operational risk and concentration/liquidity risk.

20. Guiding Principle, Category I & II (pages 110 to 112)

Industry participants should continue to identify potential areas of confusion or misunderstanding and seek to develop or refine market practices or conventions, and the accompanying documentation, to eliminate or mitigate such areas of confusion or misunderstanding.

21. Recommendation, Category II (pages 113 to 114)

CRMPG II recommends that industry participants build on the experience gained through recent ad hoc multilateral initiatives and work to develop a standardized multilateral process for the exercise and settlement of both outstanding and future credit derivative transactions on a simultaneous net basis. The development of such a process should consider the use of electronic platforms to reduce the strain manual settlements place on the back-office resources of market participants and to further transition the market toward straight through processing.

[1] (Unless otherwise defined herein, capitalized terms have the meanings used in ISDA's 2003 Credit Derivatives Definitions.) In a standard credit default swap, the "buyer" of the protection agrees to make periodic payments to the seller of the protection in exchange for the seller's commitment that, upon the occurrence of certain credit default-related events with respect to a named legal entity (the "Reference Entity"), the buyer will have the right to deliver loans or securities to the seller in exchange for an agreed upon amount (typically par). The events that parties most frequently agree to as triggering events are "Bankruptcy," "Failure to Pay," "Repudiation/Moratorium" (for sovereigns only) and "Restructuring," each of which is a complex defined term under the ISDA's 2003 Credit Derivatives Definitions.

22. Recommendation, Category I & II (pages 115 to 116)

Trade assignments require the same rigorous controls and discipline as new transactions. It is critical that market participants know their counterparty, and therefore, prior consent to assignments must be obtained. Specifically, CRMPG II recommends that market participants should not assign or accept assignments of transactions without the consent of all three parties. All market participants should initiate and take part in industry initiatives designed to facilitate compliance with the prior consent requirement can be more easily met. Industry efforts in this regard should include the use of electronic platforms to further the transition of the market toward straight through processing of assignments. With respect to existing assignments, CRMPG II urges market participants to dedicate substantial resources to ensure that these assignments are properly identified and properly documented.

CRMPG II recognizes that the prospective practices described above will require a transitional period and that it would be unreasonable to expect full implementation immediately. Nonetheless these goals should be achieved in the near term, and in the interim, market participants should keep senior management apprised of the progress being made in identifying and documenting assignments.

C. Complex Financial Products: Risk Management, Risk Distribution and Transparency (Section V, pages 119 to 138)

The Guiding Principles above related to managing market and credit risk provide a strong foundation for improving counterparty risk management practices across a full range of activities. CRMPG II believes that the complexity associated with recent product innovation raises the bar for financial intermediaries with respect to their risk management practices. Accordingly, the Guiding Principles below supplement those in Section III of the Report and are intended to help firms active in complex transactions achieve a high standard of risk management discipline.

23. Over-riding Guiding Principle, Category I (pages 126 to 127)

Senior management and business managers at financial intermediaries must rely first and foremost on sound judgment based on experience and the fundamentals of managing risk.

It is a core belief of Policy Group members that this Guiding Principle provides the foundation for strong risk management practices. In this regard, senior management and all relevant business managers at firms engaging in complex transactions should ensure that they: (1) understand the essential risk elements of the instruments their firms are buying and selling; (2) implement a well-developed process to ensure that reputational risks are adequately addressed and fit into the relationship framework being sought between firms and their clients; (3) understand the nature of the risk associated with the positions their businesses have taken; (4) understand the limitations of the pricing and risk models applicable to the instruments; (5) adjust risks tolerances and associated limits based on those limitations; (6) receive information that allows them to determine whether the risk positions are within agreed upon limits; and (7) hold business line personnel accountable for the financial, risk and operational performance of the activity.

1. Governance-Related Guiding Principles

24. Guiding Principle, Category I (pages 127 to 128)

New products and major variants of existing products should be subject to a systematic review and approval process by a senior level committee or similar group. The new product approval process should, at a minimum, have the following features:

- Effective internal communication as to the classes of activity that are subject to the review process.
- The involvement of independent control personnel.
- Reasonable expectations that the necessary operational and related infrastructure to support the new product are in place.
  - To the extent that such expectations are not being realized, management should be prepared to limit or curtail such business until the support infrastructure is well established.

- Adequate training of sales and related personnel.
- Rigorous documentation.

25. Guiding Principle, Category I (page 128)

Individual transactions that entail unique reputational issues should also be subject to an appropriate framework of escalation to senior management or committee review particularly when they entail questions regarding accounting, tax, regulatory or business intent or purpose on the part of the client. The transaction review process should, at a minimum, have the following features:

- Effective internal communication as to the classes of activity that are subject to the review process.
- The involvement of independent control personnel.
- Adequate training of sales and related personnel.
- Rigorous documentation.

26. Guiding Principle, Category I (page 128)

While new product and select individual transactions approval processes must involve both business and independent control personnel, it is an inherent responsibility of senior management to ensure that the independent control personnel are truly independent.

27. Guiding Principle, Category I (page 128)

At least annually, the effectiveness of the new product and unique transactional approval process should be reviewed by the highest level of management.

2. Intermediary/Client Relationship

Complex over-the-counter transactions in the wholesale market between a financial intermediary and an end-user require clarity with respect to the nature of the relationship between the parties and the attendant obligations each party may owe the other in connection with these transactions. Since these complex transactions will often remain outstanding for a significant period of time, it is in

the interests of both parties to have a firm and clear understanding of the principles that should guide the parties over the course of their relationship. The following principles should be considered in the context of each trading relationship in the wholesale market involving complex over-the-counter transactions between a financial intermediary and a sophisticated counterparty. These principles are intended to promote high standards of customer service and reputational as well as financial risk management. They are not intended to alter the arm's-length nature of the parties' relationship or to articulate legal standards. Of course, these principles are intended to complement, and not substitute for, compliance by financial intermediaries with their express contractual undertakings and with applicable legal and regulatory requirements relating to the offer or sale of such products.

(a) Pre-Trade

28. Guiding Principle, Category I (pages 128 to 130)

- Assess Client Sophistication and Experience — The financial intermediary should make reasonable efforts to determine the level of experience and sophistication a potential counterparty has in trading complex products to enable the financial intermediary to tailor its communications regarding the terms of, and the risks and opportunities associated with, a proposed transaction. As part of the financial intermediary's review of the potential counterparty's sophistication and experience, the financial intermediary should give careful consideration to whether the potential counterparty understands the arm's-length nature of the relationship and should take reasonable steps to reduce the risk of misunderstanding by clarifying the arm's-length nature of the relationship in written or other communication with the potential counterparty.

    - *Role of Financial Intermediary:* The financial intermediary is not, unless otherwise expressly agreed, the potential counterparty's advisor and the financial intermediary will execute a complex transaction strictly on an arm's-length basis. If the potential counterparty expects the financial intermediary to undertake any heightened responsibilities, it is the counterparty's responsibility to ensure that those expectations are clearly communicated and agreed in the transactional documentation.

- *Non-Reliance:* Because each party must independently evaluate whether the risks and benefits of a complex transaction are appropriate for it, the potential counterparty has the obligation to ensure that it has obtained any information or clarification it deems necessary to evaluate the appropriateness of the transaction in light of its own circumstances and objectives.

29. Guiding Principle, Category I (page 130)

- Term Sheets: Although it is standard market practice to reflect the terms of a complex transaction in a written confirmation exchanged by the parties following execution of the transaction, financial intermediaries have different practices with respect to furnishing potential counterparties with term sheets or other documentation describing transaction terms, including any early termination provisions, prior to execution of the transaction. This is particularly important with complex products. Financial intermediaries should provide such documentation in all situations where the particular complexities of the transaction create a risk of misunderstanding regarding the operative terms of the transaction.

30. Guiding Principle, Category I (pages 130 to 131)

- Disclosure: The financial intermediary should ensure that any written materials supplied to the potential counterparty relating to the risks of a proposed complex transaction fairly present the material risks to the potential counterparty. The form of disclosure, which may consist of scenario-based analysis or other appropriate text or metric descriptive of the risk, should be clear and accurate.

  - *Identifying Material Risks*: Both the financial intermediary and the counterparty should consider the material risks associated with each complex transaction and the financial intermediary should disclose the material risks to the counterparty upon counterparty request or if the financial intermediary believes the potential counterparty may not understand these risks. For example, a financial intermediary may conclude, under appropriate circumstances, that it should discuss the potential adverse impact of the financial intermediary's ordinary course hedging, market-making and proprietary activities on a

complex transaction's value, or the exercise by the financial intermediary of early termination rights.

- *Maintenance of Position*: Both parties to a complex transaction should consider and, as appropriate, discuss at the start of their relationship any significant issues relating to the maintenance of open positions, such as, how a complex transaction will be recorded, valued and margined. The financial intermediary should consider whether potential counterparties understand that valuation of a complex transaction is a function of the inputs and the proprietary financial models used by financial intermediaries and, consequently, that valuations determined by one financial intermediary may not be consistent with those of another or, to the extent capable of being modeled by the potential counterparty, those of the potential counterparty.

(b) Trade Execution

31. Guiding Principle, Category I (page 131)

- Trade Review: The financial intermediary should review with the potential counterparty the material terms of a complex transaction immediately prior to execution. The financial intermediary may satisfy this obligation either through explicit recitation of the key transaction terms, or by referring to a transaction summary or other document (describing the material terms of the transaction) previously provided to the counterparty and obtaining affirmation of the material terms from the potential counterparty.

32. Guiding Principle, Category I (pages 131 to 132)

- Confirmation: Both financial intermediary and counterparty must make reasonable efforts to confirm the execution of a complex transaction in a timely manner, in accordance with Recommendation 12 in Section IV of this Report.

  - *Notice of Delay:* If the financial intermediary anticipates delay in the creation of an appropriate confirmation reflecting the terms of a

complex trade, the counterparty should be promptly notified of the expected delay.

- *Trade Recaps:* Parties frequently exchange evidence of their agreement (for example, signed term sheets or electronic messages) prior to the execution of a confirmation. If the financial intermediary intends that this information will not serve as a binding confirmation of the transaction terms, the financial intermediary should disclose this fact to the counterparty before or at the time this information is provided. Even though this information may not constitute a binding confirmation and may have been provided by the financial intermediary only for informational purposes, each party should take reasonable steps to review the information for accuracy and completeness and should promptly notify the other party of any error or discrepancy it identifies.

(c) Post-Trade

33. Guiding Principle, Category I (pages 132 to 133)

- Valuations: If the counterparty requests a valuation of a complex transaction executed with the financial intermediary, the financial intermediary should have a clear understanding of the counterparty's intended use of the valuation so provided.

  - *Market Levels and Inputs*: It is acceptable market practice for a financial intermediary's sales and trading personnel to provide their sophisticated counterparties with general market levels or "indications," including inputs and variables that may be used by the counterparty to calculate a value for a complex transaction. Additionally, if a counterparty requests a price or level for purposes of unwinding a specific complex transaction, and the financial intermediary is willing to provide such price or level, it is appropriate for the financial intermediary's sales and trading personnel to furnish this information.

  - *Requests for Valuation*: If the counterparty wants to receive a valuation of a specific complex transaction from a financial intermediary, it should clearly communicate to the financial

intermediary that it is requesting a specific transaction valuation and not other more general market information. A financial intermediary should have formal procedures and controls in place for processing and responding to all valuation requests and, in addition, should have a unit independent of the financial intermediary's sales division prepare the valuation and provide it to the client in order to minimize any risk of conflict or appearance of impropriety.

- *Form of Valuation*: A valuation provided by a financial intermediary, whether based on market prices or financial models, should be in writing. Furthermore, the written valuation should clearly state the basis upon which the valuation is being provided.

34. Guiding Principle, Category I (page 133)

- Client Communication: Following execution of a complex transaction, the financial intermediary will often maintain communication with the counterparty in the interest of maintaining good client relations. As part of this communication, the financial intermediary, although under no legal obligation to do so, may wish to alert its counterparty to any observed market change that it determines may challenge the underlying assumptions or principal drivers that motivated the counterparty to establish the original position.

3. Risk Management and Monitoring

Guiding Principle 4 highlights independent model review and stress testing as important components of strong risk management practice. For firms that actively use complex products, the robustness of model review and stress testing practices take on even greater importance.

35. Recommendation, Category I (pages 133 to 134)

CRMPG II recommends that financial intermediaries have a dedicated and fully independent group of professionals who are fully responsible for all aspects of model verification including final approval of all changes in model design and specification. The model verification group should determine:

- The scope and frequency of all model reviews.
- Standards for review of model assumptions and methodology.

- Model testing and release requirements.
- Documentation and inventory standards, including user guides, technical documentation, testing notes and source code.

36. Guiding Principle, Category I (pages 134 to 135)

Firms should continue to invest in their risk measurement capabilities with a particular view towards making advances in areas of model uncertainty associated with new and complex products.

There are at least three areas where the Policy Group believes further enhancements may be warranted:

- Multi-period models for multi-name credit structures.
- Treatment of implied correlation.
- Treatment of long-dated cross-currency options.

37. Recommendation, Category I (page 135)

CRMPG II recommends that to gain insight into the potential for value changes in their portfolios, firms should conduct stress tests that alter key input variables of the models they rely on for pricing and risk measurement of new and complex products. Such tests should be both plausible and meaningful for the relevant portfolios. Firms should understand the limitations of such tests and conduct specialized tests, as appropriate.

To improve the value of stress testing exercises, firms should consider the following:

- Asking business managers and senior management to clearly express loss tolerance levels.
- Identifying a range of scenarios that could produce losses for portfolios or businesses.
- Ranking the scenarios by level of potential adverse impact.
- Assessing relative probabilities for the scenarios.
- Based on this probabilistic assessment, comparing potential loss estimates to expressed tolerance levels.

38. Guiding Principle, Category I (page 135)

Once a financial intermediary has accumulated a material position in a complex product, it should require its desk to trade a portion of the risk in the market. Such a practice is a promising way to promote price discovery and to narrow the potential for divergence between theoretical, model-derived prices and market prices, particularly if firms have accumulated similar risk positions.

4. Enhanced Transparency

39. Guiding Principle, Category I & III (page 136)

Where it is not already the practice, large and complex financial intermediaries should provide their primary supervisors with timely quantitative and qualitative risk-related information on a regular basis and be prepared to provide such information on an ad hoc basis when circumstances warrant.

- Such information should be provided on an informal and confidential basis so as to facilitate the flow of otherwise proprietary and trade-specific information, as needed.
- The responsibility for such informal exchanges of information should be vested with an appropriately senior official — typically the chief risk officer or his or her equivalent.
- Supervisory bodies should make every reasonable effort to accommodate this process by ensuring that appropriately senior supervisory personnel will be available to participate in such regular discussions of risk-related matters.

40. Guiding Principle, Category I (pages 136 to 137)

Consistent with the Policy Group's core principle concerning the importance of the judgmental aspects of risk management, firms should strive to enhance qualitative public disclosures around complex products.

Specifically, the Policy Group strongly urges that intermediaries take steps to incorporate the following in their public disclosures:

- Description of the roles the firm plays (e.g., market maker, structurer, distributor and investor).
- Discussion of how complex products are addressed in the firm's risk management framework, including:
    - The governance associated with complex transactions.
    - The nature of the limits associated with the transactions.
    - The extent to which the products are captured in reported measures of credit, market and liquidity risk, and related capital measures.
    - How the firm addresses the potential for losses in portfolio values associated with stressed market conditions.
    - Any special considerations in the areas of documentation and risk mitigation related to collateral practices and hedging.
    - How the products are valued for financial statement purposes.

In identifying these potential areas for qualitative public disclosure, the Policy Group recognizes that it would be a matter of firm preference whether to incorporate references to such products in the overall risk management discussion section or whether to develop a dedicated section.

D. Emerging Issues (Section VI, pages 139 to 154)

1. Sale of Complex Products to Retail Investors

(a) Suitability and Disclosure for Structured Products Sold to Retail Investors

41. Guiding Principle, Category I (pages 139 to 142)

Financial intermediaries should reevaluate their internal new product controls to ensure that they adequately manage the heightened reputational and related risks associated with the issuance of complex structured securities sold to retail investors. Enhanced practices that financial intermediaries should consider include:

41a. Financial intermediaries should ensure that as part of the new product approval process, an internal product description is prepared. The internal product description should cover, at an appropriate level of detail, the product's characteristics, potential conflicts of interest, targeted investors, fees, third party involvement and similar elements, so as to ensure that appropriate consideration is given to these factors by management and control personnel involved in product approval process.

41b. Where the financial intermediary is directly involved in the issuance, distribution or marketing of the product to retail investors, the approval process should designate responsibility for review and approval of disclosure documents and marketing material(s), whether for internal or external use, by personnel who have the requisite expertise in complex products and personnel who are independent of the proposing business unit or desk. Final product approval should incorporate or be subject to subsequent approval of proposed disclosure and marketing materials by designated personnel.

41c. Financial intermediaries should consider whether disclosure might be enhanced by quantitative or graphical presentations of a product's potential values at maturity in relation to specific market factors to which the value of the product is related, together with historical data for such market factors.

41d. Financial intermediaries should consider whether disclosure appropriately describes, where applicable, factors that would cause the secondary market value of the product, prior to maturity, to be materially lower than the value the product would have at maturity under identical market conditions, including, in particular, products that have a principal protection feature.

41e. Financial intermediaries should consider whether disclosure appropriately conveys the fact that the secondary market value of the product, at or near issuance, will be less than the issue price as a result of embedded pricing factors that reflect anticipated costs and revenues to the selling institutions.

41f. Product approval should delineate any appropriate limitations, in addition to asset or net worth based tests, on the eligible investors to whom the product may be marketed or sold. Product approval should also identify cases where the complexity of the product warrants the qualification of eligible investors by internal supervisory personnel on a case-by-case basis.

41g. Financial intermediaries should conduct ongoing training for marketing personnel to ensure that such personnel are familiar with, understand and can communicate effectively the performance and risk characteristics of the products offered for sale by the financial intermediary, and are able to perform required suitability evaluations. As part of the product approval process, consideration should be given to the need for additional specific training of marketing personnel, in light of any novel issues that may be presented by the product under consideration, as a condition to product approval.

41h. Senior management should conduct periodic reviews of the financial intermediary's internal controls for the sale of complex products to retail investors.

(b) Reputational Risks Associated with Third Party Conduct

42. Guiding Principle, Category I (page 142)

Where third parties are involved in the distribution or marketing of a complex product in which a firm has either a disclosed or undisclosed role, the financial intermediary may confront reputational and related risks despite the absence of legal responsibility for the conduct of such parties. A financial intermediary should take appropriate steps to evaluate those risks, familiarize itself with the other transacting parties and ensure that it is comfortable under the circumstances that it has effectively managed or addressed such risks, or otherwise determined that the relevant risks are acceptable to it based on its evaluation of the relevant circumstances. In connection with that evaluation financial intermediaries should consider, where appropriate, Guiding Principles 41a through 41h above.

2. Conflict Management

43. Guiding Principle, Category I (pages 142 to 145)

Business Review Process: Financial intermediaries should have in place a Business Review Process to help identify generic categories of conflicts and to strengthen conflict management policies and procedures, consistent with the following Guiding Principles:

43a. The Business Review Process should identify categories of potential conflicts, which might, for example, include such categories as situations involving access to non-public information, situations in which the firm has multiple roles or situations in which the firm acts as both agent and principal.

43b. The Business Review Process should take account of all relevant laws and regulations.

43c. The Business Review Process should consider the level of reputational and financial risks associated with various categories of potential conflicts.

43d. The Business Review Process should consider potential conflict questions that might arise in connection with the introduction of new products or differing regulatory requirements in various jurisdictions.

43e. The Business Review Process should identify and catalogue various measures that are designed to mitigate the financial and reputational risks associated with particular classes of potential conflicts. Financial intermediaries should consider, among other things, an assessment of the adequacy of risk mitigants such as (i) policies and procedures, (ii) disclosure practices, (iii) suitability standards and (iv) employee training programs.

43f. The Business Review Process should be documented with particular emphasis on the maintenance of a framework that permits ex-post review.

43g. The Business Review Process should include an annual assessment of the effectiveness of the conflict management process by a senior-level management committee.

3. Risk Management for Institutional Fiduciaries

44. Recommendation, Category I & II (pages 145 to 146)

44a. CRMPG II recommends that fiduciaries taking on the new and/or additional risks associated with "alternative" investments and complex products continue to conduct and, as applicable, enhance the due diligence and monitoring practices relating to their investments and investment managers. Fiduciaries should have the ability to: (a) monitor indirect investments, including derivative positions and/or risk characteristics, on a timely basis to ensure their investment managers are not taking risks beyond represented levels in terms of allowable investment exposures, leverage, etc.; (b) aggregate risk across their entire pool of assets in order to understand portfolio level implications; and (c) determine whether their investment managers are adhering to a stated investment strategy or style.

44b. It is further recommended that investment managers and fiduciaries work together along with industry groups to form a consensus on generally accepted techniques for supplying risk characteristics on a bilateral basis to provide "sufficient information to allow an independent analysis of credit and market risk being undertaken by" institutional investors, as required by ERISA. The result of such efforts should be to enable fiduciary investors to measure and monitor aggregate risk exposures in a manner that is consistent with their responsibilities as fiduciaries.

45. Guiding Principle, Category I & II (pages 146 to 148)

Market participants should take the following actions to further the goals of transparency, risk management, market discipline and financial stability:

45a. Encourage the clear disclosure in public financial statements of the use of "short cut" accounting treatment for hedging, including principles-based qualitative descriptions of the methods used to determine hedge effectiveness.

45b. Encourage the adoption by financial intermediaries and associated internal control organizations for the purpose of best practices, as

applicable, of the recommendations of the *Final Report of the Multidisciplinary Working Group on Enhanced Disclosure* published in April 2001; *Enhancing Public Confidence in Financial Reporting* published in 2004 by the Group of Thirty; and relevant related Recommendations and Guiding Principles in Sections III, IV and V of this Report.

45c. Encourage the adoption by hedge fund managers, for the purpose of best practices, of the 2*005 Sound Practices for Hedge Fund Managers* report published by the Managed Funds Association and relevant related Recommendations and Guiding Principles in Sections III, IV and V of this Report.

45d. Enhance the accounting and risk management discussion, including counterparty exposures, in the Management Discussion and Analysis sections of 10K or equivalent reporting and annual report filings in order to improve qualitative and quantitative reporting for stronger credit and overall risk management evaluation.

45e. Enhance the overall market transparency of derivatives transactions and/or risk characteristics. The goal would be assisted by:

- Encouraging industry and trade groups (e.g., Managed Funds Association, Alternative Investment Management Association) to issue surveys (on derivative uses, exposures/levels, counterparty types, etc.) to augment the information published by regulatory agencies;

- Encouraging more frequent and comprehensive surveys and derivative reporting from organizations currently issuing related information such as the reporting produced by the International Swaps and Derivatives Association, the Bank for International Settlements, the US Office of the Comptroller of the Currency and the British Banker's Association; and

- Encouraging financial intermediaries to be receptive to informal discussions with fiduciary investors regarding their risk profiles and risk management practices, particularly as they apply to prime brokerage operations.

45f. Encourage OTC market participants to take steps, including the broadening and deepening of the use of bilateral facilities, to increase the efficiency of the settlement, clearing and collateralization processes, especially for high volume and "vanilla" products (see Section IV of this Report for related recommendations and guiding principles).

45g. Encourage financial intermediaries and institutional fiduciaries (and their trade groups) to create a central clearinghouse with a dedicated website, to catalogue and make available at a single resource all reports and surveys regarding risk management practices and related statistics that might be helpful to risk management practices for fiduciaries.

4. Official Oversight of Hedge Funds

46. Recommendation, Category I (pages 148 to 149)

CRMPG II recommends that hedge funds, on a voluntary basis, adopt the relevant Recommendations and Guiding Principles contained in this Report as well as the relevant Sound Practices contained in the 2005 report of the MFA. Consistent with that, senior managers of hedge funds should systematically monitor the progress being made relative to these standards.

47. Recommendation, Category II & III (pages 149 to 150)

CRMPG II recommends that the private sector, in close collaboration with the official sector, convene a high level discussion group to further consider the feasibility, costs and desirability of creating an effective framework of large-exposure reporting at regulated financial intermediaries that would extend — directly or indirectly — to hedge funds. Using the indirect method, regulators would collect and aggregate large exposure data from traditionally regulated institutions and, through those institutions, collect data on hedge fund activity. Under the direct approach, hedge funds would, on a voluntary basis, provide large exposure data directly to the appropriate regulator.