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Program

GUEST OF HONOR

THE HONORABLE HENRY M. PAULSON, JR.
Secretary of the Treasury

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BARBARA HACKMAN FRANKLIN
Chairman of the Club

QUESTIONERS

William H. Donaldson
Former Chairman
U.S. Securities and Exchange Commission

Donald B. Marron
Chairman
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Barbara Hackman Franklin – Presiding Officer:

Good afternoon everyone. Good afternoon. I'm Barbara Hackman Franklin, chairman of the Economic Club of New York, and it's my great pleasure to welcome each and every one of you, our members, and our guests, to this: the 389th meeting in the 99th year of this esteemed club. We're so very pleased today, to welcome, as our guest of honor, the Honorable Henry M. Paulson, Jr., the 74th Secretary of the Treasury. It's a tribute to the secretary that this event sold out, literally, within hours after it was announced to our members, and I know we all look forward to hearing from him, and you'll have that opportunity in just a few minutes. Next year, in 2007, the Economic Club celebrates it's centennial as the nation's premiere non-partisan speaking platform. Since it's beginning, sixteen Secretaries of the Treasury have stood at this podium. Secretary Paulson is the 17th, and he joins a distinguished line of Americans. Now, turning to the program, we will first hear from the secretary, and then have our usual question period, during which two members of the club, one on either side of the dais, will take turns asking questions of our speaker. At the conclusion of the speaking program, your luncheon will be served. And, we're pleased indeed, that the secretary will at least stay for a bite of lunch, today. So, we'll turn directly to the program. Hank Paulson, as he's known here, needs no introduction to this audience of friends and former associates, but I'm going to introduce him,

anyway. President Bush nominated Henry M. Paulson Jr. to be the Secretary of the Treasury on June 19th of this year. The United States Senate unanimously confirmed him on June 28th, and he was sworn in on July 10th, kind of a record for confirmation these days. As Treasury Secretary, he's the president's leading policy advisor on a broad range of domestic and international economic issues. And, there are many issues to address: taxes and the budget, Medicare and social security, the strength and competitiveness of U.S. financial markets, to name a few. Already, the secretary has made a major step forward in the U.S. relationship with China. In September, he announced a new strategic economic dialogue. This will engage the presidents of both countries, and for the first time, bring together the multiplying strands of economic talk and push key concerns, such as trade, energy, currency, more quickly to a high level for a faster resolution. The first meeting of that dialogue takes place in Beijing next month. The secretary is the point person on the U.S. side and his leadership in this important initiative is widely applauded. Before coming to Treasury, Hank Paulson was well known as Chairman and Chief Executive Officer of Goldman Sachs. He joined Goldman in the firm's Chicago office in 1974, became partner in charge in the mid-West region, then President and Chief Operating Officer in 1994, co-CEO in 1998, and Chairman and CEO in 1999. Earlier, he graduated from Dartmouth College, Phi Beta Kappa, and Harvard Business School, and did a stint in government at the Pentagon and The White House Domestic Council in the Nixon years. The current issue of Fortune magazine calls him Hammering Hank; he's on the cover. He's a persuasive and tenacious leader, known for tackling things head on and he's a master at striking deals. These qualities and skills are very useful in addressing the issues at hand, but also in dealing with the

new leadership on Capital Hill. President Bush has chosen well. Please join me in a warm welcome for the honorable Henry Paulson, the United States Secretary of the Treasury.

Secretary Paulsen: Thank you very much, Barbara. It's great to be in New York City, the financial capital of the world. What happens in our financial markets is an indicator of the overall state of economy, and I'm very pleased to report that our economy is strong. We are experiencing sustained growth, and low unemployment. The economy has added more than 6.8 million new jobs since August of 2003. Productivity, an indicator of future growth has grown at an annual rate of 3 percent since the first quarter of 2001. And very importantly, this productivity is now translating into higher wages, so more American are sharing in our economic success. The U.S. economy is the envy of the world, and we must keep it that way. Capital markets are the lifeblood of our economy. They connect those who need capital with those who invest or lend capital. They play a vital role in helping entrepreneurs implement new ideas and businesses expand operations, creating new jobs. They give our citizens the confidence to invest, earn higher returns on their savings, and reduce the cost of borrowing for student loans, mortgages, and consumer credit. Our capital markets are deepest, most efficient and most transparent in the world. We are the world's leader and innovator in mergers and acquisitions advice, venture capital private equity, hedge funds, derivatives, securitization skills, and Exchange Traded Funds. This expertise has made our leading financial institutions, many of them headquartered right here in New York City, leaders in Asia, Europe, and Latin America. U.S. commercial and investment banks contribute greatly to economic success all around the globe. Yet, our markets are not immune to challenges. After years of economic expansion, and the excesses in the

exuberance of the late 90's, we face, what some call, the perfect storm: the technology and telecom bubble burst, the U.S. economy went into recession, terrorists attacked us on September 11, 2001, and a wave of corporate scandals undermined investor confidence. We weathered that storm. The President, both parties in Congress, and regulators moved quickly to address the business scandals, which helped to restore investor confidence. And the President's economic policies and tax cuts laid a strong foundation for recovery. In the United States, whenever there is a major problem in capital markets, we shine a light on it, and move quickly to clean it up. The vast majority of corporate leaders are honest people, but those executives who put their personal interest above the interest their share holders undermine confidence in our markets. That's not competing, that's cheating. And perpetrators are being punished. We responded to the corporate scandals with the Sarbanes-Oxley Act of 2002, new listing rules for corporate companies, and regulatory and legal enforcement actions to alter certain business practices. These changes have been extensive and significant, so it is quite naturally taking time for companies to understand, process, and implement the new rules and requirements. Many of the results have been positive. At the same time, as corporations, financial institutions, and regulators continue to adapt, questions are being raised about the long term impact of these changes. Our goal is to preserve the integrity of our markets, while maintaining their competitiveness. Recently, Mayor Bloomberg, and Senator Schumer emphasized this point in a Wall Street Journal Op-Ed, which was right on target. They highlighted a discussion that many in the financial community are having: Does the decline in initial public offerings in U.S. capital markets signal potentially broader challenges to our competitiveness? An IPO occur when a private company decided to sell its shares to the public. Our public markets provide the lowest-cost capital. Access to these

markets, as it should, brings regulatory governance and disclosure responsibilities. Historically, the U.S. markets have represented the gold standard, and a significant number of premiere foreign companies have willingly adhered to our standards in order to access our markets. Yet, recently, in the wake of the new, heightened regulatory and listing requirements for all public companies in the United States, we have witnessed changes in IPO activity. Despite our strong economy and stock market, IPO dollar volume in the U.S. is well below the historical trend, and below the trend and activity level in a number of foreign markets. Moreover, existing public companies in the U.S. are deciding to forego their public status, with its attendant regulatory requirements, and go private. This is occurring in record numbers at record volumes, and, as a percentage of overall public corporate M&A activity, is approaching levels we have not seen in almost 20 years. This development is being facilitated by our ever-growing private pools of capital. Given domestic trends, its not surprising that the U.S. share of total volume of foreign IPO's has also declined. Determining the causes and potential effects of these trends is more complicated. Are they temporary harmless phenomena, or more like the coal minors' canary? What is implication for America's investors and our existing public companies, which remains subject to the new regulatory standards? And, what does this mean for America's competitiveness? Let me begin, by discussing the importance of regulation. Truly, competitive capital markets must inspire investor confidence. They must be fair, and they must be perceived to be fair. Of course, fairness does not guarantee success. Laws and regulation cannot prevent investors from losses, nor should they attempt to do so. We should not discourage risk taking, but we should make sure that investors have reliable financial information, on which to base their decisions. In a recent speech, former treasury secretary, Bob Rubin, said this about regulation,

"Our society seems to have an increased tendency to want to eliminate, or minimize risk, instead of making cost/benefit judgments on risk reduction in order to achieve optimal balances. When it comes to regulation, balance is key, and striking the right balance requires us to consider the economic implications of our actions. Excessive regulation slows innovation, imposes needless costs on investors, stifles competitiveness, and job creation. At the same time, we should not engage in a regulatory race to the bottom, seeking to eliminate necessary safeguards for investors in a quest to reduce costs. The right regulatory balance should marry high standards of integrity and accountability, with a strong foundation for innovation growth and competitiveness. Some observers cite the decline of foreign IPO's in the U.S. market as an indicator of the competitiveness of our capital markets. We should go beyond the numbers, and examine some of the possible reason for this decline. The number of factors contribute to the recent trends, including public policies in other countries, but several other contributing factors offer a framework to assess our own capital markets. These include: The development of markets outside the U.S., particularly in London and Hong Kong, and the ability of U.S. investors to participate in these offerings; a legal system in the U.S. that exposes market participants to significant litigation risk; a complex and confusing regulatory structure and enforcement environment, and new accounting and governance rules which, while necessary, are being implemented in a way that may be creating unnecessary costs and introducing new risks into our economy. Each of these warrants deeper discussion. First, let me say unequivocally, the development of competitive capital markets overseas is a positive. Efficient capital markets lower the cost of capital, creating more growth and higher living standards. And economic growth abroad creates markets for our products and jobs here at home. In three weeks, I will

travel to Beijing for the first session of the recently initiated, Strategic Economic Dialogue with China. WE will encourage China to open up their financial markets to competition in order to accelerate the development of those markets and support sustainable economic growth, growth that will bring benefits to both of our nations. A number of foreign markets have developed excellent standards and protocols. In some parts of the world, particularly Europe, public companies adhere to the International Financial Reporting Standards, an accounting system that differs from ours. The important feature of the IFRS accounting system is in principles-based, rather than rules-based. By "principles-based", I mean that the system is organized around a relatively small number of ideas and concepts that provide a framework for thinking about specific issues. The advantage of a principles-based system is that it is flexible and sensible in dealing with a new or special situation. A rules-based system typically gives more specific guidance than a principles-based system, but it can be too rigid and may lead to a "tick-the-box" approach. I will be talking about the difference between principles-based, and rules-based systems in a number of contexts today. International companies that list in the United States must reconcile their IFRS statements with U.S. Generally Accepted Accounting Principles, or GAAP. We should recognize that the time and the cost that go into reconciling and restating IFRS statements may not be a worthwhile expense for a foreign company considering the U.S. market. Because of the progress being made in converging accounting standards, the U.S. and the EU have developed a "roadmap" with the goal of allowing listings in the U.S. market and the basis of statements prepared using IFRS, and likewise, continuing to permit listings in the EU, and the basis of statements prepared, according to GAAP. These efforts are encouraging. A number of foreign exchanges have also aggressively embraced technology, and developed innovative

business models that increase efficiencies and reduce cost to investors in their markets. These competitive forces have spurred responses in our country. In the most recent example, the Chicago Mercantile Exchange and the Chicago Board of Trade announced plans to merge and offer investors a broad range of exchange-traded derivatives, with the goal of creating efficiencies in technology and operations. Ten years ago, the premiere foreign companies seeking to raise attractively priced equity capital turned almost exclusively to the United States. That's no longer the case, as alternatives have developed around the world. But certain challenges to doing business in the U.S. market also are contributing to the recent trends, and these challenges merit a closer look. Let's begin with one challenge that will take a concerted effort over the long-term to correct: the need for reform of our legal system. My own 32-years experience in the private sector, working in capital markets with U.S. and foreign companies alike, has convinced me that legal reform is crucial to the long-term competitiveness of our economy. A sophisticated legal structure with property rights, contract law, mechanisms to resolve disputes, and a system for compensating injured parties, is necessary to protect investors, businesses, and consumers. But our legal system has gone beyond protection. In 2004, U.S. tort costs reached a record quarter trillion dollars, which is approximately 2.2 percent of our GDP. This is twice the relative cost in Germany and Japan, and three times the level in the U.K. The consulting firm Tower-Perrin found that the tort system is highly inefficient, with only 42 cents of every tort dollar going to compensate injured plaintiffs. The balance goes to the administration, attorney's fees, and defense costs. Inefficient tort costs are effectively a tax paid by shareholders, employees, and consumers. Simply put, the broken tort system is an Achilles heel for our economy. This is not a political issue, it is a competitiveness issue, and it must be

addressed in a bipartisan fashion. Another issue to consider in assessing the competitiveness of our financial markets is regulation. Over the course of our nation's history, we have added multiple regulators to respond to the issues of the day. A regulatory system has adapted to the changing market by expanding but perhaps not all is by focusing on the broader objective of regulatory efficiency. For example, while the business of banking has converged over time, we still have four separate banking regulators. We have a similar dynamic with the securities and commodities markets, and their self regulated structures. Each of these organizations has different statutory responsibilities, and a number have different regulatory philosophies. We also have a duel federal state regulatory system in the banking and securities markets. And the degree of federal preemption over state law in these areas varies greatly. Another large and important part of our financial sector, insurance, is regulated solely at the state level. A consequence of our regulatory structure is an ever-expanding rulebook, in which multiple regulators impose rule upon rule upon rule. Unless, we carefully consider the cost/benefit trade off implicit in these rules, there is a danger of creating a thicket of regulation that impedes competitiveness. Our rules-based regulatory system is prescriptive, and leads to a great focus on compliance with specific rules. We should move toward a structure that gives regulators more flexibility to work with entities on compliance within the spirit of regulatory principles. Rules, by themselves, cannot eliminate fraud. Wrongdoers will seek out loopholes, or ways to circumvent the rules. For instance, in the recent business scandals, management of some companies remained technically within the rules, while offering deceptive financial statements. Some rules, developed in the past have proved to be deficient in today's dynamic market place. In some that are developed today are likely to prove sub-optimal in a few years, unless they are rooted in principles, which will

stand the test of time. There is a growing awareness in the financial community of the desirability of streamlining the regulatory system. One example is the decision of the New York Stock Exchange and the NASDAQ to consolidate the regulatory operations. This is a positive development, and I encourage them to focus on achieving the right principle to result, as opposed to just combining the two rulebooks. While no nation's regulatory structure is perfect, ours has served us very well for many years. It is second to none. And, to ensure that it meets the challenges of the years ahead, we should be open to learning from our own experience, and from the experience of others. We should ask ourselves: What changes are needed to make our regulatory structure a more efficient and effective in today's world? At times, our legal system and regulatory structure produce unintended consequences. Consider the area of enforcement. Over the last several years, different regulators at the state and federal level have been focused on finding and prosecuting wrongdoing, a worth, necessary, and successful effort. But, when multiple jurisdictions and entities are involved, each with their own objectives and approaches, the enforcement environment can become inefficient and, to the regulated, can appear confusing and threatening. Given the business scandals, this is understandable, and some violations form years ago are just coming to light. Almost every week, we read about another act of corporate wrongdoing, many representing egregious violations of shareholder trust. Let's be clear: Those who commit corporate fraud are guilty of stealing from shareholders, employees, and consumers. That behavior can never be tolerated. Our challenge is to make sure that the tools are in place to punish bad actors, while recognizing that the vast majority of business leaders are honest, capable, and focused on the interest of shareholders and employees. Today we have an opportunity to make the enforcement environment more constructive. In such an environment,

public companies would be able to work with regulators to resolve ambiguities and make the right decisions. Such regulatory guidance should be easy, quick, and relatively costless to obtain. The combination of enforcement and guidance is likely to be more effective and efficient in relying on enforcement alone, particularly in an environment in which there is a greater degree of trust between the regulators and the regulated. In a sign of increasing openness to considering new approaches, the justice department has been input form outside groups and is currently considering revision to the Thompson Memorandum, which deals with the criminal prosecution of companies. If it appears that the changes are warranted, in the public interest, and consistent with the need to safeguard the integrity of our economic system, I am confident that the Justice Department will revise its policy. When discussing the competitiveness of our capital markets, we should acknowledge that Sarbanes-Oxley and the related public company listing rules brought necessary reforms to our corporate governance, and to our capital markets. These reforms are rooted in the basic principles that underpin a robust corporate governance system: accountability, transparency, and the need to identify and manage conflicts of interest. These changes were necessary to rein in abuses, but significant changes always cause stress, and early implementation of new rules may produce uneven results. We must recognize the benefits of the new rules and remain open minded about how they affect the system, both positively, and negatively. At this time, I don’t believe we need new legislation to immense Sarbanes-Oxley. Instead, we need to implement the law in ways that better balance the benefits of the legislation with the very significant costs that it imposes, especially on small businesses. By far, the single biggest challenge with Sarbanes-Oxley is section 404, which requires management to assess the effectiveness of a company’s internal controls, and requires an auditor’s attestation of that

assessment. Companies should invest in strong internal controls and shareholders welcome this development, because it is in their best interest. However, section 404 should be implemented in a more efficient and cost-effective manner. It seems clear that a significant portion of the time, energy and expense associated with implementing section 404 might have been better focused on direct business matters that create jobs and reward shareholders. Businesses around the world are eager to see how we address this issue. The chairman of the SEC, Chris Cox, recognizes the severity of this problem, and he's providing strong leadership to address it. He understand that it will take an aggressive, forward leading approach, to change the implementation of section 404, and to make it more efficient. Mark Olsen, the Chairman of the Public Accounting Oversight Board, shares Chris Cox's viewpoint. Collectively, they have responsibility for providing guidance on implementing section 404. The SEC will soon see comments on a new and much improved auditing standard, aimed on ensuring that the internal control audit is top down, risk based, and focused on what truly matters to the integrity of a company's financial statements. The new guidance for both companies, and their auditors should encourage common sense reliance on past work and the work of others. Moreover, the SEC and the PCAOB are going to provide tailored guidance for small companies that recognized their specific characteristics and needs. Overall, I believe our corporations are better governed today. Directors are more independent, more aware of real and perceived conflicts, more diligent about their fiduciary responsibilities, and they spend much more time engaged in compliance processes. But, good corporate governance is a means to an end, not an end in itself. We do not need a process-oriented mentality to corporate governance; we need better managed, more competitive corporations that earn investor confidence through sound leadership, thoughtful governance, and

outstanding performance. One important indicator of the effectiveness of corporate governance changes will be the ability of companies to attract experienced, competent board members, who can add real value, and who are able to spend more time at board meetings overseeing the businesses and developing strategies in less time on regulatory compliance. We should remember that we can't legislate or rule-make our way to ethical behavior, whether it be in the business, or any other endeavor. Proper corporate governance processes increase the likelihood that well-intentioned people will do the right thing, but they do not guarantee such an outcome, and they certainly don't guarantee that unethical people will do the right thing. In my judgment, we must rise above a rules-based mind-set that asks, "Is this legal" and adopt a more principles-based approach that asks, "Is this right?" Several weeks ago, Warren Buffett offered a warning to his leadership team at Berkshire Hathaway when he wrote, "The five most dangerous words in the business words in the business world may be 'Everybody else is doing it.'" As usual, Warren Buffett was right. The ability to avoid these pitfalls takes moral leadership, starting right at the top. The corporate scandals were, for the most part, accounting scandals, so it is not surprising that so much of the recent reform has focused on the accounting industry. Our accounting system is the lifeblood of our capital markets, and it has historically represented a very high standard. But, it was abused in the corporate scandals by manipulation and smoothing of earnings. Capital markets rely on trust, which is based on financial information presumed to be accurate and to reflect economic reality. The ultimate responsibility for accurate and transparent financial statements must rest with management. The role of the external auditor is to examine a company's financial statements in order to express an opinion that conveys reasonable, but not absolute assurance as to the truth and fairness of these statements. Auditors do this by evaluating

management's adherence to generally accepted accounting principles. The Sarbanes-Oxley reforms were intended to increase their quality of corporate audits. They have had a significant impact on the accounting industry, fundamentally altering interactions between auditors and corporate management boards in a number of ways, some of which are not constructive. Also, we've been left with only found major accounting firms, each of which is exposed to potentially large legal liabilities. This may not be healthy. The big four firms dominate the industry in terms of revenues and professional staff. The remaining accounting firms face significant barriers to competing with the big four at a time when auditors at real demand. The current situation forces us to ask questions about the industry's sustainability and effectiveness: Given the importance of our financial system, is there enough competition? Will our reformed accounting system produce the high-quality audits, and attract the talented auditors we need? Do auditors seek detailed rules in order to focus on technical compliance, rather than using professional judgment that could be second-guessed by the PCAOB or private litigants? A common theme in my remarks today is the desirability, where practical, of moving toward a principles-based system. Nowhere is this issue relevant than in the accounting system. Added complexity and more rules are not the answer for a system that needs to provide accurate and timely information to investors in a world where best-of-class companies are continually readjusting their business models to remain competitive. Last year, approximately twelve hundred publicly listed companies in the Unites States restated their financials. As of September 30th of this year, then number's more than 1,000. Some of these companies were involved in business scandals. Many others were well intentions companies, struggling to cope with a redefinition of rules in a complex system. These statements draw time and attention away from other value-adding activities, and they represent an added cost to

shareholders. Businesses and auditors are searching for something that doesn't exist in today's constantly changing world. A rules-based safe haven that still provides investors with an accurate portrayal of a company's financial performance. Auditors should be able to focus on one fundamental objective: insuring the integrity and economic substance of management's financial statements. To get there, we must recognize that accounting is not a science. It is a profession, requiring judgments that cannot be prescribed in a "one size fits all" manner that undermines the usefulness of financial statements to investors. In addressing the condition and competitiveness of our capital markets, we have also initiated a broad review of recent changes including the growth of derivatives and private pools of capital, and their implications for the stability of the system. Credit derivatives have altered the financial landscape in many positive ways, most notably by dispersing concentration of risk. They also pose potential risks, themselves. Hedge funds are among the largest users of derivatives. For the past five years, the number of hedge funds has nearly doubled, while their assets under management have more than tripled. These investment managers engage in a wide variety of strategies, generate substantial transactions volumes, and introduce significant leverage into the system. They have also made our capital markets more efficient, facilitating the dispersion of risk. And, hedge funds have developed an impressive global presence. Given their explosive growth, the instruments they trade, and the evolution of our financial market place, we must continually assess their actions and impact on the market. The SEC, which has broad anti-fraud and civil liability authority over hedge funds, is very well positioned to focus on investor protection. Another group of regulators aims to minimize the potential fir systemic risk by working with the regulated financial institutions that extend credit to and transact business with hedge funds. And, the President's Working Group on

Financial Markets – comprised of the Treasury Secretary and the Chairman of the Federal Reserve Board, the SEC and the CFTC continues to review and monitor markets, assess issues related to the performance of derivatives, and study the activities of hedge funds in three broad areas: investor protection, operational risk, and the potential for systemic risk. We have begun a series of educational meetings with a broad array of participants in the hedge fund community to gain insight as we move forward with our deliberations. In conclusion, competitive capital markets will pave the way for continues economic growth that benefits all Americans. The issues I've outlined are crucial to insuring that our capital markets remain the best in the world. And, certain principles should guide as we go forward. First, it is necessary to take a global view. We do not operate in isolation, so it is very important to consider how changes we make affect the ability of our companies to compete globally, and how these changes affect our interaction with markets and regulators around the world. Second, our regulatory structure should be more agile responsive to changes in today's market place. Third, to stand the test of time, rules should be embedded in sound principles. Fourth, regulators should take a risk-based approached to regulation, weighing the cost to shareholders against the benefits. Fifth, our enforcement regimes should punish and deter wrongdoing and encourage good behavior without hindering responsible risk taking and innovation. And, lastly, the best way our business leaders can protect the integrity and competitiveness of our markets is to exert moral leadership, where the threshold question is, "Is this right?" not "Do the rules allow us to do this?" Our capital markets remain strong and competitive, but they face significant challenges that do not lend themselves to easy answers or quick fixes. The Treasury Department plans to host a conference on capital markets and economic competitiveness early next year. We will invite participants with a wide range of

perspectives, particularly the investor perspective. The conference will cover three primary areas I discusses today: a regulatory structure, our accounting system, and our legal system, all of which impact our capital markets and are critical to the overall economic competitiveness of our nation. Our objective will be to stimulate bipartisan discussion, and lay the groundwork for a long-term strategic examination of these issues. In all that lies ahead, we must remember that the competitiveness of our capital markets depends, to a large extent, on our nation's overall economic competitiveness. We are fortunate, that because our economy is so strong, we approach our challenges from a position of strength, and we should use this position of strength to tackle long-term challenges that will affect our economic competitiveness. We much: reform our entitlement programs; advance energy security; maintain and strengthen trade and investment policies that benefit American workers; focus on economic and educational policies that will add jobs, improve productivity, and result in tangible income growth for all American; and, of course, strengthen and maintain the competitiveness of our capital markets. I came to Washington determined to accomplish as much as possible over the next two years. These challenges won't be easy, but I'm very grateful for the opportunity to work with the President, and the other members of his economic team to help America keep its competitive edge in the 21st century. Thank you all very much.

Barbara Hackman Franklin: Mr. Secretary, thank you very much. That was a powerful message and a lucid roadmap of what we need to do to maintain competitiveness, and we appreciate that very much. Now, we have two distinguished questioners well known to you, and probably to everyone in this audience. On this side of the dais, Donald Marron, who is the

Chairman and Founder of Lightyear Capital. Earlier, he was Chairman and CEO of the Paine Weber group, and he is a former Chairman of this club. On this side of the dais, William Donaldson, who is a former Chairman of the Securities and Exchange Commission, former Chairman and CEO of the New York Stock Exchange, and much earlier, a founder of Donaldson Lefkin and Jenrette. I'm going to ask Don to give us the first question.

Donald B. Marron: Thank you very much for those comments about our industry. That was the most complete and a lucid description of the issues that we faced this year that I've ever heard. We all appreciate it very much. Now, I've got an easy question for you: entitlements. Basically, the present attempt at after the '04 election a reform of social security. It didn't take one key element with the administration said that reform required private accounts of position I agree with. The democrats said it has to be done without private accounts. The first part of the question is, in this environment, what kind of social security reform is really possible, and when can it happen? The second part is, of course, as social security is the easy part, Medicare and Medicaid escalating health costs and the combination with social security are a threat to the nation's economy over the next 30 or 40 years, as you have so well documented. How, again, would you approach reforms, and what can you get done in the next two years?

Secretary Paulsen: Don, listen. You've pointed to two of the really major problems facing our nation, and there may be other problems out there we don't see, but these are ones that are just very visible, and they're for all of us to see. Let me begin by saying, I think one of the things that attracted me to coming to Washington and joining the president was the fact that he had taken on this, and that he wasn't going to shy away from it. I also would say that it's a good time to deal with it, just because our economy is so strong, and economic policies are working well and we're

better off dealing with this at a time of strength. Now, what I'm not doing right now is being prescriptive, because I really do think the answer to this is only by taking a bipartisan approach. Not conditioning the discussion, getting people on all sides to come in, and listening to everybody's ideas, and so I'm going to make a major effort to do just that, and see if we can defy conventional political wisdom. And, if we can't, at least we have tried, and I'm going to try hard.

William H. Donaldson: Let me begin by thanking you as, I guess, everybody in this room does for taking on public service. I think the comments you've made indicate how important it is for people like you to go to Washington, and take the job on. I do have a couple of questions. First of all, on the subject of possible reforms, with Sarbanes-Oxley. Assuming, for the minute, that the costs associated with section 404 should, and will be mitigated by regulatory rule making, what other reform measures do you feel are necessary visa vie Sarbanes-Oxley, and I think you've already answered the second part of this, by saying you don't think legislation is necessary, so what else about Sarbanes-Oxley do you think needs addressing?

Secretary Paulsen: To me, when you look at Sarbanes-Oxley, I don't think there is a single principle embedded in Sarbanes-Oxley that I think is ill-founded. So, I think a lot of it just has to do with implementation, and so where I focused and I do think that you see Chris Cox and Olsen focusing on 404. So, I think that's being done. I think the things that I really wanted to focus on with much more vigor are the issues facing our accounting industry, and I think some of those come out of the overall regulatory situation we have in the U.S. Focus on the legal system, and our overall regulatory structure.

Donald B. Marron: You talked about the great economic growth that we've had in the last few years, which is absolutely the case, but many Americans don't feel like they are participating in

it. Wage increases have not been as great for certain segments. And, there is a saying 'if things are so good, why do I feel so bad." Can you talk about that and could you talk about it in the context of the issue of tax breaks from the middle class and the minimum wage debate?

Secretary Paulsen: Okay, well let me say a couple things. First of all, as I said before, we have a strong economy and one of the challenges we've had for a while was that the average American, the average wage earner, wasn't feeling the full benefit of this, and it was partly a result of the high energy costs, and partly health care costs, but also it isn't unusual at a time where, given where we were in the business expansion to have real wage increases follow and lag, a bit the economic growth and the productivity increases. So, I'm going to begin by saying that we have seen it recently. There are some very encouraging signs, and so you look back over the last year. I would say, also, I do believe, and I don't mean to sound political, because I wasn't here for them; I can't take credit for putting the tax cuts in place. But, the tax cuts; anyone that argues that in some way the tax cuts have hurt them, the average American just doesn't have the facts right, because no one's worse off because of these tax cuts, and so thank goodness we've had them. But, I do think it's something we need to continue to be very sensitive to, and make sure that the benefits are being felt and have policies that work that way. Now, I think the President's made it very clear, and I share his view that on the minimum wage, we're very open to a constructive outcome there.

William H. Donaldson: My next question relates to the legacy of the Paulsen years. Given the array of challenges that you face, beyond what you've talked about this morning. Progress or success in which area would be the most important to you at the end of your tenure?

Secretary Paulsen: You know, Bill, I've only been here a few months, and so to be speaking of legacy, I want to say I want to get out in one piece. But, in all seriousness, there will, no doubt, be a series of things that we don't see now that will come up during my tenure that I'll need to deal with. But, what I really laid out are some of the bigger economic challenges, and you know, there are things that don't lend themselves to short-term easy fixes. So, I care a lot, for instance, about trade, and continuing the policies that have made this nation great: being open to trade, being open to investment flows, and there's a current that's running against this, a tide that's running against this, in certain parts of this country, and around the world. So, I'm going to work hard in that area, and I'm focused on some of the challenges I named at the end of the speech. Now, we may not be able to achieve success measured in terms of the ultimate solution in two years, but I would look toward working toward making progress on some of the issues I've raised: the longer term budget issues we talked about with entitlements, energy security, the issue that Don mentioned: maintaining economic policies that are going to benefit all Americans.

Donald B. Marron: All right, thank you. Hank, maybe we could follow up on that, and talk about globally, the two issues specifically, which are trade and capital inflows in this country. First of all, does the delay in the Vietnam Free Trade Agreement, is that a harbinger of things to come on free trades and the corollaries, obviously. How do you think your trip to China will play out in that regard? And, secondly, can you see us continuing in these big twin-deficits: a trade deficit and a capital deficit? And, will at some point we have to change our relationship with the rest of the world on these things?

Secretary Paulsen: Well, let me tell you, you figured out how to get six questions into one.

Donald B. Marron: Well, I figured I didn't have you very long, Hank. I put it all together. This is the last question.

Secretary Paulsen: Let me say, in terms of Vietnam, I'm optimistic that, that will ultimately pass Congress, so I wouldn't overreact to that single vote. But, I think if the point is, is there a sentiment, you know, protection of sentiment in this country and are trade agreements going to be more and more difficult. Perhaps, they've never been easy, in terms of the Congressional votes. In terms of my trip to China later this year, this will be the first session of the Strategic Economic Dialogue, and so I'm trying to, although I'm encouraged and I obviously think this makes sense, and that one of the things I'm trying to fight is short term-ism, and when we come up with our first meeting, everybody saying, "What did you accomplish?" And, so, we are taking a long-term approach, and I think we can make progress by having discussions that are more strategic and longer term oriented, dealing with some of the real fundamental issues, but giving us opportunity to deal, spend enough time on the short-term issues, that we increase confidence on both sides. Now, in terms of U.S. questions about the deficits. The fiscal deficit is something in and of itself. You know, we've got a fiscal deficit of about 1.8 percent of GDP, and revenues have been pouring in. I don't believe people would be asking the questions they are about the fiscal deficit were it not for what we see coming down the road for a number of the years in the entitlement area. So, I think your first question on the entitlement area is right on. The current account deficit, the trade deficit, I do believe that there's not an easy answer to this, but I really do believe this will be worked out over a period of time, and I think what it really takes here is we've got to do a better job in this country of savings and we've got to do our part in increasing our savings. But, I think a lot of it is going to have to do with what goes on outside of the U.S.

and with our trading partners. And, structural change in Japan and in China as their economies need to develop in ways in which there's more focus on consumption and importing higher value products, and getting more of the kind of development we need there, and more growth in Europe. So, in any event, I hope that, that answers your question, and thank you very much.

Donald B. Marron: That's a very good answer.

Barbara Hackman Franklin: Mr. Secretary, we thank you very, very much for, just such a lucid commentary on so many different issues. We admire your grasp of the challenges and your willingness to take them on so forth rightly. We thank you for serving our country, and we wish you success. And, come back here any time. I thought you were going to applaud. That was the right think to do. Another round of applause for our two questioners Don and Bill. And, this concludes the formal part of our program. Your lunch will now be served, and thank you for coming. And, I wish all of you a happy Thanksgiving.