SECTION III: HIGH-RISK COMPLEX FINANCIAL INSTRUMENTS

A. Introduction

As discussed elsewhere in this Report, throughout the credit market crisis, the behavioral characteristics of several classes of structured credit instruments have accounted for a significant fraction of the write-downs and losses incurred by large integrated financial intermediaries, hedge funds, specialized financial institutions and other market participants. Moreover, there is almost universal agreement that, even with optimal disclosure in the underlying documentation, the characteristics of these instruments and the risk of loss associated with them were not fully understood by many market participants. This lack of comprehension was even more pronounced when applied to CDOs, CDOs squared,[4] and related instruments, reflecting a complex array of factors, including a lack of understanding of the inherent limitations of valuation models and the risks of short-run historical data sets. As a consequence, these instruments displayed price depreciation and volatility far in excess of levels previously associated with comparably rated securities, causing both a collapse of confidence in a very broad range of structured product ratings and a collapse in liquidity for such products.

In light of these circumstances, the Policy Group has devoted considerable emphasis and resources to the subject of complex financial instruments and has developed specific recommendations designed to reform and improve market practices in response to the credit market crisis. The Policy Group has not addressed the activities of rating agencies in the credit market crisis, nor has it made recommendations concerning their role going forward. Instead, the Policy Group believes that it is vital for every market participant to understand risk and make independent credit judgments even when ratings are available. As such, the Policy Group's analysis focuses on the instruments, the participants, the practices, and the flow of information in the markets for high-risk complex financial instruments.

[4] The risk characteristics of CDOs were spelled out in great detail in the CRMPG II Report. That analysis is appended as Appendix B to this Report.

A natural starting point for this analysis centers on the attributes of high-risk complex financial instruments recognizing that <u>not all complex financial instruments are necessarily high-risk</u>. The definition of a high-risk complex financial instrument is itself a complex subject. For example, while it is easy enough to say that subprime CDOs are a high-risk complex financial instrument, it is impossible to solve the definitional issue by compiling a list of such high-risk instruments, if for no other reason than any such list would be almost immediately out of date.

Additionally, the Policy Group's focus has not been limited to discussing the characteristics and practices associated with specific instruments in the credit market crisis. Its aim, instead, is to provide recommendations that may be applied in a forward-looking manner to transactions in high-risk complex financial instruments – including both cash and derivatives – in all markets. Thus, the effort to cope with the definitional challenge is better framed by identifying the key characteristics of classes of high-risk complex financial instruments that warrant special treatment in terms of sales and marketing practices, disclosure practices, diligence standards, and, more broadly, the level of sophistication required for all market participants, including issuers and investors.

<u>The first and perhaps the most important characteristic of high-risk complex financial instruments is leverage</u>. However, recognizing the role of leverage is one thing, while understanding that leverage can take several forms is quite another matter. Leverage may refer to borrowing money to finance the purchase of securities or other financial instruments. It may also refer to so-called embedded leverage often associated with derivatives and asset tranching. An example of this is an investment in subordinated tranches of asset-backed or corporate credit derivative contracts. In the case of these instruments, the market exposure is magnified relative to an investment in the underlying instrument and gains and losses are experienced more quickly, sometimes much more quickly, than in an un-leveraged investment. Unlike leverage generally associated with borrowing, losses associated with embedded leverage are generally limited to the size of the initial investment; however, the risk of loss to which investors found themselves exposed far exceeded most, if not virtually all, stress scenario modeling they had performed.

The multiplier effect of embedded leverage may also be compounded. For example, mezzanine tranches of mortgage securitizations (which, themselves, have embedded leverage) were often purchased by CDOs, which, in turn, issued senior and subordinated tranches, creating embedded leverage on leverage in the subordinated pieces. Some of these CDOs in turn found their way into CDOs squared, compounding the leverage even further. Exposures to rising delinquency rates were, as a result, greatly magnified for investors in these instruments. On certain occasions, these highly leveraged CDO-related instruments were acquired by various forms of investment vehicles that were themselves highly leveraged.

The magnitude of this embedded leverage was in itself often model-derived value which depended, for example, on projections of mortgage delinquency and default rates. In other words, investors could not always be certain about the degree to which their exposures to the mortgage market were leveraged at the time of investment. When delinquency assumptions associated with the mortgage securitizations of 2005, 2006 and early 2007 proved to be far too low, the leverage and losses experienced by investors in these secondary and tertiary repackagings were far greater than anticipated.

<u>The second key characteristic of high-risk complex financial instruments is that, by their nature, they are prone to periods of sharply reduced market liquidity</u>. As witnessed during the credit market crisis, market liquidity for many of these instruments was not merely reduced but in some instances virtually evaporated. In this environment, risk reductions – including de-leveraging – were nearly impossible, and hedging was very expensive and often imperfect, introducing basis risk. Needless to say, in these circumstances, valuations and price verification for these instruments had limited evidential support, although this did not obscure the fact that <u>some positions</u> and <u>some trades</u> had lost much, if not essentially most, of their value, with little prospect for material future recovery.

<u>The third characteristic of high-risk complex financial instruments is that they may be characterized by a lack of price transparency</u>. These instruments are often bespoke, and their valuations depend on proprietary financial models and the inputs that drive those models. Frequently, the inputs for these models are not directly observable in the market. In addition, even a valid model with accurate inputs will not always capture the immediate supply and demand profile of the market, meaning that the model price will not

always determine the price at which a transaction will occur. In this circumstance, buyers and sellers of high-risk complex financial instruments may achieve price discovery only through actual transactions, but these may not occur because of the aforementioned illiquidity.

It is possible that an instrument which would otherwise be high-risk and complex is not regarded as such because of its liquidity and price transparency. Large capitalization common stocks are generally considered neither high-risk nor complex, avoiding the label because of their visibility in the market and liquidity. If stocks were priced in a vacuum based only on a model of one's own design, such shares would probably be considered both high-risk and complex. Conversely, price transparency does not always preclude an instrument from being labeled high-risk and complex. There are, for example, futures markets in high-risk complex financial instruments that are so labeled despite the transparency provided by the futures markets.

While issues surrounding leverage, market liquidity, and price transparency are the key characteristics in identifying high-risk complex financial instruments, other factors have contributed to the problems witnessed during the credit market crisis. For example, in some investment vehicles the high-risk factors of leverage and market illiquidity were amplified by substantial maturity mismatches, where illiquid long-term assets were funded with short-term liabilities. Additionally, for many high-risk instruments, disclosure information was limited, or to the extent it was provided, it could have been more "user friendly" in its presentation. Finally, many high-risk complex financial instruments presented significant challenges for risk monitoring and management systems, which struggled to keep up with the complexities of product design and development and, in particular, encompass the risk that hedging strategies were ineffective, so generating additional, and sizeable, exposure in the form of basis risk.

The aforementioned characteristics are neither an exhaustive list nor should they be assumed to provide a strict definition of high-risk complex instruments, which the Policy Group believes should be avoided. Instead, market participants should establish procedures for determining, based on the key characteristics discussed above, whether an instrument is to be considered high-risk and complex and thus require the special treatment outlined in this section.

In the wake of the obvious problems presented by high-risk complex financial instruments, the Policy Group has developed a series of measures and recommendations that it believes address the shortcomings that surfaced during the credit market crisis while not unduly suppressing the beneficial role of innovation in the financial marketplace. The four broad areas of reform recommended by the Policy Group are as follows:

(1) refining and elevating standards of sophistication for market participants;

(2) enhancing the level and usefulness of disclosure;

(3) strengthening intermediary-client relationships in such areas as sales and marketing practices; and

(4) ensuring consistent diligence standards for issuers and placement agents of high-risk complex financial instruments.

B. Standards of Sophistication

The Policy Group strongly recommends that high-risk complex financial instruments should be sold only to sophisticated investors. Having said that, the practicalities of making this doctrine operational are both subtle and complex. The Policy Group further recommends that a standard of behavior and consistent practice be introduced for all market participants. While there are clearly delineated roles for originators, underwriters, managers, trustees, investors, and others, the Policy Group recommends that involvement in the market for high-risk complex financial instruments in any of these roles requires:

- education and training in the nuances of these instruments;
- systems and models sufficient for tracking performance, managing risk, and running stress scenarios;
- strong governance procedures and internal controls; and

- financial resources sufficient to withstand potential losses associated with high-risk complex financial instruments.

While these standards must apply to participants at every stage in the process, perhaps the most vital point of application is the investor. The starting point is the assurance that the investor has a high level of financial sophistication. It is therefore necessary to develop a workable definition of a "sophisticated investor". One such approach followed in the United States is Securities and Exchange Commission (SEC) Rule 144A, which is itself quite complex to administer. In essence, Rule 144A lists and defines various types of entities which are called "Qualified Institutional Buyers" (QIBs). At the risk of considerable oversimplification, QIBs are entities that own and invest in at least $100 million in securities of issuers that are not affiliated with the QIB. Similar regulatory definitions are employed in other jurisdictions, including under the European Union Markets in Financial Instruments Directive (MiFID) in Europe.

Any definition of a sophisticated investor should reflect at a minimum the definition provided by the relevant regulatory jurisdiction. The details of regulatory requirements, however, are such that entities may pass the quantitative (or objective) tests of the relevant regulations but may not be appropriate buyers of high-risk complex financial instruments as discussed above.

Recommendations

III-1. The Policy Group recommends establishing standards of sophistication for all market participants in high-risk complex financial instruments. In recommending specific characteristics and practices for participants, it is guided by the overriding principle that all participants should be capable of assessing and managing the risk of their positions in a manner consistent with their needs and objectives. All participants in the market for high-risk complex financial instruments should ensure that they possess the following characteristics and make reasonable efforts to determine that their counterparties possess them as well:

- the capability to understand the risk and return characteristics of the specific type of financial instrument under consideration;
- the capability, or access to the capability, to price and run stress tests on the instrument;
- the governance procedures, technology, and internal controls necessary for trading and managing the risk of the instrument;
- the financial resources sufficient to withstand potential losses associated with the instrument; and
- authorization to invest in high-risk complex financial instruments from the highest level of management or, where relevant, from authorizing bodies for the particular counterparty.

Large integrated financial intermediaries should adopt policies and procedures to identify when it would be appropriate to seek written confirmation that the counterparty possesses the aforementioned characteristics.

C. Disclosure

As discussed in the prior section, it is critical that participants in the markets for high-risk complex instruments must understand the risks that they face. An investor or derivative counterparty should have the information needed to make informed decisions. While the Policy Group has recommended that each participant must develop a degree of independence in decision-making, large integrated financial intermediaries have a responsibility to provide their counterparties with appropriate documentation and disclosures. Disclosures must meet the standards established by the relevant regulatory jurisdiction. The Policy Group believes that appropriate disclosures should often go beyond those minimum standards, both through enhancement for instruments currently requiring disclosure, and by establishing documentation standards for instruments that currently require little or none.

Risk information should be available to participants in a format that makes it easily accessible. The format should clearly identify the factors that influence day-to-day price changes in the instrument, as well as making a clear statement of the factors and influences that might lead to significant or catastrophic losses. While no intermediary or counterparty can literally predict the outcome of an investment or forward looking market conditions, appropriate disclosures should anticipate the factors and market conditions that will cause the instrument to experience losses. Disclosure should also identify, to the extent possible, the sensitivities of the instrument to those factors and conditions, as well as the approximate magnitude of the losses the instrument will likely experience in such an environment.

For instruments requiring disclosure, the depth and breadth of information required may contribute to the difficulty of accessing the most useful information concerning risk. This information is in the disclosure documents, but the Policy Group believes that a document containing a brief discussion of significant risks will contribute to increased transparency. For instruments currently requiring little or no disclosure, this document will serve as a means of communicating relevant risk information to counterparties. For instruments requiring disclosure, this summary should not be viewed as a substitute for the often lengthy disclosures, but rather as a supplement. Ideally, it will highlight significant risks and encourage a more thorough examination of the relevant sections of the full disclosure document.

Recommendations

The Policy Group believes that there are opportunities to enhance and strengthen the documentation and disclosures provided to prospective investors in high-risk complex financial instruments, while being mindful that documentation and disclosure practices will (and should) vary somewhat from instrument to instrument and will also vary over time. With that qualification in mind, the Policy Group <u>recommends</u> the following as a matter of industry best practice.

III-2a. The documentation of all high-risk complex financial instruments in cash or derivative form should include a term sheet: a concise summary highlighting deal terms and, where appropriate, collateral manager capabilities, and portfolio and deal payment structure. The term sheets for all high-risk complex financial instruments, the full scope of which is outlined in Appendix A, must, among other factors, include the following:

- a clear explanation of the economics of the instrument including a discussion of the key assumptions that give rise to the expected returns; and

- rigorous scenario analyses and stress tests that prominently illustrate how the instrument will perform in extreme scenarios, in addition to more probable scenarios.

III-2b. The documentation associated with <u>asset-backed high-risk complex financial instruments</u> should include:

- <u>A Preliminary and Final Offering Memorandum</u>: The offering memorandum should include prominently within its first several pages the nature of the economic interest of the underwriter or placement agent (and its affiliates) in the transaction, including a clear statement of the roles to be undertaken and services to be provided by the underwriter or placement agent (or its affiliates) to the transaction, as well as any interests in the transaction (if any) that the underwriter or placement agent (or its affiliates) are required or expected to retain.

- <u>A Marketing Book</u>: The marketing book should include an in-depth description of the materials contained in the term sheet. It should especially focus on the collateral manager (in the case of a managed portfolio) and deal structure.

- <u>Portfolio Stratifications</u>: This documentation should be in the form of spreadsheets containing bond level information (sector, rating, par balance, *etc.*), where known, and weighted average loan level information (FICO, service, LTV, % fixed, occupancy, geographic distribution, 2nd liens, *etc*.).

- Cash Flow/Stress Scenarios: This documentation should be in the form of spreadsheets and cash flow model outputs. Standard runs should be provided for each tranche offered. The output will typically be in the form of tranche cash flows and default/loss percentages for the tranches and collateral.

III-2c. In addition to the documentation standards covered above, the Policy Group further recommends that term sheets and offering memoranda for all financial instruments having one or more of the key characteristics associated with high-risk complex financial instruments as discussed on pages 54, 56 must have a "financial health" warning prominently displayed in bold print indicating that the presence of these characteristics gives rise to the potential for significant loss over the life of the instrument. The "health warning" should also refer to all risk factors in the offering documents.

The Policy Group recommends that complex bilateral transactions that are privately negotiated between sophisticated market participants are not subject to Recommendations IV-2b and 2c but are subject to Recommendation IV-2a regarding term sheets. In certain circumstances, however, and by mutual written consent, the term sheet requirement may be waived for bilateral transactions between highly sophisticated market participants or in the context of a repeated pattern of transactions of a particular type.

D. Intermediary-Client Relationships

Although all market participants must be sophisticated, high-risk complex financial instruments involving a financial intermediary and an end-user or counterparty require special clarity with respect to the nature of the relationship between the parties and the obligations of each in connection with these transactions. These obligations start with the communication prior to and during the execution of a trade and often extend well beyond trade execution. This is particularly, but not exclusively, true for high-risk complex OTC derivatives. Since these 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. These principles are intended as a complement to the standards of sophistication for market participants and disclosure enhancements outlined earlier. A sophisticated participant in possession of clear and concise risk information and a thorough understanding of its counterparty relationships will be in a better position to evaluate high-risk complex financial instruments and manage the associated risks. These principles are intended to complement, rather than substitute for, compliance by large integrated financial intermediaries with their express contractual undertakings and with applicable legal and regulatory requirements relating to the offer or sale of such products.

Recommendations

The Policy Group recommends strengthening the relationship between intermediaries and counterparties in sales, marketing and ongoing communications associated with high-risk complex financial instruments. While its first recommendation calls for establishment of a common standard of sophistication for all market participants in high-risk complex financial instruments, the Policy Group believes that large integrated financial intermediaries should provide clients with timely and relevant information about a transaction beyond the disclosures discussed in its Recommendation III-2 above.

III-3a. The intermediary and counterparty should review with each other the material terms of a complex transaction prior to execution.

III-3b. Both the intermediary and counterparty must make reasonable efforts to confirm the execution of a complex transaction in a timely manner.

- The counterparty should be promptly notified of any expected delay in the creation of a confirmation.

- The intermediary should disclose whether evidence of agreement, such as a signed term sheet, is binding as to transaction terms. Each party should review the terms and promptly notify the other of any error.

III-3c. When a counterparty requests a valuation of a high-risk complex financial instrument, the intermediary should respond in a manner appropriate to the purpose of the valuation. The intermediary's sales and trading personnel may provide a counterparty with actionable quotes or indicative unwind levels. Only groups independent of sales and trading should provide indicative valuations and only in writing. Where relevant, such indicative valuations should include information describing the basis upon which the valuation is being provided.

III-3d. As a part of the relationship between intermediaries and their counterparties following trade execution, the intermediary should make reasonable efforts on a case-by-case basis to keep the counterparty informed of material developments regarding the performance of key positions.

E. Issuer Diligence

One area of focus in the creation and distribution of high-risk complex financial instruments is the responsibility of underwriters for understanding and ensuring proper documentation of the quality of assets in a securitization. Underwriters engage in a process known as "due diligence" when agreeing to bring a transaction to market. Due diligence in both the real estate and non-real estate asset-backed markets takes place on three levels: (1) due diligence of originators, (2) due diligence of the assets being securitized, and (3) due diligence of offering documents. The section that follows describes the current due diligence process in the securitization markets and offers several recommendations for improvements in practices and in communicating results. The description is quite detailed and outlines a very thorough process, but the Policy Group feels that there is room for some improvement. It also believes that the process as described along with the Policy Group's suggested improvements should be the standard by which all underwriters conduct their due diligence activities.

1. Due Diligence of Originators

Due diligence of originators in both the real estate and non-real estate asset-backed markets is driven by the following scenarios: (1) when a new or infrequent issuer comes to market, (2) when a frequent originator forms a new relationship with an underwriter, and (3) each time a frequent issuer plans to securitize a pool of loans. The process of due diligence involves developing an understanding and comfort level with respect to the business practices, background, creditworthiness, and historical performance data of an originator. When a new or infrequent issuer comes to market, the due diligence process involves a detailed examination of their business, involving a number of professionals from the underwriter representing the asset-backed business, credit risk management, and legal/compliance areas. For frequent issuers, due diligence generally occurs multiple times a year, often immediately prior to a transaction or on a fixed quarterly basis.

Once a relationship is established between an originator and an underwriter, the due diligence is largely confirmatory and relies on representations from the originator that nothing material has changed in its business practices as well as an ongoing examination of the originator's performance data in an attempt to determine if in fact there have been material changes. The due diligence conference call is a primary form of diligence of regular issuers and is composed of business and legal questions. Business questions are posed by the underwriter and focus on revealing any material issues related to the portfolio performance and forecast, changes in asset underwriting, the status of the servicer, competition within the relevant industry and any general corporate issues. Legal questions are asked by the underwriters' counsel and are meant to highlight material litigation, potential material legislation, regulatory issues and accounting concerns. Call participants include business and legal representatives from the issuer, all underwriters and their respective legal counsel. This "bring-down" acts as a confirmation of prior due diligence and is often undertaken immediately prior to a transaction, both to ensure that information is current as well as to accommodate a tight securitization schedule.

When a frequent issuer establishes a new relationship with an underwriter (*i.e.*, one with whom it has not previously been involved in a transaction), due diligence may involve the more detailed approach described above, but the underwriter may, depending on the circumstances, rely in part on the due diligence performed by another underwriter familiar with the issuer. Generally, an underwriter in the co-manager role relies on the due diligence performed by the lead managers while the lead manager(s) undertake a more thorough examination. Since there is general agreement among underwriters about the characteristics of an acceptable originator, the reliance has not been considered problematic.

2. Due Diligence of Assets

Due diligence of assets is the process by which an underwriter familiarizes itself with the assets to be securitized and establishes a comfort level as to the quality and disclosure of process and information provided by the originator. Asset due diligence is often conducted on behalf of the underwriter by third-party vendors specializing in this activity.

In the real estate and non-real estate asset-backed markets, due diligence involves the issuer or underwriter hiring an accounting firm to check data integrity. A formal "agreed upon procedures" (AUP) letter from the accountant reports the findings of this confirmatory analysis. In the United States, this letter is mandated by SEC Regulation AB, the SEC's regulatory framework for publicly issued asset-backed securities (ABS), which took effect on January 1, 2006. All publicly registered ABS are subject to Regulation AB, which dictates registration, disclosure and reporting requirements. The AUP letter diligence occurs in two parts: (1) verification of the accuracy of historical data; and (2) comparison of the data tape to the actual loan files through "tape-to-file" procedures. The issuer provides the accountants with sample documents and data related to the transaction pool of receivables. These documents and data may include: (1) a preliminary and final pool of receivables data file; (2) a prospectus supplement; (3) selection criteria; (4) the composition of receivables, distribution of the receivables split by APR, payment frequency, current balance, geography, *etc*.; (5) the managed portfolio losses and delinquencies; (6) copies of the receivables files; (7) the servicer reports; (8) the pool file cash flows; and (9) the methodology used to project various payment speeds. Much of this information is made available to investors.

To verify historical data, the accountants recalculate a selection of key data and performance metrics and compare their findings with those of the issuer to ensure accuracy. In tape-to-file analysis, the accountants will perform statistical sampling of the pool of assets and compare the information provided on the tape to underwriters with the information contained in the loan files or on the originator's or servicer's systems. If exceptions are found they are investigated by the underwriter with the originator and accounting firm to determine what caused the data discrepancy. Exceptions will generally result in the need for additional (or more targeted) sampling in order to determine whether there are systemic problems within the pool of assets and, a determination made, whether to proceed with a transaction. <u>The accountants provide the results of their review via letter to the issuer and underwriter, but this is not shared with investors. AUP letters are also customary in nonpublic (*e.g.*, Rule 144A) underwritten transactions.</u>

In the real estate asset-backed market the due diligence involves random sampling of loans with a detailed examination of the loans in the sample. Here again, if exceptions are found, they are investigated and an additional (and larger) sample is taken. This process may be repeated. If problems persist in the larger samples, the underwriter may determine that the transaction should not proceed.

<u>In both markets there is a tension in the sampling process between the desire for thorough review and the desire to respond quickly to an originating client's desire to come to market quickly. The sample size is sometimes a point of negotiation between the issuer and the underwriter with whom it is considering transacting.</u>

3. Due Diligence on Disclosure

Regulation AB specifies disclosure requirements in four key categories: static pool data, credit enhancement, transaction parties, and pool assets. Static pool performance data on delinquencies, losses, prepayments and residual realization must be provided for the past five years or for such shorter period during which the sponsor has been securitizing, originating or purchasing the same type of assets as those in the subject transaction. Such detailed performance data disclosure is mandated at the time of sale and the initial data are available throughout the life of the transaction on the issuer's static pool performance website, a link to which is typically provided in the prospectus. The prospectus should describe internal credit enhancement, including applicable subordination, overcollateralization and reserve accounts. The prospectus must articulate the experience of and material concerns regarding transaction parties, specifically the sponsor, originator(s) and servicer.

Regulation AB also contains extensive disclosure guidelines regarding the securitized asset pool. For example, the “credit underwriting process” description must include: (1) details of any internal credit grading scales such as FICO or an equivalent internal scoring metric; (2) a description of any economic or other factors that may effect the pool assets; and (3) definitions of delinquencies, charge-offs and uncollectible accounts that address the effect of any grace period, re-aging, restructuring, partial payments considered current or other practices on delinquency experience.

Underwriters examine the disclosure documents to ensure that they accurately reflect the characteristics of the pool of assets. This includes a review by accountants and attorneys. The accountants undertake to comfort the portfolio statistics in the disclosure document and include this in their AUP letter referenced above. The attorneys ensure that the disclosure is not only accurate, but that it also does not omit any material facts. This review is generally thought to be quite thorough. While there are differences among disclosure documents there are no questions or recommendations for changing this due diligence procedure.

The Policy Group has some recommendations concerning due diligence, but is left with the question of what went wrong in the process and how diligence practices might have contributed to the unexpected nature of the losses associated with a number of asset-backed securitizations. This problem appears to have arisen more from a general reliance by all market participants – including, perhaps, the rating agencies – on historical information in assessing the potential for losses, rather than systemic shortcomings in due diligence. While the Policy Group has identified some areas for enhancement of diligence and strongly urges all underwriters to adhere to rigorous standards like those described above, it does not believe these changes would have materially changed performance expectations in the market at the time of the bubble. For this reason, the Policy Group recommended elsewhere in this Report more imaginative use of stress tests and so-called “reverse stress tests” to better inform potential investors and counterparties of the risks they face.

Recommendations

With respect to high-risk complex asset-backed securitizations, underwriters and placement agents should have in place an ongoing framework for evaluating the performance and reputation of issuers as well as effective and clearly articulated procedures for evaluating the quality of assets. The Policy Group <u>strongly urges</u> that underwriters and placement agents redouble efforts to adhere fully to the letter and spirit of existing diligence standards, and seek opportunities to standardize and enhance such standards. These enhancements include the following recommendations:

III-4a. Requiring all firms to follow statistically valid sampling techniques in assessing the quality of assets in a securitization; and

III-4b. Encouraging disclosure to investors of due diligence results, including making the AUP letter publicly available.

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