AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL

PREAMBLE

The President's Working Group on Financial Markets, in the course of our ongoing review of market practices and events, has set forth the following fundamental principles that will inform our approach to private pools of capital. Since we last made a statement on these issues in 1999, the market has matured and expanded considerably, and these fundamental principles have increasingly been reflected in best practices. The current regulatory structure, which is also based on these principles, is working well. As we noted in 1999, "[i]n our market-based economy, market discipline of risk-taking is the rule and government regulation is the exception." We look forward to further progress as these principles continue to inform our actions and strengthen our vibrant capital markets.

OVERARCHING PRINCIPLES

1. **Private pools of capital bring significant benefits to the financial markets. However, these pools of capital also present challenges for market participants and policymakers. Investors, creditors, counterparties, pool managers, and supervisors must be aware of these challenges, including those related to some over-the-counter derivatives, and work to address them. Public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk.**

2. **The vitality, stability and integrity of our capital markets are a shared responsibility between the private and public sectors. Market discipline most effectively addresses systemic risks posed by private pools of capital. Supervisors should use their existing authorities with respect to creditors, counterparties, investors, and fiduciaries to foster market discipline on private pools of capital. Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.**

INVESTOR PROTECTION PRINCIPLES

3. **Private pools of capital can be an appropriate investment vehicle for more sophisticated investors. Because these pools can involve complex, illiquid or opaque investments and investment strategies that are not fully disclosed, the risks associated with direct investment in these pools are**

most appropriately borne by investors with the sophistication to identify, analyze and bear these risks.

3.1 Investors should understand their investments and the corresponding risks, and should not expose themselves to risk levels they cannot tolerate.

3.2 Sophisticated investors that determine to invest in a private pool of capital should ensure that the size of their investment is consistent with their investment objectives and the principle of portfolio diversification.

4. Investors in private pools of capital should obtain accurate and timely historical and ongoing material information necessary to perform due diligence regarding the pool's strategies, terms, conditions, and risk management, thereby enabling such investors to make informed investment decisions.

4.1 As with all investment products and vehicles, clear and meaningful disclosure is essential for investors to evaluate properly their investment decisions.

4.2 Investors should evaluate the investment objectives, strategies, risks, fees, liquidity, performance history, and other relevant characteristics of a private pool.

4.3 Investors should evaluate the pool's managers and personnel, including background, experience, and disciplinary history. Investors also should assess the pool's service providers and evaluate their independence from the pool's managers.

4.4 Investors should consider the private pool's manager's conflicts-of-interest and whether the manager has appropriate controls in place to manage those conflicts.

4.5 Investors should conduct an appropriate analysis regarding the valuation methodology and performance calculation processes and business and operational risk management systems employed by a private pool, including the extent of independent audit evaluation of such processes and systems.

5. Concerns that less sophisticated investors are exposed indirectly to private pools through holdings of pension funds, fund-of-funds, or other similar pooled investment vehicles can best be addressed through sound practices on the part of the fiduciaries that manage such vehicles. These fiduciaries have a duty under applicable law to act in the best interest of the beneficiaries. They have an ongoing responsibility to perform due diligence to ensure that their investment decisions are prudent and conform to sound practices for fiduciaries. Such pooled investment vehicles should address any special issues relating to investment in private

pools of capital, including the availability of relevant, accurate, and timely historical and ongoing material information.

5.1 Fiduciaries should consider the suitability of an investment in a private pool within the context of the overall portfolio and in light of the investment objectives and risk tolerances. Fiduciary evaluation should include the investment objectives, strategies, risks, fees, liquidity, performance history, and other relevant characteristics of a private pool.

5.2 Fiduciaries should evaluate the pool's manager and personnel, including background, experience, and disciplinary history. Fiduciaries also should assess the pool's service providers and evaluate their independence from the pool's managers. Fiduciaries should consider the private pool's manager's conflicts-of-interest and whether the manager has appropriate controls in place to manage those conflicts.

5.3 Fiduciaries should conduct the appropriate due diligence regarding valuation methodology and performance calculation processes and business and operational risk management systems employed by a private pool, including the extent of independent audit evaluation of such processes and systems.

5.4 Fiduciaries that determine to invest in a private pool of capital should ensure that the size of their investment is consistent with their investment objectives and the principle of portfolio diversification.

SYSTEMIC RISK PRINCIPLES

6. Market discipline by creditors, counterparties, and investors is the most effective mechanism for limiting systemic risk from private pools of capital, which is the possibility that losses at one or more entities could threaten the stability of the broader financial system.

6.1 Creditors and counterparties of private pools of capital are generally large, sophisticated financial firms that have the incentives and the expertise to provide effective market discipline. As institutional investors have become an increasingly important source of capital to private pools, the potential for market discipline from investors has increased.

6.2 By limiting their own exposures to losses from a default by a private pool, creditors and counterparties can better protect their own solvency from losses at a private pool. Moreover, the financing terms provided by creditors and counterparties can be an important constraint on leverage employed by private pools of capital.

7. Key creditors and counterparties must commit resources and maintain appropriate policies, procedures, and protocols to define, implement, and continually enhance best risk management practices. Those policies, procedures, and protocols should address how the quality of information

from a private pool of capital should affect margin, collateral, and other credit terms and other aspects of counterparty risk management.

7.1 Creditors and counterparties should undertake appropriate and effective due diligence before extending credit to a private pool of capital and on an ongoing basis thereafter. Due diligence should include a review of the counterparty's ability to measure and manage its exposures to market, credit, liquidity, and operational risks. Due diligence should establish the information flows that will occur during the course of the credit relationship.

7.2 Creditors and counterparties should measure their credit exposures to a private pool of capital frequently, taking into account the availability of collateral to mitigate both current and potential future exposures, and should assess the range of uncertainty around their exposure estimates. Rigorous stress testing should be used to quantify the impact of adverse market events, both at the level of an individual counterparty and aggregated across counterparties. Stress tests should take into account potential adverse market liquidity events in which multiple market participants seek to unwind trades simultaneously.

7.3 The amount of credit exposure to a private pool of capital that creditors or counterparties assume should reflect the level quantity and quality of available information about the pool, the extent to which exposures to the pool can be mitigated through margin and other credit terms, and the amount of capital that the creditors or counterparties have allocated to support the exposure.

7.4 Information that creditors and counterparties should seek to obtain from a private pool includes both quantitative and qualitative indicators of a private pool's net asset value, performance, market and credit risk exposure, and liquidity. The level of detail expected should respect the legitimate interest of the private pool in protecting its proprietary trading strategies. Where sufficient information is not forthcoming from a particular private pool, creditors and counterparties should tighten margin, collateral, and other credit terms.

7.5 Creditors and counterparties should implement and comply with industry sound practices to strengthen processing, clearing, and settlement arrangements for credit derivatives and other over-the-counter derivatives. These practices include protocols for issuing and completing trade confirmations, obtaining prior written consent for assignments, and using cash-settlement procedures for over-the-counter credit derivatives following a credit event.

7.6 Large exposures to private pools of capital are among the risks that should be reported to senior management periodically. Senior management should ensure that its firm's aggregate exposure to such pools is consistent with approved risk tolerance for bearing losses in adverse markets.

8. Investors in a private pool of capital should carefully evaluate the strategies and risk management capabilities of the private pool to ensure that the pool's risk profile is compatible with their own appetites for risk.

8.1 Such investors should undertake appropriate and effective due diligence before investing in a private pool of capital and on an ongoing basis. Due diligence should include a review of the counterparty's ability to manage its exposures to market, credit, liquidity, and operational risks. Due diligence should establish the information flows that will occur during the course of the relationship.

8.2 Such investors should seek assurances that the private pool in which they invest complies with industry sound practices, including practices for risk management, reporting, and internal controls.

8.3 Such investors should evaluate the extent to which similarities in strategies pursued by multiple private pools in which they invest undermine efforts to limit their risks through diversification.

9. Managers of private pools of capital should have information, valuation, and risk management systems that meet sound industry practices and enable them to provide accurate information to creditors, counterparties, and investors with appropriate frequency, breadth, and detail.

9.1 Managers must devote sufficient resources to the creation and maintenance of information, valuation, and risk management systems to ensure that high quality, material information can be delivered to creditors, counterparties, and investors in a timely fashion.

9.2 Risk management and valuation policies employed by private pools of capital should comply with the industry sound practices. Such pools also should implement and comply with industry sound practices to strengthen processing, clearing, and settlement arrangements for credit derivatives and other over-the-counter derivatives. These practices include protocols for issuing and completing trade confirmations, obtaining prior written consent for assignments, and using cash-settlement procedures for over-the-counter credit derivatives following a credit event.

9.3 The information provided by managers of private pools to their creditors, counterparties, and investors should adhere to the sound practices articulated in industry guidance. Managers of private pools of capital should provide information frequently enough and with sufficient detail that creditors, counterparties, and investors stay informed of strategies, the amount of risk being taken by the pool, and any material changes.

10. Supervisors should clearly communicate their expectations regarding prudent management of counterparty credit exposures, including those to private pools of capital and other leveraged counterparties, who are increasingly utilizing complex instruments, including certain over-the-counter derivatives and structured securities, such as collateralized debt obligations. Because key creditors and counterparties to pools are organized in various jurisdictions, international policy collaboration and coordination are essential.

10.1 Supervisors’ expectations with respect to prudent risk management practices should take into account developments in financial markets and advances in best practices for counterparty credit risk management. Supervisors should actively monitor such developments and revise their policies and associated guidance as appropriate in a timely manner. In turn, supervisors should actively monitor and assess whether policies and procedures measure up to regulatory guidance and industry efforts to identify best practices.

10.2 Supervisors should take full advantage of both formal and informal channels of coordination and cooperation across financial industry sectors and international borders when carrying out their responsibilities related to internationally active financial institutions’ management of exposures to private pools and leveraged counterparties.