

SECTION VI: EMERGING ISSUES

Since the publication of the CRMPG I report in 1999, a number of issues indirectly related to the scope of that report have come into sharper focus that are important to the functions of financial intermediaries and the well-being of financial markets. Given the very ambitious schedule established earlier this year for the publication of the CRMPG II Report, it was not possible to cover all of them or even to cover the more important of these emerging issues in the detail that might otherwise be desirable. Nevertheless, the Policy Group determined that there were five such issues that were of sufficient importance that they should not be ignored. Those issues are:

- Sale of complex productions to retail investors
- Managing conflicts of interest
- Risk management for fiduciaries
- Official oversight of hedge funds
- Supervisory challenges

A. Sale of Complex Products to Retail Investors

It is now fairly common for financial intermediaries to design complex structured products for sale to a range of retail investors. Complex structured products incorporate features not found in traditional asset classes and can therefore assist investors in achieving a broad range of investment objectives. Equally, these products may also present new or heightened investment risks. Often such structured products provide assurances of full (or partial) principal repayment at maturity. However, even when full repayment of principal at maturity is assured, redemption prior to maturity may result in realization of less than the full principal amount. Further, the fees and expenses associated with the sale of such instruments to retail investors — and the manner in which such fees and expenses impact the value of such instruments at or near the time of purchase — may not always be transparent.

To further complicate matters, regulatory standards governing the sale of such products to retail investors — in particular, suitability requirements — vary considerably from country to country. Thus, it would be impractical, if not impossible, to craft a universal set of standards governing the sale of such structured products to retail investors. Nevertheless, the Policy Group concluded that it was desirable to frame a statement of Guiding Principles that relate to suitability standards and disclosure practices as applied to the sale of such structured products to retail investors. Of course, these Guiding Principles are intended to complement, and not substitute for, compliance by financial intermediaries with applicable legal and regulatory requirements relating to the offer or sale of such products. Additionally, while appropriate disclosure and related sales practices such as those outlined in these Guiding Principles are important, they should not be seen as absolving even retail investors from their responsibility to ensure that they understand and carefully consider their investment alternatives.

For purposes of these Guiding Principles, retail investors are individual investors who are not investment professionals and who act for their own account. Complex financial transactions entered into by financial intermediaries with institutional or otherwise sophisticated counterparties are discussed in Section V of this Report.

A.1. Suitability and Disclosure for Structured Products Sold to Retail Investors

41. Guiding Principle (Category I)

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 are as follows.

- 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 at maturity 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.

A.2. Reputational Risks Associated with Third Party Conduct

42. Guiding Principle (Category I)

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.

B. Managing Conflicts of Interest

In the wake of the bursting of the high-tech bubble of the late 1990s and the various financial scandals of the past few years, the subject of potential conflicts of interest in the activities of financial institutions has been thrust into the limelight. The existence of potential conflicts of interest involving the activities of financial institutions — and especially large integrated financial intermediaries — is not new. Indeed, in the United States concerns about potential conflicts of interest involving financial institutions can be traced to the earliest days of the Republic. Over time, the pendulum of public and political concern about such conflicts has swung in both more liberal and more conservative directions. For example, while still subject to

debate on the part of economic and financial historians, the belief in many quarters that conflicts had a major role in the stock market crash of 1929 and the subsequent depression clearly played a significant role in shaping the financial reform agenda of the 1930s. More generally, it has been recognized that the potential conflicts associated with financial intermediation cannot be eliminated while still preserving the significant societal benefits generated by the banking and financial system. Thus, the central tendency of public policy in virtually all countries has, over time, centered on how to effectively manage conflicts in part through regulation, but also by means of effective conflict management practices by individual institutions. The issue, therefore, is not whether such inherent conflicts can be eliminated, but rather how effectively financial institutions manage potential conflicts in the day-to-day conduct of their activities.

Unfortunately, in recent years there have been instances in which there have been obvious breakdowns in the rigor and effectiveness with which individual financial institutions have managed conflicts of interest. These failures have prompted greatly increased regulatory scrutiny and aggressive managerial initiatives at financial institutions aimed at systematic efforts to strengthen conflict management practices. In light of these developments, the Policy Group determined that it would be desirable to address conflict management.

Broadly speaking, the conflict management process at financial intermediaries is a well-established element of corporate governance in that typically there are senior level committees or similar groups that review classes of transactions, or sometimes individual transactions, to ensure that potential conflicts are well understood, effectively managed and, where appropriate, that adequate steps have been taken to mitigate potential conflicts. While the organizational and governance vehicles used to manage conflicts can vary substantially from one intermediary to the next, the increased size and complexity of many larger integrated financial intermediaries and the substantially more complex financial market environment in which these institutions operate present new challenges for conflict management.

In the changed business and regulatory environment, financial intermediaries have taken steps to augment and strengthen their conflict management policies and procedures. Often, these efforts are focused on the development of a more forward-looking process whereby individual business units, in consultation with legal and compliance personnel, identify broad categories of potential conflicts that might arise

in the day-to-day activities of the business units. The term “categories” as used above is directed at generic situations faced by financial intermediaries that have the potential to raise conflict issues. By way of illustration, an intermediary could face a potential conflict if it is advising one client on a prospective merger and it receives word from another client that it too has an interest in the same target company. As another example, there are many situations in which an intermediary has access to non-public information that could be used to the intermediary’s benefit, thus giving rise to a potential conflict of interest.

Because the Policy Group believes that the conflict management process should be more forward-looking and because the Policy Group knows that conflict management situations seldom involve straightforward and easy solutions, the Policy Group has identified the following Guiding Principles that are designed to further strengthen the conflict management process.

Guiding Principles: Conflict Management

43. Guiding Principle (Category I)

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.

C. Risk Management for Fiduciaries

Reflecting in part increased complexity and the growing importance of so-called “alternative investments,” the risk management challenges faced by institutional fiduciaries such as pension funds have undergone profoundly important changes in recent years. In the face of these changes, the Policy Group commissioned a Working Paper that summarizes these changes and is contained in Appendix D of this Report. Reflecting the importance of these changes relative to the inherent fiduciary responsibilities of these institutions, a number of the Recommendations and Guiding Principles in Sections III and IV of the Report were framed taking account of the risk management challenges facing such fiduciaries. These Recommendations are summarized in Attachment I to Appendix D. In addition, a number of further Guiding Principles designed to assist such fiduciaries in their risk management practices are outlined below.

Recommendations and Guiding Principles: Risk Management for Institutional Fiduciaries

These Recommendations and Guiding Principles are framed to take account of the fact that many fiduciaries may not be capable of or lack the full complement of human resources needed to manage complex risks and must rely in varying degrees on “institutional solutions” to aid them in their risk management activities.

44. Recommendation (Category I & II)

- 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)

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 *2005 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.

D. Official Oversight of Hedge Funds

The subject of whether, and to what extent, hedge funds should be subject to direct supervision and regulation is not new. Indeed, in the aftermath of the LTCM episode it was a lively topic of discussion. At that time, the subject of hedge fund regulation was discussed by CRMPG I but the Policy Group did not take a public position on the subject. The thinking of Policy Group I in 1999 was driven by two primary considerations:

- First, there were expressed concerns about the “moral hazard” issues that would inevitably arise by virtue of direct regulation of hedge funds; and
- Second, the 1999 Policy Group strongly believed that many of the benefits of direct regulation could be achieved through indirect regulation.

Specifically, the 1999 Policy Group concluded that supervisors and regulators of already regulated institutions could — by working with those regulated institutions — achieve much of what could be achieved by direct regulation of hedge funds. CRMPG I made several proposals as to how indirect regulation might work in practice, including a proposed large-exposure regulatory reporting framework. For a variety of reasons, the proposed regulatory reporting framework was not implemented.

As discussed throughout this Report, a great deal has changed since 1999 with regard to the number, aggregate size and complexity of hedge funds. In these

circumstances, the subject of hedge fund regulation has arisen with fresh momentum in a number of countries including the US, the UK and Germany. Some of the issues that have driven this renewed interest in hedge fund regulation relate to concerns such as investor suitability, the potential for market abuse and anti-money laundering. However, in many circles, the current debate about hedge fund regulation is also linked to financial stability issues.

More specifically, both the SEC in the US and the FSA in the UK have recently taken steps that, in effect, mean that direct regulation of hedge funds is at hand. Nevertheless, in both the US and the UK there are many open questions as to the details of such regulations over time. As an example, the FSA's discussion paper entitled "Hedge Funds: A Discussion of Risk and Regulatory Engagement" is carefully crafted so as to invite public comment on a wide range of regulatory options for the future.

In contemplating these developments regarding the hedge fund sector, CRMPG II brings to the table much of the philosophy of CRMPG I. Specifically, the Policy Group continues to believe that moral hazard issues as they relate to hedge fund regulation are quite real. However, the Policy Group continues to believe that indirect regulation has considerable merit. Therefore, the Policy Group believes that a deliberate approach to hedge fund regulation is appropriate. Consistent with that deliberate approach, the Policy Group believes that its Report and the 2005 report on "Sound Practices" prepared by the Managed Funds Association provide a broad menu of steps that hedge funds should adopt on a voluntary basis to strengthen their business practices and further enhance their risk management capabilities. Accordingly:

46. Recommendation (Category I)

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.

The Policy Group has also considered again the question of whether some form of a large-exposure regulatory reporting system directed at regulated financial institutions might play a constructive role in helping to better anticipate and mitigate systemic

risks. As practitioners, the members of the Policy Group are keenly aware of the formidable and practical challenges associated with designing and implementing an efficient and effective framework of large-exposure reporting requirements. However, while recognizing all of the problems, the Policy Group also believes that if an effective system of large-exposure reporting could be created, the potential benefits of such a system could be significant. Thus, devoting at least some resources to further consideration of such a framework seems well worth the effort. Accordingly:

47. Recommendation (Category II & III)

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.

E. Supervisory Challenges

For centuries, financial institutions have been — appropriately — subject to a higher degree of official supervision and regulation than is the case for most classes of private enterprise. In recent years, the challenges faced by supervisory and regulatory bodies (including bodies that set standards for accounting practices) have been significantly shaped by two powerful forces:

- First, the systemic risk implications of the enormous increase in the complexity, speed and linkages that characterize the global financial system; and
- Second, the apparent weaknesses in business practices on the part of financial institutions, as evidenced by the various scandals of recent years.

In light of these circumstances, the Policy Group commissioned a Working Paper to examine and summarize major regulatory developments since the publication of CRMPG I in 1999. That summary Working Paper is contained in Appendix C of this

Report. Drawing on that Working Paper and the experience and expertise of its members, the Policy Group has identified what it believes to be the four highest level challenges facing supervisory and regulatory policy in the period ahead. These challenges are framed with a view toward helping both the public and private sectors to work together in a cooperative spirit in order to better and more fully ensure that the public interest goals associated with the workings of the financial system are achieved to the maximum extent possible.

1. Supervisory Challenges

(a) Principles versus Rules

Virtually all areas of supervisory, regulatory and accounting policy are drifting into an environment in which rules are gradually displacing principles — a trend which will be very difficult to reverse. The Basel II capital regime, accounting standards, prescriptive compliance related regulations and the acute information overload problem associated with public disclosure requirements are all illustrations of situations in which basic principles are being displaced in the name of rules. Of particular concern are situations where new standards are effectively first imposed through enforcement actions. In some situations, this creates a situation where financial intermediaries must operate for a period of time without the necessary level of regulatory guidance regarding the specific contours of the new standard.

More generally, the trend toward detailed rule-making reflects a tension that is seen in both the public and private sectors, whereby the perceived need on the part of accountants, lawyers and regulators to anticipate virtually all contingencies produces so much detail as to make it difficult for managers to manage and supervisors to supervise. Even worse, the focus on detail inevitably can create incentives for practitioners to arbitrage the system, thereby producing the need for still more detail.

One area in which this trend can be checked relates to the prudential supervision of so-called large and complex financial institutions where greater reliance on the application of Basel II, Pillar Two in a risk sensitive manner holds promise of a return to a more principles-based approach. In fact, in this area movement in the desired direction is already occurring. Also, greater progress in a principles-based supervisory approach in this area could point

to other areas in regulatory and/or accounting policy where principles might play a larger role.

(b) Division of Responsibilities between Intermediaries and their Clients

In the aftermath of corporate and financial scandals, there has been a tendency to prescribe in some detail the responsibilities of financial intermediaries regarding structured products sold to their clients even when the client is unambiguously a sophisticated institutional client. Few would dispute that it is critical for financial intermediaries to maintain high standards of internal control and discipline relating to client/counterparty relationships. Moreover, virtually no observer would dispute the assertion that we have seen examples in recent years where financial institutions were not as rigorous as they should have been in managing client relationships.

Financial intermediaries have taken steps to strengthen their policies and practices in this area. The larger question, however, is the danger — however small — that efforts to articulate detailed new responsibilities for financial intermediaries could undermine the historic and delicate balance of responsibilities between intermediaries and their clients. Clearly, there is a point where sophisticated clients in particular must take responsibility for their own actions. This balancing of responsibilities and obligations between financial institutions and their institutional clients has been one of the great strengths of the financial system for centuries.

Nothing said above should be seen as suggesting that financial intermediaries should not have clear and high standards in managing their relationships with both retail and institutional clients. Indeed, Sections V and VI of this Report contains meaningful guidance as to heightened standards that should better and more rigorously guide the relationship between intermediaries and both their retail and institutional clients while at the same time assisting all parties to financial transactions in meeting their underlying economic objectives.

(c) Harmonization of Accounting Standards and Risk Management

There is a clear need to accelerate the national and international harmonization of accounting, regulatory and disclosure requirements and to ensure their alignment with proper risk management incentives. The

differences between the bases on which financial firms measure financial instruments for risk management purposes, for regulatory capital purposes and for reporting to shareholders under GAAP can produce unintended and perverse risk management incentives, and also contribute to costly and confusing financial statements. Thus, accounting authorities must continue and intensify their efforts to harmonize international standards and work with regulators with the ultimate aim of reducing the differences between accounting and regulatory capital treatment of the same product. Consideration should be given to the establishment of a single, common forum at which such issues could be promoted. Needless to say, such efforts must also strive to resolve the long standing disputes about the application of fair value accounting to financial instruments.

(d) Regulatory Coordination and Convergence

The financial system as a whole would benefit from more coordination and convergence among regulators in different jurisdictions on key issues (e.g., Basel II, home/host issues, etc.). Successful implementation of global standards depends importantly on the degree of coordination among national authorities and regulated institutions. Without such greater coordination, there is an increased risk of uneven application of standards that could lead to issues of competitive inequality or arbitrage opportunities as regulators exercise different interpretations of standards. The need for regulatory coordination and convergence also extends to the inherent tensions that can exist between so-called umbrella (or consolidated) supervisors and functional supervisors.

The financial services industry welcomes and encourages strong cooperation among the regulators, including the state securities regulators in the US. To the extent practicable, the goal should be the development of one set of standards concerning a particular functional regulatory area that would apply across national boundaries. In brief, the challenge is to develop a more holistic approach to regulation so that firms can follow global principles of conduct and develop procedural protocols to fulfill global regulatory requirements. This, in turn, will enhance global regulatory oversight of firms and contribute to the goal of financial stability.

