The Financial Economists Roundtable
1993 – 2008
The Kaufman Years

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Foreward

We all know George Kaufman as an amazingly productive scholar. The 26 pages of George's publications in the appendix to this volume are a testament to his energy, insights and range of expertise. His research is always informed by his experiences in the public sector and on corporate boards, but most importantly by his passion for making institutions and markets work better. The number and variety of his co-authors speaks to his role as a catalyst in bringing new insights to fundamental issues in finance and regulatory policy. We could have included another 26 pages of conferences that he has organized and probably another 52 pages of conferences at which he has been a principal speaker.

But what is most distinctive about George is his incredible ability as an academic entrepreneur. We know of no other economist who has organized and nurtured as many organizations and journals as George. This volume is to honor his commitment to the Financial Economists Roundtable (FER) for the past 16 years. That alone has been a remarkable accomplishment in light of the quality of members he has attracted and the valuable policy insights that have been generated by the annual statements. But, of course, FER is merely one of the many organizations he has founded. He also founded the Shadow Financial Regulatory Committee in 1986, which has issued quarterly press releases on a wide variety of regulatory initiatives. Among its most important accomplishments have been the prompt- corrective-action, least-cost-resolution reforms embodied in the Federal Deposit Insurance Improvement Act of 1991 and the highlighting of the many flaws that are now becoming apparent to even the most enthusiastic proponents of Basel II. George's Shadow Committee has spread globally with Shadow Financial Regulatory Committees now operating in Europe, Latin America, Japan, Southeast Asia and the Antipodes. Indeed, he will be leading a joint meeting of all the Shadow Financial Regulatory Committees in Santiago, Chile next month.

In addition he has played a key role at several journals. He is founding editor of both *The Journal of Financial Services Research* and *The Journal of Financial Stability*, editor of *Research in Financial Services* and on the editorial boards of *The Journal of Money, Credit and Banking, Contemporary Economic Policy, Review of Pacific Basin Financial Markets and Policies, Journal of Managerial Issues, The North American Review of Economics and Finance, Journal of Applied Business Research, and The Multinational Finance Journal.*

He has also served in a variety of academic leadership positions: President of the Western Finance Association, President of the Midwest Finance Association, President of the North American Economic and Finance Association, the Board of Directors of the American Finance Association, and the Board of Directors of the Western Economic Association. In addition, he has won a number of awards for his teaching and scholarship, including the Adam Smith Award, presented by the National Association of Business Economists, the Distinguished Scholar Award presented by the Midwest Finance Association and is a Distinguished Fellow of the North American Economics and Finance Association.

George began his career at the Federal Reserve Bank of Chicago in 1959, where he continues to be a consultant and advisor to the Bank. His first academic position was as a professor at the University of Oregon. He is currently the John Smith Professor of Finance at Loyola University of Chicago. George also has been a visiting professor or scholar at numerous other institutions, including the University of Southern California, Stanford University, the University of California at Berkeley, the U.S. Treasury Department, and the Federal Reserve Banks of San Francisco, Dallas, Cleveland and New York, as well as the Reserve Bank of New Zealand.

In recognition of George's role in founding and sustaining the Financial Economists Roundtable, we are pleased to present him with this volume containing all of the FER statements discussed and issued under his leadership. We look forward to his continued wise counsel and active involvement with the FER and as a member of the FER's Executive Committee.

Financial Economists Roundtable
Statement on
Registration Requirements for Foreign Securities

July 28, 1993

We the undersigned members of the Financial Economists Roundtable (FER) propose that American investors be allowed to trade the shares of major foreign companies as easily as they now trade the shares of U.S. companies. Our proposal should be viewed as a first step towards eliminating the regulatory impediments that now preclude the securities of most foreign firms from being traded on the principal U.S. equity markets.

The Securities and Exchange Commission now requires foreign firms that wish to have their securities traded in these markets to register under the Securities Exchange Act of 1934, and, among other things, reconcile quantitatively their financial statements to U.S. generally accepted accounting principles (U.S. GAAP). This registration requirement hinders U.S. investors and exchanges in trading foreign shares.

Eliminating impediments to the trading of foreign shares will enhance the competitive position of the United States in world equity markets and reduce the cost to U.S. investors, who trade these shares. Our proposal to facilitate the trading of foreign shares in U.S. markets is consistent with the principal elements of a recent suggestion made by the New York Stock Exchange.

We propose that the equities of very large foreign companies be made eligible to be traded and/or listed in the United States on registered exchanges and on NASDAQ without conforming to all current SEC registration requirements. To be traded on U.S. equity markets, foreign companies would need to have available only their customary financial statements, independently audited, and have revenues of at least 3 billion dollars and a market capitalization of at least 1 billion dollars.

Adopting our proposal will benefit U.S. investors and make U.S. financial markets more competitive.

Financial Economists Roundtable
Statement on
Derivative Markets and Financial Risk

September 26, 1994

Observers recently have expressed heightened concern that derivatives may undermine the stability and efficiency of our financial markets and institutions. Firms increasingly are using forwards, futures, options and swaps, and various combinations of these fundamental derivative instruments both to manage or reduce risk and to increase returns. Current concern about derivatives centers on the expanding use of customized offexchange (or OTC) derivative instruments, the largest component of which are interest rate and currency swaps. Although acknowledging that the growth of derivatives is a reflection of the market's demand for better instruments with which to manage risk, both the Congress and regulators remain uneasy about the misuse of derivative instruments and the potential consequences that might flow from a major default in derivatives markets.

This concern, no doubt, partly stems from the sheer size of derivatives markets in general and to the ballooning OTC derivatives market in particular. The General Accounting Office (GAO) reports that at year-end 1992 the notional value of outstanding futures, forward, options and swap contracts alone totaled more than $17 trillion, up from $7 trillion in 1989. Another reason for concern about derivatives is the seemingly impenetrable complexity of some of these instruments. This complexity has created an aura of mystery about derivatives markets, and has fostered a fear that a miscalculation by someone, or an undetected but vital flaw in the market or regulatory system, could trigger failures cascading into a financial market meltdown.

Several studies of OTC derivatives markets in the last few years by the Bank for International Settlements (the "Promisel" Report), the Bank of England, the Group of Thirty, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, and the Government Accounting Office reflect these concerns. The GAO Report, the latest of these, contains the most provocative policy recommendations.

The GAO Report recommends additional regulation of both derivatives dealers and endusers of derivatives. The study concludes that OTC derivatives could pose a systemic risk to financial markets if a major OTC dealer were to default on its counterparty (or contractual) obligations. It also finds that certain "unregulated" dealers, such as those affiliated with securities and insurance firms, have created a potentially dangerous "regulatory gap" that needs closing. The Report recommends bringing these dealers under federal government supervision and imposing on them capital adequacy standards similar to those now imposed by federal regulation on bank OTC derivatives dealers. In addition, the GAO Report recommends that the Congress give the Securities and Exchange Commission (SEC) power to oversee the use of derivatives by all major end-users of complex derivative instruments. Finally, the Report calls for improved accounting and disclosure principles for derivatives for both dealers and end-users and recommends market-value accounting for all financial instruments, but stops short of spelling out how it can be implemented.

In response to the GAO Report, Rep. Edward Markey (D., Mass.) has introduced legislation that would require unregulated derivatives dealers, such as those affiliated with securities and insurance companies, to register with the SEC. The SEC would set capital and other standards for these dealers, conduct inspections or examinations of the dealers, and receive periodic financial reports from them. In addition, by amending the definition of the term "security" to include derivatives based on the value of any security, this bill would enlarge the SEC's regulatory purview. Other proposed legislation, introduced by Rep. Henry B. Gonzales (D., Tex.) and Rep. Jim Leach (R., Iowa), respectively the chairman and ranking Republican of the House Banking Committee, would expand regulation of financial institutions engaged in derivatives activities.

Do OTC derivatives justify the concern which underlies the GAO Report and the proposed legislation? While one cannot rule out the possibility of a systemic crisis in almost any financial market, the Financial Economists Roundtable believes that the use of OTC derivatives does not justify the current fear that they might cause a systemic meltdown. Moreover, members of the Roundtable worry that precipitous and unnecessary government intervention directed at preventing such a possibility may create rigidities that impede the responsiveness of markets in times of stress.

Fear of a market meltdown appears to center on the possibility of a major default by an OTC derivatives dealer. The GAO Report emphasizes the high level of concentration that exists among derivatives dealers and the extensive domestic and international linkages among these dealers. Although there are approximately 150 derivatives dealers worldwide, the GAO reported that, in December 1991, eight U.S. bank dealers accounted for 56 percent of the total worldwide notional (or contractual) amounts of interest-rate and currency swaps. In addition, the GAO noted that there are only five U.S. securities affiliate dealers of any size. Thus, there is a fear that the failure or withdrawal of one of these major dealers could spill over to other dealers and markets in the United States and abroad. Some also worry that, if this were to occur, no authority in any one country could contain the fallout and subsequent disruptions from spreading to other countries.

The Financial Economists Roundtable believes that this view both exaggerates the counterparty risks involved in derivative transactions and understates the ability of dealers and derivatives users to manage their own risks and to avoid losses that threaten their solvency. Banks, which comprise the major derivatives dealers, already operate under effective regulation. They are subject to capital requirements, extensive reporting requirements, and must maintain internal systems for estimating and evaluating risk. In addition, after interviewing U.S. broker-dealers and insurance companies with major derivatives dealer affiliates, the GAO reported that these dealers are well-managed and well-capitalized, and have good systems in place for evaluating and managing the risks involved. Pressures from rating agencies and counterparties, as well as self-preservation incentives, already impose considerable discipline on derivatives dealers.

Properly measured, dealers' credit exposures arising from OTC derivatives transactions currently do not seem excessive. As the GAO Report recognizes, "notional" amounts of derivatives contracts do not provide a useful measure of counterparty risk. Figures like the $17 trillion notional size of the market do not provide a meaningful measure of actual exposures. Unlike credit instruments, such as loans or bonds, derivatives transactions (such as swaps) do not involve payments of principal amounts. Derivatives involve periodic payments based on notional amounts but not payments of the notional amounts themselves. For example, a swap of a variable interest rate for a seven-percent fixed rate on a $10 million principal (notional) amount commits the swap parties to annual payments to each other in the order of $700,000, with differences in future payments depending on how interest rates move in the future. Neither party to the swap risks $10 million. The credit exposure is not the notional value of the contract, as it is for a loan, but the "replacement cost" of the contract. Consequently, the typical derivative involves a credit exposure equal to only a small fraction of its notional principal.

Both dealers and end-users also use a variety of risk-management techniques to control counterparty risk and to reduce the magnitude of their credit exposures. Internal credit limits are commonly used to diversify credit risk and to restrict the size of exposures to individual counterparties, industries, and countries. Bilateral contractual netting provisions, which allow firms to offset losses with gains from other contracts outstanding with the defaulting party and its corporate affiliates, further reduce counterparty exposure. In addition, credit "triggers" reduce potential losses from counterparty defaults by requiring the automatic termination of a swap if the credit rating of either party to the swap falls below a prespecified threshold (such as a single A rating). When dealers undertake swaps with lower-rated counterparties, they usually also require counterparties to post collateral on a market value basis.

Based on its survey of fourteen major financial institution derivatives dealers, the GAO reports that "net" counterparty risk is generally about one percent of notional principal. At year-end 1992, these dealers had derivative contracts (futures, forwards, options, and swaps) outstanding with a notional amount totaling $6.5 trillion. The GAO Report estimates the "gross" counterparty credit exposure for these dealers to be $114 billion, less than two percent of the reported notional amount. After taking into account netting agreements, collateral requirements, and other risk-reduction provisions, this $114 exposure reduces to a "net" exposure of $68 billion, about one percent of the reported notional amount. Moreover, the GAO found that actual losses incurred by derivatives dealers as a result of counterparty defaults have been minimal: 0.2 percent of their combined gross credit exposures in 1992.

To put dealers' counterparty exposures in perspective, we can compare banks' derivatives exposures to their loan exposures. For the seven largest U.S. bank derivatives dealers, the GAO reports derivative-related "gross" credit exposures (as a percent of equity) to be less than a fourth of their loan exposures. Further, although the "gross" derivatives exposure exceeds 100 percent of equity for all of these banks, only a default by all of a bank's counterparties would wipe out the bank's capital, and only then if there were no offsetting netting agreements and other risk-reducing mechanisms in force and the actual losses incurred were identical to the total exposure. Such conditions seem unlikely for derivatives as well as for loan defaults.

The Financial Economists Roundtable agrees with the GAO that financial statements need to better reflect the use of derivatives, but neither the GAO nor we know what to recommend. Although we generally favor market value accounting, imposing market value accounting principles on firms' financial assets and derivatives without imposing it on their liabilities will create misleading financial statements. For example, an interest rate swap that effectively transforms a fixed-rate liability of a firm (such as a bond) into a floating-rate obligation should not be valued at market unless the firm's financial liability is also valued at market. Similarly, reporting changes in the market value of commodity linked derivatives used as a hedge against physical-delivery contracts without also reporting at market value the offsetting gains and losses on the physical-delivery contracts may mislead investors, creditors, and senior management. The huge derivatives loss suffered recently by Metallgesellschaft is an example of what can occur because of misleading accounting principles (in this case, German accounting principles). The Supervisory Board of Metallgesellschaft, observing large unrealized losses on the firm's hedging positions (energy futures and swap contracts), and apparently not recognizing the offsetting unrealized gains on the firm's physical-delivery contracts, ordered the general liquidation of the firm's hedging positions, realizing substantial losses. Thus, whatever accounting and disclosure practices are adopted should treat derivatives and hedged positions symmetrically. Market value accounting applied exclusively to derivatives will mislead and will likely discourage firms from using derivatives to manage risk.

Costly accounting and disclosure provisions also should meet a cost-benefit test – the value of the additional information produced should outweigh the cost of obtaining it. At least some of the additional accounting requirements now under consideration may fail such a cost-benefit test. For example, the proposed requirement for corporate end-users of derivatives to report intra-year maximum and minimum values of financial assets and derivatives would require them to mark-to-market many illiquid derivative positions for which obtaining accurate daily values would be costly. The value of this information to both shareholders and management may not justify the costs involved.

The Financial Economists Roundtable has reached the following conclusions:

1. Derivatives serve a highly useful risk-management role for both financial and nonfinancial firms.

2. It is not necessary to impose federal prudential regulation on nonbank derivatives dealers. There is no evidence that the activities of these dealers pose a significant systemic risk. In addition, we see no reason to impose the same regulatory structure on nonbank dealers as on bank derivatives dealers. As recipients and beneficiaries of government-insured deposits, banks are the proper concern of government and should be subject to different regulation.

3. Requiring banks to segregate their derivatives activities into separate and distinct affiliates is not necessary. Regulators can and do apply prudential provisions to banks' derivatives activities as well as to other bank activities. A segregation requirement for derivatives also may impose unwarranted costs on banks. However, U.S. bank holding companies should be permitted by regulation to form separately-capitalized derivatives affiliates not subject to the Basle Accord capital requirements or other types of bank regulation.

4. Increased SEC regulation of SEC registrants that are major end-users of derivative instruments is not needed. While the use of derivatives by these firms may pose a risk to themselves, it does not pose a risk to the economy as a whole. Moreover, increased regulation may harm firms and their shareholders either by inhibiting the use of derivatives for risk-management purposes or by imposing unnecessary costs on firms.

In conclusion, although some major end-users, mutual funds, hedge funds, securities firms, and even banks have incurred derivatives-related losses, most of these losses have been due to inadequate risk-management systems and poor operations control and supervision. These losses have not threatened the stability and efficiency of financial markets, and, by encouraging the development of better risk-management and operational controls, they have had a salutary effect. The best discipline against systemic risk in any market, including derivatives, is to foster a market in which participants have an incentive to manage themselves prudently and can respond quickly and innovatively to market conditions.

Financial Economists Roundtable
Statement on
The Structure of the Nasdaq Stock Market

September 18, 1995

The Nasdaq Stock Market has recently come under intense scrutiny because of charges that some of its dealers have colluded to inflate the bid-ask spreads of Nasdaq-listed stocks. These charges of collusion were largely precipitated by a study by Professors William Christie and Paul Schultz, which was first reported in the press on May 26, 1994 and ultimately published in the December 1994 Journal of Finance. Subsequent to this study, both the Department of Justice and the Securities and Exchange Commission began broad investigations of Nasdaq.

Christie and Schultz find that many Nasdaq stocks exhibit a paucity of odd-eighths quotes (quotes that end in one, three, five, or seven eighths) and conclude that "individual market makers implicitly agree to maintain spreads of at least $0.25 by not posting quotes on odd eighths."

At its annual meeting, the Financial Economists Roundtable discussed some of the issues involved in this controversy and reached the following conclusions:

First, the Financial Economists Roundtable is skeptical that an effective and sustainable collusive arrangement is possible among Nasdaq dealers. Both economic theory and history provide substantial support for the belief that effective collusive arrangements generally require that two conditions be met: (1) there be a small number of firms, and (2) there exist significant barriers to entry. Neither of these conditions is met in Nasdaq. The number of dealers is large (as many as 60 dealers trade the more active stocks) and entry is easy (any existing securities firm that meets minimum capital requirements can become a dealer in any stock by merely notifying Nasdaq).

Second, the publicly available economic evidence reviewed by the Financial Economists Roundtable, including that developed by Christie and Schultz in their original study and in a follow-up study, does not provide convincing evidence of the existence of an effective collusive arrangement. In particular, the shortage of odd-eighth quotes in Nasdaq stocks does not necessarily imply the existence of an effective collusive arrangement on Nasdaq.

Third, the evidence to date suggests, nonetheless, that the displayed and effective bid-ask spreads of Nasdaq stocks are, on average, substantially wider than those of comparable NYSE stocks. The difference between Nasdaq and NYSE spreads also cannot be accounted for by economic factors such as share price, trading volume, company size, volatility of return, and the degree of adverse information facing dealers. In interpreting this evidence, it is important to note that bid-ask spreads are only one dimension of quality in the execution of an order. The effect of wider Nasdaq spreads may be mitigated for customers who pay no commissions when their broker is acting as a dealer or who are easily able to negotiate prices inside the spread (such as institutional investors).

Fourth, the Financial Economists Roundtable evaluated various structural features and practices of Nasdaq that might contribute, both separately and together, to the wider spreads on Nasdaq and agreed that the following are the most important:

- Limit orders priced within the best bid and offer usually do not improve the quote on Nasdaq, while they do on the NYSE. Nasdaq is a dealer market with the best bid and offer being determined by the bids and offers of the individual dealers, but there is no requirement that a Nasdaq dealer display price-improving limit orders in the quotation system.

- Preferencing and internalization of order flow may reduce the incentive for a dealer to improve bids or offers. Order flow is preferenced when a broker agrees to route its retail customer order flow to a particular dealer (often in return for a payment), and the dealer agrees to execute that order flow at prices no worse than the best bid or offer, as required by Nasdaq rules. Order flow is internalized when a dealer trades with its own retail customers at prices no worse than the best bid or offer of any dealer. If a large fraction of the order flow is preferenced or internalized, a dealer's incentive to improve quotes is reduced because posting better prices may not attract additional order flow. The preferencing and internalization of order flow also exist in other markets, such as the NYSE, but not to the same degree.

- Alternative interdealer markets for Nasdaq-listed stocks may reduce the incentive for dealers to post quotes that will narrow the displayed spread. An example is SelectNet, which is an interdealer trading system that allows dealers to trade among themselves at prices different from those available to the general public. Such parallel markets permit dealers to adjust their inventory without the need to offer better quotes over Nasdaq.

In summary, while Nasdaq spreads are substantially wider than spreads of comparable NYSE stocks, this fact alone is not sufficient to infer the existence of a collusive arrangement among Nasdaq dealers. The Financial Economists Roundtable identified several structural features of the Nasdaq market that could cause wider spreads: treatment of limit orders, order preferencing arrangements, and the availability of alternative interdealer markets. In addition, the large number of Nasdaq dealers and the absence of significant entry barriers for potential dealers together provide a substantial obstacle to the creation of an effective and sustainable collusive arrangement among Nasdaq dealers.

Financial Economists Roundtable Statement on Accounting Disclosure About Derivative Financial Instruments

November 21, 1995

The use of derivative financial instruments by financial institutions, other companies, investment funds, and individuals has grown rapidly in recent years. By transacting in exchange-traded instruments (such as futures and options) and "over-the-counter vehicles" (such as swaps, forwards, and other customized instruments), market participants are able to transform their risk exposures in anticipation of movements in interest rates, (currency) exchange rates, indices of stock prices or groups of commodities, and the prices of numerous specific commodities. Derivatives, properly employed, enhance overall economic welfare by making these risk transformations feasible and cost-effective.

Unfortunately, current external reporting requirements for financial assets and liabilities and for derivatives are incomplete and inconsistent. These reporting requirements often induce firms not to hedge important risk exposures and sometimes to hedge accounting rather than economic impacts.

At its 1995 annual meeting, the Financial Economists Roundtable examined the external reporting requirements for financial assets and liabilities as well as derivatives. We conclude that the informational content and comparability of financial statements would be enhanced by adoption of the following external reporting requirements:

1. All financial assets and liabilities should be recorded at "fair value", i.e. marked to market, except for derivative positions established to hedge cash flows related to nonfinancial assets or to future expenditures. When prices cannot be directly observed in the market by reference to liquid instruments, marking to market entails the use of models to infer fair value.

2. Hedges of nonfinancial assets or future expenditures should be reported in accordance with the matching principle of accounting, that is, the gain or loss on the hedging instrument should be recognized in the same period that the specified event or the hedged item is taken into income or expense, regardless of the nature of the hedged item.

- If the hedge instrument is not terminated when the hedged item is brought into income, it converts to an instrument to be marked to market.

- Gains on hedging instruments realized prior to the accounting recognition of the specified event should be deferred until they can be matched against the income or expense associated with the hedged item. In accordance with the accounting principle of conservatism, realized or measured losses on hedge instruments should be deferred only to the extent that they do not exceed the unrecorded gains to date associated with the hedged item.

- At the end of each accounting period, material unrealized and deferred gains or losses on hedging instruments, along with (offsetting) unrealized losses or gains on the hedged item, should be disclosed in a footnote.

3. External reporting must be supported by an adequate risk management/internal control system, which provides an immediate and continuous ex ante basis for establishing whether or not a derivative position is a hedge. Furthermore, such a control system provides an audit trail for the independent accountants (CPAs) who must give an opinion on the firm's financial statements.

The above measures would go a long way toward improving the informational content and comparability of financial statements with respect to transactions involving financial instruments in general and derivatives in particular.

Financial Economists Roundtable Statement on Risk Disclosure by Mutual Funds

September 18, 1996

The Need for Information about Mutual Fund Risks

The growth in the U.S. mutual fund industry in recent years has been explosive. Individuals invest in such funds directly and through retirement funds such as 401(k) plans. With broader use comes the need for investors and their advisors to have more and better information concerning the nature of the investments these funds undertake. To help achieve this goal, in March 1995 the U.S. Securities and Exchange Commission (SEC) issued a Concept Release and Request for Comments on "Improving Descriptions of Risk by Mutual Funds and Other Investment Companies". Interest was great - 3,600 individual investors submitted comment letters and the Investment Company Institute (an industry trade association) surveyed an additional 600 fund shareholders on the subject.

In May1996, Arthur Levitt, the Chairman of the Commission, stated that "... at least for the time being, we do not need to mandate a specific risk measure..." but that funds would be asked to select names more closely related to their investment practice and that a bar graph showing historic annual returns should be included in a fund's prospectus, along with "...a brief, plain English risk summary.

Financial Economists Roundtable Views and Recommendations

At its annual meeting in July, 1996, the Financial Economists Roundtable examined the issue of mutual fund disclosure and reached the following conclusions:1. Current disclosure practices in the mutual fund industry are inadequate. Investors and their advisors need more information to help them assess the risks associated with investment in mutual funds.

2. Since the impact of a single mutual fund on an investor's overall financial situation may be complex, a one-dimensional measure is often inadequate. For this reason, fund risk disclosure should go beyond the reporting of historic return variability. Investors and their advisors need information that can enable them to assess sources of future risk; in many cases, history may not be the best guide to the future.

3. To better communicate the sources of risk associated with mutual fund investments, fund managers should provide estimates of the principal risk factors that are likely to influence fund returns in the future. Specifically, fund managers should describe and quantify the expected relationship between their fund's future returns and relevant security market indexes as well as the likely extent of divergence of their returns from such indexes and the probable sources of such divergence. In subsequent periods, actual fund returns should be compared with the portfolio of market indexes previously selected

by a fund. It is important that fund managers both provide estimates of exposures to key risk factors in advance and subsequently report returns relative to those same exposures.

4. Management predictions of future actions and outcomes are, of necessity, subject to error. Thus the SEC must provide an adequate safe harbor for such predictions so that managers can provide honest estimates without fear of later litigation.

5. We hope that individual investors and sponsors of retirement plans that use mutual funds will demand that fund managers provide the above information, thereby avoiding the constraints and costs of mandated disclosure.

The Need for Disclosure of Future Risk

The Roundtable concurs with the SEC's conclusion that disclosure of a specific risk measure need not be mandated. However, the Roundtable believes that investors and their advisors need more information to help them assess the risks of mutual funds and other investment companies.

By its very nature, risk concerns the uncertain future. While investors know (or can know) what happened to a fund's returns in the past, their primary need is to predict the likely range of a fund's returns in the future. The greater is this range, the more risky are a fund's prospects.

Investments in funds are risky because they are exposed to economic forces or factors for which the future is uncertain. Some of these are unique to individual funds, but many are common to many funds. Thus, a U.S. stock fund will typically move to a greater or lesser extent with the overall U.S. stock market. A fund's risk depends on how closely its return is coupled with given indexes, the riskiness of each index, and how closely the indexes tend to move together.

A fund manager can communicate the nature of exposures to major risk factors of this sort by specifying a portfolio of security market indexes that, averaged over the next two to four years. is likely to have exposures similar to those of the fund. Thus, a growth stock fund might specify that a U.S. growth stock index would be an appropriate benchmark for this purpose. Another fund might select a combination of indexes, with 5% in a money market index, 75% in a value stock index, and 20% in a non-U.S. stock index. The Roundtable recommends that each fund manager provide a well-defined index or portfolio of indexes so that investors can be informed of the fund's likely future exposures to major sectors of the security markets.

Since disclosures of this nature will, of necessity, describe management's intentions and predictions concerning future actions and outcomes, the SEC should provide an adequate safe harbor by specific reference under Rule 175 so that funds can provide honest best estimates without fear of later shareholder litigation.

Investors must ultimately be responsible for understanding or making predictions about the risks associated with major market sectors, as well as the extent to which sectors are likely to move with one another. Much of this information is common to many funds and thus can be most efficiently provided to investors by third parties such as financial planners and database providers. In contrast, the manager of a mutual fund is in the best possible position to predict his or her intended future investment strategy and to choose a benchmark portfolio of indexes that best describes that strategy.

In some respects this proposal resembles the SEC requirement that each fund compare its historic returns with those of a broad-based index, preferably one provided by a third party. However, there are three major differences. First, in many cases, funds can provide better information if they use narrow-based indices. Second, where relevant, funds should use portfolios of indexes. Third, and most importantly, a fund should select a benchmark of indexes representative of future investment strategy whether or not this benchmark was representative of the fund's past strategy.

Many narrow-based indices could be used for this purpose. Some examples are:

- Cash equivalents (for example, short-term U.S. Treasury Bills)
- Intermediate-term government bonds
- Long-term government bonds
- Corporate bonds
- Mortgage-related securities
- Large value stocks
- Large growth stocks
- Medium-capitalized stocks
- Small-capitalized stocks
- Non-US Bonds
- European stocks
- Pacific stocks
- Emerging Market stocks

There is at least one index readily and cheaply available for each of these, and many are already tracked by index mutual funds.

Risk not Related to Principal Factors

Not all risk arises from exposures to major factors. A fund's returns will typically be more risky than those of its selected portfolio of indexes, for one or both of two possible reasons. First, the fund may concentrate its holdings within a sector and hence be less diversified than the corresponding security index. Second, it may rotate its holdings around the long-term average positions represented in the portfolio of indexes.

While it would be useful to formally quantify the non-factor risk arising from one or both of these activities, this may be difficult to do with precision. However, fund managers should provide a narrative account of the likely divergence of their fund's returns from those of the selected portfolio of indexes and the extent to which such divergence is likely to be due to (1) concentrated holdings and (2) rotation among asset classes.

Performance Evaluation

The Roundtable recommends that subsequent disclosures by funds provide historical comparisons of returns with the returns that could have been obtained had investments in the selected portfolio of indexes been made instead. Thus, in all subsequent periods, the fund's returns would be compared with returns on the portfolio of indexes selected by the fund management in advance of that period. To emphasize the risk arising from its operations, the fund should show the difference between its return and that of a portfolio of indexes for each year for which the information is available.

Reporting Historic Variability

In many instances the total variation in a fund's returns may not adequately measure its risk for a specific investor. A fully relevant measure of risk will take into account all the investor's assets and liabilities. For example, an investor making payments on a fixed-rate mortgage will view the sensitivity of a bond fund to change in interest rates differently than will an investor with no such liabilities. Similarly, an investor with existing holdings in a U.S. stock fund will be more concerned with the sensitivity of a stock fund to changes in the level of the U.S. stock market than will one with only holdings in other countries. It is for these reasons that the Roundtable has advocated a focus on the exposures of funds to principal risk factors.

Despite these caveats, the historic variability of returns still provides useful information for many investors. Thus, the Roundtable does not oppose the presentation of information on historic returns for the benchmark portfolio of indexes selected by a fund for the forthcoming period. However, it advocates that any chart based on the previous returns on such a portfolio show the difference in the portfolio's return each year from the average portfolio return over the years portrayed in the chart. Such a presentation emphasizes the effects of risk rather than on historic average returns. Both theory and empirical evidence indicate that history is a much better predictor of future risk than of future average return.

The Need for more Information on Portfolio Holdings

These recommendations are not intended to minimize the importance of third-party studies of past mutual fund performance. Such analyses require high-quality data, some of which can only be provided by fund management. There is one area in particular where the data provided by mutual funds is deficient for this purpose. Funds are now required to report their portfolio holdings after-the-fact once every six months, on a delayed basis to protect proprietary information. To increase the usefulness of studies of mutual fund performance, analysts should ultimately have access to monthly portfolio holdings. To facilitate this, the Roundtable recommends that the SEC mandate that funds include holdings at the end of each of the prior six months when filing their bi-annual reports.

Financial Economists Roundtable
Statement on
Social Security
March 31, 1998

Summary

The Financial Economists Roundtable met in July 1997 to consider long-run problems facing the Social Security system. The goal was not necessarily to endorse any particular proposal for Social Security reform, but to explore how the principles of modern finance can clarify the current debate.

The Roundtable reached definite conclusions on the following points:

- Investing part of the Social Security Trust Fund in common stocks does not help solve the basic problems facing the current, pay-as-you-go Social Security system.

- A reformed Social Security system should be partly funded through individual retirement accounts. But it should preserve a safety net, that is, a minimum benefit for all participants, financed on a pay-as-you-go basis.

- Individual retirement accounts should be invested in well-diversified portfolios of securities, including common stocks. But the money's worth ratios reported in the Report of the Advisory Council on Social Security exaggerate the value of investing in common stocks.

- Individual retirement accounts should be fully owned by workers, just as they own IRAs and 401K plans. Prudent and low-cost management is essential. Competition between private and public management could be healthy.

Introduction

Unlike private pension plans, Social Security is not funded; it is a pay-as-you-go system. The payroll taxes paid by each generation of workers are not invested to cover that Generation's retirement. Instead the taxes are used to pay benefits to workers who have already retired. The young pay the old, and when the young become old, they in turn are paid by the next generation.

Payroll taxes will exceed benefit payments for the next few years. These surpluses will flow to the OASDI (Old Age, Survivors and Disability Insurance) Trust Fund. The Trust Fund is not intended to fund future Social Security liabilities. At its projected peak in about 2020, the Trust Fund will cover less than three years of benefit payments.

The Social Security system faces two serious problems. First, pay-as-you-go will not work in the long run at current tax rates and benefit levels. Projected annual benefits will exceed taxes before 2015, and the Trust Fund will be exhausted by about 2030. Projected annual and cumulative deficits become steadily worse through at least 2075.

The projected deficits are created by several economic and demographic trends. For example, the ratio of young workers entering the workforce to older workers retiring from it will decrease, and once retired, workers will live longer and therefore collect more Social Security benefits.

Second, pay-as-you-go systems do not encourage saving. Young workers invest payroll taxes in exchange for a promise of Social Security payments at retirement, but no net aggregate saving takes place, because the taxes flow to current retirees.

The Advisory Council on Social Security has put forth three proposals for reform:

- Maintenance of Benefits (MB) would shave benefits, eventually increase payroll tax rates and (seriously consider) investing 40 percent of the OASDI Trust Fund in common stocks instead of Treasury bonds. The assumed higher return on stocks in the Trust Fund is used to reduce or delay planned increases in taxes or future reductions in benefits.

- Individual Accounts (IA) would shave benefits and also create mandatory investment accounts for all participants, financed with an additional 1.6% payroll tax. The accounts would be invested in government-managed stock and bond index funds. As annuities from the accounts become available for retirement, there would be offsetting reductions in pay-as-you-go benefits.

- Personal Security Accounts (PSA) would divert 5% of the payroll tax to accounts placed with private investment companies. The rest of the payroll tax would finance a flat monthly benefit of $410 in 1998 dollars. The transition to the new system would be spread over 72 years, financed with an additional1.52% payroll tax and by Federal borrowing.

The Roundtable concentrated on these three proposals, not to endorse or refute any one of them, nor to rule out other proposals, but to focus discussion on the financial issues in Social Security reform.

Individual accounts invested in common stocks

If Social Security participants acquire individual accounts, as in the IA and PSA plans, the accounts should be invested in well-diversified portfolios. Most portfolios would include common stocks as well as fixed-income securities. The additional risks of investing in common stocks -- compared, say, to investment just in Treasury bonds – are offset by higher expected rates of return.

But it is wrong to project the higher expected returns without accounting for the additional risk. The Advisory Council Report makes this mistake.

The Report says that the IA and PSA plans give participants greater money's worth ratios than the MB plan, that is, more valuable benefits relative to payroll taxes paid. In fact, these misstated ratios make the IA and PSA plans look much better than they really are, relative to the MB plan.

The money's worth ratios calculated for the IA and PSA plans look good mainly because the Report projects relatively high rates of return from investments in the stock market and then discounts projected future benefits at a lower Treasury bond rate. The resulting money's-worth ratios are therefore overstated.

Future benefits that depend on the performance of the stock market should not be discounted at a Treasury bond rate. Finance theory and practice require that discount rates include risk premiums sufficient to compensate for investment risks incurred. Replacing a safe investment with common stocks increases expected return, but does not increase present value once risk is accounted for.

In short, the money's-worth ratios in the Advisory Council Report are incorrect and unreliable. They overstate the value of investing in common stocks.

Investing the OASDI Trust Fund in common stocks

Although the MB plan has no individual accounts, its proponents contemplate investing 40% of the OASDI Trust Fund in common stocks. This allows more favorable actuarial assumptions and delays the need for a future payroll tax increase or a further cut in benefits. But this is a cosmetic improvement only.

What are the actual effects of investing part of the Trust Fund in common stocks, other things constant? The Trust Fund is now invested in Treasury bonds. If the Trust Fund buys \$1 billion of common stocks from private investors, the Treasury will have to issue an additional \$1 billion of bonds to private investors. The Federal government would be borrowing to buy equities, that is, swapping bonds for stocks. There would be no change in the funds received or paid out by the Federal government, and aggregate saving would not be increased.

The secondary effects of Trust Fund investment in equities are difficult to forecast. Purchases of stocks by the Trust Fund, and sale of additional bonds by the Treasury, may push stock prices up a little relative to bond prices. Therefore expected rates of return on equities may fall slightly, relative to long-term interest rates, making risk capital relatively less expensive. However, the Roundtable believes that any such changes will be small and probably imperceptible.

Trust Fund investment in equities may also shift risks between current and future generations. Suppose, for example, that the stock market does much worse than projected. (Given the market's volatility, this outcome cannot be ruled out, even in the long run.) If the benefits formula is not changed, the shortfall in projected return has to be made up by future workers (as taxpayers in a pay-as-you-go system). But of course benefits might also be reduced. On the other hand, if the stock market does exceptionally well, future payroll taxes could be lower. But in this case, the political will to hold the line on benefits will weaken. Thus risk would probably be shared by future workers (as taxpayers) and current workers when they retire.

An improved Social Security system

An improved Social Security system should:

- Move to a partially funded system, gradually eliminating part of the unfunded deficit of the current pay-as-you-go system. Funding should be accomplished through mandatory individual retirement accounts.

- Promote saving and assure that individual accounts are invested prudently and managed efficiently.

- Preserve a safety net, that is, a minimum retirement benefit for all participants, financed on a pay-as-you-go basis.

Moving to a partially funded system requires transition financing to maintain benefits for retired or nearly retired workers. Otherwise the shift of payroll taxes to individual accounts will create a dollar-for-dollar shortfall in the Federal budget, and aggregate saving will not increase. It is not clear that the transition costs should be covered by increased payroll taxes; this forces younger workers to pay for current retirees' benefits and also for their own future retirement. A broader-based tax should be considered.

The PSA plan is generally consistent with the goals just stated. The Roundtable does not endorse PSA specifically, but it is better than the IA or MB plans as a framework or prototype for change. The PSA plan moves towards partial funding through individual accounts, preserves a guaranteed monthly payment for all participants, and provides transition financing (although the financing comes from an additional payroll tax, not a broader-based tax).

The IA plan also creates individual accounts funded by an additional 1.6% payroll tax. Annuities supported by the IA account balances would gradually replace part of the benefits from the existing pay-as-you-go system. The IA plan moves toward a partially funded system, but much more slowly and cautiously than the PSA plan. Also, it is not clear whether participants would truly own their accounts. For example, the IA proposal does not say what happens to a participant's account if he or she dies before normal retirement. Does the balance revert to the government?

The MB plan contemplates minor changes to the present system and is not a significant improvement.

Management of individual accounts

Partial funding of Social Security requires a savings program designed to accumulate assets to cover part of retirement benefits. Saving would be mandatory for all workers covered by the system, and many participants would have few other financial assets. Therefore, excessively risky investment strategies would be unacceptable. Securities would be held in index funds or other widely diversified portfolios. Portfolios would be balanced, with investment in fixed-income securities as well as stocks. Participants would be allowed to move to safer portfolios, for example by investing less in stocks and more in fixed-income securities, as they approach retirement.

The PSA plan calls for private management of individual retirement accounts, with few restrictions on investment. Some participants would choose excessively risky portfolios and/or end up paying high investment management fees. The IA plan calls for the government to pool the accounts and invest in index funds, perhaps subcontracting management to a small number of investment companies. In this case diversification would be assured and costs would be very low.

The Roundtable believes that mandatory individual retirement accounts should be restricted to widely diversified portfolios. Excessive costs or fees for investment management should be avoided. Given these constraints, the differences between government and private management of workers' retirement accounts would not be marked. Each would require oversight by an independent agency or regulatory authority to assure that workers? investments go to widely diversified and efficiently managed portfolios. The Roundtable reached no specific conclusions about how this oversight
should be implemented.

A government-managed system would not necessarily be more or less simpler or less cost-effective. Keeping track of collections, transfers and cumulative balances might be more complex in a privately managed system, partly because workers would have greater choice. On the other hand, a government-managed system would require firewalls to prevent political interference in investment management.

The Roundtable did not evaluate any detailed proposals for the administration and management of individual retirement accounts. However, it believes that a combination of private and public management could be healthy. For example, a worker's initial contributions might be directed to publicly supervised index funds invested in bonds and stocks; this would minimize investment management expenses on small accounts. But the worker could be given the option to switch to a privately managed portfolio once a minimum account balance is reached.

Whatever the arrangements for administration and investment management, workers should own their investment accounts. The account balances should be available to a deceased worker's heirs. Upon retirement there should be a choice of payout options, including inflation-indexed annuities.

Minutes of Annual Meeting, Yountville California, July 17-18, 1997

The FER held is fifth annual meeting at the Napa Valley Lodge, Yountville, CA. on July 17~18, 1997. Twenty-five members attended, including new members Tony Santomero and Dennis Logue and first time participants Ned Elton and John McConnell.

Stewart Myers led the discussion on the privatization of social security. He was assisted by Marshall Blume and Dennis Logue. After two days of discussion, Myers, Marshall Blume and Logue "volunteered" to draft a policy statement to be circulated to attendees for comment. Bill Sharpe agreed to put all FER statements through 1996 on his website and keep it current. His website address is www_sharpe.stanford.edu.

The participants also decided to send a summary of last year's statement on "Risk Disclosure for Mutual Funds" to CREF with a request to consider the recommendations carefully, circulate them to the trustees, and make policy-holders aware of them by publishing the summary, cover letter, or other discussion in their quarterly Participant newsletter. A committee of Sharpe, Dick West, Ken Scott and George Kaufman agreed to be "volunteered" for this mission.

Now that FER appears to have reached a degree of permanency, the Steering Committee recommended that members of the Steering and Executive Committees be put on staggered, fixed-term basis and rotated starting with the 1998 meeting. The revised organization structure is attached. The greater sense of permanency also permits us to plan more than one year ahead. The attendees decided to meet next year (1998) on the east coast, on the west coast in San Diego in 1999, and, tentatively, in Montreal or Bermuda in 2000, although the group expressed a preference for west coast venues rather than alternating east and west coasts. We are negotiating with the Spruce Point Inn in Boothbay Harbor in Southern Maine for Monday-Tuesday, July 13-14, 1998. This is a resort and it will be an all inclusive 2 or 3 day package. Please block out these dates. We will likely have to make room reservations earlier than usual.

To permit us to make early group deposits at hotels, which is becoming more prevalent as occupancy rates climb, the group voted a one-time refundable $150 assessment per member. I attached a billing for the assessment and will send a receipt for payment if members request one. Please return it to me with your payment no later than October 1, so that we can use the fund to secure next year's site.

Financial Economists Roundtable
Statement on
Institutional Investors and Corporate Governance

December 1, 1998

Implications of Increased Institutional Ownership of Common Stock

Common stock ownership in the United States has increasingly passed into the hands of financial institutions. It is estimated that institutional ownership of public corporations' common stock grew from 6 percent of the total in 1950 to 47 percent by the end of 1996. Institutions now hold nearly 60 percent of the stock of the 1,000 largest U.S. corporations, and they collectively hold more than 50 percent of the stock in two-thirds of these corporations. In only 12.5 percent of these same corporations do institutional holdings account for less than 30 percent.

The increase in institutional holdings clearly creates the potential for financial institutions to play a greater role in corporate governance. Some, arguing from the American populist political tradition, see this as a potentially dangerous aggregation of power in the hands of concentrated financial interests, The Financial Economists Roundtable views increased institutional ownership of common stock as a favorable development because of its potential for mitigating the problems associated with the separation of ownership from control in large corporations.

Shareholder ownership carries with it voting rights, but in public corporations such voting rights provide a less effective mechanism for oversight of management the more diffuse ownership becomes. As recognized by Adolph Berle and Gardiner Means more than sixty years ago, the resulting separation of ownership from control can afford management the latitude to entrench itself and to pursue objectives that may be inconsistent with shareholders' best interests. Increased institutional stock ownership has the potential to overcome problems that can render ineffective the oversight exerted by individual shareholders. First, the larger the ownership position held by any one entity, the greater is its incentive to oversee management actively. Because larger owners more fully capture the economic benefits stemming from their activism, they are more likely to perceive oversight activities as cost effective. Second, larger ownership positions can reduce the costs of coordinating management oversight activities with other owners. Third, as institutional ownership positions become larger, institutions may find it more difficult and costly to sell their positions in large blocks of shares of companies in which they feel managers are not maximizing shareholder value.

The Financial Economists Roundtable recognizes that institutional ownership poses its own incentive conflicts, since the ownership of stock in institutional portfolios is separated from the management of those portfolios. Institutional portfolio managers represent their shareholders or beneficiaries. It is important that they pursue objectives that are consistent with the interests of such shareholders or beneficiaries.

The Appropriate Role for Institutions in Corporate Governance

The Roundtable encourages institutional owners to take a proactive role in corporate governance. Specifically, the institutions we are referring to include mutual funds, bank trust departments, defined contribution pension funds, and variable annuities. By taking a proactive role, the Financial Economists Roundtable means: (1) thoughtfully and responsibly voting their shares, (2) communicating with management, the press, and, to the extent allowed by law, other shareholders and (3) introducing proxy resolutions.

The Objective of Institutional Participation in Corporate Governance

The primary objective of institutional participation in corporate governance should be to maximize economic value for the institutions' shareholders and beneficiaries. Institutional shareowners should pursue governance initiatives that will maximize the market value of their portfolios. They should not pursue initiatives intended to further the interests of other corporate stakeholders, such as suppliers, customers or employees, to the detriment of shareholders. This also excludes the pursuit of social or political objectives that will not be economically beneficial to shareholders.

While we strongly encourage institutional owners to be governed by the general principle of enhancing economic value, we recognize that in some cases institutions and their beneficiaries will wish to pursue noneconomic objectives. These might stem from shared religious beliefs, as in the case of a retirement fund managed on behalf of a religious order. In other cases, a majority of beneficiaries may wish to see their fund invested so as to promote such goals as social equality or environmental improvement.

The pursuit of these alternative goals should be constrained by two conditions. First, any noneconomic objective should be clearly and fully disclosed to all shareholders and beneficiaries. Second, with the possible exception of funds managed for religious groups (in which membership is voluntary and based on shared noneconomic values), a viable alternative should be made available to any shareholder or beneficiary who does not wish to participate in the pursuit of a noneconomic objective. Such an alternative could consist of the right to withdraw one's funds entirely and without penalty, as in the case of openend mutual funds. The availability of an alternative investment fund that pursues only value maximization would also satisfy this requirement. We believe that the burden should be on institutional fund managers to show that viable alternative investment opportunities exist for shareholders and beneficiaries.

Public Policy Issues

It should be a public policy objective to make corporate governance by institutional owners as effective as possible. The Roundtable therefore opposes any legal or regulatory constraints on the ability of fund managers to vote or communicate with management of portfolio companies. The Financial Economists Roundtable also urges a thorough legislative review of existing restrictions on institutional ownership positions and or other legal impediments to effective governance by institutional owners. The review would seek to determine what changes might either reduce the costs associated with institutions' exercise of ownership powers or increase the incentives of institutional fund managers to take an active role in corporate governance.

Conclusions

Institutional stock ownership has grown steadily in the post-World War II period, and financial institutions are now major shareholders in U.S. corporations.

•Increased institutional ownership of common stock has the potential to increase the effectiveness of corporate governance and to mitigate the problems created by the separation of ownership from control in large corporations.

• Financial institutions should take a proactive role in corporate governance.

• The primary objective in institutions taking this role should be the maximization of economic value for the institution's shareholders or beneficiaries.

•Financial institutions that pursue noneconomic objectives in their governance initiatives should meet two tests: (1) such objectives have been clearly and fully disclosed to shareholders and beneficiaries and (2) shareholders and beneficiaries have a viable alternative investment strategy made available to them.

•The Financial Economists Roundtable urges a review of existing restrictions on institutional ownership and other legal impediments to the institutions' effective exercise of ownership rights.

Minutes of Annual Meeting, Boothbay Harbor, Maine, July 13-14, 1998

The sixth annual meeting of the Financial Economists Roundtable was held at the Spruce Point Inn in Boothbay Harbor, Maine on Monday-Tuesday, July 13-14, 1998. A record 29 members attended. Upon the recommendation of the Steering Committee, the members approved a reorganization of the Steering and Executive Committees and the establishment of an executive director, as described in the attachment. The Steering Committee nominated Marty Gruber and Nils Hakansson to the Steering Committee and George Kaufman as Executive Director. All were elected by the membership. The Steering Committee also elected Marshall Blume to the Executive Committee.

Three new members were announced (George Constantinides, Elroy Dimson, and Artur Raviv) and three members were dropped from active membership for failing to attend at least one of the last three meetings. Active membership totals 37. Kaufman reported on finances. Primarily as a result of the one-time "refundable" $150 dues, the Roundtable is in healthy financial shape. The current bank balance is approximately $6,500. The principal drafters of the previous six policy statements reviewed happenings in these areas since the release of their statement. Last year's statement on Social Security Reform was or will be published in, at least, the Journal of Financial Services Research, Journal of Applied Corporate Finance, Journal of Financial Engineering, and the Financier. Marshall Blume reported that he had used the statement in his recent testimony before the U.S. Senate Committee on Aging, where it was well received. He was approached afterwards by the Economic Security 2000 Committee, an organization "saving" social security that Marshall vetted and found ok, about having FER members participate as individuals in radio/tv/etc. programs on this topic. The group responded favorably and a number of members agreed to participate.

The desirability of a FER website was raised and a committee of Santomero, Weil, and Kaufman was appointed to investigate its feasibility and cost. Ingo Walter invited the group and spouses/friends to his nearby summer home for cocktails on Monday night.

In line with alternating east and west coasts, next year's meeting will be in the La Jolla-San Diego area on Monday-Tuesday, July 12-13. (please block out these dates NOW.) A number of suggestions were offered for the east coast meeting in 2000, including Bermuda and Annapolis. Additional suggestions should be sent to Kaufman.

Bill Carleton and Bob Taggart lead the discussion on "Institutional Ownership and Corporate Governance", based on a package of readings that they had sent to members. After a thorough airing, a committee of Carleton, Taggart and Edwards was charged with drafting a statement reflecting the consensus of opinion on the issues discussed. This draft will be circulated to attendees for comment.

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Topics suggested for next year's meeting included 1) potential restrictions on 401 k's and other individual retirement accounts and 2) the growth in non-voting corporate shares. Kaufman will solicit members for additional topics as well as suggestions for new members in December. A listing of addresses, including telephone, fax, and e-mail, of all current members is attached. Also included are the names of spouses/friends/etc. These are only for current information and need not imply a long-term commitment. Please send corrections and changes to Kaufman.

Financial Economists Roundtable Statement on Long-Term Capital Management and the Report of the President's Working Group on Financial Markets

October 6, 1999

In April 1999 the President's Working Group on Financial Markets released its report on "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (hereafter referred to as the Report). The report describes the near-failure of the hedge fund Long-Term Capital Management (LTCM) in September 1998 and provides an analysis of the events which surrounded that episode. LTCM received worldwide press coverage because of the unusual actions taken by the Federal Reserve in facilitating a $3.625 billion creditor-rescue of LTCM and because of the apparent breakdown in fixed-income markets in August and September 1998 that precipitated LTCM's collapse, as liquidity in those markets all but disappeared everywhere. In justifying its actions, Federal Reserve Chairman Greenspan suggested that, had the Federal Reserve not acted swiftly, the bankruptcy of LTCM "... could have potentially impaired the economies of many nations, including our own." Not surprisingly, the Federal Reserve's having to intervene to facilitate the rescue of LTCM has put all hedge funds and their activities at center stage, and has raised questions about the regulation of both hedge funds and the banks and securities firms that deal with them. In particular, the large amount of credit extended to LTCM by large banks and securities firms has raised questions about the risk management practices of banks and securities firms and about the effectiveness of the regulation of those institutions.

The Financial Economists Roundtable finds that the Report sheds almost no light on the events surrounding LTCM's collapse. The extraordinary role of the Federal Reserve in the LTCM episode is not even mentioned in the Report, and there is no analysis of the causes of the perceived breakdown in fixed-income markets that the Federal Reserve feared would turn the failure of LTCM into a worldwide financial and economic disaster. The Report also does not provide an informative analysis and assessment of the risk management practices of banks and securities firms, and does not tell us whether there was an aberrant breakdown in the regulation of these institutions or whether current regulations are intrinsically flawed and need be to recast. Even more disturbing, the Report provides no new information or data about either LTCM or the banks and securities firms which were LTCM's creditors and derivatives counterparties. In the absence of such information it is nearly impossible for outside observers to make an independent assessment of the exposures that these institutions had to LTCM in the event of its default, and about whether the current regulation and supervision of these institutions is sufficient.

The Report chooses to focus on the dangers of excessive leverage as the main policy lesson to be drawn from the LTCM debacle. It says: "The principal policy issue arising out of the events surrounding the near collapse of LTCM is how to constrain excessive leverage." (Cover letter to the Honorable Al Gore, April 28, 1999). Thus, its chief policy recommendations, not surprisingly, are measures which it believes will, if adopted, ... "constrain excessive leverage." However, the Roundtable finds that the Report is exceedingly vague on exactly why it considers leverage to be a systemic concern, on what it means by "excessive" leverage, and even on how leverage should be measured. It seems obvious that the Report does not mean to suggest that high leverage per se is a systemic concern. The failure of a small but highly-leveraged firm, hedge fund or other financial institution would clearly not pose a threat to the financial system. For leverage in financial institutions to constitute a systemic concern, large size must also play a role. Finally, the Report is unclear whether its concern is with excessive leverage by hedge funds or with excessive leverage by all large financial institutions, such as the banks and securities firms which were LTCM?s creditors and counterparties. The Report, for example, fails to point out that leverage in most hedge funds is generally much less than is true for most large banks and securities firms.

Thus, the Roundtable believes that, while the high leverage used by LTCM certainly contributed to LTCM?s near-failure, the Report's emphasis on "excessive" leverage as a systemic concern is unsupported. It fails to make a case that excessive leverage is a systemic concern, that private markets fail to constrain hedge fund leverage adequately, and that additional regulatory steps are needed to assure that in the future hedge fund leverage will not be excessive. Even assuming that a case can be made (which the Report does not make) that excessive leverage was the primary culprit in the LTCM collapse, this single event cannot by itself be the basis for the claim that leverage is in general excessive in either the hedge fund industry or the financial system as a whole.

The Report recommends increased disclosure requirements for hedge funds as a way to enhance private market discipline and constrain excessive leverage. But this recommendation also is unsupported. It is premised, in the first instance, on the Report's unsubstantiated allegations that hedge fund leverage is generally excessive, and that such leverage, were it to exist, would pose a threat to the financial system. More generally, while additional (or better) hedge fund disclosure would undoubtedly help investors and outside observers like academics to better assess the performance of hedge funds, there is no obvious public policy objective to be served by instituting mandatory hedge fund disclosure laws. The law already requires that hedge fund investors be wealthy and sophisticated investors, and hedge fund creditors are typically large financial institutions which are already highly regulated. All of these parties have a strong incentive to protect themselves from losses that can flow from excessive risk-taking. There is, therefore, no obvious public policy rationale which supports additional regulation to protect hedge fund investors and creditors from their own mistakes in not demanding adequate disclosure from hedge funds. It is hard to think of a market environment more conducive to allowing private markets to determine market disclosure practices than the hedge fund industry -- an intensively competitive industry with sophisticated investors and creditors. In these conditions it seems reasonable to leave the determination of hedge fund disclosure practices and requirements to private parties and to the workings of the private market, rather than setting them by government mandate. Indeed, we expect that an important fallout of the LTCM episode will be a greater demand by investors and creditors for better hedge fund disclosure.

The Report also calls for more hedge fund disclosure to government regulators. The Financial Economists Roundtable sees no overriding government interest in additional hedge fund disclosure. There should be no government guarantee of either hedge fund investors or creditors. They, of all people, are able to bear their own losses. Indeed, given the extraordinary events surrounding the LTCM episode, it is important that government regulators, and especially the Federal Reserve, make it crystal clear that hedge fund investors and creditors will have to bear the full costs of their mistakes or misjudgments. Hedge fund losses should be borne by hedge fund investors and creditors, and not by other market participants or taxpayers, either directly or indirectly.

That the Report does not analyze or attempt to justify the unusual actions of the Federal Reserve in engineering a creditor-rescue of LTCM is, at best, a curious omission. The Working Group may have thought it unnecessary to address this issue out of a belief that there was no federal "bailout," contrary to widespread public perception. In facilitating the rescue of LTCM the Federal Reserve did not explicitly commit any federal monies and does not appear to have extended any promises or guarantees to any participants. However, any Federal Reserve intervention that changes the market outcome from what would otherwise have occurred has the clear potential to exacerbate the moral hazard problem in financial markets. The Federal Reserve's actions clearly raise a question about what its "lender-of-last-resort" policy is, and about whether in the future it intends to extend the Federal safety net that underpins financial markets to all financial institutions deemed "too large to fail." The prospect of receiving federal assistance in times of market stress has the potential to affect private incentives in undesirable ways and to create additional moral hazard risk in the financial system. This concern provides an overriding public interest in the actions taken by the Federal Reserve in assisting LTCM , and the absence of any discussion of this event in the Report constitutes a glaring omission that needs to be corrected. At minimum, the Federal Reserve itself should have to demonstrate publicly that its actions in organizing LTCM's rescue were a necessary and appropriate response to unusually disorderly market conditions, and that alternative solutions were not available or would have proved inadequate.

Unsubstantiated assertions of "systemic risk" are not a sufficient justification. A useful aspect of the Report is the attention it gives to inconsistencies in the U.S. Bankruptcy Code that appear to have interfered with a private market resolution of LTCM's debt problems and derivatives contracts. To the extent that current bankruptcy procedures are in fact not conducive to private market solutions in complex situations involving both standard loan contracts and derivatives contracts, these procedures need to be fixed. A major function of government is to provide a legal and institutional environment within which private market solutions can be found to episodic institutional or market failures, such as LTCM. Further, to the extent that inadequacies in the Bankruptcy Code made necessary the Federal Reserve's intervention in the LTCM episode, this argument needs to be spelled out in greater detail.

In summary, the Financial Economists Roundtable considers the Working Group Report to be a disappointingly uninformative analysis of the events surrounding the collapse of LTCM, and of the interplay between those events and the regulation of financial markets and institutions. Hopefully, a more detailed and thorough analysis of those events will follow at some point in the future, when all of the facts are in and can be disclosed to the public. Until then, any recommendations for additional regulation and market reforms based on the analysis in the Report of the President's Working Group should be greeted with a healthy degree of skepticism.

Minutes of Annual Meeting, San Diego, California, July 12-13, 1999

The seventh annual meeting of the Financial Economists Roundtable was held at the San Diego Hilton Hotel in San Diego, California on July 12 and 13, 1999. Twenty-three members attended. Three new members have accepted invitations to join the group: Bernard Dumas (HEC School of Management, Paris), Julian Franks (London Business School), and Lemma Senbet (University of Maryland). Two members missed their third straight meeting and accordingly were ceremoniously dropped from membership: Haim Levy (University of Jerusalem) and Franco Modigliani (MIT). Currently, there are 39 active members.

Kaufman reported that the Roundtable's finances are in good shape. The bank balance is about $7,500, not including dues from the three new members or any refunds of the "refundable" dues to the new members dropped from membership.

Richard Brealey and Alan Kraus were nominated by the Executive and Steering Committees to become members of the Steering Committee and were unanimously so elected by the members. Martin Gruber was nominated by the Executive and Steering Committees to become a member of the Executive Committee and was unanimously elected. Frank Edwards and Edward Kane, who had served on the Executive Committee since the organization of the group completed their terms and were thanked for their services by the members. They remain on the steering committee.

Kaufman recommended that next year's meeting be at the historic Hotel Mount Washington in Bretton Woods, New Hampshire on Monday-Tuesday, July 10 and 11, 2000. The hotel is in the White Mountains, two hours from airports in Portland (Maine), Manchester (New Hampshire), and Burlington (Vermont), and three hours from Boston. It is the hotel where the IMF and World Bank agreements were signed in 1944 and the ghosts of John Maynard Keynes and Harry Dexter White reportedly still roam the hallways. The recommendation was supported by the Executive and Steering Committees and the members and Kaufman will enter into negotiations with the hotel.

Kaufman will solicit topics for the 2000 meetings next year-end. Two topics suggested at this year's meeting were the growing use of e-money and the proposed requirement that members of corporate board of directors audit committees need to be "financial literature." Because of the location of the meeting, it may also be appropriate to consider international topics.

Various members updated the Roundtable on recent events related to past policy statements. Frank Edwards, Eduardo Schwartz and Bill Sharpe led the discussion on "Hedge Funds: Disclosure, Regulation, and Too Big to Fail." After spirited debate moderated by Edwards, the three discussion leaders were charged with drafting a statement. This draft will be circulated to the attendees for comment and approval.

On Monday, a dinner will be held at the San Diego Yacht Club. The Roundtable thanked Commodore Marshall Blume for the excellent arrangements.

Financial Economists Roundtable
Statement on
The Future of the International Monetary Fund

October 23, 2000

The International Monetary and Financial Conference at Bretton Woods, N.H. in the summer of 1944 set the institutional ground-rules for international economic and financial relationships in the post-World War II world, and established two complementary institutions, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank). The World Bank was to focus on longer-term development finance, notably specific projects that could bring to bear the institution's technical expertise, while the IMF was to focus on the restoration of foreign exchange convertibility, the maintenance of a fixed but adjustable exchange rate regime, and the provision of short-term lending facilities to countries in temporary balance of payments difficulties. Together with the General Agreement on Tariffs and Trade, the Bretton Woods design for a postwar economic order that would speed economic recovery and promote sustained development of the global economy undoubtedly represents one of the great achievements of international economic policy in the 20th Century.

Much has changed with respect to the IMF's mission. Restoration of full currency convertibility among industrial countries was achieved by the beginning of the 1980s, and has been progressively attained by most of the major developing countries as well. The fixed but adjustable exchange rate system ended in 1973. With it, the need declined for massive short-term balance of payments financing for countries moving to floating exchange rates, thus focusing central bank intervention on the maintenance of orderly conditions in currency markets. Consequently, the IMF's activities shifted increasingly to providing financial assistance and advice to developing countries, often under crisis conditions in which an existing fixed exchange rate regime became unsustainable in the light of domestic or international economic and financial developments. The IMF's role in the global lending crises of the 1980s, the Mexican crisis of 1994-95 and the Asian, Russian and Brazilian crises of 1997-98 was notable and in some cases highly controversial. By July 2000 some 69 developing countries had IMF programs in place and many had drawn on IMF facilities for decades, effectively extending the Fund's mandate from short-term stabilization lending into long-term finance. The Fund's recent, long-term Poverty Reduction and Growth Facility exemplifies this expansion of scope. IMF advice, inevitably controversial, became increasingly intrusive to many client countries and susceptible to political manipulation by major creditor countries. Meanwhile, the size of available IMF facilities, even after successive increases, has steadily dwindled in relation to cross-border financial flows involving developing countries.

Pressure for Change

Almost six decades after the founding of the IMF there is a consensus, reflected in the reports of numerous task forces, study groups and conferences, that it is now time to reassess the role of the IMF ? even as there is little agreement on key elements of reform. The basic issues are: (1) The appropriate scope for Fund activities; (2) The role of the IMF as a quasi lender of last resort; and (3) The terms on which IMF assistance should be made available to member countries.

The Financial Economists Roundtable (FER), meeting at Bretton Woods in July 2000, examined these issues against the background of the intense debate that has characterized the past several years, and has come to the following conclusions:

1. We are concerned that mission creep has compromised the effectiveness of the IMF over the past three decades. As the IMF has responded to demands from many of its member countries to finance structural transformations and alleviate poverty, its role in preventing and managing international financial crises has been undermined. Although these are all worthy activities, structural transformation and poverty alleviation are central to the mission of the World Bank and the regional development banks and do not fit comfortably with the shorter-term, macroeconomic focus of the IMF. FER believes that the IMF should constrain the scope of its activities to the prevention of international financial crises and the provision of limited liquidity-assistance to countries in temporary financial distress in order to help them resolve their difficulties in internationally responsible ways. We urge that the IMF cede responsibility for financing structural change and poverty alleviation to the World Bank and the regional development banks.

2. The IMF cannot and should not be an international lender of last resort. Unlike a national central bank, the IMF is severely resource-constrained and therefore lacks credibility as a lender of last resort. This has become evident in major recent support actions such as that in Mexico, in which IMF resources had to be supplemented with bilateral and other multilateral support in order to restore confidence. But even if it were possible to vastly increase the resources of the Fund so that it could meet the liquidity needs of any of its member countries, we believe that it would be undesirable to do so. The provision of unlimited liquidity would surely encourage imprudent borrowing and lending, ultimately increasing the number and severity of international financial crises, an outcome that is counterproductive to the IMF?s central purpose. Since our recommendations imply a restriction on official resources, some of the shortfall will necessarily be borne by private creditors.

3. Financial crises may involve widespread costs that are not necessarily recognized by private sector market participants in their lending and pricing decisions. Consequently, the IMF might usefully provide assistance on a temporary basis when a country in financial distress loses access to the capital markets.

Elements of a New Approach

FER has considerable sympathy with the view that the traditional IMF approach of tranched lending subject to detailed, intrusive and complex policy conditions is not always well suited for dealing with countries in financial distress. Instead, we concur with the report of the recent International Financial Institution Advisory Commission that the IMF should establish preconditions which, if met, will entitle a member country to automatic access to a limited amount of credit (proportional to the country's quota in the Fund), for a limited term , e.g., no more than five years, at a penalty rate of interest above the market rate that existed shortly before the crisis. The penalty rate will ensure that the line of credit is used only in the event of financial distress, when the country cannot borrow on international capital markets. The preconditions are designed, in particular, to encourage countries to strengthen their financial systems so that they are less crisis-prone. Preconditions should include the following:

(i) Openness to foreign financial institutions. Foreign-based financial institutions should be subject to no greater restrictions than domestic institutions with respect to entry and scope of activities. This will increase the likelihood that a country's financial institutions meet international standards for risk management and efficiency, and will help safeguard the local financial system. Local depositors will have the option of placing their funds with a wider range of banks, placing competitive pressure on local institutions. The presence of foreign banks can also serve as a constraint on the ability of governments to pursue unreasonable fiscal and monetary policies, since they are less likely to be pressured into allocating credit for governmental politically expedient but financially questionable purposes.

(ii) Adherence by the local bank regulatory system to the Basel Core Principles for Effective Banking Supervision. These principles, designed to strengthen banking systems, to a considerable extent address the preconditions for effective banking supervision, licensing and structure, prudential regulations, capital adequacy requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking. The principles have been developed in consultation with banks and their national regulators in many countries, and today represent a broadly consistent and credible set of minimum banking industry benchmarks.

(iii) Subscription to the Fund's Special Data Dissemination Standard (SDDS). The SDDS was designed to improve the availability of timely and comprehensive statistics. Compliance with the SDDS will enhance the transparency of a country's external financial position, including its international reserves and the maturity structure and currency composition of its external debt. This will enable financial markets to monitor and price sovereign risk more effectively.

(iv) Commitment to a responsible fiscal policy. This precondition might be quantified analogously to the Maastricht Treaty fiscal requirement, i.e., a budget deficit no greater than a specified percent of GDP and a ratio of public sector debt to GDP no greater than a specified percent (or trending downward decisively and credibly). The standard should be sufficiently stringent to prevent fiscal policy from being a cause of financial crisis. Countries that meet these preconditions could also be permitted, if necessary, to borrow some additional amount beyond that which is automatically available during periods of temporary distress. Under such circumstances the IMF would impose only those conditions that reasonable bankers would require in order to ensure that their loans are likely to be repaid.

We do not wish to prohibit the IMF from making loans subject to conditions. Countries that do not meet the above preconditions would not necessarily be barred from receiving IMF assistance. But they would not have automatic access to funds and, relative to countries that have met the preconditions, the amount of support would be less, the interest rate would be substantially higher than the rate just prior to the crisis, and the required repayment period considerably shorter. Uncertainty about the availability of funds and the increased cost should give countries an incentive to meet the preconditions, while protecting the option for the IMF to intervene when necessary to minimize potential systemic costs. However, acceptance of IMF loans should be conditioned on meaningful action by the recipient country leading to compliance with the four preconditions specified above.

Structural Financing

In our view there have been a number of occasions where access to IMF funding has encouraged a country to implement needed reforms, many of which are consistent with the aforementioned preconditions. FER therefore supports a system in which the IMF is empowered to make tranched, medium-term loans not exceeding five years in duration at subsidized interest rates in return for specified reforms. Such loans should not be rolled over to provide long-term financing and the IMF should avoid overly detailed policy prescription. We also wish to see such structural lending clearly separated from shortterm crisis lending. We suggest that consideration should be given to possible organizational changes that would help preserve the separation between short-term crisis support and long-term structural assistance, either by clear functional separation within the IMF or by delegating structural assistance to another institution.

The Way Forward

The approach to financial distress and the future role of the IMF suggested by the Financial Economists Roundtable emphasizes prevention of financial crises rather than post-distress stabilization and adjustment and, as such, seeks to promote global financial stability primarily though a rule-based rather than discretion-based approach. Like other rule-based approaches, such as the World Trade Organization, NAFTA, and the EU Maastricht Treaty, it seeks an optimum combination of clarity, transparency, automaticity, consistency, and compatibility with the incentives facing private-sector lenders and investors, as well as public policymakers. Within this framework, it is our view that the proposed recalibration of the IMF mission would alleviate many of the institution's shortcomings and provide an efficient, equitable, and effective mandate for this important supranational institution.

Minutes from Annual Meeting, Bretton Woods, New Hampshire, July 10-11, 2000

The FER held its eighth annual meeting at the Mount Washington Hotel Bretton Woods, New Hampshire on July 10-11, 2000. Twenty-six members attended. (Tony Santomero cancelled because Monday was the first day on his job as President of the Federal Reserve Bank of Philadelphia.) Three new members accepted invitations to join -- Richard Herring (Wharton), Katherine Schipper (Duke), and Cliff Smith (Rochester). Herring and Smith attended. Two members were disinvited for missing three consecutive meetings and one member resigned. There are currently 39 members.

The financial collection of FER is good. The Treasure has a balance in excess of $8,000, before collecting the $150 one-time "refundable" dues from the three new members. The Executive and Steering Committees recommended and the members approved the election of Ed Altman and Andy Chen to 4 year terms on the Steering Committee and George Benston to a two year term on the Executive Committee to replace Marshall Blume, who remains on the Steering Committee. In line with the reorganization adopted in 1998, no one was dropped from the Steering Committee this year, but the original eight members will be dropped next year:

More recent past policy statements were reviewed and updated brief1y:

1999 Hedge Funds -- Edwards
1998 Corporate Governance -- Carleton
1997 Social Security - Myers
1996 Mutual Funds – Gruber
1995 The NASDAQ Market – Stoll

They appear generally to have held up pretty well.

The 2001 Meeting will be at the Grand Summit Resort Hotel in Park City, Utah on Sunday - Monday July 15-16. (Block out your calendars.) This will be an experiment with starting the meeting on Sunday rather than Monday, as in the past. Park City is in the mountains only one-half hour from the Salt Lake City airport. Attendees proposed numerous possible sites for 2002, when we return east, including Dublin (Ireland), Halifax, Maine, Puerto Rico, Kiwa Island, and Cape Cod. Various members will scout the possibilities more rigorously and report back. In 2003, a strong preference was voiced for Vancouver, B.C. Kaufman will poll members for suggestions for both new members and discussion topics for 2001 near the end of the year. The desirability of increasing membership from outside the U.S. was discussed and supported. A possible topic for 2001 is "The Structure of Securities Exchanges," but things may change between now and polling time.

Brealey, Herring, and Walter led this year's discussion on "Restructuring the IMF." Based on the two day discussion, they will draft a statement for circulation to the attendees and revise it in light of timely comments received. The revised draft will be recirculated to attendees for signatures. If two-thirds sign on, it will be an official statement and circulated to nonattendees for their signatures, as is. Photographs of FER attendees signing on to their proposed revisions in the IMF structure after two days were taken in the Gold Room, where the original 1944 agreement was signed after 22 days. The photograph will be circulated to all members to mark this “historic” occasion. A good time was had by all.

Financial Economists Roundtable
Statement on
The Structure of Securities Markets

November 15, 2001

The structure of U.S. securities markets is both a topic for technical specialists and a matter that affects in very practical ways all investors in their pocketbooks. The effectiveness and efficiency of securities markets in processing transactions in hundreds of millions of shares each day, at an annual cost of billions of dollars, deserves more attention from the financial press and the public than it customarily receives.

It should receive the attention of the new Chairman of the Securities and Exchange Commission (SEC), Harvey Pitt, as he sets his agenda. He will confront few issues of greater importance, but he will not be writing on a clean slate. For the last quarter century, the SEC has been pursuing the goal of a national market system (NMS), without a clear specification of what that might be. Based on the discussion at its annual meeting in July, 2001, the Financial Economists Roundtable (FER) adopted the following statement to help guide policy makers in their oversight of the nation's securities markets.

I

The general legal concept of a NMS stems from the Securities Acts Amendments of 1975, which in Section 11A directed the Commission to facilitate the establishment of a NMS but did not undertake to define it. That was left up to the SEC, having in mind the general goals of economically efficient execution of orders in the best market, fair competition among brokers, dealers and markets, and availability of information about quotations and transactions. The SEC has been moving by tentative steps ever since.

Early actions abolished fixed commission rates, a boon to all investors, and established a consolidated transaction reporting system. The SEC also established a consolidated quotation system for all exchanges and market-makers, but never resolved how firm a quotation was and how long it lasted. The SEC required exchanges to be linked through the Intermarket Trading System (ITS), which permitted market makers on one exchange to send orders to another exchange to achieve better execution. However, best execution of customer orders has proved elusive of precise definition. But the general objective of trying to achieve greater linkage of equity trading markets remained. As the SEC was seeking to link markets more tightly, new electronic communications networks (ECNs) arose to serve particular investor needs. Some, such as Instinet and POSIT, serve institutional investors. Others, such as Island and Archipelago, serve individual investors. The result has been that markets have become more fragmented, not less so.

One school of thought believes that all the problems of fragmentation would be best solved by a single, fully integrated market, coordinated by a central computer and mandated by the SEC. Customer market orders would be gathered from all sources, matched and executed at the best price quoted anywhere. All limit orders would be entered and displayed in a central limit order book. Trades (except possibly large block orders) would be executed by a computer, following rules of strict price and time priority. The rationale for such a centralized system is that it guarantees the same prices for all investors, particularly for small retail customers, who do not now have the same access as institutional investors such as mutual funds or pension plans.

A second school of thought observes that fragmentation is a natural result of competition and innovation. As a variety of markets with different technologies and trading procedures compete for somewhat different groups of customers with different needs, the result is competing market centers registered exchanges (such as NYSE and AMEX) with designated specialists; NASDAQ with competing dealers; third market dealers in listed securities; alternative trading systems (regulated as brokers) serving institutional investors or providing on-line trading to individual investors. This second school of thought views the multiplicity of markets as a sign of innovation and vibrant competition, not as a problem that requires regulatory intervention. Markets are, in fact, linked, albeit not completely, in various ways and degrees, for example, by information and by private order routing systems of brokers and markets.

How should these alternative views be evaluated from the standpoint of the public interest? It is not an easy question to answer. The central choice is between fully integrated markets, which will level the playing field among investors immediately but would impede future changes, and fragmented markets, which will permit greater competition and are likely to lead ultimately to more efficient markets. A number of factors are relevant in analyzing this choice. One is transparency of price and quote information. Securities markets are in large part markets for information, serving to evaluate companies and their management and to allocate capital to the most productive uses. A second is the degree of customer access to each market. A third is the extent of the broker's duty to the customer to obtain best execution. And whenever there are multiple goals or values, there will inevitably be trade-offs among them.

II

In considering those questions, the FER believes there are some principles and empirical constraints that should be kept in mind. To begin with, securities trades are not homogeneous, standardized products but combinations of a bundle of attributes. Trades differ in speed, market impact, and commission or spread cost, as well as in the price per share paid or received. All of these enter into best execution.

Different customers value those attributes differently. Informed traders (those who believe they have an informational advantage) value anonymity, while retail customers or index fund managers, who are rebalancing portfolios, do not. Dealers incur less risk in transacting with uninformed traders, and can charge lower transaction fees or spreads. Informed traders are concerned with the market impact and speed of execution of their orders, matters that may be of less concern to other traders. Day traders may pay far greater attention to speed of execution than to its cost. Mutual fund complexes can, under SEC rules, trade among their fund portfolios, pricing off market trades or quotes but without incurring execution costs.

Given these varying customer needs and preferences, different trading systems are constantly being created to serve them. Some systems (such as Instinet) cater to institutional investors seeking to avoid incurring the full trading costs of brokers and exchanges. Other systems automate procedures for handling small orders.

But these alternative trading systems depend to varying degrees on prices derived from the primary markets, so information linkages across markets are important and desirable. Recognizing this, the SEC has mandated transparency the immediate dissemination of trade prices and quantities as well as the quoted prices and quantities at which future transactions may take place. In a transparent market, investors can make informed decisions about where an order should be sent.

The SEC has ventured beyond transparency in mandating an intermarket trading system (ITS) for routing orders among the exchanges and the NASDAQ system. The purpose of better intermarket linkages is to enable orders to be routed to the market center where they will receive best execution. The downside is that it has tended to discourage new trading systems because of the difficulty of integrating them into the ITS structure.

Institutional investors can and do monitor the execution of their orders, and develop ways to bypass market centers that they view as not performing satisfactorily. So obtaining best execution is a greater concern for retail investors. Retail brokers have a legal obligation to ascertain the best market and transact in that market to get the customer as favorable a price as possible he issue has been exactly what does best execution mean in operational terms? Many market makers believe it requires only that they execute customer trades at the national-best-bid-and-offer (NBBO) price, as shown on their computer screens, and not an obligation to seek better offers. That in turn makes it important that the NBBO include all limit orders, so that retail customers obtain the best prices.

III

As the foregoing background discussion makes evident, we have a complicated market system and set of issues. After extended review, the FER arrived at certain conclusions and recommendations.

(1) The multiplicity of market centers currently observable has been criticized as fragmented and inefficient. Indeed it is fragmented, but it is not inefficient. Fragmentation is another term for the existence of competitors seeking particular customer clienteles, and like competition in general, it promotes both innovation and better prices for customers. In our view, such competition will produce greater efficiency and lower transaction costs than would come from a NMS in the sense of an SEC mandated, single integrated market. Furthermore, market participants have themselves developed links among market centers.

(2) Transparency of the quotes and trades is a desirable attribute of markets. Transparency has two important benefits. First, it enhances competition because it allows consumers to compare prices. Second, it helps achieve best execution because customers can monitor brokers to determine whether they are sending orders to the best market. Consequently, it may be desirable to display more information about trading interest at, and outside, the NBBO.

(3) Linkages among the multiple market centers for quote information, order routing and settlement are definitely needed. But the market centers and vendors have incentives to develop them in accordance with customer specifications, and they are evolving. The FER believes that the precise form of linkages is best left to the market centers, in their quest for trading volume and liquidity. Linkage should not take the extreme form of requiring a central limit order book (CLOB). A mandated CLOB would constrain competition and innovation.

(4) Detailed specification of the duty of best execution, spelling out price priority or price improvement or trade-through requirements, is a highly technical subject. The FER does not believe it is in a position to conclude that a particular set of execution rules should be adopted, given the different needs and priorities of different traders. In its view, the SEC has followed the correct policy of enhancing disclosure, most recently by new rules on disclosure of execution quality by each market center. As the data on execution quality receive attention from intermediary firms and academics, the issues and proper balance may become clearer. But we would urge the SEC not to adopt at this point a specific best execution standard.

(5) In the very broadest sense, these issues raise the question of what should be the role of government regulators in the structure of securities markets. We commend the SEC for having acted prudently in addressing such a sweeping question in a field in which technology is rapidly changing. It has avoided a rigid NMS, and has made useful moves toward enhanced transparency and linkages. But we have one note of caution: the 1975 Act placed the SEC, at its own request, in the awkward position of having to approve the rules of self-regulatory organizations (for example, the NYSE or NASD) in advance. That places on the SEC the onerous and impossible responsibility for foreseeing how trading markets should evolve. A natural reaction to such a burden, particularly for complicated and contested issues, is too often to delay and to consider everything at inordinate length. The consequence is a drag on innovation and, in a global market, the possibility that trades move offshore. It would be preferable for the SEC to exercise its oversight discretion ex post, by subsequently ordering repeal or modification of rules that prove abusive or anti-competitive.

Minutes of Annual Meeting, Park City, Utah, July 15-16, 2001

The ninth annual meeting of the Financial Economists Roundtable was held at the Grand Summit Hotel in Park City, Utah on July 15-16, 2001. Twenty-one members attended. This was the lowest turnout by one. But five members cancelled at or near the last minute or had their plane reservations cancelled without notice. Thus, the group did not view the low attendance as a reduction in interest.

Kaufman announced that six new members had accepted the executive committee's invitation to join (Mark Flannery, Charles Goodhart, Myron Gordon, Curt Hunter, Rick Mishkin, and Stephen Schaefer) and two ex-members were readmitted (Brennan and Scholes). Two members were exed for missing three consecutive meetings (Franks and Taggart). As a result, total membership stood at 45. It was recommended that we select new members earlier in the year to give them more time to schedule that year's meeting.

The Steering Committee nominated Stoll and Van Horne to serve on the Steering Committee and Kraus to replace Blume on the Executive Committee. All nominees were elected unanimously. In line with the amendment to the bylaws adopted in 1998, all original members of the Steering Committee not currently on the Executive Committee were removed from the Committee. They were thanked for their service. A change in the bylaws was adopted to permit persons who had served on the Steering Committee to be eligible for future election after being off the Committee for at least one year.

Kaufman reported that the financial condition of the organization was good. The current bank balance exceeded $9,100, not including the dues to be collected from the new and readmitted members.

With respect to future meeting, the members favored the Sunday-Monday format of the current meeting over the Monday-Tuesday format of previous meetings. After considerable discussion, the alternate east coast - west coast venue will be continued for at least the next two years. However, strong preferences were voiced for more west coast meetings. Next year's (2002) meeting will be tentatively scheduled for the Queen Elizabeth Hotel in Montreal on Sunday-Monday, July 14-15. (Please bloc out these dates now.) A final decision will be made shortly. The 2003 meetings will be in Vancouver. Kraus ha~ been surveying the hotels and will work with Kaufman on the selection. Kaufman polled the members on their preliminary feelings about meeting in 2004 or later in Europe, e.g., Lugano. The members were favorable to considering the possibility.

Kaufman will poll members in December on topics for the 2002 meeting. Topics proposed by attendees were: mutual funds and corporate governance, housing GSEs, and implications for financial markets of reductions in outstanding U.S. Treasury debt.

Stoll, Benston, Blume, Eisenbeis, Edwards, Carleton and Kaufman (for Herring) reviewed and updated the past policy statements. The Statements appeared to have weathered time reasonably well. Members were urged to send the more recent statements to the new policymakers. All statements are on the FER website.

Blume, Scott and Stoll led the discussion on "A National Market System for the U.S." After long and lively discussion, the discussion leaders agreed to draft a statement to be circulated first to attendees for comment and suggestion and then in revised form to all members. The members thanked Blume, Scott, and Stoll for their preparation, work, and effort. The members also thanked Scholes and Weil for their hospitality in hosting the receptions and dinners on Sunday and Monday, respectively.

Financial Economists Roundtable
Statement on
The Crisis in Accounting, Auditing and Corporate **Governance**

October 1, 2002

Executive Summary

The Financial Economist Roundtable met on July 14 and 15th 2002 in Montreal, Canada to discuss the crisis in corporate governance, auditing and accounting resulting from the recent revelations in the Enron, Global Crossing, Adelphia, WorldCom and other corporation cases, which has led to heightened uncertainty in US equity markets, ultimately resulting in passage of the Sarbanes-Oxley Act of 2002 (the "Act")*. The Roundtable endorses the on-going efforts to strengthen corporate governance and the accountability of management and external auditors. However, it questions whether some of the legislative proposals, subsequently enacted, are effective, and may even be counterproductive. For this reason, among other things, the Roundtable also recommends the establishment of an outside blue-ribbon commission to investigate a series of questions and issues that are either not addressed or not likely to be resolved by the recent law.

*The Sarbanes-Oxley Act of 2002 was passed subsequent to our meeting. While it was clear that the general thrust of the legislation would be, we did not know all the details or specific provisions the legislation would contain. This statement reflects the Roundtable's position on those provisions of the Act that had been generally discussed in the meeting, but does not necessarily reflect the Roundtable's views on the entire legislative package.

Statement

The efficient functioning of US securities markets and valuation of publicly traded debt and equity relies upon the availability of timely and trustworthy accounting and other information on company financial performance. Audited financial statements, an important but not sole source of this information, should be constructed with the aim of providing reliable information to allow a reasoned assessment of the economic position and prospects of enterprises and to evaluate their managers' performance. A web of checks and balances supports this information flow that should assure users that the data are reliable, that company performance is reasonably transparent, and that owners, managers and others have proper incentives to reveal what is truly going on in the business. If effective, this system will minimize the conflicts of interests that might induce managers to act contrary to the interests of shareholders and other creditors. It includes: (a) a process of corporate governance, (b) laws and accounting rules, (c) internal and external auditors who determine that management follows the rules, (d) the SEC, self regulatory bodies, and the stock exchanges that provide regulatory oversight and enforcement of the rules and laws governing disclosure and behavior, and (e) the outside rating agencies and financial analysts, who monitor and interpret financial performance.

While the current system has served the country and investors well over time, recent events surrounding Enron, Global Crossing, Adelphia, and WorldCom, to name a few, raise significant questions about whether the present set of checks and balances is defective. Do some of the components need to be changed or strengthened? For example, people question the adequacy of the oversight of management provided by boards of directors. Do current accounting and auditing rules, and the auditing process itself, assure that management follows these rules sufficiently to prevent abuses from occurring? Indeed, questions now abound about the accounting and audit profession's internal structure and practices, which can contain conflicts of interest and prevent material information about firm performance from being revealed or result in the production of misinformation. Why did these internal checks and balances break down and are there possible flaws in the internal governance structure in the remaining firms?

Numerous proposals have been offered and some have been implemented, either by the major stock exchanges of through legislation, to fix the problems exposed by recent events. These include instituting reforms to corporate governance, changing rules governing the compensation of executives, expanding corporate executives' liability for providing misleading accounting statements, enhancing oversight and enforcement by the SEC, creating a new oversight board to regulate and supervise accounting and auditing firms, establish audit standards and punish malpractice.

As is often the case when abuses surface in financial markets, the first reaction is to "do something, "even if that "something" does not address the main problems at hand or may have perverse effects on incentives or markets. Witness the speed at which Congress enacted the Sarbanes-Oxley Act of 2002. Clearly, in some of these spectacular cases, management deliberately engaged in aggressive and even fraudulent accounting and other practices. Their actions generated earnings that weren't real and/or hid costs and risk indicators through reliance upon complex organizational structures and accounting gimmicks. While many of these devices may have met the letter of the law or existing accounting rules, they violated the intent of disclosing fully the firm's business to the investing public. Worse, in several spectacular cases management of these firms enriched themselves at the expense of investors and employees. All of these actions beg to be addressed.

The Financial Economists Roundtable notes that in many egregious cases, adequate laws and prohibitions were in place, but senior management, either because of avarice or hubris, failed to adhere to the rules and regulations. No system can force people who willfully decide not to follow the rules to do so anyway. In some of these cases, the oversight activities of parties who were in a position to identify and to put a stop to such behavior broke down. Why, for example, did some boards of directors acquiesce in questionable behavior and accounting practices? Why didn't either the inside or outside auditors raise red flags with the boards of directors or SEC rather than facilitate questionable behavior by management? Why didn't the SEC examine the statements of registrants at least to determine that technically knowledgeable investors could understand them? Why has the SEC not disciplined external auditors who attested to statements that clearly violated the SEC's disclosure rules? Why were the rating agencies and financial analysts slow in recognizing the warning signs that questionable practices and inherently risky behavior was taking place?

This experience not only has negatively affected the shareholders and employees of the affected corporations, but also has imposed costs on law-abiding, well-run companies. Investor uncertainty has been heightened, and investors now question both the veracity of the accounting information and their ability to separate the firms providing trustworthy representations of their performance from those who are not. This results in higher financing costs for all firms and wider borrowing spreads for those that may appear to be relatively more risky. These increased short-term costs have predictable impacts on incentives. For example, well-run firms are attempting to reveal to investors that they are indeed truly representing their current and future expected performance honestly. This is what one would expect if markets were basically functioning as they should. The most recent announcements by Coca-Cola, General Electric and the Washington Post, amongst a growing list of firms, that they would expense employee stock options represents such a market-induced change in financial reporting.

The Financial Economists Roundtable agrees with those urging that improvements be made in the system, and many of the changes both being proposed and already included in the newly passed Act make a great deal of sense. For example, requiring external auditors to report directly to the Audit Committee of the Board of Directors is critical. Similarly, increasing incentives for CEOs truthfully to reveal their firm's performance is important. Such incentives include forfeiture of bonuses and other incentive-based compensation in the event that the financial reports are deemed to be materially in noncompliance with reporting requirements.

As a result of our discussions at our recently concluded meeting and reviews of analyses of what occurred at Enron and some other apparent failures of corporate governance and accounting, we endorse many of the provisions of the Act, and suggest that additional changes be adopted concerning the governance, auditing and financial disclosures of publicly traded corporations:

1. We agree with the newly passed requirement in the Act that CEOs and CFOs sign and affirmatively declare that the financial statements present a fair view of their corporation's financial position as of the date of the statements and changes over the previous accounting period. Generally, the "fairness" of the statements means that they accord with generally accepted accounting principles (GAAP), both in letter and spirit. However, a way with some teeth in it must be found to induce executives to embrace the "spirit" of the principles rather

than just following the "letter." We are not sure that either the proposed declarations or increased criminal sanctions will provide those teeth. The requirement that corporate managers who are convicted of criminal fraud must serve longer sentences is likely to be of small importance. The outcome of the current wave of indictments should provide some evidence on this issue.

2. The Roundtable also supports the Act's requirement that Audit committees include only independent persons. Recent proposals of the New York Stock Exchange and NASDAQ would go even farther by requiring that the entire board contain a majority of independent members. While it is not clear what the appropriate proportion of independent and inside directors should be, we do believe that the independent director requirement for the Audit committee should also be extended to other important board committees, such as the Management Compensation Committee and the Nomination Committee. The real task is to devise an operational definition of "independent," an issue that was addressed inadequately in the Act, and may require further consideration.

3. We endorse the NYSE/NASD/NASDAQ proposals that audit committee members should be financially literate. This should entail both an understanding of the transactions that their company undertakes, and an understanding of the accounting issues with respect to the recording of these transactions. Members of boards of directors need not show the requisite degree of financial literacy when they accept appointment to the audit committee. However, they should be capable of acquiring these skills and be willing to invest in maintaining them. We later suggest that research be undertaken to determine how best financial literacy might be determined.

4. We agree with the requirement in the Act that external auditors be hired by and report to the audit committee, and we suggest that this be done in meetings not attended by corporate management. We would go farther and also require that the internal auditors also report to the audit committee and do so in meetings not attended by corporate management.

5. The Roundtable does not believe that the Act's establishment of an additional regulatory structure in the form of the Public Company Accounting Oversight Board is necessary. The Board adds another layer of bureaucracy that will have to be supported by additional taxes on corporations and auditors and, hence, on shareholders. The SEC already has the mandate and authority granted this new bureaucracy, and the SEC should be held accountable through appropriate oversight for its failure to enforce its regulations and the securities laws that Congress put in place.

6. We agree that the SEC should be given a budget sufficient to allow it to carry out its responsibilities. At present, the SEC collects from registrants much more than it is authorized to budget or to spend. In fiscal year 2001, it collected $2.06 billion in fees but Congress

provided for it a budget of only $423 million. The Act nearly doubles this amount. What is not clear is how the SEC will choose to deploy those funds or whether the amount is sufficient.

7. At the same time, other areas are possible targets for reform and deserve careful consideration. For example, has previous tax treatment of executive compensation unintentionally provided incentives for corporations to use less transparent forms of payments? Additionally, there is a growing debate about whether it is better to have financial disclosures governed by specific accounting rules or by broader principles. It is natural, and perhaps efficient, to have a set of basic rules, which if followed, provide a "safe harbor" in terms of disclosure, but such rules should not be used as a way to disguise or otherwise hide material information relevant to investors in measuring or estimating the value of the firm. Similarly, is the structure of the accounting industry, with now only four major firms, so concentrated that the market would not be competitive, such that shareholders would bear higher audit costs? Might the "final four" perceive that they have sufficient power to be more independent of management than heretofore and that audit quality will improve as a result? Or might they perceive that they were "too-big-to-fail" and, consequently, have incentives to engage in moral hazard behavior? The Act requires the General Accounting Office (GAO) to study not only these structural issues, but also to study the impact of requiring mandatory rotation of auditing firms. The Roundtable questions whether the GAO has the necessary expertise to undertake these studies and suggests an alternative below.

The Financial Economists Roundtable believes that any additional legislative changes should be examined and fully understood before they are enacted. Our analysis suggests that some companies experienced significant breakdowns in the chain of corporate governance linking managerial performance to the conduct of the boards of directors and to the external controls systems comprised of fiduciaries, analysts, shareholders, debt holders, rating agencies, accountants and auditors, financial advisors and regulators. In one case or another, nearly every one of these links in the chain failed to operate as advertised. Some of the deficiencies are already being addressed, some in the form of loss of market reputation and firm value, some by criminal and civil litigation, some by good firms seeking to distinguish themselves from those relying upon questionable accounting practices, and some by regulation and new legislation. The process is messy, but is proceeding and in the end should result in better functioning financial markets.

The Financial Economist Roundtable believes that is important to determine how much of he current crisis represents a breakdown in the governance of individual firms that is idiosyncratic in nature and how much is due to systemic problems. We therefore urge that as part of the current reform efforts, Congress should establish an independent Blue-Ribbon study commission comprised of recognized financial and accounting experts to identify ascertain if and what additional regulatory issues should be addressed. In addition to the questions posed earlier, list of issues is provided in the appendix at the end of this statement.

Given the large economic losses that many have incurred as a result of the recent revelations and abuses, it is a natural response of Congress, regulators and advisory boards to seek and propose changes. On the other hand, financial markets are now more aware of the issues and we are confident that solutions to many of these problems will evolve naturally. While there may be opportunities to fine-tune regulation to align better the monitoring of institutions with the interests of shareholders and employees, any changes to governance and regulatory systems should carefully consider the costs and, benefits of effecting those changes, including possible perverse and unintended incentive
effects of those changes.

Appendix

Questions for Further Study
Questions that should constitute part of the charge to the Blue Ribbon Commission on Corporate Governance should include:

1. Extent of the Problem
Are the problems revealed by Enron, Global Crossing, WorldCom and other well-known corporations specific or systemic? Did more than a few corporate managers fail in their fiduciary responsibilities and, if so, how and why?

2. Boards of Directors
a. How does one construct an operational and effective definition of an "independent director?" The NYSE and NASDAQ in recent separate proposals go beyond the definitions included in the Act and provide alternatives, which consider such factors as the ability to exercise independence from management, including duration of former employment, forms and sources of compensation, familial relationship, etc. Are these sufficient criteria?

b. Of particular concern is the role, the size and form director compensation should play in defining independence, an issue that is considered more broadly in both the NASDAQ and NYSE proposals than in the Act. It has been suggested that directors' compensation should be sufficient to compensate them for the time demands and risks they have accepted, but not so great as to discourage them from risking loss of income should they make demands or take actions that might displease the CEO. Agency theory suggests that directors should have significant stakes in the long run success of the firm, so that by acting in their own interests they also act in the interests of shareholders. But what might be a significant stake to one might be insignificant to another. What form should compensation take and should there be limits on executive compensation more general? Should directors be rewarded with stock options that might give them incentives to allow CEOs, who also have stock options, to attempt to increase share prices by misreporting the company's performance because they only have a stake in the upside? A more fundamental question about director independence is who selects them and who makes the decision about their retention? How should the Board evaluate itself? What are the performance metrics? How are they to be implemented?

c. What is the appropriate proportion of independent members for boards of directors? Indeed, should the only inside member of the board be the CEO? Is a simple majority enough, as the NYSE proposes, or should independents comprise at least 2/3rds of the board? This issue is being addressed by some firms in response to perceived market need, but will the remedies prove effective?

d. Most approaches to compensation of the board or the audit committee members have focused on direct compensation. The question is whether there should also be limits placed on acceptance of substantial indirect payments (e.g. support of organizations with which directors are associated) as proposed by the NASDAQ? What form should those limits take?

e. Shall best practice say that all independent directors be put forward by a Nominating Committee composed of only independent current directors, as proposed by the NYSE?

f. Should there be a financial literacy standard, as the Roundtable and others have recommended for boards of directors, and more specifically for the audit committee? Clearly more research is needed on the basic issue of what financial literacy means and how a literacy requirement might be implemented.

3. External Auditors

a. The Act puts severe restrictions on the kinds of other services that external auditors can provide to audit clients, such as fairness opinions, actuarial services, investment banking services, management functions, legal services, or any other services proscribed by the Public Company Accounting Oversight Board. What other activities should or should not be proscribed, and what will these restrictions do to the profitability and hence cost of audits of publicly traded corporations? Do the existing limitations go too far?

b. The Act requires the auditors to attest that audits are based upon generally accepted auditing standards (GAAS) and that management's financial statements are in accordance with GAAP, but should the requirement also be that the statements represent a true and fair assessment of the business?

c. Are the Act's auditor-in-charge rotation requirements sufficient or should publicly traded companies be required to rotate audit firms as well?

4. Self Regulation
Did the system of self-regulation of the accounting industry fail us and, if so, how and why?

5. Accounting and Audit Industry Structure
Is the structure of the accounting and audit industry so concentrated that the existing major firms might not objectively criticize the work of their competitors? Might they be subject to moral hazard behavior? Or might they act as a cartel and increase the costs of audits above the competitive level?

6. SEC
Did the SEC's regulation of accounting and accounting firms fail us and, if so, how and why? Why has the SEC taken so few actions to discipline individual CPAs who attest that financial statements conform to GAAP, when they did not to a significant extent?

7. Accounting Principles
Is our system of developing accounting principles flawed? Should the Financial Accounting Standards Board (FASB) or the SEC be the sole determiner of what should be reported and not reported in the financial statements that corporations must file with the SEC? Should greater emphasis be placed on accounting principles rather than specific rules to govern disclosure in financial statements?

8. External Rating Agencies
Did bond-rating companies fail competently to evaluate and monitor the performance of the firms they rated? If so, why was this the case?

9. Securities Analysts
Are sell-side securities analysts sufficiently independent? If not, what incentives or penalties need to be imposed?

10. Recent Legislation
What incentive or informational problems has the recent legislation addressed successfully or meaningfully, and what areas remain wanting?

Minutes of Annual Meeting, Montreal, Quebec, Canada, July 14-15, 2002

The tenth annual meeting of the Financial Economist Roundtable was held on July 14-15, 2902 at the Queen Elizabeth Hotel, Montreal Canada. Twenty-eight members were in attendance (Abdel-Khalik, Altman, Benston, Bierman, Blume, Brealey, Dimson, Edwards, Eisenbeis, Ferson, Fisher, Flannery, Goodhart, Gordon, Gruber, Hunter, Kaufman, Logue, Myers, Santomero, Schipper, Siegel, Smidt, Stoll, Van Horne, Walter, Weil and Westerfield). Kaufman reported that six new members had accepted the invitation to join - - Bierman, Ferson, Saunders, Siegel, Subrahmanyam and Westerfield - - and two members were missing their third consecutive meeting and dropped from active membership. Total active membership is 49. A complete list of active members is attached. Kaufman reported that the financials were in good shape. The total money market and Bank account was slightly in excess of 10,000, not including dues to be billed to the new members.

The Steering Committee nominated Dimson and Edwards for four-year terms on the Steering Committee. Benston, Blume, Gruber, and Hakansson completed their terms. This completed the transition adjustment to bring the size of the Committee to eight. The Steering Committee also nominated Altman for a two-year term on the Executive Committee to replace Benston, whose term had expired. All nominees were elected unanimously. The outgoing members were thanked for their service.

The Steering Committee reaffirmed Vancouver as the site for the 2003 meetings and approved Kaufman's recommendation to enter into negotiation with the Listel Hotel, a downtown boutique hotel. The target dates are Sunday - Monday, July 13-14, 2003, starting as usual with a reception on Saturday evening, July 12. (A number of members inquired about Alaska cruises afterwards and Kaufman will collect and distribute information on cruises leaving Vancouver on July 15 or so.)

Kaufman reviewed the purpose the organization and its emphasis on public policy issues. Benston reported briefly on the 1995 policy statement on "Accounting Disclosure about Derivatives," Gruber on the 1996 statement on "Risk Disclosure by Mutual Funds," Myers on the 1997 statement on "Social Security," Edwards on the 1998 sfatement on "Institutional Investors and Corporate Governance," and the 1999 statement on "Long-Term Future of the International Monetary Fund," Walter on the 2000 statement on "The Future of the International Monetary Fund," and Blume and Stoll on the 2001 statement on "The Structure of Securities Markets." The 1996 statement on "Risk Disclosure by Mutual Funds" was viewed of particular current importance and Gruber volunteered to review and update the statement and circulate it to the members for possible reissue as a new statement

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Altman, Benston and Weil led the discussion on this year's topic - - "issues in accounting, auditing and corporate governance." They will serve as the drafting Committee and attempt to get a first draft circulated to the attendees for comment in August. The meeting adjourned on Monday, July 15.

Financial Economists Roundtable
Statement On
The Controversy over Executive Compensation

November 24, 2003

Executive Summary:

The Financial Economists Roundtable met on July 13 and 14, 2003 to discuss the controversy over top-level executive compensation plans in US companies. Recent corporate scandals have drawn attention to the high levels of executive compensation in the United States and to the possibility that some executive compensation plans may have been one of the causes of these scandals by fostering a corporate environment of greed and dishonesty. The Roundtable provides a number of recommendations that we believe will mitigate the potentially harmful effects of some executive compensation plans and should ensure a better alignment of managerial and shareholder-owner interests. Among these recommendations are (a) treating the granting of stock options as an expense in company financial statements, (b) repealing section 162 (m) of the U.S. Internal Revenue Code, (c) more disclosure of financial transactions by executives that affect the sensitivity of their pay to shareholder wealth, and (d) various corporate governance changes that will enhance the independence and responsibilities of corporate boards and their compensation committees, and give shareholders the power to monitor and control executive compensation.

I. Introduction

Recent corporate scandals have drawn attention to the high levels of executive compensation in the United States and to the possibility that the structure of executive compensation plans may have contributed to these scandals by fostering a corporate environment of greed and dishonesty.

A widespread view is that top-management compensation in the United States is higher than that required to motivate managers and has created a corporate environment in which the incentives of managers are not closely aligned to those of shareholder-owners. In the 1990's average CEO compensation increased significantly, both in absolute and in relative terms. The inflation-adjusted level of average CEO pay for S&P 500 companies grew from $3.5 million in 1992 to $14.7 million in 2000. Over the last two decades, the average CEO pay has risen to a level about 419 times that of average employee compensation, up from only 42 times in 1980.[1] By far the largest component of this increase in CEO pay has been the dramatic increase in the use of stock option grants during the 1990's.

Many believe that top-level executive compensation also is not linked closely to long-term corporate performance. In recent years, many executives saw their compensation rise sharply even though those companies were doing poorly and their stock values plummeting. Further, it has been argued that overly generous compensation packages, and in particular the

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1 Jennifer Reingold, "Executive Pay: The Numbers are Staggering, but so is the Performance of American Business. So how closely are they linked?" Business Week, April 19, 1999, p. 72.

widespread use of stock option grants, may have created incentives for managers to manipulate company financial statements in order to drive up stock prices, contributing to the recent corporate scandals.

II. Why the increase in stock option compensation?

Stock option compensation increased sharply during the 1990's for several reasons.

First, during the late 1980's and early 1990's there was an increased demand from institutional investors, such as the United Shareholders Association, the Council of Institutional Investors, and large state pension funds, for companies to tie executive pay to company performance in order to better align executive incentives with those of stockholders.

Second, accounting rules for stock options have reinforced the desirability of using stock options relative to other forms of compensation. Under APB Opinion 25, issued in 1972, the accounting expense associated with stock options equals the difference between the market price of the stock and the exercise price of the option on the date that both the exercise price and the number of options are fixed. This spread is zero when the exercise price is set at the market price of the stock on the grant date; so, the expense charge for such an option grant is zero. In 1995, Financial Accounting Standards Board (FASB) promulgated Financial Accounting Statement (FAS) 123 which recommended, but did not require, that options be expensed at their "fair market value" determined at the grant date, determined by using the Black-Scholes valuation model or another similar valuation methodology. Until late 2002, only a handful of companies had adopted the proposed FASB recommendation. Thus, since the firm typically bears no accounting charge and no cash outlay when granting options, the cost of option grants to the corporation and to corporate boards may be "perceived" to be low or even zero, which may have resulted in the overuse of stock options. Not expensing options also reduces the transparency of the cost of stock options to shareholders and investors and may reduce market scrutiny of this form of compensation.[2]

Third, section 162(m) of the U.S. Internal Revenue Code (IRC), a tax law enacted in 1993, may have unintentionally encouraged the use of stock options. The statue disallows tax deductibility for all compensation paid to "proxy-named executives" in excess of $1 million, unless such compensation takes the form of "performance-based" compensation. This law made stock options (as well as other performance-based compensation) less expensive than, for instance, base salaries and stock grants, because stock options satisfied the "performance-

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2 Kevin J. Murphy "Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options," University of Chicago Law Review, Vol. 69(3), Summer 2002, pp. 847-869.

based" test as directly linked to the company's stock value.[3] Fourth, the bull stock market during the 1990's may have increased the demand by some executives to be compensated with stock options, because they expected returns to continue to be high.

Finally, some CEOs may have been able to "capture" their boards and persuade them to approve large pay packages, even if such packages were not in the interests of the corporation. For instance, Dennis Kozlowski, former CEO of Tyco, was granted nearly six million options – 5.1 million new options in Tyco, plus 800,000 options in a Tyco subsidiary – with a value of $81 million at the very time that Kozlowski was allegedly looting the company of millions of dollars. Where was the Tyco board? Indeed, the virtual absence of indexed option plans among U.S. firms seems inconsistent with the existence of an arms-length compensation process conducted by an independent and informed board. Why would shareholders want to compensate executives for a rise in the company's stock price that is unrelated to the manager's or firm's specific (or relative) performance?

III. Is Executive pay "excessive"?

Although there have clearly been instances of mega stock option grants being made to undeserving top-level executives during the last ten years, it is difficult to conclude that on average executive compensation is excessive. What is "excessive"? In theory, compensation is excessive if it is more than that required to minimize the principal-agent (shareholder-manager) costs due to the separation of ownership and management, or, alternatively, is more than that required to maximize shareholder wealth. Put another way, it is higher pay than the executive could command in a competitive labor market. It is difficult, however, to provide an operational measure that is consistent with these definitions. Thus, while it is probably safe to say that there have been incidences of excessive executive pay, we are not able to generalize from these cases about whether the average level of executive compensation is excessive.

IV. Policy issues raised by the increase in Executive compensation

Our analysis suggests three areas where changes can be made that would improve the process by which executive compensation is determined: accounting and tax rules related to stock option grants; corporate governance; and the contractual design of executive pay packages.

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3 Brian J. Hall and Kevin J. Murphy, "The Trouble with Stock Options," Journal of Economic Perspectives, Summer 2003, pp. 49-70.

1. Accounting and Tax Treatment of Stock Options

Guiding principles should be that the choice of compensation structures should be left to the firm, and accounting rules and tax treatments should not favor one form of compensation over another (say stock options over cash or stock). (a) The Roundtable recommends that option grants be expensed by the issuing firm at the grant date. Currently, most firms do not show stock options as an expense in their financial statements and only report information about the grants in their financial statement footnotes. While some large companies (e.g., General Electric, Procter and Gamble, Coca-Cola, Microsoft) have publicly stated that they will expense options in the future, other heavy users of employee options, notably Intel Corp, have resisted expensing. The Roundtable believes that financial statements should reflect the true costs of doing business, and labor acquired and compensated with employee stock option grants impose a real economic cost on the current stockholders that should be shown as an expense and as a deduction from earnings. We are not, of course, the only ones to hold this view. Warren Buffett, for instance, has said, "If stock options are not a form of compensation, what are they? If compensation is not an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go?"[4] Expensing stock options also will enhance transparency and will help to eliminate the "perceived" cost advantages of options over other forms of executive compensation.

(b) The Roundtable also recommends that Internal Revenue Code section 162 (m) be repealed. As noted, this section limits the tax deductibility of compensation to $1 million unless such compensation is performance-based. This rule is a clumsy attempt to regulate the level and structure of executive compensation, and should be repealed. Corporations, through their boards and shareholders, should be free to determine the optimal form and level of executive compensation. If there is a concern that corporate boards are not exercising this function in a responsible way, the appropriate response is to improve the performance of boards through changes in either corporate law or other corporate governance institutions, or to enhance the power of shareholders to monitor executive compensation directly.

2. Corporate Governance

To increase the likelihood that the process for setting executive compensation is conducted as an arms-length bargaining process, the Roundtable believes that it is important that corporate boards be independent of managers and have some compensation expertise. (a) The Roundtable agrees with and endorses recent proposals directed at making compensation committees more independent, such as the new NYSE rule which would require that only

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4 John Dyson, "Accounting Issues Financial Reporting-Share Options- Logic Breaks Down," Accountancy, June 30, 2001, p. 97.

independent directors serve on compensation committees. In addition, the Roundtable recommends that at least one member of the compensation committee possess sufficient expertise in compensation practices so that the committee can understand the compensation contracts and the methods used to value the different forms of compensation, as well as the likely effects of these on the incentives of managers. This recommendation would broaden the existing requirement for "financial literacy," which is targeted more towards accounting literacy than financial literacy.

(b) The Roundtable also endorses the proposed NYSE requirement that all top-management compensation plans, as well as material changes in these plans, be approved by a shareholder proxy vote. Items requiring such approval should include material changes in the level of salary, equity-linked compensation, and severance packages.

(c) Lastly, the Roundtable recommends that any financial transactions by top-level executives that materially alter the sensitivity of the pay package to the value of the company be reported to the compensation committee and the board. In particular, hedging transactions entered into by an executive that change the sensitivity of his/her compensation or equity position in the company with respect to shareholders' wealth should be disclosed in advance to the board and approved by the board. Such transactions may materially change the managerial incentives associated with pay packages and should be monitored accordingly.

3. Design Features of Compensation Contracts

While the design of compensation packages should be the responsibility of corporate boards, we believe that boards should give serious consideration to the following mechanisms when designing and approving compensation contracts. It is our view that many of the perverse incentives attributed to stock options are due to poorly designed contracts rather to inherent flaws in option compensation.

First, executives should not be rewarded or punished for outcomes that are beyond their control. Compensation schemes may include some form of indexation as a means of relating pay to the component of company performance that is more directly within the control of executives. For example, the exercise price of stock options could be pegged (or indexed) to a well-defined market index. The concern that the incentives effects of indexation can be undone by the executive through market transactions can be greatly mitigated by the disclosure requirement in 2 (c). A possible reason for the virtual absence of indexed options is the current difference in the accounting treatments for index options and regular options. Since the exercise price of index options is not set at the current stock price and is unknown, indexed option grants must be expensed under current accounting rules, whereas standard stock option grants do not have to be expensed. If all option grants were expensed, as we recommend, there may be less reluctance to use indexed stock option grants.

Second, the "repricing" of existing options by corporations should not be prohibited, because repricing can be useful in enhancing the effectiveness of compensation contracts. Repricing refers to the practice of replacing options with new ones that have lower strike prices, typically in response to a fall in the stock price of the firm. Repricing of stock options has been widely criticized as rewarding managers even for bad performance. There can, however, be good reasons for repricing the options. When stock prices decline, perhaps for reasons unrelated to an executive's performance, existing options may become virtually worthless, destroying the original incentive features associated with the use of options. Repricing can restore these incentives and realign managerial-shareholder/owner interests. It is important, though, for boards to ensure that repricing does not benefit poorly performing executives or create perverse managerial incentives. When there clearly has been poor managerial performance, the remedy should be termination of the managers, and not the repricing of their options.

Third, vesting requirements and restricted stock periods should be used to ensure that managers' incentives are linked to long-run corporate performance, and not to short-run financial results. In the spirit of this objective, the Roundtable endorses the Sarbanes-Oxley Act requirement that CEOs and CFOs have to disgorge any profits from bonuses and stock sales obtained during the 12-month period following a financial report that is subsequently restated because of “misconduct.”

Minutes of Annual Meeting, Vancouver, British Columbia, Canada, July 13-14, 2003

The eleventh annual meeting of the Financial Economist Roundtable was held on Sunday-Monday, .July 13-14, 2003 at the Listel Hotel, Vancouver Canada. Thirty members were in attendance (Abdel-Khalik, Altman, Benston, Bierman, Bierwag, Chen, Copeland, Edwards, Eisenbeis, Ferson, Fisher, Goodhart, Herring, John, Kane, Kaufman, Kraus, Schaefer, Schwartz, Scott, Senbet, Sharpe, Siegel, Smidt, Stoll, Subrahmanyam, Van Horne, Walter, Weil and Westerfield). This was a record attendance. Kaufman reported that four new members had accepted the invitation to join - Copeland, John, Stulz, Thales - and that Sharpe and Weston's requests for readmission were accepted. Two members missed their third consecutive meeting and were dropped from membership. Current membership is 53.

A number of members noted that this year's attendance at the meeting was about the maximum size for discussion and urged a slower growth in membership going forward. Kaufman reported that the Steering Committee voiced a similar concern at its meeting before the general meeting and that slower growth would be targeted through a combination of fewer new members and tougher readmission requirements. Kaufman repotted that the financials are in good shape. Not including dues paid by new members or small expenses for the meeting, the assets of the Roundtable were about $10,800, held mostly in a municipal money market fund.

The Steering Committee nominated Eisenbeis, Scott, and Weil for four-year terms on the Committee, replacing Brealey, Chen, and Kraus, whose terms had expired. They were unanimously elected by the attendees. The Steering Committee elected Stoll to the Executive Committee to a two-year term to replace retiring Kraus. All outgoing members were thanked for their service.

The Steering Committee recommended Niagara-on-the-Lake, Canada for the 2004 meeting with the Mount Washington Hotel at Breton Woods, New Hampshire as backup. The dates will be Sunday-Monday, July 11-12, starting as usual with a reception on Saturday, July 10, 2004. The members approved the recommendation. Kaufman will distribute additional information on the location and dates ASAP.

Altman, Benston, and Weil briefly discussed events related to the Roundtable's policy statement of 2002 on "The Crisis in Accounting, Auditing and Corporate Governance." John and Senbet led the discussion on "Executive Compensation." After the discussion, Edwards was drafted as a third member of the drafting committee, which will circulate a draft statement to the attendees for their review and comments. The meeting adjourned Monday, July 14 at 2:00p.m.

Financial Economists Roundtable
Statement on
Corporate Pension Fund Accounting

December 22, 2004

The Financial Economists Roundtable (FER) is a group of senior financial economists, who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets, both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decision.

FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among the majority of the attending members and is signed by all members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media.

The following statement on "Corporate Pension Fund Accounting" is the result of a discussion at FER's annual meeting on July 11-12, 2004 in Niagara-on-the-Lake, Canada.

Executive Summary

1. **Discount rate for liabilities**: The Pension Fund Equity Act permits companies to increase the discount rates used for valuing their pension liabilities, thereby allowing them to understate the amounts for which they actually are liable. The FER condemns this imprudent legislative change, and recommends a return to valuing liabilities using a discount rate based on U.S. Treasury interest rates.

2. **Funding of PBGC guarantees**: The FER is dismayed by the increase in the potential liabilities of the Pension Benefits Guaranty Corporation (PBGC), partly as a consequence of the Pension Fund Equity Act. The PBGC guarantees a minimum pension for retirees, and is funded by premiums paid by companies with defined benefit obligations. The current premiums do not adequately reflect the risk that insured firms will default on their pension obligations. As a result, the PBGC will likely have insufficient funds to pay promised obligations and will have to seek funds from the US Treasury, which is ultimately underwritten by the taxpayer. The FER recommends that plan sponsors be charged a sufficient high penalty rate for underfunded plans so as to cover the PBGC's expected obligations and encourage management of underfunded firms to take stronger measures to bring themselves to a fully funded status.

3. **Valuation of assets**: The FER is concerned that pension funds may be invested in illiquid assets whose market values are below their reported values. The market values of assets that are illiquid (such as real estate and corporate debt and stock that are not regularly traded in arm's length transactions) often cannot be readily determined or effectively audited. Therefore, the FER recommends that pension assets should be invested overwhelmingly in marketable securities, that they should be reported at currently realizable market values, and that there should be strict guidelines as to how illiquid assets may be valued.

4. **Smoothing (averaging) of deficits**: The FER regards the practice of smoothing deficits over multiple years as potentially dangerous. At times, this creates the illusion of improvement for plans whose position is in fact worsening. The FER recommends that assets and estimated liabilities be reported no less frequently than quarterly, and based on current market values of assets and the appropriate discount rate applied to liabilities. A full actuarial analysis of liabilities may be updated on an annual basis.

I. Introduction

The business and daily press increasingly are reporting that the defined-benefit pension plans of many corporations are underwater. These plans promise employees monthly pensions after they retire, usually based on their earnings in their last years of employment multiplied by the number of years they were employed. In 2003 and 2004, company pension plans were underfunded by nearly $400 billion. In 2000 and 2001 the underfunding was less than $40 billion.[**]

Will there be enough money to pay those promised pensions? This question has become particularly important to employees and retirees of companies that have experienced or are at risk of bankruptcy. If a company with an underfunded pension plan experiences severe financial distress, such that it is likely to shutdown if it had to fully fund its plan, the Pension Benefits Guaranty Corporation (PBGC) would take over the plan and guarantee pension payments up to a maximum amount (in 2004, $3,700 per month for workers who retire at age 65). The PBGC then becomes a general creditor of the bankrupt sponsor and has a priority claim against the sponsor's assets for contributions that accrued within 180 days prior to the bankruptcy filing. Claims on behalf of employees with pension claims exceeding the PBGC maximum are pursued by PBGC as plan trustee. The plan is a general unsecured creditor of the sponsor. These claims are unlikely to be fully met, considering both that the plan was underfunded and that the stated amount of the underfunding might have been substantially understated. For example, only 84% of Bethlehem Steel's reported pension

[***] See *Business Week*, "The Benefits Trap" by Nannette Byrnes, 19 July 2004, 64-71[**]

liability of $4.3 billion was covered by the PBGC. Coverage for LTV Steel and National Steel was similar (84% and 81%). Furthermore, when the PBGC took over Bethlehem Steel's pension plan, it learned that only 45 percent of its plan's pension liability was actually funded. Therefore, employees have reason to be concerned about the extent to which their companies have really put away enough to meet pension obligations.

An important issue is whether the PBGC will be able to meet its guarantees. As of its year-end, September 2003, the PBGC reported a deficit of over $11 billion. This deficit is a result of its having had to assume liabilities for pensions of $45 billion from bankrupt companies. The largest of these has been Bethlehem Steel, which terminated its plan in 2003. The PBGC assumed the pensions for some 97,000 participants with claims of $3.65 billion. If the PBGC cannot increase the premiums it charges sufficiently or earn enough on its assets, and if it must assume even greater liabilities, it is likely that the shortfall will have to come from taxpayers, s happened in the S&L crisis when the Federal Savings and Loan Insurance Corporation (FSLIC)went bankrupt.

The Financial Economists Roundtable (FER) recommends several actions to minimize the deficit of the PBGC, increase the security of pensioners, and reduce the likelihood of a bailout of the PBGC by the US Treasury and ultimately the taxpayer. First we consider the appropriate discount rate used to discount pension liabilities and then the inadequacies of the current method of funding the PGBC. We then consider the valuation of plan assets and the timely reporting of assets and liabilities of the plan. All our recommendations are designed to lead to a more transparent and better-funded plan that minimizes risks to employees and taxpayers.

II. Company Pension Liabilities That Should Be Reported to Employees

A company's pension liability is based on (1) the amount promised to employees when they retire; (2) an estimate of which employees will stay with the company long enough to get pensions; (3) an estimate of how long pensions will be paid to retirees and their spouses; and (4) a discount rate to bring these amounts to the present. As financial economists, we are concerned with the appropriate discount rate.

The PBGC specifies that actuaries must use a discount rate no greater than 105% of the four-year weighted average of the 30-year US Treasury bond yield. The 30-year Treasury rate (or the equivalent, since these Government obligations are no longer issued) presently is low relative to prior years. The Administration and Congress have responded by enacting the Pension Funding Equity Act of 2004 (which covers 2004 and 2005). All companies with defined benefit plans may now use 90% to 100% of a long-term high-quality corporate bond rate. For 2004, the applicable range now is 5.89% to 6.55%, compared to the prior range of

4.72% to 5.51%. Through the magic of government fiat, reported pension liabilities shrink by roughly 20%.

We object to this change for two reasons. First, it necessarily will understate pension liabilities. Second, the appropriate discount rate should not be set politically, as this runs the risk of a hidden subsidy to some companies and taxpayers, the cost of which will be borne by others. Rather, we believe that the correct rate for measuring a company's promised obligation to its employees is the pre-tax rate on risk-free obligations with approximately the same average maturity as the pension liability. Any higher rate would require pension funds to take the risk of assets being insufficient to pay the promised pensions.

III. Pension Assets – What Should be Reported to Employees and to the PBGC?

Pensions are funded with assets transferred from companies to separate legal entities that are tax exempt. Employees' pension claims would not be at risk if companies were required to fully fund their pension liabilities with matching risk-free assets. However, companies actually invest pension funds in risky assets. If the assets increase in value, the fund sponsors can reduce their future payments. If they decline substantially, though, the sponsors may not be able to make up the shortfall and it may have to be fulfilled by the PBGC if the sponsor declares bankruptcy.

Although a good case could be made for requiring pension funds to be invested in assets whose characteristics match their pension liabilities, this is too draconian a change. At the least, pension fund assets should be those that can be valued by reference to arm's-length-determined market prices or the equivalent. Although the market price of such assets might decrease substantially, at least the shortfalls will not be due to accidental or deliberate overvaluations. Overvaluations might occur because corporate officers are overoptimistic or because the values of some assets, such as real property, cannot be determined accurately until they are sold. In addition, opportunistic and dishonest sponsors may invest in overpriced pension assets, such as the untraded securities of related companies or property previously owned by corporate insiders or related parties.

The Financial Economists Roundtable recommends that pension assets must be invested overwhelmingly in marketable securities that can be valued with relevant, reliable, and verifiable actual market prices, and that infrequently traded assets be valued at realizable values. Registered Public Accountants (usually CPAs) should attest to the validity of these valuations. Asset values should be restated at least quarterly and reported to employees and to the PBGC, together with the amount of the pension liability.

IV. PBGC's Obligations

The Pension Funding Equity Act of 2004 has exacerbated the PBGC's deficit. In addition to raising the allowable discount rate for computing pension obligations, thereby understating those liabilities, Congress made the change retroactive to 2003. Under this act fully funded plans generally did not have to contribute to their pension funds in 2004. The Act also exempts underfunded plans in the commercial airline and steel industries from paying in 2004 and 2005 all but one-fifth of the expedited contributions that are required when a plan is less than90% funded. Exempting weak industries from funding requirements increases the chance that PBGC will run increasing deficits.

The Financial Economists Roundtable believes that the PBGC should not be allowed to continue to run a deficit, and that plan sponsors should not be able to continue to underfund pension plans over lengthy periods of time. Forbearance of company funding requirements is likely to result in a greater burden on compliant companies and taxpayers, similar to the unfortunate experience with savings and loan associations in the 1980s.

In some cases, requiring corporations to meet their obligations to the PBGC may cause a company to declare bankruptcy. Nevertheless, the possibility of bankruptcy is preferable to forbearance, for two main reasons. First, it allows such corporations to restructure their obligations so that they can return to normal operations; and the cost of the restructuring should be borne by all creditors, including employees whose promised pensions exceed the PBGC guarantee. Second, forbearance gives companies an incentive to put off having to deal effectively with disproportionate pensions obligations. The net result is that the costs are likely to be passed on to companies that meet their obligations and (to the extent of any Congressional bail-out) to taxpayers.

We recommend that the PBGC both assess a sufficiently high penalty fee for companies with pension funds that are inadequate to cover their accumulated benefit obligations (correctly measured, as we outlined earlier) and expeditiously monitor underfunding. PBGC now assesses a fee of $9 per $1000 of underfunded liability. However, Richard Ippolito, former chief economist of the PBGC, calculates that it has collected only $0.50 per $1000.[††**] It is no wonder that many companies have not made required payments for years, thereby substantially increasing the amount that will have to be made up by companies that meet their obligations and possibly by taxpayers. It is clear that both the penalty rate and its

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†† Richard A. Ippolito, "How to Reduce the Cost of Federal Pension Insurance," *Policy Analysis*, No. 523, CATO Institute, August 24, 2004. He recommends conversion of the PBGC into mandatory self-insurance pools whose members are jointly liable for deficits.

effective administration by the PBGC should be increased to provide strong incentives for companies to fund their plans fully.

The actuarial analysis of a company's pension liability need not be re-estimated more often than annually, unless there is a substantial change in the key assumptions. However, the present value of those obligations can readily be computed, and these estimates should be made at least quarterly, to accompany the valuations of pension assets. With valuations that are at least quarterly, there is no role for smoothing of deficits. The Financial Economists Roundtable recommends that the funding position of pension plans should always be assessed from current –not smoothed – market values.

The changes we recommend will provide more accurate information to policy-makers and corporate decision makers, as well as to those whose retirement income is at risk.

Minutes of Annual Meeting, Niagara-on-the-Lake, Ontario, Canada, July 11-12, 2004

The Financial Economists Roundtable held its twelfth annual meeting at the Queen's Landing Inn in Niagara-on-the-Lake, Canada on Sunday-Monday, July 11-12, 2004. Twenty-one members were in attendance. The Steering and Executive Committees met on Saturday, July 10.

Kaufman reported that there are 45 members in good standing. No new members were added. Two were invited and both declined. The low attendance was discussed. Three members had cancelled shortly before the meeting because of last minute problems. Adjusting for this increases the members who would have attended to 24, almost exactly the average of 25 for the previous eleven meetings. Many members expressed their opinion that the smaller number was better for purposes of discussion and that the 30 members last year in Vancouver were probably more than optimal. There is no attendance pattern with respect to East Coast - West Coast locations, and Europeans had expressed their preference for East Coast sites. The committees and the members as a whole recommended that a target attendance of 25 was probably appropriate, but that the Executive Committee should relax the stricter standards that were applied for new membership last year. Moreover, nominations for new members should be solicited and agreed on earlier to notify new members selected by the fall. Lastly, the members preferred to maintain alternating between East and West Coast meeting sites.

The committees and all the members also discussed the format of the meetings. They concluded that devoting two days to one topic and the process of trying to develop a policy statement as much as the policy statement itself was as good a format as any. Nevertheless, the Steering Committee solicits suggestions for alternative formats for future consideration.

Ed Altman completed his terms on both the Steering and Executive Committees and was thanked for his services. The Steering Committee nominated Lemma Senbet to the Steering Committee and Jim VanHorne to the Executive Committee. Both the nominees were elected unanimously.

Kaufman reported that the finances were sound. The bank balance was near $11,000. In response to a question, a reason for the high balance was the universal "failure" of any past members to successfully request a refund of their "refundable" dues.

In response to the request of many members at last year's meeting to schedule the 2005 meeting in the California wine country - a return to the roundtable's roots – Kaufman recommended the Lodge at Sonoma, which is a high-end Renaissance hotel in the Marriot Hotel chain. It is located two blocks south of the square in the center of Sonoma. The dates will be Sunday - Monday, July 10-11, 2005, starting as usual with a reception/dinner on Saturday, July 9. Possible topics will be solicited from members near yearend.

The past five policy statements were briefly reviewed and updated by:

Edwards: 1999 - "Long-Term Capital Management and the Report of the President's Working Group on Financial Markets"
Herring: 2000 - "Long-Term Future of the International Monetary Fund"
Stoll: 2001- "The Structure of Securities Markets"
Weil: 2002 - "The Crisis in Accounting, Auditing and Corporate Governance"
Senbet: 2003 - "The Controversy Over Executive Compensation"

Because the 2003 statement both received widespread publicity, spearheaded by the Wall Street Journal story and picked up by UPI, and then reported more extensively in the European and Asian Wall Street Journal, the Washington Times, St. Louis Post-Dispatch, and JACF and was still current, Senbet suggested the group may wish to prepare a follow-up addressed to Congress opposing a pending bill to prohibit stock option expensing for all but options given to the top 5 officers. After discussion, the group recommended that Senbet and Edwards draft and distribute an op-ed type piece that makes reference to the FER statement. The members discussed the 2004 topic, "Accounting for Corporate Pensions," led by discussion leaders Benston, Dimson, Logue, Siegel and Weil (substituting for Schipper who had to cancel at the last moment). After the discussion, the discussion leaders were reconstituted as a drafting committee and will circulate a draft statement to attending members for their review and comment.

The annual meeting adjourned at 2 p.m. on Monday, July 12.

Financial Economists Roundtable
Statement on
Hedge Funds

November 3, 2005

STANFORD, CA. - The Financial Economists Roundtable (FER) discussed hedge funds at its 2005 annual meeting and prepared the following policy statement.

Executive Summary

Hedge funds have grown rapidly in recent years and are now about one-eighth the size of mutual funds. But these largely unregulated limited partnerships give rise to a number of concerns. Their management expenses are very high and their investment strategies are often risky with a small probability of very large losses. This and other risks are not understood by all investors. In response, the Financial Economists Roundtable recommends that fiduciaries for retail investors should limit their investments in hedge funds to a modest percent of assets under management, that regulators should not rescue troubled hedge funds, and that measures of performance and risk be standardized among funds. Caveat emptor should still apply, but more rational and informed investor behavior should result.

Introduction

Hedge funds typically are private, largely unregulated, limited partnerships with wealthy individuals and institutional investors as limited partners and the manager/investment advisor as the general partner. A hedge fund can employ leverage, thereby amplifying the variability of outcomes. It restricts redemptions so the investment is largely illiquid. Reportedly, the first hedge fund began in 1949, and it adopted a long/short equity strategy. Not until the mid 1980s did hedge funds swell in importance. By 1985, approximately 40 hedge funds existed. This number expanded to over 1,000 in 1995 and to some 8,000 in 2005. Currently, hedge funds manage about $1 trillion in assets, roughly one-eighth of the amount managed by mutual funds.

A. Observations and Concerns

1. Understanding returns, expenses, and risk. Some worry that investors in hedge funds do not fully understand the true returns or the risks they bear. Expenses are high. The management fee to the general partner usually is 1 to 2 percent of assets, payable annually, and there often is an asymmetric performance fee in addition. This incentive, or carried interest, fee usually is 20 percent, and is often structured to be paid only if cumulative returns over time exceed a threshold return, known as the high-water mark. When cumulative returns fall below this mark, the general partner can close the fund, then start a new one in order to establish a new base mark for generating performance fees. This exit risk is easily overlooked by new investors. The asymmetric fee structure creates an incentive for the general partner to adopt a high-risk investment strategy, since he/she stands to make a large return if the strategy is successful but not to suffer losses if the strategy fails. Offsetting this incentive to some extent is the fact that investors generally insist on the general partners investing in the hedge fund. Nonetheless, the average life of a hedge fund is only about 3 years.

The returns on many hedge-fund strategies are not normally distributed, but have a distribution characterized by fat tails. Some refer to this risk as the peso problem. That is, the Mexican government does not devalue the peso for a long period of time and then one day devalues it sharply so that peso holders lose a lot. Expressed differently, day by day there is a small probability of a large loss. Tail risk makes standard measures of return volatility and performance, such as the Sharpe ratio, inappropriate guides to investors. By its very nature, tail risk is difficult to measure. In addition, risk-adjusted average returns tend to be overstated, because of survivorship bias and other reporting and data problems, making it difficult to compare hedge-fund performance with competing alternatives. Another risk is the illiquidity associated with particular positions undertaken by hedge funds.

The investor, particularly the retail investor and his/her agents, should be wary; available performance data make it difficult to judge true hedge-fund returns and risk for this high-cost vehicle. While reputation may serve as a disciplinary device, it has not always been effective. Simply put, the investor needs to be extraordinarily careful.

2. Systemic risk. By systemic risk, we mean the risk that failure of one counterparty to a transaction will trigger failure of other counterparties: A cannot pay B, who then cannot pay C, and so on. The FER believes that systemic risk of a cascading nature that would jeopardize financial institutions is now small, but we recognize the inherent difficulty in drawing any firm conclusion in this regard. More recently, back-office delays in processing trades have made it difficult for hedge funds to know accurately their actual positions in real time. Outsiders cannot observe who the counterparties to transactions are and this uncertainty, together with the tail risk, is a concern for investors seeking to understand the risk of any cascading type of meltdown. The difficulty of assessing the potential exposure to systemic risk reinforces the need for caution in determining portfolio allocations to hedge funds. On occasion, liquidity in particular markets can be temporarily frozen as a result of hedge-fund activity. However, since the Long Term Capital Management (LTCM) episode in 1998, many hedge funds have become more cautious in their choice of counterparties and no single hedge fund is as large relative to the market as LTCM was at the time. Moreover, bank regulators now monitor the credit and counterparty exposure of financial institutions to hedge funds much more carefully. 3. Fund of Funds. Funds of (hedge) Funds can play useful information and disciplinary roles. A Fund of Funds allocates capital among a number of individual hedge funds, giving investors access to managers they might not otherwise know and giving them diversification as to style and as to the law of large numbers. For such services, a Fund of Funds will charge additional management and incentive fees, up to another 50 percent of the underlying funds' fees. This added cost must be evaluated relative to the information efficiency and discipline they bring to the process. Some of us suspect that the services provided by some Funds of Funds are worth the cost, and that they make the market for hedge funds more efficient. Others of us believe that with some 8,000 hedge funds playing against each other in many of their strategies, there surely will be losers, particularly when the high costs are taken into consideration. All of us believe that Funds-of-Funds-of-Funds, F3s, which invest in Funds of Funds, do not have a favorable cost/benefit ratio.

B. Recommendations

1. **Fiduciaries should carefully limit their investment in hedge funds**. With the tail and exit risks involved, together with a lack of transparency, the FER has concerns about whether a large exposure to hedge funds is appropriate for pension funds and other fiduciary investors who make investments on behalf of others, particularly retail investors. The recent Bayou hedge fund fraud attests to what can go wrong. Money managers face incentive conflicts that might prevent them from adequately representing the interests of the beneficiaries whose funds were entrusted to them. The difficulties in assessing the full range of hedge-fund risks should dictate a limitation on investments in hedge funds to a modest proportion of the total assets under management. The FER fears that some fiduciary boards, particularly those composed largely of non professionals, do not adequately understand the true returns, risks and costs associated with investment in hedge funds.

2. **Regulators should vow not to bail out hedge funds.** The FER believes that banking regulators should not rescue hedge funds. No one or two hedge funds pose systemic risk, though an individual failure might temporarily disrupt the market. The prospect of free government bail-out insurance creates adverse incentives for speculative behavior. Expressing a no bail-out policy would reduce those incentives. While tail risk is a problem, we do not foresee likely scenarios in which the monetary authority would need to intervene in its capacity as lender of last resort.

3. **Performance and risk measurement should be standardized**. The FER recommends that institutions, such as the CFA Institute and the Chartered Alternative Investment Analyst Association, develop standards for measuring performance and risk for hedge funds as has happened for other investment vehicles. That is to say, there should be standardized measures pertaining to gross and net returns, expense ratios, leverage, volatility of returns, credit risk and liquidity. While some hedge funds are reputed to have developed good internal risk measures, they have not made them available to investors. With better measures of risk and return, more understanding and rational investing will be possible. Comparisons of hedge funds will be more uniform. Finally, the FER encourages research on the

asymmetric fee structure and its effect on investment behavior by hedge funds. The adoption of these recommendations should improve the climate for hedge funds, and result in a better understanding of performance, expenses and risks. We are hopeful the industry will provide more standardized information voluntarily. Caveat emptor will still apply, but more rational investment behavior should ensue.

Minutes of Annual Meeting, Sonoma, California, July 10 – 11, 2005

The thirteenth annual meeting of the Financial Economists Roundtable was held at the Lodge at Sonoma (California) on Jul 10-11, 2005. Twenty-three members attended (Altman, Carleton, Chen, Copeland, Dimson, Edwards, Eisenbeis, Ferson, Fisher, Herring, Ho, Kane, Kaufman, Logue, Schaefer, Schwartz, Scott, Sharpe, Siegel, Stambaugh, Van Horne, Weil, Westerfield). The Steering Committee met briefly on July 9th.

Kaufman noted that six new members had been nominated and all had accepted. Two (Ho and Stambaugh) were in attendance. Current membership stood at 50, but five members missed three consecutive meetings and were dropped from membership. Because one cycle of the new rotation of membership on the steering committee had not been completed, no changes were recommended. Stoll completed his two-year term on the Executive Committee and Dimson was nominated and elected to the Committee. The financial situation of the roundtable remained strong. The bank and money market balance was near $11,000 and would increase to near $12,000 upon the receipt of the $150 dues from the new members. The only regular annual expenses are small and associated with the annual meeting. The remainder serves primarily as protection against contracted guarantees to hotels in case of abrupt cancellation of an annual meeting. Herring, Scott, Weil, and Logue reviewed and updated the most recent policy statements.

Potential sites for future meetings were discussed at length, particularly whether proportionately more meetings should be held on the west rather than east coast instead of alternating annually as at present. A strong majority favored more meetings on the west coast but concern was expressed for the longer traveling this would impose on European members, The group accepted the Steering Committee's recommendation that the 2006 meetings be in Newport, Rhode Island and backup, if necessary, at Mt. Washington in Bretton Woods (N.H.). Meeting dates will be Sunday - Monday, July 9 - 10, starting as usual with a reception/dinner on Saturday July 8. The 2007 west coast meeting will be in the Santa Barbara area, with the San Diego area as backup. Dimson and Schaefer were asked to explore the possibility of a meeting in Europe in 2008. Otherwise the group preferred to return to the west coast. Kaufman will poll members for nominations for new members and topics for the 2006 meeting near yearend. The discussion leaders committee of Van Horne, Edwards, Scott and Stambaugh led an enthusiastic and through discussion on regulating hedge funds and will circulate a draft report to attendees for their review and comment.

Financial Economists Roundtable
Statement On
Best Practices for the Design of Defined Contribution Pension Plans

October 18, 2006

Over the last two or three decades, there has been a marked shift in private pension plans from defined benefit to defined contribution plans. In 1980, over 60 percent of employees in a private pension plan were in defined benefit plans. Now, the numbers are reversed with over 60 percent in defined contribution plans.[1]

The key characteristics of employer-provided defined benefit (DB) plan are that the benefits are tied typically to some measure of the employees' earnings and number of years of work at that employer and are paid during the remaining life of the retired employee and possibly the spouse. The key characteristics of a defined contribution (DC) plan are that the employee contributes to the plan with a possible match from the employer, owns the assets, usually determines how to invest these assets, and must choose a payout option upon retirement. Payout options typically include a choice of one or more annuities or a lump sum payment. The magnitude of the payout is determined by the market value of the plan at retirement, and not directly by the employee's salary.

On July 9 and 10, 2006, the Financial Economist Roundtable (FER) met at Bretton Woods, New Hampshire, to examine the implications of the shift toward defined contribution plans and to make recommendations to improve their design.

The Pros and Cons of Defined Contribution Pension Plans

The principal advantage of a defined contribution plan over a defined benefit plan is that the employee has ownership rights over the assets in the plan. Thus, with a DC plan the assets are portable and benefits from these assets do not depend upon the viability of the employer. (Witness the recent DB defaults in the airline industry, which were not all covered by the Pension Benefits Guarantee Corporation.) Another potential advantage is that the employee, who has some control over how the funds are invested, may be able to integrate the investment of these funds with the rest of his portfolio of assets and liabilities.

However, there are some major disadvantages of defined contribution plans as well. Specifically:

- Participants may be ill-informed and make poor investment choices.
- Participants, and even those who make well-informed decisions, bear the risk of market losses.

1 Improving Defined Contribution Plans, Economic Policy Brief, Joint Economic Committee Democrats, October 2005 and Private Pension Plan Bulletin: Abstract of 2001 Form 5500 Annual Reports, US Department of Labor, February 2006. These percentages involve some double counting as an employee may have both a defined benefit plan and a defined contribution plan. This publication omits government plans

- DC plans are less likely to assure that all participants have adequate savings for retirement, because each participant determines how much to save and how to allocate these savings across investment choices.
- DC plans expose most participants who do not annuitize to longevity risk—the risk that an employee could outlive his or her assets.

In theory, a defined benefit plan suffers from none of these disadvantages.

Many of the potential disadvantages are related to the possibility of human error: Defined contribution plans are designed for well-informed people who take active interest in planning for their retirement and who can evaluate longevity risks, portfolio allocation, and saving decisions. But, the large number of people who are prone to error, including spouses who can suffer from their partner's errors, is of social concern. Governments have erected social safety nets to protect such people from the worst consequences of these errors. Since the general public bears the expense of such safety nets, the amount of savings in defined contribution plans and how they are invested is a valid public policy concern.

Even if employees do not fall into social safety nets, differences in their choice of savings and investments may lead to large differences in retirement incomes, even among employees with the same earnings profile. Such inequalities may create demands for the government to redistribute income.

Addressing these concerns involves a delicate balance between instructing the unschooled and the mandatory imposition of saving levels and investment vehicles. Nonetheless it is the FER's view that a combination of increasing the emphasis on automatic enrollment and specifying an appropriate default portfolio would be a major improvement in pension design in the United States.

Automatic Enrollment

There is much empirical evidence that the initial default provisions of a defined contribution plan play a key role in the decision whether to participate and, if so, how much to contribute and how to allocate that contribution across investment choices. In many existing plans, an employee must take the initiative to participate or opt-in. A significant percentage of employees, particularly new employees, do not take the initiative to participate.

If an employee decides to participate, there are usually defaults as to the percentage of salary that is contributed and the type of investment. The default contribution percentages are usually less than the maximum allowed, and the default investment is frequently a money market fund. One reason that an employer chooses a money market fund over a perhaps more suitable diversified portfolio of bonds, stocks, and other assets is to guard against lawsuits over potential losses.

The FER recommends that new employees be automatically enrolled unless they take the initiative to opt-out.[2] It takes no position on the level of the default contribution rate, although it noted that contribution rates are often too low to provide adequate retirement income, and consequently the FER was intrigued with the Save More Tomorrow Plan where employees commit to increase their contribution rates at a later date. It concluded that the default investment option should be a low-cost, low-risk, prudently diversified portfolio, which may be a life-cycle portfolio whose asset allocation changes over time[3].

Until recently, laws in some states effectively ruled out automatic enrollment, as an employer could not take a deduction without the employer's consent. The recently passed Pension Protection Act makes it easier for employers to offer automatic enrollment. Also, employers need assurance that, as long as they chose a low-cost low-risk prudently diversified portfolio as the default option, they are protected from lawsuits if the returns of such a portfolio turn out to be negative. The Department of Labor is currently examining the nature of the investment default option.

Company Stock

Company stock is often a significant component of a defined benefit plan. The recent collapse of Enron reveals the risk of such holdings. The FER distinguished between holdings purchased with employee contributions from holdings purchased with employer contributions. Since the employer's contributions are voluntary, if the employer wants to give company stock, the FER believes that employers' contribution of stock should be allowed. However, the FER concludes that employees' contributions should generally not be invested in company stock except for the small amount in which investments would occur in index funds and well diversified actively managed funds.

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2 There was some discussion as to whether making the default option mandatory with an opt-out provision would reduce the number of corporations offering defined contribution plans, but the overwhelming sentiment was that the advantage of mandatory enrollment outweighed this possible reduction in the availability of defined contribution plans.

3 There were some members who thought that this portfolio should include TIPS as an inflation-hedge; others thought that the inflation rate facing retired employees was not well captured by the usual CPI, making TIPS a poor inflation hedge.

Annuities

As noted at the outset, longevity risk is retained by most plan participants in any DC plan. Annuities eliminate this longevity risk, as they provide payments as long as the beneficiaries or joint beneficiaries live. Annuities come in various forms. The most widely known are immediate annuities that make payments periodically, such as monthly or yearly. Most annuities pay a fixed nominal amount, but a limited number provide payments that are indexed to inflation or even to the return on an equity or bond portfolio. Deferred annuities have an accumulation period where the premiums earn a fixed or variable return, and the annuities are deferred in that the payments begin sometime after the purchase.

Individuals who buy annuities directly in the retail market generally receive less favorable rates that those buying through employer groups. The reason is that providers incur more marketing expenses in the retail market. In addition, they may charge higher prices to protect themselves against the adverse selection that a disproportionate number of retail purchasers in comparison to those in employer plans expect and often do live longer than the average member of their age cohort.

The FER concluded that annuities can play a major role in eliminating longevity risk, and employers should offer at retirement the default option of joint life annuities that protect both employees and spouses. An employer can obtain annuities at group rates and may be in a better position than an individual employee to evaluate different annuities.

The Pension Protection Act recognizes the importance of annuities by allowing the tax-free incorporation of long-term insurance into annuities. It also directs the Department of Labor to clarify the current "safest available annuity" standard.

Education

The FER recognizes the importance of investor education to enable employees to make better investment decisions. Employers are often reluctant to provide this education, as they worry about potential liability. It is increasingly common for employers to subcontract this education function. One danger of this subcontracting is that the subcontractor may also be profiting from the recommended investments, thereby creating a conflict of interest[4]. In this

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4 The FER considered recommending the creation of a tax-free education institute financed by either public or private funds. However, some FER participants noted the slow and troubled start of the independent research organizations created by the SEC in response to the recent financial analysts' scandal and financed by the industry.

regard, it might be noted that the Pension Protection Act explicitly allows the providers of investment vehicles to provide this education. Still, it is FER's view that employers, either directly or through subcontracting, should bear the primary responsibility for financial education.

Minutes of Annual Meeting, Bretton Woods, New Hampshire, July 9–10, 2006

Kaufman welcomed the 26 attendees to the fourteenth annual meeting of the FER. He noted that 26 was close to the average attendance for the previous thirteen, meetings. He announced that five nominated new members had accepted the invitation - Mary Barth (Stanford), Maureen O'Hara (Cornell), Robert Shiller (Yale), Chester Spatt (Carnegie-Mellon), and Josef Zechner (Wien, Austria). Two members failed to attend for the third successive year and will be dropped from membership. Total members currently numbers 46.

Kaufman mentioned that Stoll and Van Horne had completed their terms on the Steering Committee and the Executive Committee appointed Goodhart and Siegel to replace them. Van Horne also finished his term on the Executive Committee and is replaced by Edwards. Kaufman reviewed the financials. The organization is in good shape. The current "bank" balance was near $19,000, before collection of $150 dues from new members. Kaufman announced that FER has been incorporated in Illinois as a not-for-profit corporation and that the bank and money market accounts will be shifted to the corporate name. Kaufman is also exploring incorporation as a tax-exempt organization at the federal level with the assistance of a colleague at the Loyola Law School.

Kaufman discussed the options for the meeting site for July 15-16, 2007. At the 2005, meeting the attendees expressed a preference for Santa Barbara followed by the South California coast. A search for hotels found many either already booked or of the eligible hotels, particularly in Santa Barbara, not receptive to a group like FER. As a result, the Steering Committee narrowed the choices to the San Diego Hilton on Mission Bay and the Laguna Cliffs Marriott in Dana Point. Kaufman will explore these options more thoroughly. At the request of Kaufman, the Executive Committee recommended that a committee be established to review all aspects of FER to determine whether any chaJ1ges going forward should be recommended. Dimson will chair the committee. The other members are Blume, Ferson, Siegel, and Senbet, who represent different age cohorts within FER. Kaufman will serve as an ex-officio member. The Review Committee will operate through email and report to the membership no later than the 2007annual meeting.

Van Horne reviewed the 2005 policy statement, Benston the 2004 statement, Senbet the 2003 statement, Blume the 2002 statement, Stoll the 2001 statement, and Herring the 2000 statement. The attendees then discussed the 2006 topic "Designing an Optimal Defined Contribution Pension Plan." Goodhart chaired the discussion leaders committee. The other members were Blume and Shiller. The drafting committee is composed of the latter two and Santomero, with Blume as chair. The Roundtable adjourned on Monday, July 10 afternoon.

Financial Economists Roundtable
Statement On
The International Competitiveness
of U.S. Capital Markets

September 7, 2007

The Committee on Capital Markets Regulation (better known as the "Paulson Committee") issued an Interim Report (the "Report") on November 30, 2006, concluding that "the United States is losing its leading competitive position as compared to stock markets and financial centers abroad." 1This report was quickly followed by a study commissioned by New York Mayor Michael Bloomberg and Senator Charles Schumer and prepared by McKinsey & Co., which reached similar conclusions.[2] At its July 2007 annual meeting the Financial Economists Roundtable (FER) discussed the Report and the issues raised by it. This statement represents a consensus of the views of a majority of the FER members on several issues raised by that report.

The Report

As evidence in support of its conclusion that "the U.S. is losing its leading competitive position," the Report cites the decline in the U.S.'s share of global IPOs, the migration of trading volume to less intensively regulated securities markets (London and Hong Kong in particular), and the increasing preference of foreign firms to raise capital in the United States in private rather than public markets (thereby avoiding most of the SEC's mandated disclosure requirements and their accompanying liability potential)[3] While the Report acknowledges that there are many factors responsible for the loss of U.S. competitiveness (such as the increased integrity and trust in competing foreign markets, the increase in liquidity in foreign and private markets, and improvements in technology that make it easier for all investors to use foreign markets), the focus of the report is on legal and regulatory conditions in the U.S. that make U.S. capital markets less attractive to investors.[4] In the words of the Report: "There is little public policy can do to reverse the impact of the first three factors …. There are opportunities, however, to make adjustments to our regulatory and litigation framework so that public markets are less burdensome."[5]

The Report finds that a major reason for the loss of U.S. competitiveness is the "shift of regulatory intensity balance" towards what might be deemed "excessive" regulation of U.S. markets, and "concludes that the solution to the competitive problem of U.S. capital markets lies, on the one hand, in reducing the burden of litigation and regulation and, on the other hand, in increasing shareholder rights."[6] To redress this imbalance the Report makes no less than 32 specific recommendations on how to change the regulatory and enforcement system

1 p. ix
2 McKinsey & Co, "Sustaining New York's and the US' Global Financial Services Leadership", The City of New York Office of the Mayor (January 2007)
3 p. x.
4 pp. 4-5
5 Id.
6 p. xii

in four areas: regulatory process, the public and private enforcement system, shareholder rights, and implementation of the Sarbanes-Oxley Act of 2002 (SOX), especially §404.

Critics of the Report have rightly noted the lack of a clear connection between the measures of the loss of U.S. competitiveness cited by the Report and the importance it attaches to "regulatory and litigation burdens" as explanations or causes of these trends. We do not believe it would be useful to add still another voice to those pointing out the failure of the Report to make specific causal connections between the international competitiveness problems it identifies and the "regulatory and legal" changes it proposes as a solution to these problems, or the failure of the Report to even consider the potential benefits of some of the regulations it would either eliminate or significantly alter.

Indeed, we are skeptical even about the relevance of the measures of competitiveness that the Report relies on to buttress its argument that the United States has a significant competitive problem. For example, the Report makes much of its contention that new foreign listings on U.S. exchanges have fallen in recent years, while foreign listings in London have increased significantly, allegedly because of "overregulation" in the United States. But in the opinion of the FER, the Report does not demonstrate any causation between "overregulation" and the decline of foreign listings. Recent listing patterns appear to be driven by factors other than "overregulation," and in particular by changes in the characteristics of firms that seek an international listing. In addition, there is evidence that foreign corporations that list in the United States receive a higher valuation premium compared to similar firms that do not cross-list in the U.S., and that this valuation premium has not declined since passage of SOX.[7] While there also are academic studies that do find a decline in cross-listing premia after the adoption of SOX, they too recognize the difficulty of concluding that SOX is the cause of this decline.[8] Thus, even the measures of competitive erosion that the Report points to do not unequivocally support its contention that "overregulation" in the U.S. subsequent to the passage of SOX has been the cause of a significant competitive erosion of U.S. stock markets.

Notwithstanding the Report's shortcomings, its specific recommendations do serve the purpose of focusing attention on regulatory and enforcement mechanisms in U.S. securities markets that may not be working as anticipated and may need improvement. The FER identified four such mechanisms: litigation costs imposed on firms raising capital in the U.S. because of securities class action suits; audit costs associated with the implementation of §404

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7 Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, "Has New York become less competitive in global markets? Evaluating foreign listing choices over time," European Corporate Governance Institute Working Paper 173/2007 (June 2007).

8 See, for example, Kate Litvak, "Long-Term Effects of Sarbanes-Oxley on Cross-Listing Premia," U. of Texas Law School, June 2007, at p. 6, available at http://ssrn.com/abstract=994583

of Sarbanes-Oxley Act (SOX); requirements imposed on foreign companies wishing to issue and have their securities traded on U.S. exchanges; and shareholder rights with respect to the adoption of poison pills as a takeover defense.

The starting point of an analysis of these issues should be to clarify the purpose or goal of capital market regulation in all countries. The FER believes that the goal of such regulation should be to increase the economic efficiency of global capital markets, rather than to protect certain financial institutions or markets in any particular country from legitimate global competitive forces. Improvements in technology and the development of the infrastructure of capital markets in other countries inevitably create new competitive conditions for both financial institutions and individual countries and have ramifications for the regulatory and legal structures of individual countries. In addressing these issues, the principle of what is best for investors in general should guide each country, rather than considerations about what is best for specific financial institutions or markets.

Maintaining or enhancing the leading global competitive position of a particular country's institutions or markets should not by itself be a justification for adopting new regulations and laws. For example, we view the alleged migration of foreign issuers to non-U.S. markets rather differently than does the Report. (Indeed, one interpretation of the often dismal performance of new foreign listings in London is that U.S. listing and reporting standards may have had the beneficial effect of discouraging dubious foreign issuers from listing in the United States.) The policy recommendations of the FER that follow are based on the assessment that their adoption will benefit not only investors in U.S. capital markets but also will enhance the efficiency of global capital markets, by either increasing competition or reducing operating costs.

Securities Class Action Suits.

Prominent among the concerns often mentioned by foreign issuers in deciding not to sell or list securities in the United States is the extent of potential liability they may incur under U.S. securities laws and class action procedures – in particular, class action suits alleging a violation of Rule 10b-5, usually attributed to some material misrepresentation or omission in a company's financial statements. U.S. issuers share this concern as well. Securities class action (SCA) settlements reached $10 billion in 2006, not even counting the $7 billion Enron settlement.[9] An earlier study found that SCA settlements were paid 68.2% by insurers, 31.4% by the corporation, and 0.4% by others.[10] But shareholders of the corporation actually incur

9 L. Simmons & E. Ryan, Securities Class Action Settlements: 2006 Review and Analysis, p. 2, Cornerstone Research (2007).

10 F. Dunbar et al., What Explains Settlements in Shareholder Class Actions, p. 9, Nat'l Econ. Res. Assoc. (1995).

almost all of the settlement costs because the insurance premiums paid by the corporation reflect the amounts insurance companies pay out plus their capital, litigation and administrative costs.

Class actions can serve as a useful and effective civil enforcement device when there are many plaintiffs with relatively small individual claims, as in many defective product or environmental pollution cases. They afford a mechanism, not dependent on government, for internalizing to the enterprise costs that its operation imposes on outsiders. But SCAs present different issues.

It is important to distinguish two categories of SCAs – (1) those arising out of security purchases and sales in the secondary trading market among outside shareholders, and (2) those where the company itself or its insiders (officers and directors) are transacting to their own benefit. In the first category, the allegation is that the market price was distorted (usually, inflated) by misleading information from the company, so that one party lost and the other gained (as compared to what would have occurred had the price reflected accurate information). But the remedy is not that the winner makes restitution to the loser, but that the corporation pays the losers, though it was not a party to, and derived no benefit from, the transaction. Consequently, the great bulk of non-trading innocent shareholders of the corporation pay the equally innocent losers, since it is the continuing shareholders who bear the burden of what the company pays, either directly or indirectly through insurance premiums.

Over time, diversified or long-term shareholders, trading infrequently, are more likely to be losers than winners, so that the net expected effect on their wealth would be negative even if such wealth transfers were costless. But they are far from costless. Plaintiffs' attorneys take about 25-35% of what the company pays, and the company's defense costs (paid directly or through higher insurance premiums if covered by its insurance) are about the same magnitude.

Public shareholders would be better off if there were no potential for class action recovery in these secondary market situations, therefore, because they would avoid the deadweight loss from litigation costs and ex ante they are as likely to be on one side as the other. But that is not the case in category (2), where the company or its insiders are taking money from outside shareholders on the basis of securities fraud (assuming the allegations are proven). Here liability could serve the useful purposes of both deterrence and compensation.

The Report (at p.79) recognizes the distinction, as have academics,[11] but does not follow its implications. Instead, it merely recommends that some of the required elements –

11 See, for example, J. Coffee, Reforming the Securities Class Action, 106 Colum. L. Rev. 1534 (2006).

materiality, scienter (intent) and reliance – of a rule 10b-5 cause of action be clarified in the light of conflicting lower court decisions. Reducing legal uncertainty and cutting back on interpretive creep have merit but do not go to the heart of the matter. The FER recommends that the SEC abolish (as it has the clear power to do) enterprise liability under rule 10b-5 in category (1) situations, while retaining managerial and firm liability in category (2) transactions. Both domestic and foreign issuers would be relieved of an intimidating but ill-founded liability, and our capital markets would be made more attractive for all issuers.

Shareholder Rights: The Market for Corporate Control and Takeover Defenses

The Report concludes that shareholders of publicly traded U.S. firms have fewer rights than their counterparts in many other counties, and that it would be in the interest of the United States to strengthen shareholder rights.[12] We concur. Stronger shareholder rights can reduce agency costs associated with the potential divergence of interests between professional managers and dispersed shareholders, the typical corporate ownership structure in the United States. In particular, the Report supports majority, rather than plurality, voting for corporate directors, and commends efforts now underway to give shareholders greater access to the director nomination process, but offers no concrete recommendations on exactly what shape these reforms should take.[13] The FER agrees with the Report's sentiments in these areas, but would have liked to see specific recommendations as to how to achieve these goals.

In many other countries, such as the United Kingdom, if shareholders believe that the management and board of a company they own are not performing adequately, they can call a special shareholder meeting at which they can nominate and elect an entirely new board of directors.[14] Under the current governance system in the United States, it is in practice impossible for dispersed shareholders to oust incompetent boards and elect a new board. Giving shareholders greater rights to oust poorly performing boards, in their entirety if need be, by electing new boards would have important side benefits. It would eliminate the entrenchment use of "staggered boards" (where only a minority of the board is up for election each year), and serve to increase the incentive of corporate managers to be more responsive to shareholder concerns. Discussions between institutional shareholders, in particular, and corporate managers and boards would obviously take on a more cogent character if managers and boards knew that shareholders had the ability to call for a special meeting to vote on removing them if they failed to respond adequately to shareholder concerns. Another suggested reform has been to give shareholders under certain limited

12 pp. 93, 100-101.
13 pp. xii-xiii
14 See U.K. Companies Act of 1985, section 303.

circumstances the right to nominate and place on the company's proxy statement some directors in competition with the management slate. The SEC has been deeply divided on this change, and recently proposed for comment two diametrically opposed rules to permit or bar shareholder nominations.

Until major governance reforms are adopted, however, the only effective mechanism in the United States for removing poorly performing boards remains an effective market for corporate control – via hostile takeovers. The FER agrees with the Report that "shareholder rights plans" (the so-called "poison pills" which dilute a hostile purchaser's equity holdings) are a prohibitive defense against hostile takeovers. When coupled with a staggered board it is almost impossible for shareholders to replace boards who refuse to remove such poison pill defenses. Its effect is to deprive shareholders of a say (or vote) in whether or not to accept a hostile bid, effectively eliminating hostile takeovers as a market mechanism for disciplining ineffective managers. The Report recommends that U.S. companies with staggered boards should be required to obtain shareholder authorization (by majority vote presumably) prior to the adoption of a poison pill, unless the company is the target of a takeover attempt, in which case the firm might adopt a poison pill subject to obtaining shareholder approval within three months of its adoption.[15] The FER would go further, and require shareholder approval of poison pills for all companies, regardless of whether they have staggered boards. This would conform to the broad principle that the board of any company should not be able to deny its shareholders of the opportunity to decide on the merits of a takeover bid, and would be consistent with UK policy of prohibiting the use of poison pills entirely.[16] It would also restore the market for corporate control as an effective disciplinary mechanism for self-enriching or poorly performing boards and managers.

Cost Burdens of SOX Section 404.

The Report devotes an entire section to an analysis of the compliance costs associated with implementation of §404, concluding that these costs have been excessive and have significantly reduced the competitiveness of U.S. capital markets. The aim of §404 is to increase the accuracy of companies' financial statements and to reassure investors that companies are maintaining effective controls over financial reporting. But §404 implementation costs have been high. The Report estimates that these costs for issuers totaled between $15 and $20 billion in 2004, more than 35 times higher than the SEC's original cost estimate.17 It recommends a number of changes aimed at reducing the costs of §404 implementation, in particular, a redefinition of the scope and materiality standards of

15 p. 102

16 See General Principal 3 of the City Code on Takeovers and Mergers, and City Code Rule 21.

17 p. 126. See also I. Zhang, "The Economic Consequences of the Sarbanes-Oxley Act of 2002", Carlson School of Management working paper, University of Minnesota (February 2007).

the current audit requirements, and enhanced guidance by the Public Company Accounting Oversight Board (PCAOB) and the SEC for external auditors in carrying out their assessment and attestation responsibilities under §404.[18]

The §404 controversy over implementation costs comes down to the precise accounting and auditing standards that companies and external auditors must use in assessing the effectiveness of a company's internal controls. Section 404 requires that the corporation management shall assess in the corporation's annual report "the effectiveness of the internal control structure and procedures of the issuer for financial reporting" and that "management must state whether the controls are effective and note any significant deficiencies or material weaknesses in internal controls." In addition, it requires that the company's external auditor "attest to, and report on, the assessment made by the management of the issuer …."

Subsequently, the PCAOB issued Auditing Standard No. 2 (AS2) which required auditors to provide "reasonable assurance" that no "material weaknesses exist" in a company's internal controls over financial reporting.[19] A "material weakness" was defined as "more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected …"

The Report is concerned that this high standard has resulted in excessive compliance costs. Thus, the main thrust of the Report's recommendations is to relax or moderate the high standards that have been adopted by the PCAOB and the SEC in the implementation of §404. In particular, it would change the "probability threshold for the detection of control weakness from AS2's existing 'more than remote likelihood' standards to 'reasonably possible' that a material misstatement could occur." [20] Furthermore, this assessment would be required only for annual statements. Both the SEC and PCAOB (in AS5) subsequently made the change to a "reasonable possibility" standard.[21]

We agree that this change is desirable and should serve to reduce costs. However, the Report gives little reason to believe that, even then, the benefits of §404 will exceed the costs. Consequently, the FER recommends a statutory amendment to make it optional for a company to adopt the §404 procedure for a management assessment and auditor attestation of the effectiveness of its internal controls, with the requirement that if it chose not to comply, it would have to explain why in its financial statements. The market will assess a company's explanation for non-compliance and will value the company accordingly. Indeed,

18 p. 131-32

19 PCAOB Standards and Related Rules – Auditing Standard No. 2, as of May 12, 2006.

20 p. 19.

21 PCAOB Standards and Related Rules – Auditing Standard No. 5, effective for fiscal years ending on or after November 15, 2007.

recent evidence suggests that the market both appreciates and rewards 'good' explanations and can punish perfunctory explanations.[22] Presumably, if non-compliance is viewed as a material reduction in the transparency or reliability of a company's financial statements, investors will put a lower value on a company that does not comply, providing an incentive for that company to meet §404 requirements if the expense is worthwhile.

Maintaining Open Markets: Listing Requirements for Foreign Issuers.

The Report argues for the United States to maintain open markets and remove impediments both to foreign firms listing in the United States and U.S. firms listing on foreign markets.[23] Eliminating such impediments would arguably create a more competitive marketplace for listings and allow individual firms to choose which country's regulatory and governance structure best suits the needs of their shareholders. The Report stops short, however, of endorsing this as a general policy approach, and instead singles out the difficulty that foreign firms already listed in the United States have in exiting the U.S. marketplace (deregistering) as a significant impediment that the U.S. should relax.

Until recently, foreign companies already listed in the United States could not exit the United States as long as they had 300 or more U.S. shareholders. Relaxing this impediment, the Report argues, will encourage foreign companies to come to the United States in the first instance because they will know that they can later leave if they wish. The Report recommends that the SEC "loosen these capital controls, at least for foreign issuers," and "exclude … [large] institutional investors from the calculation of the U.S. shareholder base."[24] The SEC adopted instead a rule to permit a foreign issuer also to delist and stop reporting when its U.S. daily trading volume is below 5% of its worldwide average daily trading volume.[25] In our view this was a sensible addition.

But the FER believes that the Report fails to address what may be the most important impediment to the development of open markets for foreign cross-listings: the duplicative reporting standards for foreign firms. The SEC requires all listed foreign corporations to report in conformity with Generally Accepted Accounting Principles (US GAAP), or to reconcile International Financial Reporting Standards (IFRS) with US GAAP if they use IFRS, as do many foreign-chartered corporations and all EU-based corporations. As a consequence, foreign firms that list in the United States must bear significant additional reporting or reconciliation costs.

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22 S. Arcot and V. Bruno, "One Size Does Not Fit All, After All: Evidence from Corporate Governance", Financial Markets Group, London School of Economics WP (April 2007).

23 p. 49.

24 p. 50.

25 SEC Release No. 34-55540 (March 27, 2007) available at http:/www.sec.gov/rules/final/2007/34-55540.pdf

The SEC recently proposed that foreign issuers be allowed to file financial statements prepared in accordance with IFRS, without any reconciliation with US GAAP, and has issued a “concept release” on allowing US firms to do the same.[26] The FER supports allowing *both* foreign and U.S. firms to choose to report in conformity with either IFRS or US GAAP.

There are still some significant differences between these reporting standards.[27] In particular, US GAAP provides more comparability across reporting entities than does IFRS because IFRS provides less specific guidance as to how to account for specific transactions. Nonetheless, in our view both IFRS and US GAAP provide reasonable foundations for financial reporting for investors. Allowing firms to adopt whichever of these standards they believe to be the most cost-effective provides an opportunity for the market and investors themselves to sort out which reporting standard best serves their interests. We recognize that management may choose the accounting rules that best serve their personal benefit, as many believe was the explanation for much of the heated opposition to expensing stock options. But if investors judge IFRS as inferior to US GAAP, we expect the result would be a discount on the valuations of companies that use IFRS, providing an incentive for such companies to adopt US GAAP, and vice versa. The FER believes it likely that the potential benefits of allowing greater competition between the different reporting regimes would outweigh the potential costs associated with less comparability and possible abuse of the discretion to choose.

A potential problem is that jurisdictions that allow or require their constituents to use IFRS currently may modify, and do not uniformly enforce, the IFRS, which can result in non-comparability across firms. The FER suggests that, to mitigate this potential problem, the description accompanying IFRS financial statements should always say that management prepared such statements "in conformity with IFRS as adopted by [name of jurisdiction, such as EU].” Although there has been little enforcement of IFRS standards in most of the world, we expect that if SEC registrants were to use IFRS, their auditors would check compliance with IFRS just as auditors now do for compliance with US GAAP.

26 SEC Concept Release “Allowing U.S. Issuers to Prepare Financial Statements in Accordance With International Financial Reporting Standards,” Release No. 33-8831 (August 7, 2007) available at http://www.sec.gov/rules/concept/2007/33-8831.pdf

27 PricewaterhouseCoopers, “Similarity and Differences: A Comparison of IFRS and US GAAP.” (October, 2006). For example, US GAAP provides better information about the de-recognition of financial assets, while IFRS provides better treatment of potential and contingent liabilities.

Recommendations

1) Securities class action suits -- *Abolish enterprise liability under rule 10b-5 in situations arising out of security purchases and sales in the secondary trading market among outside shareholders, while retaining managerial and firm liability where the company itself or its insiders (officers and directors) transact to their own benefit.* Imposing massive liability on a company that is not a party to the securities transactions and does not benefit from the fraud does not serve a targeted deterrence function because it is the continuing shareholders of the corporation who bear the burden of what the company must pay if found guilty, either directly or indirectly through insurance premiums. Public shareholders would as a whole be better off if there were no such liability. On the other hand, retaining liability for insiders and firms that trade in the secondary market and directly benefit from a fraud on the market requires the wrongdoers to make restitution and serves a significant deterrence function.

2) Shareholder rights -- *Require all corporations to obtain shareholder approval to adopt a poison pill, regardless of whether a company has a staggered board.* "Poison pills" are a prohibitive corporate defense against hostile takeovers and can prevent the removal of poorly performing boards and management through the market for corporate control. Requiring shareholder approval for the adoption of a poison pill would conform to the broad principle that the board of any company should not be able to deny its shareholders of the opportunity to decide on the merits of a takeover bid, and it would help restore the market for corporate control as an effective disciplinary mechanism for poorly performing boards and managers.

3) Compliance costs associated with SOX §404 -- *Adopt a statutory amendment that makes it optional for a company to follow the §404 procedures for a management assessment and auditor attestation of the effectiveness of its internal controls, with the requirement that if the company chooses not to comply it must explain why in its financial statements.* §404 is highly controversial because of sharp disagreement about its relative costs and benefits. Costs are much higher than expected and benefits are difficult to identify and quantify. Consequently, the FER recommends that the market be allowed to determine the value of §404 compliance. If a company chooses not to comply, the market will assess its explanation for non-compliance and will value the company accordingly. Presumably, if non-compliance is viewed as a material reduction in the transparency or reliability of a company's financial statements, investors will put a lower value on a company that does not comply, providing an incentive for that company to meet §404 requirements if the expense is worthwhile.

4) Maintaining open markets -- *Allow both foreign and U.S. firms to choose to report in conformity with either IFRS or US GAAP.* The SEC requires all listed foreign corporations to report in conformity with Generally Accepted Accounting Principles (US GAAP), or to reconcile International Financial Reporting Standards (IFRS) with US GAAP if they use

IFRS, as do many foreign-chartered corporations and all EU-based corporations. Consequently, foreign firms that list in the United States must bear significant additional reporting or reconciliation costs. The FER believes that both IFRS and US GAAP are high quality accounting standards that provide reasonable foundations for financial reporting for investors. Allowing both foreign and U.S. firms to adopt whichever of these standards they believe to be the most cost-effective provides an opportunity for the market and investors themselves to sort out which reporting standard best serves their interests.

Minutes of Annual Meeting, San Diego, California, July 15 – 16, 2007

Kaufman welcomed the 28 attendees to the fifteenth annual meeting of the FER. He noted that attendance was slightly above average. Three new members accepted FER's invitation to join –Engle (NYU), Harris (USC), and Shanken (Emory). Four members attended for the first time-Engle, Harris, Spatt, and Zechner. Walter was welcomed back and Gordon was dropped from membership for missing wee consecutive annual meetings. Total membership stands at 50. Given that the membership has expressed a preference for between 25 and 30 persons at the annual meeting and that some 50 to 60 percent of members typically attend, total membership is approximately on target. Members will be polled for nominees for new membership near yearend.

Kaufman noted that Dimson and Well had completed their terms on the Steering Committee and Dimson also on the Executive Committee. The Steering Committee nominated Copeland and Herring to the Steering Committee and Senbet, who is serving on the Steering Committee, to the Executive Committee. All were elected unanimously by the attendees.

Kaufman reviewed the financials. There was little change from previous years. The only source of revenues is the one-time dues from new members and the only expenses are minor charges incurred at the annual meetings. Kaufman reminded the Roundtable that all administrative costs were absorbed by Loyola University. As of June 30, 2007, adjusted net assets (bank balance) were $12,600. (Note that the balance for June 2006 was $12,300, not $19,000, as incorrectly reported in last year's minutes.)

In accordance with the standing policy of alternating annual meetings between the east and west coasts, the Steering Committee accepted Kaufman's recommendation of the Glen Cove Mansion on Long Island, NY as first choice and Niagara-on-the-Lake in Canada as backup. Both properties provide all inclusive packages. The members accepted the recommendations. The 2008 dates are Sunday-Monday, July 13-14, starting as usual with a reception on Saturday evening. Members were urged to block out these dates.

At last year's meeting Kaufman noted his' desire to transition out of his position as Executive Director and a committee was appointed consisting of Dimson (Chair), Blume, Ferson, Siegel, and Senbet to review the future of the organization and the transition. Dimson reported that a volunteer from outside FER who runs an expert witness firm had applied and will be interviewed by the members of the Steering Committee after the meeting. The attendees expressed their preference for an inside candidate. The Dimson, Executive, and Steering Committees will report back to the membership at next year's annual meeting.

Goodhart briefly discussed and updated the 2006 policy statement on Defined Contribution Pension Plans, Scott on the 2005 statement on Hedge Funds, Benston on the 2004 statement on Accounting for Corporate Pensions, Senbet on the 2003 statement on Executive Compensation, Weil on the 2002 statement on Corporate Governance, and Stoll on the 2001 statement on the Structure of Securities Markets. Edwards, Scott, Dimson, and Ho led the discussion on this year's topic on the International Competitiveness of U.S. Capital Markets. They will attempt to draft a policy statement for circulation. The Roundtable adjourned after lunch on Monday, July 16.

Financial Economists Roundtable
Statement On
Reforming The Role Of SROS In The Securitization Process

December 1, 2008

During the last few decades, securitization has become a primary channel for enlarging financial markets and transferring credit risk from lenders to investors. Outstanding issues of privately securitized assets peaked worldwide at just under $12 trillion in 2008.[1]

When properly structured and monitored, securitization promises numerous benefits. It can generate opportunities for specialization that reduce funding costs, increase the range of financial products available, encourage financial institutions to deploy capital more efficiently, and allow borrowers, lenders, and investors to manage their risks more flexibly. However, transferring risk undermines incentives to perform due diligence at virtually every stage in the securitization process. In the last year, evident shortfalls of care and diligence in the origination, rating, and securitization of mortgages have led to a collapse in the prices of securitizations related to subprime mortgages, alt-A mortgages and other leveraged loans. The suddenness and extent of this price decline has undermined confidence in the reliability and integrity of the ratings process for asset-backed securities, and has reduced prices and credit flows in every market in which investors count on ratings firms to ascertain the quality of debt.

Meeting in Glen Cove, New York in July 2008, the Financial Economists Roundtable (FER) discussed the need to strengthen the securitization process by changing the incentives under which Statistical Ratings Organizations (SROs) operate. SROs (profit-making firms that prefer to call themselves credit rating "agencies") play a central role in testing the quality of the pool of obligations being securitized and in creating and marketing "tranches" of graded claims to cash flows from the underlying mortgages or other debt. The scope and scale of ongoing ratings downgrades and defaults on securitized debt make it clear that the ways in which credit ratings are used and constructed must be reformed.

The FER sees a strong need for three types of credit-rating reform. First, FER supports strategies designed to improve SRO incentives by increasing the transparency of their modeling practices and holding their managements accountable for negligent ratings errors. Second, the FER challenges the wisdom of incorporating SRO ratings in securities and banking regulations issued by governmental entities. By outsourcing public authority to private firms, this practice intensifies the conflicts of interest that SRO personnel must resolve. Finally, to acknowledge differences in the degree of leverage that is imbedded in different issues of securitized debt, FER recommends that SROs be required to state an express margin for error in their ratings for every tranche of securitized instruments.

1 See Table 1 at the conclusion of this statement.

Some Historical Perspective

Bond markets functioned internationally for 300 years before the first rating organizations appeared in the United States. An active corporate bond market, largely in debt issued by railroad companies, emerged in the middle of the 19th century in the United States more than half a century before the first SRO opened for business. SROs remained largely US-focused until the 1970s, when global capital markets began to reemerge after fading in the interwar period.

In the pre-SRO era, underwriters performed some certification and monitoring for investors. Thereafter, third-party ratings mitigated asymmetric-information problems between issuers, underwriters, and investors by credibly centralizing efforts to collect and analyze the information needed to estimate, monitor, and update the probability of default of individual bonds.

Ratings data also expanded the range of investors willing to hold corporate bonds to include parties that lacked the resources to undertake a complete and independent credit analysis. SROs originally earned their revenue by selling ratings manuals directly to investors.

Building a reputation for accuracy is critical to the success of any SRO. Ratings firms prospered to the extent that their predictions of the probability of default proved reliable after the fact. Over time, the accumulation of reputational capital by successful SROs made entry difficult for new SROs. The result is that two or three SROs have dominated the market for credit ratings, and did so long before the SEC began to designate particular SROs as Nationally Recognized Statistical Rating Organizations (NRSROs) in the 1970s.

In the early 1930s, incentives for SROs to produce reliable information for investors were complicated by introducing ratings into the regulatory process. Regulators of banks, insurance companies and pension funds began to use ratings to limit the riskiness of the assets held by regulated entities. Regulators now set two kinds of rules: rules that restrict the extent to which a firm can hold assets that fall below investment-grade or, as in the case of money market mutual funds, require a higher threshold than investment grade, and rules that link capital requirements to the ratings on individual securities, with lower capital charges for high-rated securities.[2] The existence of such regulatory consequences was bound

2 For example, (Sylla 2002, p. 37) notes that in 1936, the US Comptroller of the Currency issued a regulation prohibiting banks from purchasing investment securities with characteristics that were "distinctly or predominantly speculative," and then added that "the terms employed…may be found in recognized rating manuals, and where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported by not less than two ratings manuals." The latter phrasing, referring to recognized raters, was attacked as placing too much authority in the private rating agencies, and on that ground it was deleted from

to intensify pressure on SROs to inflate the grades of lower-rated securities, because regulated clients routinely explore and develop ways of reducing their regulatory burdens. Frank Partnoy (1999, p.684)[3] describes client pressure in this way: "[O]nce regulation … incorporates ratings, rating agencies begin to sell not only information but also valuable property rights associated with compliance with the regulation." As ratings became more widely used in trigger clauses in bond contracts, strong ratings conveyed additional benefits to the issuer.

Of course, a concern for protecting their reputations can act as a healthy counterincentive. Studies of ratings accuracy during the 20th century find that SROs have done a reasonably good job of predicting the probability of default of corporate bonds relative to regulatory indicators[4] of default risk and market measures of default risk. Still, grade inflation has occurred. Caouette et al. (2008) observe that though the ratings do represent relative risks (on average) reasonably well, they are less reliable as indicators of absolute credit risks; default probabilities associated with specific rating levels drift over time and therefore need to be frequently updated.[5]

The spread of photocopying technology facilitated unauthorized reproduction of SRO rating manuals, which undermined the traditional user-pays revenue model. SROs responded by shifting to a business plan in which the issuer pays for their services. This plan intensified SRO conflicts of interest with issuers. Issuers and underwriters actively shopped for ratings and were unwilling to pay for ratings they deemed too low.[6] In the case of the newer securitized debt, pressure for favorable ratings has been particularly intense because the large

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the regulation in 1938, although in a less formal way it remained in effect with regulators. For additional details see Richard Sylla, 2002, "An Historical Primer on the Business of Credit Rating," in *Ratings, Rating Agencies, and the Global Financial System*, edited by Richard M. Levich, Giovanni Majnoni, and Carmen Reinhart, The New York University Salomon Center Series on Financial Markets and Institutions, Kluwer Academic Publishers, pp. 19-40

3 Frank Partnoy, 1999, "The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies," Washington University Law Quarterly, 77, October.

4 For example, Hickman (1960) used legal investment lists for savings banks adopted by regulatory authorities in the states of Maine, Massachusetts, and New York as an indicator of regulatory ratings. For additional details see W. Braddock Hickman, 1960, Statistical Measures of Corporate Bond Financing since 1900, Princeton: Princeton University Press.

5 See J. Caouette, E. Altman, P. Narayanan, *Managing Credit Risk*, 2nd edition, John Wiley & Sons, NY, 2008. The expected dollar-denominated default rate on non-investment grade corporate bonds in 1984 was 1.6% per year, but is now 3.9% per year. As late as 2007, Fitch reported that the default rate on structured products through 2006 was similar or lower than that on corporate bonds. Subsequently, results for structured products deteriorated sharply.

6 The June 2008 settlement between the New York Attorney General and the ratings agencies mandated charging separate fees for indicative ratings. While the intent was to reduce shopping for ratings, some FER members raised concerns that it may have the opposite effect by lending tacit official approval to the practice of shopping for ratings.

underwriters of structured debt could direct substantial future revenue to a cooperative NRSRO, thus increasing the potential for undue influence. SROs argued that concern for maintaining their reputational capital would nevertheless insulate ratings decisions on securitized debt from undue influence by issuers. This argument became increasingly less persuasive as income from rating structured debt began to increase sharply and account for almost half of the revenues of the three dominant firms.

A further weakness inherent in issuer-pays arrangements is that they undercut SRO incentives to monitor and downgrade securities in the post-issuance market. The re-rating of securities is usually paid for by a maintenance fee that is collected in advance from each issuer. Few issuers are eager to be monitored closely, especially when monitoring is apt to result in downgrades, and so it is not surprising that ratings are seldom downgraded until long after public information has signaled an obvious deterioration in an issuer's probability of default.[7]

Not until 1975 did the SEC confront the problem of how to determine whether a particular SRO could be relied upon to provide ratings of sufficiently high quality that they could be used in the regulatory process. The SEC's solution to this problem was to certify particular SROs as meeting sufficiently high standards to be designated by the SEC as an NRSRO. Other regulatory agencies, Congress, and many private agreements made use of the SEC's designation of qualified NRSROs. For potential new entrants to the ratings industry, the costs and uncertainty of obtaining NRSRO status imposed an additional, legal barrier on top of their already substantial reputational disadvantage. From 1975 to 2002, although the SEC received numerous applications from entities in the United States and abroad, only one new general purpose NRSRO was approved.

The NRSRO designation strengthened the market power of the dominant three incumbent firms: Moody's, Fitch, and Standard & Poors. In turn, the oligopolistic position these firms enjoy reduces their incentives to compete in ratings methods and procedures. For example, even though SROs inevitably lack long histories and through-the-cycle data on innovative instruments, they have all been slow to draw on the information generated by derivatives trading (especially in credit default swaps) and from secondary markets for debt and equity, both of which would help them analyze potential defaults in a forward-looking context. Nor have SROs developed procedures for supplying information on correlations that investors need to protect against concentrations in risk exposure that might exist in a portfolio of securities.

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7 E. Altman, H Rijken, "How Rating Agencies Achieve Rating Stability," *Journal of Banking & Finance*, 28 (2004),2629-2714, and E. Altman & H. Rijken, "A Point in Time Perspective on Through the Cycle Ratings," *Financial Analysts Journal*, 62, No. 1, (2006), 54-70.

Despite the potential benefits of strengthening competitive forces in the SRO industry, the three major NRSROs have been permitted to acquire competitors virtually without challenge.[8] The FER believes that the regulators could enhance competition among SROs by more vigorous application of antitrust policy. Although the SEC recently recognized a handful of additional firms as NRSROs in the last two years in response to pressure from Congress to ease barriers to entry, it will take considerable time for new entrants to wean much market share away from the three dominant firms.

FER's Evaluation of SEC Proposals for Reform

Because some market participants are bound to base investment decisions primarily on credit ratings, efforts to improve ratings quality are important. In June, the SEC proposed several ways to improve the work of SROs and to increase competition in the ratings industry in three ways. The avowed and laudable purpose of these proposals is to foster increased transparency, accountability, and competition in the credit rating industry for the benefit of investors. The precise models used by SROs are proprietary and to encourage an individual SRO to invest in improving its models, the models themselves must remain proprietary. At the same time, to hold SROs accountable for their performance requires that each SRO release enough information on data input into its models to allow outside experts to verify its conclusions or provide alternative results.

The SEC's first proposal seeks to mitigate conflicts of interest, enhance disclosures, and improve internal policies and business practices at SROs. The second proposal would require NRSROs to differentiate the ratings on structured products from those that they issue on traditional bonds and loans, and perhaps to provide a timely and relevant accompanying narrative. The third proposal would nearly eliminate the role of ratings in SEC regulations. FER supports the thrust of each proposal. To explain why, we discuss each in turn.

In the important areas of disclosure and incentive conflicts, the SEC's first proposal would require SROs to:

- Publish all ratings and subsequent re-ratings in ways that facilitate comparisons of SRO performance in a timely manner. Disclosures would include performance statistics for spans of 1, 3, and 10 years within each rating category.[9]

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8 For example, Moody's purchased the market-based credit risk and portfolio management firm, KMV, in 2001 and Duff & Phelps was purchased by Fitch in the early 1990s. Although KMV was not formally an NRSRO, it competed directly with NRSRO firms.

- Disclose all information used to determine ratings for structured products. In addition, this would require each SRO to explain whether and how it might rely on the due diligence of others to verify the character of the assets underlying a structured product and to include sufficient information on the changing value of underlying assets to permit outside analysts (i.e., persons who are not paid by the issuer) to evaluate the riskiness of the structured claims issued against them.

- Explain how frequently credit ratings are reviewed, whether different models are used for ratings surveillance than for setting an initial rating, and whether, when changes are made in an SRO's models and procedures, they are applied retroactively to existing ratings.

The FER is less enthusiastic about the SEC's proposed prohibition against letting an SRO act as both a rater of and a paid advisor for a tranched securitization. Although we appreciate that acting in these dual capacities intensifies SROs' conflicts of interest, we believe that the customary industry practice of presenting alternative structures for an SRO to rate makes it impossible for the courts to distinguish ratings services from advisory services in a definitive way. Moreover, we believe the enhanced disclosures will ease this conflict of interest.

The SEC or Congress might also impose disclosure requirements on issuers. Every US issuer of securitized claims could be required to provide a monthly balance sheet and income statement for each and every securitization structure it creates, even if the securities are to be marketed offshore. The revenue-generating pool of underlying assets constitutes the structure's assets and the tranches set by the securitization structure constitute claims against these assets. When underlying assets lose value, whether through rating downgrades or outright defaults, prospective revenues diminish and the values of affected tranches deteriorate. These easy-to interpret disclosures would make pending deteriorations in cash flows more visible to investors and permit the joint distribution of risk statistics for the various tranches to be studied more effectively.

The SEC's second proposal seeks to differentiate ratings on securitizations in the future from those on ordinary bonds. Because of their imbedded leverage, securitized instruments may have a much deeper downside loss exposure than ordinary bonds. Using the same grading scale for both kinds of instruments reduces the effectiveness of restraints on institutional risk taking built into longstanding regulatory protocols. This renders many inherited regulatory strategies obsolete and was bound to confuse at least some investors. As an estimate, every

9 Although SROs provide data on default rates for bonds and loans by rating categories, data on structured products have been provided less frequently and ought to be published faster and more extensively in times of market turmoil.

credit rating carries a calculable margin for error. Introducing a differentiated scale is one way to alert investors that downside margins for error are much larger for securitized claims than for ordinary debt. Because imbedded leverage and downside margins for error grow larger when claims on an underlying asset pool are tranched and retranched, SROs should be required to express ratings on securitized debt in a two-dimensional fashion (i.e., with an accompanying estimate of their particular margin for error). This would be much more useful than merely developing a separate scale for securitized instruments. SROs might either use estimates of potential downside variability to rate claims in an interval framework (e.g., a particular rating might be expressed as lying in the range from A to AAA) or prepare and publish the volatility estimates themselves.

The SEC's third proposal addresses its practice of basing rules and reporting procedures on NRSRO ratings. The concern is that the use of NRSRO ratings in supervision simultaneously outsources some of the regulatory authority's political accountability to profitmaking firms and appears to confer an official seal of approval on their methods that might reduce the willingness of other parties to undertake due diligence and invest in securities analysis. The SEC proposes to remove references to NRSRO ratings from virtually all of its rules and protocols.[10]

The FER discussion divided references to NRSRO ratings in SEC regulations into two categories: prescriptive mandates that tell asset managers what they must do and quasi-safeharbor provisions that provide firms, managers and directors some protection from liability for adverse outcomes.

The FER strongly endorses eliminating from SEC regulations every prescriptive mandate that is or would be based solely on credit ratings set by NRSROs. We believe this will have three advantages. First, the prudence of investment decisions must ultimately be evaluated in a portfolio context and cannot be assured by constraining the credit quality of individual assets an institution holds, regardless of how accurate the SRO ratings might be. Second, depriving SRO ratings of regulatory consequences will remove a major source of pressure for ratings inflation. Third, in the absence of SEC mandates, managers and directors can and will subject the prudence of their decisionmaking to review by a much wider array of outside monitors.

10 An exception is drawn for rules and forms that "relate to non-public reporting or recordkeeping requirements used to evaluate the financial stability of large brokers or dealers or their counterparties and are unlikely to contribute to any undue reliance on NRSRO ratings by market participants." (Quoted from SEC 17 CFR Parts 229,230, and 240, Release No. 33-8940; 34-458071; File No. S7-18-08, p. 5.) These include rules which impose certain recordkeeping and reporting requirements for holding companies that own broker-dealers and of supervised investment-bank holding companies and reports regarding the risk exposures of large broker-dealers and OTC derivatives dealers.

In particular, they will expand their use of directors and officers insurance and introduce letters of assurance from well-respected experts. Whether or not these other monitors aspire to attain SRO status, they would supplement, extend, and challenge the assessments of individual securities made by SROs, thereby injecting valuable competition into the market for rating services.

The FER found it harder to assess the net benefits of quasi- safe- harbors (offered mainly to directors and officers of money market mutual funds) based on credit ratings.[11] Some members felt that removal of quasi-safe- harbors would yield benefits from increased managerial diligence and reduced pressures for grade inflation that would more than offset the increased compliance costs and costs of defending nuisance lawsuits. Other members believed that there are efficiencies to be achieved by use of intermediaries specialized in credit review. They argued that the rating requirements for money market mutual funds had worked reasonably well (apart from the current credit crisis) and that increased compliance costs, especially for smaller funds, would swamp any benefits that might emerge from increased managerial effort. Moreover, it was agreed that retaining this role for NRSROs would provide SROs with an incentive to register for NRSRO status and comply with the enhanced disclosure requirements. Even if the SEC should decide to continue to offer quasi-safe- harbors based on credit ratings, requiring a new ratings scale for securitized debt means that the content of such provisions has to be analyzed afresh to acknowledge the implications of the distinctions created. A new scale will similarly force banking agencies and state regulatory bodies to rethink and rephrase all rules and regulations that rely on credit ratings. In view of the importance of regulation-induced innovation in creating financial turmoil, such rethinking is long overdue.

Implications for Other Regulators

Although the SEC stressed that it had consulted with the President's Working Group on Financial Markets, the Financial Stability Forum and the Technical Committee of the International Organization of Securities Commissions (IOSCO), the SEC's proposed removal of references to ratings in its regulations diverges sharply from reform strategies currently being implemented by other regulators in the US and abroad. For example, the Treasury's temporary insurance of money market mutual funds relies on compliance with rule 2a-7 that relies on rating as a useful indicative guidance, and the Treasury's recent plan to recapitalize banks will be contingent on ratings to some extent. FER sees the SEC's third proposal as providing a timely challenge to other regulators to reexamine the extent to which they plan to employ SRO ratings in their own regulatory schemes.

11 This protection is at best a quasi- safe- harbor because rule 2a-7(c) (3) states that the board must take into consideration "factors pertaining to credit quality in addition to any rating." It might better be viewed as indicative guidance.

Although new rules and enhanced supervision might induce slightly better SRO performance, it is unlikely that increased government oversight of the production of credit ratings can improve SRO performance over time and improve the performance of investment managers as effectively as market forces can. It is particularly important for banking regulators to reconsider their reliance on ratings decisions. By adopting Basel II, they are linking minimum capital requirements for some banks to ratings issued by whatever SROs they recognize in each individual nation. Some banks will be free to use Basel II's Standardized Approach, which the European Union and Japan have already begun to implement and is proposed for implementation in the United States. In this scheme, capital charges are assigned to each bank's assets according to their credit ratings, with unrated assets receiving a 100% risk weight. Since loss reserves are already based on anticipated losses, capital requirements are intended to provide a buffer against unexpected risks. Thus, it is illogical to use credit ratings to establish capital requirements, since they convey no information about the volatility of an asset's return around expected loss experience. In addition, ratings may be useful for establishing loss reserves for particular assets, but they say nothing about how a bank's net worth or its portfolio of assets may vary in value. The amount of capital that must be set aside to achieve a particular target level of safety has to be linked explicitly to measures of the volatility of its earnings, not asset ratings.

Since the subprime crisis has had a world-wide reach, regulatory authorities in other countries are also thinking about how to regulate SROs. Despite the SEC's attempt to coordinate its actions with IOSCO, it is clear that different countries may respond to the crisis in different ways. The use of ratings is hard-wired into many European Union regulations. The EU's internal market commissioner is thinking of introducing some exacting regulatory requirements to make sure ratings are not "tainted" by the conflicts of interest inherent to the ratings business. The European Commission has proposed a registration and oversight regime that would have two features. The first charges the Committee of European Securities Regulators (CESR) with the responsibility for choosing an individual country to register, coordinate and consolidate oversight of individual SROs. The second creates a central supervisor, financed from the EU budget, to license rating organizations. As capital markets become more closely integrated, ratings organizations are bound to find it difficult to operate under different rules in different locations. Also differences in rules would complicate cross-country comparisons of ratings for investors and regulators. If a single supervisory approach is to be adopted, FER strongly supports the SEC's strategy which relies on greater transparency, increased competition and the abandonment of the practice of incorporating NRSRO ratings in regulatory mandates. The FER hopes that other regulators will follow the SEC's lead.

Table 1. Estimated Size of the Global Asset -Backed Securities (ABS) Securitization Market
Classified by Collateral Employed
(in billions of dollars)

Prime Mortgage-Backed Securities	$3,800
Subprime Mortgage-Backed Securities	$780
Commercial Mortgage-Backed Securities	$940
Consumer ABS	$650
High-Grade Corporate Debt	$3,000
High-Yield Corporate Debt	$600
Collateralized Debt Obligations	$400
Collateralized Loan Obligations	$350
Other ABS	$1,100
Total	**$11,920**

Source: Compiled from a variety of sources including Goldman Sachs, JP Morgan Chase & Co, Lehman Brothers, Markit.com, Merrill Lynch and IMF Staff estimates

Minutes of Annual Meeting, Glen Cove, New York, July 13-14, 2008

The 16th annual meeting of the Financial Economists Roundtable was held at the Glen Cove Mansion, Glen Cove, New York on Sunday-Monday, July 13-14, 2008, starting with a reception and dinner on Saturday, July 12.

Kaufman reviewed a number of administrative items. A record 31 members attended the meeting. Five persons had been invited to join FER this year and all five had accepted: Charles Calomiris (Columbia), Darrell Duffie (Stanford), William Goetzmann (Yale), Ravi Jagannathan (Northwestern), and Pete Kyle (Maryland). Martin Gruber was readmitted. Eduardo Schwartz missed three consecutive meetings and was dropped from membership. Current total membership is 50. This is close to the membership's preferred size, so that attendance at anyone annual meeting does not exceed 30 by much and interfere with the free flow of discussion.

Two years ago, Kaufman had stated that he wished to step down as executive director. This would also involve moving FER's administrative office. Last year, the membership indicated its preference for an inside appointment. Dick Herring agreed to become executive director effective the end of the 2008 meeting and move the administrative office to the Wharton Financial Institutions Center. The transfer of records, bank accounts will be carried out gradually over the next year.

Kaufman reported that Eisenbeis and Scott had completed their four-year terms on the Steering Committee and that the Committee had nominated Ferson and Santomero to replace them. Edwards rotated off the Executive Committee, but remains on the Steering committee. As executive director, Herring joins the three person Executive Committee and Kaufman was nominated to a two-year term on the Committee.

Kaufman reviewed the financials. The organization is in healthy financial shape with net assets in excess of $13,000. Currently, revenues come from individual dues and expenditures reflect small items at annual meetings that are not charged to attendees individually. The endowment serves as a safety-net in case of default on annual meeting hotel guarantees. Kaufman suggested that FER apply for IRS 5Ol(c)3 tax-exemption status. The membership supported this suggestion and Herring agreed to pursue the possibility.

Herring discussed the 2009 annual meeting site and date options. He suggested that the dates be one week later on Saturday-Monday, July 18-20. The first preference was the Columbia River Gorge outside of Portland, Oregon. Second preference was Carmel-Monterey, California. He will report back to the membership ASAP.

Edwards, Blume, Scott, and Logue briefly updated the last four policy statements adopted. Kaufman reviewed the conditions and procedures for officially adopting a policy statement. The discussion leaders group of Kane (chair), Altman, Goodhart, and Herring guided the discussion on the 2008 topic of "Securitization and Credit Ratings Under Fire: Causes, Effects, and Policy Lessons." The group will draft a statement based on the discussion for comment by attendees.

During the session, the US Treasury and Federal Reserve announced strategies for rescuing Fannie Mae and Freddie Mac. The Roundtable interrupted its discussion on credit ratings to discuss the proposals and issued a brief policy statement (attached) by unanimous vote of those attending the discussion.

Appendices

Appendix A

FER Members

Rashad Abdel-Khalik, University of Illinois at Urbana-Champaign
Franklin Allen, University of Pennsylvania
Edward I. Altman, New York University
George J. Benston, Emory University
Harold Bierman, Cornell University
Gerald O. Bierwag, Florida International University
Marshall E. Blume, University of Pennsylvania
Richard Brealey, London Business School
Charles Calomiris, Columbia University
Willard T. Carleton, University of Arizona
Andrew H. Chen, Southern Methodist University
Jennifer Conrad, University of North Carolina- Chapel Hill
George Constantinides, University of Chicago
Tom Copeland, Massachusetts Institute of Technology
Elroy Dimson, London Business School
Darrell Duffie, Stanford University
Franklin R. Edwards, Columbia University
Robert Eisenbeis, Cumberland Advisors
Edwin Elton, New York University
Robert Engle, New York University
Wayne Ferson, University of Southern California
Lawrence Fisher, Rutgers University
Mark J. Flannery, University of Florida
Julian Franks, London Business School
William Goetzmann, Yale University
Charles A.E. Goodhart, London School of Economics
Myron Gordon, University of Toronto
Martin J. Gruber, New York University
Nils Hakansson, University of California at Berkeley
Lawrence Harris, University of Southern California
Richard J. Herring, University of Pennsylvania
Thomas Ho, Thomas Ho Company
Robert Hodrick, Columbia University
W. Curt Hunter, University of Iowa
Ravi Jagannathan, Northwestern University
Michael C. Jensen, Harvard University

Kose John, New York University
Edward J. Kane, Boston College
George G. Kaufman, Loyola University Chicago
Jan Pieter Krahnen, Goethe University, Frankfurt
Albert “Pete” Kyle, University of Maryland
Alan Kraus, University of British Columbia
Haim Levy, Ben Gurion University of the Negev
Robert Litzenberger, University of Pennsylvania
Dennis E. Logue, Ledyard National Bank
Ronald Masulis, Vanderbilt University
John J. McConnell, Purdue University
Allan Meltzer, Carnegie Mellon University
Robert C. Merton, Harvard University
Merton Miller, University of Chicago
Franco Modigliani, Massachusetts Institute of Technology
Stewart C. Myers, Massachusetts Institute of Technology
Maureen O’Hara, Cornell University
Jay Ritter, University of Florida
Jean-Charles Rochet, Universite des Sciences Sociales de Toulouse
Richard Roll, University of California at Los Angeles
Stephen Ross, Massachusetts Institute of Technology
Mark Rubinstein, University of California at Berkeley
Anthony M. Santomero, McKinsey & Company, Inc.
Stephen Schaefer, London Business School
Myron Scholes, Stanford University
Eduardo Schwartz, University of California at Los Angeles
Kenneth E. Scott, Stanford University
Lemma Senbet, University of Maryland
Jay Shanken, Emory University
William F. Sharpe, Stanford University
Robert Shiller, Yale University
Jeremy Siegel, University of Pennsylvania
Seymour Smidt, Cornell University
Clifford W. Smith, University of Rochester
Chester Spatt, Carnegie Mellon University
Robert Stambaugh, University of Pennsylvania
Laura Starks, University of Texas
Hans R. Stoll, Vanderbilt University
Marti Subrahmanyam, New York University
Robert A. Taggart, Boston College
Seha M. Tinic, Koc University (Turkey)

Peter Tufano, Harvard University
James Van Horne, Stanford University
Ingo Walter, New York University
Roman L. Weil, University of Chicago
Richard West, New York University
Randolph Westerfield, University of Southern California
J. Fred Weston, University of California at Los Angeles
Josef Zechner, University of Wien (Austria)

Appendix B

FER Bylaws

Description and Statement of Purpose

The Financial Economists Roundtable (FER) is a group of senior financial economists, who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets. both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decisions. FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among the majority of the attending members and is signed by all members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media.

Bylaws

I. Objective

A. To encourage spirited intellectual interaction among finance specialists with a broad range of scholarly and policy interests.
B. To encourage and facilitate in-depth analysis of finance issues with important policy implications.
C. To provide input into policy debates about important policy issues in finance and to affect public and private policy decisions.

II. Membership Requirements

Members are individuals:

A. Recognized for substantial contributions to financial economics
B. Who have a breadth of interest in financial economics
C. Who are professionally active; and
D. Who are at least 50 years of age.

Members commit themselves to participate actively in the deliberations of the Roundtable, including reading and commenting on papers, attending meetings, and considering and assenting to or dissenting from policy recommendations. Starting with the 1994 annual meeting, members must attend one of every three annual meetings in order to remain in good standing.

III. Organizational Structure

A. Steering Committee
Responsibilities

1. Establish objectives and membership requirements
2. Provide oversight for Executive Committee
3. Provide leadership

B. Executive Committee
Responsibilities

1. Membership Selection
a. New members may be proposed by any member of the Roundtable to the Executive Committee
b. The Executive Committee makes the final determination

2. Organize Annual Meetings
a. Place and time
b. Topics
c. Discussion Leaders

Procedure for Policy Statement Adoption

1. Drafting Committee circulates draft to all attendees for comment, etc.
2. Drafting Committee revises statement in light of attendees' comments.
3. Revised statement submitted to attendees for approval. Requires approval by two-thirds of attendees to become an official statement.
4. If approved, circulated to attendees for sign-on.
5. Approved statement circulated to nonattendee members for sign on without change.
6. Approved statement with sign-ons released publicly.

Appendix C

George G. Kaufman
Publications

ARTICLES

"Factors Determining Bank Deposit Growth by State: An Empirical Analysis," Journal of Finance, March 1965 (co-author with Bruce C. Cohen).

"Is the Federal Reserve System Really Necessary?: Comment," Journal of Finance, September 1965.(Reprinted in Lawrence S. Ritter, ed., Money and Economic Activity, Houghton Mifflin, 1967.)

"Bank Market Structure and Performance: The Evidence from Iowa," Southern Economic Journal, April 1966.

"Near Banks and Local Savings," National Banking Review, June 1966 (co-author with Cynthia M. Latta).

"The Demand for Money: Preliminary Evidence from Industrial Countries," Journal of Financial and Quantitative Analysis, September 1966 (co-author with Cynthia M. Latta).

"Indicators of Monetary Policy: Theory and Evidence," National Banking Review, June 1967.

"The Sensitivity of Interest Rates to Changes in Money and Income," Journal of Political Economy, June 1968 (co-author with William E. Gibson).

"Proposed Experiment in Monetary Policy," Financial Analysts Journal, December 1968. (Reprinted in J. Boorman and T. Havrilesky, eds., Money Supply, Money Demand and Their Impacts on Macroeconomic Models, Allyn and Bacon, 1972.) (Received a Graham and Dodd Award for outstanding article.)

"More on an Empirical Definition of Money," American Economic Review, March 1969.

"Financial Assets and Economic Activity," Southern Journal of Business, October 1969.

"Bank Employment: A Cross-Section Analysis of the World's Largest Banks," Journal of Money, Credit, and Banking, February 1970.

"An Empirical Study of Interest Rate Determination: A Comment," Review of Economics and Statistics, August 1970 (co-author with William E. Gibson).

"Implications of Federal Reserve Operations on Monetary Aggregates: The Evidence from the FRB-MIT Model," Nebraska Journal of Economics and Business, Autumn 1970 (co-author with Ann Marie Laporte and Robert D. Laurent).

"Simulating Policy Strategies on the FRB-MIT Model Under Two Alternative Monetary Policy Regimes," Quarterly Review of Economics and Business, Winter 1970 (co-author with Robert D. Laurent).

"The Strange Journey of Monetary Indicators," Journal of Financial and Quantitative Analysis, March 1972.

"The Thrift Institution Problem Reconsidered," Journal of Bank Research, Spring 1972.

"A Proposal for Eliminating Interest-Rate Ceilings on Thrift Institutions," Journal of Money, Credit, and Banking, August 1972.

"Federal Reserve Inability to Control the Money Supply: A Self-Fulfilling Prophecy," Financial Analysts Journal, September/October 1972.

"Deposit Variability and Bank Size," Journal of Financial and Quantitative Analysis, December 1972.

"Bond Price Volatility and Term to Maturity: A Generalized Respecification," American Economic Review, September 1973 (co-author with Michael H. Hopewell). (Reprinted in D. Farrar, J. Francis and C. F. Lee, eds., Readings in Investments, McGraw-Hill, 1980 and G. Hawawini, ed., Bond Duration and Immunization, Garland, 1982.)

"The Questionable Benefit of Variable Rate Mortgages," Quarterly Review of Economics and Business, Autumn 1973.

"The Case for the Long-Term Zero Coupon Treasury Bond," The Bankers Magazine, Autumn 1973.

"The Cost of Inefficient Coupons on Municipal Bonds," Journal of Financial and Quantitative Analysis, March 1974 (co-author with Michael H. Hopewell).

"The Thrift Institution Problem Reconsidered: A Rejoinder," Journal of Bank Research, Spring 1974.

"Improving the Structure of Competitive Bidding Procedures for Municipal Bonds," Governmental Finance, August 1974.

"Costs to Municipalities of Selling Bonds by NIC," National Tax Journal, December 1974 (co-author with Michael H. Hopewell).

"Optimal Bidding Constraints on Municipal Bonds Sold Competitively by NIC," Governmental Finance, February 1975.

"Treasury Bill Auction Procedures: A Comment," Journal of Finance, June 1975 (co-author with Henry N. Goldstein).

"The Case for Mortgage Rate Insurance," Journal of Money, Credit, and Banking, November 1975.

"The Municipal Bond Auction: Reply," National Tax Journal, March 1976 (co-author with Michael H. Hopewell).

"State and Regional Effects on the Interest Cost of Municipal Bonds," Local Finance, June 1976.

"The Thrift Institution Problem Reconsidered: An Historical Oversight Corrected," Journal of Bank Research, Summer 1976.

"Variable Rate Mortgages: The Early Experience from California," Economic Review (Federal Reserve Bank of San Francisco), Summer 1976.

"Teaching the Basic Money and Financial Institutions Course," Journal of Financial and Quantitative Analysis, November 1976.

"Coping with the Risk of Interest-Rate Fluctuations: A Note," Journal of Business, July 1977 (co-author with G. O. Bierwag). (Reprinted in G. Hawawini, ed., Bond Duration and Immunization, Garland, 1982.)

"Consumer Attitudes Towards Residential Variable Rate Mortgages: A Survey Analysis," Federal Home Loan Bank Board Journal, August 1977 (co-author with Gerald S. Albaum). (Reprinted in the Mortgage Banker, November 1977.)

"Sharing Arrangements in an Electronic Funds Transfer System: Comment," Journal of Bank Research, Autumn 1977.

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