FOREIGN POLICY ASSOCIATION

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THE WORD FROM WALL STREET

Featuring:

James P. Dougherty, Moderator -
Partner, Great Hill Partners

Panelists:
Archibald Cox, Jr. Chairman Barclays Americas

Dr. Henry Kaufman, President and CEO, Henry Kaufman & Company Inc., and Author, The Road to Financial Reformation

William W. Priest, CEO & CIO, Epoch Investment Partners, Inc.

MR. JAMES DOUGHTERY: And it's a great honor to be here at this forum and I just when I heard that Teachers was formed in 1918 that was the same year that the Foreign Policy Association was formed so a lot of great ideas happened at the same time. So what we are going to do at this conference we have Archie Cox Henry Kaufman and Bill Priest and we are going to begin this session on Wall Street with a short presentation by Henry Kaufman and then he'll take his seat back and then we will have some other discussions and some presentations. Then we will open it up to the audience for questions and we guarantee we will end on time. So without further ado I will address Henry Kaufman to stat the program off. Thank you.

MR. HENRY KAUFMAN: Thank you very much. I am going to talk to you about an important issue that is sitting in front of us and that is financial concentration and regulatory reform. The most severe financial crisis since the great depression damaged not only the financial system but also the larger economy. On the

financial side the worst may be over. But there is no guarantee or sustained economic growth and no guarantee that markets will not be shaken again in the next few years. To minimize the chance of a near future as bleak as the recent past we must put in place rules of behavior for private sector financial institutions along with reformed financial supervision that can insure really such rules are followed. The many proposals in circulation today but so far very little action has been taken. Now today I want to focus on a critical need in new regulation that has gotten far too little attention among policy makers and pun dance. That is the current and the future role of financial conglomerates or as some call them integrated financial institutions. As debt has grown expeditiously in the United States and as the financial system has tethered and collapsed. Financial authorities have given most of their attention to financial instruments such as derivatives, mortgage backed securities and credit defaults works and relatively little to the structure of dominant financial institutions. My - - in watching one drama a second drama play has continued to unfold on the same stage through little notice the unprecedented consolidation of Behemoth financial conglomerates. Massive financial concentration seemed quite unlikely in the early post War World II years. The great depression that followed the speculative excesses of the 1020's inspired sweeping political backlash. Congress has to wave a very tough legislation that constrained financial institutions chiefly banks within specified markets and segregated them from many activities. Financial conglomerates not only became unfashionable but they have been outlawed. For their part senior management at most leading financial institutions still recall vividly the harrowing banking failures and massive dead write offs of the depression years. It was reasonable to expect that financial specialization with its segmented and well-defined borders would be there forever. The consolidation of the American Financial markets increased gradually almost I would say in perceptively in the 1960's and 1970's. It centered mainly on the mergence of banking institutions. Especially among deposit type institutions such as commercial banks, savings and loan associations and savings banks. Many of the institutions had lost their independence through mergers had fallen victim to excessively liberal lending practices, a harbinger of the future. The competitive pressures in the late 1970's and 1980's led to a way of deregulation that essentially dismantled the new deal era of regulatory regime. By the 1990's financial concentration reached a title wave proportion. The lynchpin was the abandonment of the glass legal act, which had kept most financial business separate. At the time official supervisors and regulators didn't seem to grasp the ramification from the risk contagion to conflict of interest of lowering the firewalls between financial sectors. Now consider just some of the data on recent financial consolidation. As recently as 1990 the ten largest financial companies held about ten percent of U.S. financial assets. Today they hold at least sixty percent. The share controlled by the 20 largest has grown during the same period from 12% to nearly 80%. Of the fifteen largest U.S. financial institutions in 1991 all but five have lost their independence as they were merged into survivors. Today only two investment banks remain even as they are sheltered by a legal structure supported by the Federal Reserve. Back in 1990 there were more than fifteen thousand FDIC insured banks. Since then failures and mergers into larger institutions have cut

that more than in half. Today large financial conglomerates are so diverse and so integrated that to classify them along what I would call traditional lines as commercial banks, insurance companies or investment bank would be highly misleading. Many provide deposit facilities within their own holding company. Quite a few are active in the US market and abroad in a wide range of activities including investment banking, the trading of securities, proprietary trading, insurance, money market funds and money management itself. Now in light of the developments that have occurred what have we learned really from the prevail of the last couple of years? There are several conclusions that I believe are undisputable. First, large financial institutions did not anchor, were not an anchor of stability in our financial system. It seems fair to say that if the Federal Government had not provided enormous amount of direct and indirect financial support in key markets all of them would have failed. Even the healthiest ones would have been pulled down by their interconnection with weaker players and that collapse in turn would have been followed by harrowing economic depression. Second, the top firms drove the credit creation process with great ingenuity and force. Their large and skilled management teams were at the forefront of securitization propelling markets for derivatives, credit defaults - -, mortgage back securities and other exotic instruments to an unprecedented scale and to new levels of risk. They also played a central role in popularizing quantitative risk analyst techniques. Techniques that rather than controlled risk tended to encourage risk taking and contribute to the debt overload in our system. And third I think we should recognize that the leading financial conglomerates played a central role in shifting the concept of liquidity to one that was based on the assets side to the liability side of the balance sheet. Years ago liquidity of business corporations meant the size of liquid assets to maturity of conceivable, the turn over of inventory and the relationship of their assets to liabilities. For households it primarily meant the maturing assets being held for contingency but in recent decades liquidity has increasingly come to mean access to credit. Access to borrowing. The dominant conglomerate financials were instrumental in this transformation. I aggressively marketed credit cards by popularizing and array of new liberal mortgage financing techniques and by spinning off many risky business and household assets into subsidiaries or securitizing them. Risk taking strategies and tactics of financial giants were not the sole cause of the crisis of 2007 and beyond. Much of that damage could have been prevented by effective regulatory over sight. It is widely acknowledged that the financial regulatory system itself has become anchoritic in an age of diversified conglomerates but even within this framework system key players failed to act decisively and effectively and none more so than the Federal Reserve. Under the current system the FED is the primary guardian of our financial system with its power to raise and lower interest rates primarily through open market purchases and sales of securities, the Fed has enormous influence over the growth of debt. But in recent decades the central bank failed to adequately restrain the growth of their companies. It allowed them to grow much more rapidly then the gross national product. For a variety of reasons Fed officials did not understand the powerful role that financial innovation such as securitization in the derivative revolution would play in propelling the

growth of debt. Monetary policy might have curbed many of these potential market excesses. The Federals have failed to recognize that abandoning the Glass Steagall Act that would accelerate financial concentration and create more institutions deemed to big to fail. It is revealing that the Fed officials never publicly admitted that large institutions were to big to fail until the current credit crisis took hold. The prevailing philosophy for a long while among simple bankers was that markets with disciplined leading institutions as shareholders and some creditors would suffer losses and management would be removed but as we learned the hard way during the past year or so, market discipline is not enough. Some institutions are too big to fail and by the time they reach that point they have piled up a massive excess debt on the public and seriously weakened the credit structure. Now this doesn't mean that markets don't work anymore than it means that only markets work. The challenge is to strike a right balance in financial markets between entrepreneur drive and fiduciary responsibility. By its very nature the fiduciary role in our financial system must fall chiefly on government. Financial institutions will always push to the edge of risk taking. When they innovate profitability competitors will imitate. There is no copyright patent on most financial innovations. Therefore firms often seek profits through new trading techniques and new ways of increasing leverage that new and growth through acquisitions and diversifications. It is therefore the job of the government to set prudent rules of financial behavior. In recent decades leading financial institutions, the FED and other regulatory bodies alike were caught up in the financial libertarian view that most who perform well will fail and those who will do well will prosper. As Chuck Prince, former head of Citi said several years ago, "As long as the music plays, Citi will be on the dance floor." What he meant was because as long as the Federal Reserve supplied funds Citi would push hard to employ them and if not Citi would loose market share and might not be able to pay competitive employees' salary or might not generate enough earnings to satisfy stock holders. That view engulfed all large financial institutions and on the regulatory side economic libertarianism was an important force behind the demise of the Glass Steagall Act in the 1990's. Now unless our government acts to reverse the rapid growth of financial bigness, financial concentration will increase even more. It seems likely that with the growing acceptance and popularity of two big to fail some firms will consolidate in order to find safe harbor under the government protective wing. But greater concentration would be quite harmful to our financial markets and our economy. To begin with in recent events have taught us that financial conglomerates are very difficult to manage. Second, financial consolidation will continue to undermine competition in financial markets leading conglomerates already control huge shares of key sectors of your markets. They are deeply entrenched and engaged in both the buy side and well as the sell side of transactions. They are underwriters and they are also institutional investors and portfolio managers and on both and also financial advisors. Third, diversified financial firms that engage in proprietary trading are ripe with conflicts of interest in this typically highly leveraged activity they garner information from their huge volume of client activity insights to which other participants are not privy. It's a kind of inside information. More over many financial holding companies house

deposit institutions and benefit for the association with the deposit facility when they carry on proprietary trading. Again the recent financial crisis reveals fissures in the system. The government should halt proprietary trading and other highly leveraged activities of many conglomerates in part because of a guaranteed deposit operations. And fourth rate of financial concentration will significantly impede the marketability of all securities. With fewer market makers, dealers and underwriters, financing costs will increase and spreads for security trading in the market will ultimately widen. The greater concentration of financial markets the greater will be the swing in financial asset prices. The lack of diversity in markets will bring with it sharp shifts in market prices over time as noticeable in recent years this will become a global phenomenon. Financial conglomerates have global reach. The sixth damaging effect of financial consolidation perhaps the most important of all is its role in pushing our political economy from an economic democracy to whatever imperfect protection that they have to a more socialize system. In an economy with highly concentrated financial sectors the Government will remain a powerful force in the allocation of credit as we have seen in the current crisis. Even for those who support such intervention they assume it would be temporary. The risk is that temporary emergency measures will become permanent. Although Congress is devoting a lot of attention to health care reform, financial reform will also figure prominently in the months ahead. This legislation from my perspective might take several directions. One would be to transform the largest, the two big to fail conglomerates into a financial public utilities kind of organization structure. This could entail limits on profits for instance or higher capital requirements in their smaller counterparts. In addition such firms might be required to maintain an equity interest in the instruments they securitize and reserves against derivatives they originate they also maybe be derivative from proprietary trading. This is probably not the best way to go. Giant conglomerates all surely will continue to dominate the financial scene from time to time. When markets are royal again in the future some financial firms will merge again in order to be to big to fail. Alternatively regulators might require the largest financial conglomerates to spin off a significant proportion of their assets so what remains would not be to big to fail. But I doubt Congress would legislate such action. Not surprisingly the urgency to act decisively I think has waned somewhat as the business recession shows signs of easing and security are bouncing back. But financial concentration and all the serious risk that it imposes to our financial markets and our economic democracy may have merely paused to catch a breath. Without real reform to reign in excessive financial behavior we continue to risk the kind of financial upheaval that could to even greater socialization of our financial system. Thank you.

[applause]

MR. DOUGHERTY: Thank you Henry. Now Bill Priest will make a few comments.

MR. BILL PRIEST: Again thank all of you for coming and an opportunity to interact with my panel members is a pleasure. I think Henry's one of the great sages in the world of economics and its, many of my comments are going Para ell his so I will shorten

those. I will start off with the idea in many respects what we just went through is of enormous significance. A year ago we were looking over the abyss and if we had Armageddon we were approaching it when Ted Spread which is a measure of liquidity that trades the Euro dollar spread at 450, 460 basis points just about a year ago. If there was going to be the end of the world that was about to fore see that. But we are and in fact the Ted Spread today is 19 basis points. The liquidity storm that we faced is essentially over in that respect. There are other storms that we are dealing with but unfortunately I think the feel good of the re-flation and the financial markets through the lowering of the credit spreads have made some of Henry's comments particularly relevant. We cannot loose sight of what happened. It was really pretty awful and this is close to the end of the world as we know it as the experience and one of my suggestions are actually already is I saw in the New York Times but I had a meeting about two weeks ago with a couple of people and govern I really do think you need the equivalent of a 9/11 commission to kind of look at what happened over the last decade or so. Lots of blame to place here. You can look at government policy. Federal reserve policy, the role of banks, the role of compensation systems in banks. There's an awful lot of stuff that came together to indicate the size and seriousness of this problem. And again just to give you a little evolution of an aspect of it because I think much of what Henry said is absolutely true. We should have this commission and he should be a member. I think he reflects an awful lot of un-political insight. He is not a politically correct person, that's good and I think what you need are truth tellers. There are two few truth tellers in the financial system today. So let's just take a little bit of a look at the evolution of investment banking. Henry alluded to this in his comment. Investment banking model in many respects after 1929 or so and Glass Steagall having been passed in 1933, you had a separation of commercial banking and investment banking because we had a near disaster at that time in the financial world as well. The investment banks were simply private partnerships at that time. They were advisors to industry. They provided advice, they did underwritings, and they did M & A suggestions. They were essentially handmaidens to industry. The investment bank in the 1930's was nothing like the investment banks today. Actually there is not any of them left according to that model which I will walk through but what we see today is a lot of prop desk trading, the conflicts of interest that Henry alluded to all very present. What changed from that period in the 30's to today? Let's start with the concept of OPM, Other People's Money. In the 60's - - Lufkin went public and what happened with that with them when they came public essentially you had the input of outside capital shareholder money. It was permanent capital. You essentially you lowered the cost of capital to this industry in that process. It made it easier to grow; you could become a little more aggressive. It was essentially shared by management ownership and public ownership. It's all well and good but it also set the stage for some conflicts, which I will get into, but OPM to me was the first stage. The second stage was the development of derivatives. Now the explosion of new tools for hedging risk, taking risk, arbitrage and on and on all came out of the application of derivatives. In many respects Myron Schulz, Fisher Black and Bob Mertin split the atom. They could do a lot of very very good things and it could do a lot of very

very bad things. Warren Buffet has them weapons of mass destruction, financial weapons of mass destruction. But the instruments themselves were not the problem. It was the leverage that got placed to them, the opaqueness, and the misuse potential proved to be the problem. So you had OPM, you had the Black Schlitz option theory in the mid 60's. Most of the people that had been running banks at that time had no clue what that development would do. Then you had the issue of leverage. Now leverage was built into the system and you can't blame all the banks. You can take a look at what happened between 1980 and 2000. Essentially between 1980 and 2000 interest rates fell over a thousand basis points. We had the great moderation. Central bankers got to be pretty full of themselves in terms of we obtain the business cycle we don't have a problem. That was rather foolish particularly if you look to the period of 100 years rather than just 20 years. Risk was in. The 1968 period of risk avoidance with all of its problems gave way to a significant attraction to risk and frankly if you are running a bank and you looked around and you thought you know what the world is less risky. Volatility is coming down. We can actually put more risk if you leverage up your return and equity goes up, stocks go up. Let's start to practice that. Essentially this was a combination of what was going on in business, the Federal Reserve and now the emergence of a compensation model. Now the new business model investment banks by the time we got to the 90's in particular was this. You know I think about 50% of revenues ought to go to comp, then we have SG&A and the rest will go to our shareholders. Now lets see, the more revenues the more comp. But in a little more leverage and we have got more revenues and we have got more comp. Essentially this was going on and you started to have the beginning of a systemic problem in the banking system but it was really coming out of what was a mounting to a lay say fare capitalistic system. Capitalism is not going away. All the other ISM'S have proven to be much less attractive. The kind of capitalism we had, the quasi fare capitalism to me basically failed us. But it wasn't all by itself. It had to do with government policy. But anyway we had this new business policy and low and behold we have in 1999 we have the passage that is the repeal of the Glass Steagall Act. I completely with what Henry said in terms of the effect of that. Repealing Glass Steagall was done under the guise of you know what these European Banks and universal banking model, they are far superior to what our poor buys are doing. Our poor commercial bankers can't do the investment banking, investment banking wanted to do with commercial banking people wanted to do too. So in many respects Bob Rubin whether knowledgably or unknowledgeable essentially was a lobbyist for the banking system. One week after the passing of that repeal I think Bob took a job at Citibank as Vice Chairman, probably one of the shortest job interview processes I am familiar with. But at this point investment banks and commercial banks could merge but there was one big difference. Commercial banks essential are deposit institutions. Investment banks are wholesale financed institutions and it only works if you have confidence. So through commercial paper and the ability to roll over commercial paper that was what the issue was. Once there was no confidence in that segment of the market there really was credit gridlock, you had investment banks such as Lehman leveraged 40 to 1. They had leverage, they had toxic assets and basically it was

game over for the investment-banking model. Investment banking model as existed two years ago is gone. It doesn't exist. They had huge leverage these toxic assets, faulty raised by agencies and short term credit markers all produced game over but to Henry's point and it is actually a quote I have in a paper coming out, the quote by Prince was actually a realistic quote, if you think of what the essence of the banks are it really is to maximize the profitability for the owners of the business. That's the charge so they behaved how you would have thought. The problem is we also had a backdrop of government policy through deregulation, role of Fed and Alan Greenspan having essentially telegraphing what's then called the Greenspan Put. You essentially had a put to big problems. This encouraged risk taking. It wasn't that the government caused the problem but they permitted it through twenty years of behavior Democrats and Republicans but there was a twenty year period where there was permission, deregulation was in, quasi fair capitalism was in, self regulation was in and then if you were running a company even if you thought you saw a problem the reality is that there was a race to the bottom. You had no choice if you were going to compete with the guys who were more risk takers you had to be in that same situation. So in many respects the government policy through thirty years of deregulation and faulty fed policy provided the backdrop for this problem. The incentive systems that were embedded in a lay say fare capitalism and self-regulation is the match that lit the tender that was provided by government policy. There are so many elements to this and it's complicated. I really do think we all benefit from having a 9/11 Commission or the equivalent thereof. You don't want to make rash decisions in a short period of time but it happened after the period in the 29, 30 periods when the congress set up the core commission. But you really, it needs to be serious. You need to have serious truth tellers on there and the last thing you need to have an open democracy is to have a concentration in the financial system. Gigantism, which is certainly, I agree with Henry on this point, gigantism is certainly anti-democracy. In the long run it is not going to be good for America and the values that we have so I will stop there and turn it over to Archie.

MR. DOUGHERTY: Thank you.

MR. ARCHIBALD COX, JR.: I think I am in the camp where the same place Bill is and that is one thing is very clear. What we shouldn't do is act precipitously which I think there is a tendency to do and which we have done in the past in various things and there are an awful lot of legitimate questions about both about what happened and about the role of different institutions, the role of the regulators, changes in legislation and so forth and the protection of depositors. Do you ring fence deposits or don't you ring feds deposits. Do you set the question of whether you try and turn the clock back and reinstitute the Glass Steagall type of thing? I think those are all legitimate questions. I think they can't be answer, there is no simple answer to them and I personally think it is too late to turn the clock back to Glass Steagall. I think that size has become a problem; too big to fail is a problem. I think there is some interesting potential solutions out there such as been suggested in the UK where the large financial institutions have in effect living wills that if they get into a position where they are failing there is a wind down

mechanism which is an interesting concept rather than simply getting government support and carrying on. I think that's worth looking at. I think it's easy to condemn derivatives. It is easy to condemn compensation. It's easy to condemn a variety of different things. But I don't think that those that condemn always understand the role they play. It's not clear for instance the credit default swaps played much of a role in what happened and in fact when Lehman Brothers and General Motors broke settling out credit default swaps wasn't a problem. Settling most derivatives I think the debate going on with derivatives is an interesting one and I think there is some merit to central clearing bodies to exchange trading of standardized derivatives. How you define standardized derivatives and the devils in the detail as usual and the unintended consequences of various actions are what we need to worry about and fully understand. What's standard and what's none standard when it comes to a contract? What's the impact on the not the dealer who maybe be perfectly happy to list and to clear through central clearing body standardize contracts but what's the impact on the clients, people who are using hedging as a mechanism for something themselves and I like to sight the example of the mid cap medium sized expiration and production companies that use hedging as a method of raising capital. We will, we have outstanding I would say between ten and fifteen billon dollars of exposure through hedges to mid cap oil and gas companies in the United States. If those companies had and similarly we deal with government institutions producers such as Mexico, if they had to list if they had to clear their contracts through a central clearing organization they would have to put up post collateral whenever the price of oil or gas went up, whatever they had hedged. They don't have collateral. The mid-cap sized companies don't have collateral. Where are they going to get the money? They're the ones doing all the energy exploration in this country. The majors have abandoned this country on shore for practical purposes. You'd take away a huge amount of employment and a potential you know something that contributes to the solution of our energy problem if you forced the companies themselves to clear through central clearing organizations. We and others in the industry would never lend the amount of money to companies that we're prepared to have as exposure through hedging transactions where we have security of the reserves and if the price of the reserves go up they don't have to post collateral we're perfectly happy because the value of the reserves has gone up. Things like that, the devil is in the detail. People don't understand and don't get into detail. This is a comment on I think two things I might say without taking too much time. Size and compensation. The latter in particular and maybe regulation briefly. There will be more regulation. There should be more regulation. De-regulation has failed. Again we need to get it right and that's part of the debate that is going on right now. I hope it's a sensible debate and people don't act too quickly. On size yes I agree with some of the things that Bill said having been at Morgan Stanley during the time when we debated going public which was in 1986 we could not accumulate and grow fast enough to serve our clients and compete with other institutions without going public and raising outside funds. Now it was at that time that the model of paying out roughly fifty percent of revenues in compensation was established. Is it right that that same model exists today when revenues are many multiples of what they

were then and the institutions are many sizes of what they were then? I think that is a far question to ask but it's still the model. Compensation itself and the size of the institution I would argue that there has been no question as Henry says there has been concentration and the institutions have gotten bigger so too have the clients that they serve. It seems to be in every industry there is a long-term trend towards concentration whether it's the chemical industry or the energy industry or anything else and you have to be bigger to serve your clients. So in and of itself there is a question of too big to fail and what you do about it and you build a living will route and you go some other route and I don't think we want to go the government supported route even though we are there, we need to get out of that. Compensation is a hot button. I think there to there's no easy answer on compensation. You can, you can, and I have been the chairman of the compensation committee on publicly listed companies. It's a very difficult task to align the interest of shareholders with management and to reward for performance and particularly for performance verse their piers. The level of compensation in many respects is so structure of compensation is issue. I think we have - - pretty good. I think that there is other places where it is not as good. But in any event it needs to be looked at seriously. It's a real issue. Level of compensation I have to say it's obviously an issue at great extremes. There are some social questions I think that people raised that you can't ignore. But it's also a competitive issue and not just a competitive issue among financial institutions. If we don't pay our best people who make the most money for us they will go elsewhere such as to hedge funds which are unregulated and where people make a lot more money than they make in financial, in banks frankly. So we can't just say people shouldn't you know whatever the amount is. Should people get paid a hundred million dollars a year? That's a different issue. That gets to the corporate world as well though. Not just the financial institutional world so a lot of questions, no easy answers. A lot of thought needs to be given and we don't need to act precipitously as we did with - - which was passed in three days without I believe a single corporation commenting on it which in hindsight was a great mistake.

MR. DOUGHERTY: Bill you have a comment?

MR. PRIEST: Yeah. I agree with many of the things that Archie was saying. The problem with compensation structure is the asymmetric nature of them. When you place leverage in there and you create a situation where an individual can win but the firm or the industry or society looses, that's a problem. You've got to deal with this systemic effect that is embedded in leverage. You can look at it when you look at hedge funds or private equity people for example. There's a fellow in Boston that has written a very nice paper on compensation systems of two and twenty. It is very interesting. The two percent is very often justified. It's the asymmetric claim on profits with a twenty percent structure that is often the problem and it's so one sided in favor of the manager, basically the client that you kind of wonder why people sign up for it. It's a free world. There is full disclosure, there's consent and disclosure and consent cover all the sins in the world in my view. But still you have to be very careful with compensation structure with regard to the leverage embedded in there.

MR. COX: I agree with that. I will say though one should not forget that people say that people own enough have enough of an ownership interest it will be a mitigating factor to behavior. The people who got hurt worse, individuals who got hurt worst in what happened were the CEO's of Lehman and Bear Sterns which in theory did a lot of what people are proposing gets done and maybe their stakes were too big so it led to the wrong behavior but they in fact were doing what a lot of people are proposing and it didn't help. There are no easy answers. I think at the individual level all of this makes sense. The problem is when all of the individuals start to behave a certain way you have a systemic affect. You can't blame the individuals for behaving in what is the rational way for that particular model. It's just the government and I do think regulation failed miserably. They were gone. The two or three days before Bear Sterns went under Christopher Hocks said we are totally comfortable with the balance sheet of Bear Sterns. Where was he? When they went broke they had a book value of sixty dollars. The day they went and filed they had a sixty-dollar book value. It was that's the reality. It was an institutional failure at the regulation of these institutions and that is, you just can't go out and react to that. I do thin this needs to be studied. It sounds like it's deferring a problem but it's not. You really need some thoughtful reason people. The jurist Posner whose has written a fabulous book called Capitalism, it's really worth reading. It will give you another perspective. There are some very thoughtful people in this country on this issue. They don't really have an axe to grind they just want the place to work better. I think those are the people that should comprise any commission we put together.

MR. DOUGHERTY: Henry do you think the tactical; I mean we'll talk broadly about regulation. Do you think the government should regulate compensation of people who work in the financial industry?

MR. KAUFMAN: No I don't think government should regulate compensation with people working in institutions. But you can have a dampening impact of a significant magnitude if you increase the equity requirements in business substantially therefore you decrease the leveraging that goes on. A lot of the profits that have been garnered have occurred because of the massive amount of leveraging meaning financial institutions have piled on huge amount of debt of various magnitudes, all kinds of financial arrangements on balance sheet, off balance sheet which allows profit as you pile up more debt and you generate profits everything goes to the bottom line. Now you can reduce that significantly. You can reduce it by raising capital requirements very very substantially number one. Number two, if you have a deposit facility within your orbit as a holding company you ought to recognize you have a kind of a responsibility here where the government is insuring the deposits and at the same time indirectly you are using the strength of that insurance as a way of increasing your liabilities to bring things down to the bottom line I think that's completely incorrect. It also ought to be noted those who are and I have been in financial markets all my life and I have the best interest for the well being of that system but those who are engaged in financial institute as creators, as middle management as such are in a business where they have no downside risk. The downside if they do well in a year they get the good rewards. If

in subsequent years they don't do so well the worst that can happen is they leave and go to another organization. That's not the way really to run financial institutions. There's something wrong with our financial economic system. Profits of financial institutions, profits of the financial sector rise increasingly as a proportion of total profit in a country. It isn't right. Financial institutions didn't invent the wheel, they didn't invent Microsoft, and they didn't invent any of the real activities going on. They helped finance it and support it and such but that financial sector should increasingly get more and more profits as a percent of total profits in a system is wrong. It is absolutely wrong. That ought to be reordered not by the government coming in and saying does this or that. To a large measure that can be accomplished by increasing the equity state that is in that institution. A comment was made before about hedge funds. Hedge funds charge 2 and 20. As such I don't run a hedge fund so I have no direct interest in it but in a hedge fund there are limited partners and general partners. When you are a limited partner you are at risk period. You are at risk if the partnership does well you make more money. If it doesn't do well as we saw during the last year or two your capital goes down. There is no insurance. There is no protection of any magnitude. But think about it. We have money market funds that were being distributed by financial conglomerates and others and there was always the feeling well money market funds are the equal of deposits. But they are not the equal of deposits as we learned. And if the government hadn't intervened and practically insured those money market funds there would have been a great disaster beyond what has already occurred. How can and the marketing of a money market was in such a way that you believed that it was the equal of a deposit and somehow the government would protect it and secondly there was always the belief you had instant access money. That wasn't true but that was the way it was perceived in the system. That's wrong and the institutions involved had a lot to do with disguising the role of activities in such a way that they were user friendly to the clients. That's wrong so we have a lot that can be done to straighten out what the rights and the wrongs are in the system.

MR. DOUGHERTY: Yes ma'am.

MS. ERICA KARP WITH UBS and the question is for Mr. Cox and the panel and thank you by the way. Can you make some comments on the globalization of financial organizations and Archie I used to work for you actually 20 years ago at First Boston but you know the opportunity for financial regulation to really be synchronized globally to a greater extent and especially with the kind of consolidation we are seeing across borders, anything you might want to share?

MR. COX: That's a good question and a particularly topical one right now when various countries seem to be staking out different positions on the subject with I guess France right now Mr. Sarcosi being the furthest on one extreme and others not being let's say anywhere as near as extreme as that. Very difficult to coordinate financial regulation other than through the BIS, the bulk agreements, Bow one, which is followed, it has certainly been useful Bow two. I think there will be changes made in those agreements and those to me are the ones that make the

most sense. If you are going to try and have some sort of global framework and I think you need some. What we don't need is to have regulatory shopping going on. I don't think there is much of that but there's a risk of different countries that react differently. It also will create uncompetitive landscape for people, which would be unfortunate. The two most important ones, which seem to be somewhat in sync I think, are the UK and the US. Those are the two major financial centers still but we shouldn't forget, we shouldn't forget the others as well so it's a real problem and maybe it will get addressed somewhat this weekend but at G20 I am not sure.

MR. DOUGHERTY: Sir?

MR. JIM REILLY: I am Jim Reilly from Needman and Company. You've made a very compelling argument that scale is a problem and concentration of assets is a problem. One of the things that are clear is that the growth engine of this country has small companies and I'd be interested in your perspective on the impact of concentration of assets at these large institutions on the IPL market. Intel, Microsoft you mentioned they went public as relatively small companies and is that even feasible today given the concentration of holdings amongst large domestic institutions and if that's not possible how can it be fixed so that we can have a thriving growth economy in the US?

MR. COX: Well the hope is the Microsofts of the future will be able to find a smaller underwriter or a medium size underwriter and that will pursue this kind of an adventure. The hope is that we have these companies now that seed and provide investment capital as such but it is true that very large financial institutions tried to systematize their lending and investing operation and therefore certain kind of client or may even fall through the cracks. It can't get the personal attention that you get when you walk into a medium size or a smaller institution. You are perceived to be more important than if you walk into a very large institution where the lines of authority are quite quite numbered before you see the top and the systemizing having a system and a clearing process that doesn't really fully cope necessarily with the opportunity, which you described. One of the problems here that we have today is the pressure that's on our medium sized and smaller banks for example. What happens to these medium and smaller banks? Well close them down. How do you close them down? The FDIC comes in and tries to find a buyer. Probably a larger institution, further concentration as such so we're really doing very little to help those communities have a financial institutional environment that is friendly to them. It's just the reverse. Standardize everything through getting big. I think our government has done very little really to reverse that trend. Having said that there are these private funds that are out there looking for IPOs to invest in and so on and can nurture them along which is indigenous to a large extent or have been indigenous to the United States and was not apparent in Europe or in Asia and so on. It's an American process. It's about the best answer I can give.

MR. DOUGHERTY: Comment?

MALE VOICE 2: I think a large; there are two sides to the issue. One is as the financial institutions gotten bigger caused that to happen or financial institutions, banks and brokerages and investment banks.

MALE VOICE 1: The asset managers themselves.

MALE VOICE 2: The asset managers the other side of that. They have gotten so big that frankly anything with a market capitalization below sometimes you think is below five hundred million but Bill maybe it is two hundred million but it's something like that isn't of much interest to most of the big institutions and that is a, that is an issue as a person who invested venture capital. Understand it is a real issue. I think Henry's right that there are institutions that you can turn to but you do have to be a bigger size today to go public.

MR. KAUFMAN: Yeah. I would add a couple of things in principal you have - - characterized this as creative destruction. One of the great economists of our world and our day but essentially we keep reinventing ourselves. We will reinvent ourselves and I can see it in our own little business. We are a publicly traded company. We are a long only asset manager. We are going to have the best year we have ever had for new business. We're small compared to Barclay. They have got more zeros after what they manage than we do but the truth is people are always looking for somebody who has a better way to do things. Very often it starts with a smaller firm because doing something different or you are going to die and there has to be a transparency to it. You have a vested interest. There is a passion to it. You can find this in smaller firms. I also think if you look at underwritings this year, look at the lead underwriters. Many of these firms I have never heard of before. They were so far down the list of distribution it's a very different list. We have firm in Australia, Grant Samuels being one of the biggest distributor of deals this year so I do think we will reinvent ourselves in this way.

MR. DOUGHERTY: Sir?

MR. FERNANDO MULON: Good morning gentlemen. My name is Fernando Mulon and I teach Foreign Policy at West Point and I am here with my students. I wanted to ask an inverse question in what Jim asked. Bearing in mind all the different foreign policies or all the different economic policy prescriptions that have circulated around Capital Hill right now in your opinion what are the top one or two worst policies and issues you could take in the short term to make things go bad?

MALE VOICE 1: How broad can we be?

[laughter]

MR. MULON: And how much time do we have?

MR. COX: We have spent more time on this healthcare issue than I think we need. We should have a gasoline tax in this country. It would be good for this country. We cannot even discuss it. You want to make America safe start to put on a gasoline tax. It's one of my personal; we cannot talk about it. It's just something that we

can't deal with. You have big policies and something that you're front and center in and you've got a big debate with respect to Afghanistan, that role the systematic claim that a war has on the resources. I also think two things are happening in this country that's very unfortunate. One of them has to do with the military. The fact that we have a volunteer army is unfortunate. We would react very differently if it were the children of the people in this room that were taxed with going to war. We have, we take a very hey it's not my family; it's someone else's. That's wrong. We should have a vested interest in those things. I also think the same thing is relevant with politicians. There are actually majors in colleges now called career politicians. What does that mean? You know? What is a career politician? I'd like to know that somebody worked understands what it means to have a job, perform a service, then go try and do something good. The system is broken and if you read - - this book the Post War America it is another must read in my view. We have such a short-term view among our politicians we can't deal with ten-year issues let alone twenty-year issues. I'll get off my soapbox.

MR. DOUGHERTY: Henry one of the worst ideas that are being bounced around Capital Hill now?

MR. KAUFMAN: Well I will speak just from the financial side of it rather than paint a broad issue because the broad issue it would be just as a citizen but I think the worst idea in terms of financial is to have a separate supervisor and regulator over system risk. I think that can't occur effectively because how can that separate system regulator communicate effectively with the Federal Reserve. The Federal Reserve is the creator of reserves. The Federal Reserve allows debt expansion and such and how can a supervisor that sits on the outside there fully have the intimacy of what the Fed is doing or have the Fed really know what the supervisor is doing? You can't separate those responsibilities. It's like somebody on a baseball team where he's only a fielder and never hits as such. That's not the way the game ought to be and I have to say that there is a perception here that you can just establish firm rules, firm regulations. You know you can't do that in the financial markets. I think the role of a financial regulator is to have a better mousetrap, to build a better mousetrap all the time for the financial system. Participants in the financial system will always say hey that's the cheese I don't like so there has to be a way of keeping the financial system really on a sound basis and you can't do that with this ongoing quantitative rules and regulations.

MR. DOUGHERTY: Go ahead ma'am.

MS. PAULINE KIRSHENBAUM: Pauline Kirshenbaum, CEO of Chapin Associates another small money management firm. The American citizens around the world are really questioning the voracity and integrity of our financial system. They feel it's been severely impaired by the naked shorting by the derivatives quadrillion or so that we are still not discussing. What is the business model of the United States and the financial services industry that has to deal with financing the business model of the United States and how do we get through this?

MR. PRIEST: I am not sure the United States has a business model per say.

MR. KIRSHENBAUM: Otherwise we are, right now we are a Casino.

MR. PRIEST: I don't think we really are a Casino. I don't believe that. I do think you had a systemic, you had a systemic risk pop up that shouldn't really have popped up. There were many many signs over many many years regarding deregulation as a government policy. A Federal Reserve policy was a problem and it intersected with quasi fare capitalism and an element of quasi fare capitalism that had to do with compensation. The worm came together. Now at the same time I think the more we understand it the more, when you can articulate a problem accurately the responses and the answers are embedded in the articulation of the problem. That's why I think you need really this commission. I think then you can put in place regulatory issues you need, some of the safeguards. We can't just fix everything. People are responsible for their behavior. I think what you can do is set some rules of the road and make sure their enforced standards if you will. Then you have to let the free market kind of manage it themselves. That would be my view. I think what we just done in the United States we've put on nine trillion dollars of debt. That's a big deal. Now I don't know what's how that's going to play out essentially we were looking at Armageddon a year ago. We moved away from that but we traded one problem for another and as someone once told me a long time ago when you never solve a problem simply trading one for the other and hope the second one is more manageable than the first. And that's where we are. We hope the second one that is coming our way is more manageable than what we faced a year ago. I don't think we had a choice though. I don't think we had a choice last year except to do what it did. It was haphazard but it needed to be done. It was over in my view.

MR. DOUGHERTY: Thank you.

MS. SANDRA HAYES: Sandra Hayes, Professor of Mathematics at University of New York. I'd like to ask you to please elaborate excuse me on your remark that credit defaults - - did not play as large a role in the current crisis as one often reads? In 2007 there was more money involved in the credit defaults swap market then the worlds GDP. There was more money involved in producing and the bets weren't regulated. There was not enough collateral to honor them.

MR. COX: Well first of all I have no problem with credit default swap being traded in a more visible fashion. All I am saying is I don't think credit defaults, I think credit defaults swaps are in many respects misunderstood and like derivatives they get tarred with being the cause of the problem and there's some very good things about credit default swaps and as I said when some major corporations have gone broke, the credit default swaps and they were huge in volume, there was no, nobody went broke as a result of the default swaps not selling out. If the attempts to regulate credit default swaps it's the unintended consequences of doing it. Suppose we as a financial institution or any financial institution has exposure to a say a Argentinean Corporate customer and we want to hedge that exposure, there's no way of hedging it other than through a Sovereign a credit default swap on the Sovereign Credit. Now what people call you know a covered or an

uncovered, a naked or a none-naked credit default swap it's the only way to do it. It's relatively covered but by definition some people would put it in the wrong category.

MR. KAUFMAN: I would agree with Arch on this. You had roughly sixty-two trillion dollars of the revenues. More than but when you looked at what those derivatives were many were just currency hedges. They just matched off with one another. It wasn't a big deal. Another suggestion would be around July of every year the bank for International Settlements puts out an annual report. It is one of the most boring things - -. I promise you will fall asleep three times before you get to the end of it but it's very very good.

MR. PRIEST: If you get to the end.

[laughter]

MR. KAUFMAN: It's very very good though and to me it's an unbiased picture of the state of the Global Finance and they have a lot of insights prior to the crash you could, I wrote a book a couple of years ago that dealt with some of these issues. A lot of the source data was the 2006 VIS DATA. A lot of this was there. You could see some of this.

MR. DOUGHERTY: Very quickly. You're next. No. No. No. This gentlemen. You are after him.

MALE VOICE 3: She's got a bad back. It is hard for her to stand.

MR. DOUGHERTY: Oh please sorry.

FEMALE VOICE 1: (Inaudible)

MR. DOUGHERTY: Can you speak into the microphone please.

FEMALE VOICE 1: The short recovery which you still don't you can short without an uptake and that I think can cause huge problems and tremendous amount of movement of the market and if you had, if you couldn't short take it would make a huge difference and I asking you Mr. Cox you've been talking about it for a few years and nothing sort of has been done. Do they expect to do something about that because to me that's one of the most important things?

MR. COX: I would make two comments. First of all the, I happen to, the studies that have been, that there is no impact on liquidity on the markets if you'd have an uptake rule or you don't have an uptake rule I myself instinctively think there ought to be an uptake rule despite what studies show. The bigger problem to me is the naked short selling. There is a rule that you can't sell short unless you can borrow the stock. I don't believe that was enforced in light of the crisis last summer and I think that is the bigger problem.

MR. DOUGHERTY: Yes.

FEMALE VOICE 1: (inaudible)

MR. COX: Yeah and that caused there is no question that the pressure that was put on the stocks and the financial sector a lot of it came from I won't say organized, some people would but from short selling and I find it hard to believe that people were short selling in those volumes that were being able to borrow the stock. So it contributed to the crisis ugh confidence with out any question.

FEMALE VOICE 1: (inaudible)

MR. COX: No I think it would have provided for less instability in the market.

FEMALE VOICE 1: (inaudible) You have been a pillar on Wall Street.

MR. COX: Thank you.

MR. DOUGHERTY: You have ninety seconds left. Sir I hate to put you on the spot.

MALE VOICE 4: Sure this is another one related to the previous two. My name is Jim Stoddard and I teach in the business school at - - Technical Institute. I was confused by Chairman Cox's comment that by going towards trading that small and medium enterprise in the oil industry would be squeeze out of hedging. Isn't that a part of the unfortunate evolution of financial terms where they come to mean they are opposite but you know the hedge funds aren't really about hedging. Um because there are already exchange-traded commodities in oil and grain which very small farmers, I mean poor farmers in India exchanges to trade hedge on their crops so I didn't understand your comment.

MR. COX: No, no. I was talking first of all most of these contracts, the many of these contracts they use are unstandard but whether they are standard or un-standard I was addressing more the question to had to clear their trades not through a dealer like us who would clear through a central clearing. They themselves had to clear directly to a central clearing corporation. Not a question where the contract is traded. If they have to clear it through a central trading corporation then they have to post collateral if there are price movements. They don't have the collateral to post. That would be the impact, which would basically mean they wouldn't get the financing. After what they are doing is selling their production and if they have to post collateral they don't have the collateral to do it. I would be a huge contraction of financing to the mid-cap energy sector.

MR. DOUGHERTY: So we are now going to take a fifteen-minute coffee break. Back in the room at 10:45. Thank the panel for an excellent job. Thank you very much.

[applause]

[END OF The_Word_From_Wall_Street.MP3]