STATEMENT OF

WILLIAM JOHNSTONE

PRESIDENT AND CHIEF EXECUTIVE OFFICER

DAVIDSON COMPANIES

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Perspectives on the Economic Implications of the Federal Budget Deficit

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Chairman Tester, Ranking Member Vitter and Members of the Subcommittee, my name is Bill Johnstone. I am the President and Chief Executive Officer of Davidson Companies.

Davidson is an employee-owned financial services holding company, headquartered in Great Falls, Montana. We have been in business for 76 years, have 1,100 employees and operate in 16 states, primarily west of the Mississippi.

Davidson has three principal lines of business:

- We provide investment advice and products to approximately 120,000 individual and institutional investors.
- We provide institutional research for approximately 260 companies and make markets in approximately 425 stocks (mostly small and mid-cap companies). We also trade stocks with institutional investors and provide underwriting and investment banking advisory services to small and mid-cap companies.
- Last, we trade tax-exempt and taxable bonds with institutional investors and underwrite bonds for and provide advisory services to government units throughout the Western United States.

We are not a commercial bank or depository institution and we do not originate or underwrite mortgages or mortgaged backed securities or engage in proprietary trading or the creation of or trading in complex derivatives. We have never received a government bailout. In the past 10 years, in the context of challenging financial markets and economic conditions and the demise or consolidation of many financial services firms, we have remained independent and doubled in size.

In contrast to the other panelists, I am not an economist, nor do I have significant prior academic or government experience in analyzing or developing tax or economic policy. Prior to my current position, I practiced finance law, managed an international law firm and was the CEO of a regional securities firm in the Southwest.

My views and observations regarding the deficit are shaped and informed by my experiences, particularly my recent experience at Davidson.

In my position, I talk either directly or through our employees with a range of investors and businesses. These include retirees, small business persons, families saving for retirement and college education, businesses trying to raise capital, commercial bank clients, institutional investors from small to large and state and local governmental units that access the bond market. I also speak with colleagues in other similar financial services firms.

I want to make clear that my views and observations do not necessarily represent those of Davidson, its employees or clients.

My larger views and observations are not materially different from those espoused by many others. Perhaps some of my sources and reasoning are and will be helpful.

I want to discuss three key points:

- There is considerable investor concern about the Federal deficit and our ability or will to address it. The concern is negatively influencing the ability of investors and businesses to make business and investment decisions necessary to drive economic growth and job creation.
- Policies to address the deficit should be bold, concrete and credible, but implementation should be staged to avoid exacerbating the current weakness in the economy. While the particulars of the solution are important, more important is that the development and implementation of a solution is credible and understood. In this situation, perfection, as defined by narrow self-interest, is the enemy of the good.
- To the extent the solution involves changes in tax policy, as I believe it should, we should use this as an opportunity to commence reform of our federal tax laws.

Historically, the federal deficit and its implications were not frequently voiced investor concerns. At least three developments have occurred to change it. The growth in the deficit's size (absolutely and relatively), this summer's highly publicized debt limit debate and the financial crisis in Europe. Most investors, whether institutional or individual, have concluded that the deficit, and as important its projected growth, will result in substantial damage to our economy unless we make meaningful changes. The situation in Europe has heightened awareness of the economic implications of fiscal deficits and the difficulty of addressing them, particularly if responses are delayed. At the same time, the length and nature of the debt limit debate raises serious questions among investors and business persons as to whether government has the ability to develop and implement a deficit solution.

Certainly, the deficit is not the only factor inhibiting economic growth and, at present, maybe not the most important factor. The continuing difficulties in the housing market, high unemployment, the apparent increase in regulatory burden and general de-leveraging by consumers and business are among other important factors that I frequently hear in my discussions. But the deficit and the uncertainty of whether and how it will be addressed are critical factors in reducing investor and business confidence and willingness to take risk and make business and investment decisions necessary to drive economic growth and job creation. I consistently hear that from investors and businesses and their representatives and I see it in their behavior.

The financial system is short of neither capital nor liquidity to fund economic growth. The financial system, businesses and the consumer are short of confidence and much of this deficit in confidence is related to the federal deficit.

I am not here to offer a recommendation regarding the details of a policy response to address the deficit. There is a plethora of reasonable potential responses, including those suggested or discussed by the other panelists. I happen to believe the Simpson-Bowles Commission offered a number of thoughtful and sensible suggestions and provides a very good starting point. However, I will share my views regarding what I believe are three important elements of a solution.

First, I would be an advocate of a larger rather than smaller reduction target more in the range of the Simpson-Bowles suggestions, for a couple of reasons. I think it better addresses the issue. And, it reflects my skepticism regarding the ultimate outcome of the legislative process and the natural inclination to develop overly optimistic projections of future revenue growth and expense reduction.

Second, as has been oft noted by others more expert than I, the desire (perhaps zeal) to make a meaningful and quick reduction in the deficit has to be balanced with the realities of the current economic situation and the scope and economic impact of the policy changes. The required changes necessarily will be profound in their scope and impact. They have to be evolutionary, not revolutionary. While implementation of a plan should be staged, the plan should be agreed to sooner than later. The longer we wait the more costly the solution, the more limited the policy options and the more damage arising from the current uncertainty.

Last, I am struck by the difference in the narrative I hear in my conversations with employees, clients and business persons and the narrative I hear from Washington D.C. My audience is probably somewhat older and more conservative than the general populace. And certainly, there are significant differences of opinion. However, in general, the narrative I hear is more pragmatic, balanced and in my view sensible relative to the range of appropriate policy options. And, the narrative reflects an acknowledgement that change is necessary and that it will require some sacrifice and loss of benefit or advantage that is conferred by existing policy.

I will only briefly note my belief that any deficit reduction plan should include some effort to reform our federal income tax, both corporate and individual. I am skeptical that the necessary deficit reduction can be accomplished entirely on the expense side or that some increase in revenue will materially damage our economic prospects, and I would not approach the issue on the condition that revenue cannot or should not be increased. However, regardless of how you stand on that point, we need to move to a tax code that is simpler and fairer, with lower marginal rates and with far fewer deductions and exemptions. The proliferation of targeted deductions, exemptions or distinctions in sources of income too often distorts rational economic and business decision making and should be reversed. This has been a widely held policy goal for decades. Perhaps the reality of our current challenges will produce the will to do something.

Thank you for allowing me to share my thoughts on this important topic.