Securities and Exchange Commission Historical Society
Interview with Robert Plaze
Conducted on June 7, 2016 by William Thomas

WT: This is an interview with Robert Plaze for the SEC Historical Society's virtual museum and archive of the history of financial regulation. I am William Thomas. The date is June 7, 2016, and we are in Washington, DC. Bob, thanks very much for agreeing to speak with us today. We usually start with just a little bit of personal background, so could you tell me a little bit about where you're from and how you ultimately ended up in law?

BP: Small town in Connecticut, the New England part of Connecticut, which means we all rooted for the Red Sox, that part of Connecticut. My father was a lawyer and an elected judge, and so I was exposed to law and politics at an early age and thought I wanted to go into politics. I came to Washington to go to college, government major, and realized at some point that I needed to make a living in addition to get involved in politics, which is a pastime for most people.

I went to law school. Almost went to law school in Connecticut, back to Connecticut if I was going to get into politics, but decided at the last minute to go to Georgetown and went to law school at night, where I met a lot of fascinating people who were classmates of mine that were working here in Washington – some in Congress, in the various agencies, and some in the military. I was exposed to that alternative way of practicing law that would combine the legal skills that I was acquiring at law school with my interest in politics, which as it turns out was really in policy.

WT: So you finished your bachelor's degree in 1978, I see, and then your law degree in '83, and then you went directly on to the SEC from there.

BP: Directly on to the SEC. Wasn't planned that way. I had been a summer associate at a law firm back in Hartford, Connecticut, and was planning to go back to Hartford, and somewhere in the middle of fall my last year I decided to stay in Washington. It was late into the hiring season and I wasn't sure what I was going to do, but I had an adjunct professor named Paul Gonson, who was at the time the Commission solicitor, he argued the appellate cases for the Commission. He taught a course at night, and one evening asked me if I'd ever considered joining the staff of the SEC and I told him frankly it never had occurred to me. And he said, "Well, I really think you should consider. I think you'd be great, and I'd be pleased to write a recommendation for you." I was so impressed by somebody of Paul's stature suggesting that that I went home and filled out a very, very long form and submitted it to the SEC, and they asked me to come talk.

WT: So you ended up in the Division of Investment Management. Was that happenstance?

BP: Oh, quite so. Quite so. I'd like to think it was a planned career, but, you know, life doesn't turn out that way. The division was the only one that was interested in talking to me at the time, which was interesting. I didn't know what they did. I hadn't a clue. But by this time, I really did want to stay in Washington. I had met a girl, who's my wife today, and had committed to stay in Washington and they had made the offer. So I accepted at the end of the fall, and then took the '40 Act course at Georgetown. I was at Georgetown Law School. To this day, they're one of the few schools that offer a course in the 1940 Act, and it fortunately is offered in the spring semester. I took that course knowing that I would be starting in the division in the coming fall, and I fell in love with it. I would say it was my favorite course in law school.

WT: And it's really kind of occupied you pretty much ever since then.

BP: Occupied me ever since then.

WT: So, I see from your CV that you went to the Office of Insurance Products. I was actually not aware of this office, so could you tell me a little bit about it?

BP: Well, it doesn't exist anymore, but it did then. Variable insurance products, variable annuities, and variable life insurance. Variable life insurance hadn't begun yet. The Commission won a Supreme Court decision saying that the variable products are securities in addition to being insurance.

WT: Which decision is that?

BP: Well, it was *Valic*. And they created an office, because stuff was so complicated and it required quite a bit of expertise, of course none of which I had when I walked into the office. They sat me down to read my first variable annuity prospectus, and this was back before N-1A and N-3 and N-4, so they were filing on the old NAB2 and S-1s. And I still remember my first afternoon trying to wade through a prospectus of a variable annuity and thinking, my God, what a career mistake I've just made. Because I understood so little of it, and frankly, if you don't understand any of it, it can be a pretty boring read-through.

WT: Was this integrated with the disclosure for ordinary funds?

BP: It was separated. In fact, we did the review for variable products separate from the disclosure branches for mutual funds, but we worked with them to some extent.

WT: And so you were doing this then for about three years?

BP: Yes.

WT: Is there anything in particular we should discuss from this period?

BP: Well, I got my first taste of SEC rulemaking in that office, and I found that I gravitated towards it more than I did the other legal work in the office, and that it reflected my interest in policy. It turns out that my skill set – I concluded this was what I should do. This is where I had my comparative advantage.

WT: Did this area have to do with exemptions?

BP: Yes, it took the entire division and scoped it into one office for insurance products, and it did disclosure review, it did exemptive applications, and it did rulemaking all as it related to variable insurance products. So I got a taste of everything, and no-action letters, so I got a taste of everything the division did in the context of variable insurance products.

WT: Were there discussions of the position of insurance products versus mutual funds versus the banks, which were now becoming more and more involved in this area as well?

BP: Well, that '40 Act course that I took, the entire course was a comparison of various systems of regulating financial products in the United States. So we used mutual funds as the base, we compared it to banking, compared it to ERISA, compared it to insurance. And in that context, the comparison to insurance, we did variable insurance products to see the interplay and the tensions between how we regulate insurance versus securities. What was great about the Variable Insurance Products Office is it dealt with those issues, those tensions. When does the Commission accommodate insurance regulation and when does insurance regulation give way to securities law, how does that play out?

WT: This being such a rapidly changing area, was there a lot of ambiguity to wade through?

BP: There were a lot of ambiguities, but what was quite interesting during my period is that the variable annuities had been in place for a while, but the variable life insurance was brand new – where the cash value was invested in the markets and so it fluctuated with the markets – that was brand new. And so the Commission needed to do rulemaking in order to accommodate variable life insurance, and that was one of my first significant projects.

WT: And then in 1986, you become special counsel in the Office of Disclosure and Investment Adviser Regulation.

BP: Right.

WT: Okay, so tell me a little bit about this area. It seems like two different things mixed together.

BP: Right. I moved out of the Insurance Products Office after about three years and concluded that if I wanted to stay in the division I needed to broaden my exposure. A position became available in this office, and I knew people in the office, and the chief of the office was Mary Podesta, who is well known to people who have had a career at the SEC and I enjoyed working with her, had some experience working with her. So, went to do more mutual fund investment adviser work, and basically most of my career forward was shaped by the things I did in that office, working both in the Advisers Act space as well as a straight mutual fund space.

I had an opportunity to work on a couple of projects in that office, first as a staff attorney and then as a branch chief. That really cemented my decision to make the Commission a career. The best known one is the standardization of the calculation of mutual fund total return and yield, standardization provisions, and the fee table that appears in the front of all prospectuses. Those were very large projects that I had a big role in, and in working on those projects, people in the division, senior people to the division, who I got a chance to work with, like Gene Gohlke, who was at the time the chief financial analyst of the division, and Larry Friend, who was the chief accountant, taught me everything there was to know or everything they could about the operation of mutual funds, the calculation of yield, bond yields, financial statements, all of which fed into the issues that we were dealing with in the rulemaking. So it was an important project. Kathy McGrath was division director. This was her principal initiative by this time and it consumed most of two years of my career.

WT: I definitely want to ask more about this, but as far as the Advisers Act space is concerned, people who I've spoken to who were in the division in the 1970s refer to it at that time as basically a kind of census of advisers, and there wasn't much to it beyond that. Was it changing by this time? What was going on?

BP: I wouldn't say at this time it was changing terrifically, but the census, when people talk about the census they talk about the days prior to, say, until the Commission got examination authority. When the Commission got examination authority, it was well before I arrived, the Commission was more active in terms of bringing cases and going out and seeing what was going on. So I think the census days go back to the forties, fifties, and sixties. By the seventies, the Commission had a program.

But still, the Investment Advisers Act, there were very few rules that had been adopted under it and some of them were very technical rules and in unusual situations. But I would say beginning in the 1990s – I would say not eighties – the Commission became much more active as the adviser industry. Money management industry grew, and you see now a number of regulatory initiatives in the Investment Advisers Act that are very important to the operation of advisers.

For instance, the brochure rule was developed and expanded to make sure clients' advisers had good information about their adviser. The compliance rule came in, but that wasn't until the 2000s. So we became more active in the eighties in the adviser space. We didn't standardize the yield or advertising. That's never been done, nor in my view will it be done for a lot of complicated reasons. But there was more activity beginning in the eighties.

WT: Yes, let's get into some of that context. Of course, the ability of funds to advertise was fairly new, and you also had the two-part prospectus. I believe in this time that there was a statement of additional information which was a new innovation as far as how that worked.

BP: Right.

WT: So did that impact the sorts of things that you were trying to do as far as standardizing the yield calculations?

BP: Well, to some extent, to the extent that the formulas were in Form N-1A. But that was a separate track of issues, although I was involved on those issues. It's a perennial issue in mutual fund regulation, disclosure. How much is enough, how much is too much, and how do you reconcile those two things. If the prospectuses are too long and detailed, investors never pick them up and read them. But if they omit material information that's required by the securities laws, then the Commission hasn't done their job. And so how do you reconcile those issues?

When Form N-1A was adopted, the Commission scraped a lot of things that had been in the prospectus, took it out, and put it in the statement of additional information. Many people's view on the staff back then could have just not been placed anywhere, could have been just taken out of the registration statement, because the conclusion was this information was not material to investors. But the interesting thing is, the lawyers wouldn't let us, because if the Commission took them out of the prospectus the lawyers would tell their clients, no, you've got to put that in, because there's, of course, private liability associated with that. And after the Commission has been saying this information is material for all these years, or at least some people who have been reviewing prospectuses have been saying that, lawyers are hesitant to take it out for fear of private liability.

So the statement of additional information was created with the idea that it would be incorporated by reference into the prospectus and resolve those liability issues, but still take it out of the prospectus. It was sort of the neat solution to a problem. But of course, over time, issues come up in the mutual fund industry and the staff of the division is faced with how do we address these issues. Do we regulate these issues? Do we say you can't do this? Do we write a rule prohibiting it, assuming the Commission had authority? Or do we say, we'll just disclose it in the prospectus.

Faced with those two alternatives, the industry will typically say, well, just disclose it. That's sufficient. Think of this happening over a number of years, the disclosure being the solution to many of the problems, the prospectus gets bigger and bigger and bigger because it contains so many solutions to so many issues that the Commission wish not to regulate on for one reason or the other, and the industry didn't either. So the prospectus would get longer and longer, and inevitably somebody from the industry or the ICI would yell about prospectus creep, the staff or the Commission's requiring more and more information in the prospectus. They're correct oftentimes, but it was a way to avoid regulating those issues in some respects.

And in some cases, of course, lawyers seeking to protect their clients from private liability would add paragraphs in the prospectus that, from the staff's perspective, weren't really necessary or helpful. And so, then there would be another proposal to simplify and shorten prospectuses that would be talked about for years, and that was done once again. And I suspect, listening to the statements recently of the current chairman, Mary Jo White, that they're going through this cycle again. They're trying to figure out how to deal with the problem of mutual fund prospectuses.

One of the things that's interesting, and let me talk about this, is that one of the themes of the 1980s and my service in that office was trying to figure out ways to use the 1933 Act to serve, essentially, a consumer product, which is a mutual fund. The '33 Act was designed where large companies were floating an issue of common stock or bonds of some sort, and the whole design is capital-raising. How do you make it work for essentially an investment vehicle that's in continuous registration and whose investors are helped oftentimes by brokers, but whose investors are not financially as literate as most purchasers of IPOs. And how do you do that? And so some of the real creative things that the Commission did during the eighties that I was a part of was, for instance, the fee table.

You know, you think normal public offering, which is, have financial statements in the back. Well, a new mutual fund does not have financial statements because it has no assets and no history of operations. And even an existing one will have numbers about expenses and operating expenses that individual investors can't relate to very well. Not to say that financial statements aren't important, it's just they're not presented in an investor-friendly way. And so what we did was present a fee table which summarized all of the expenses in front with the goal there of informed investors, but also facilitating greater competition among mutual funds.

One of the things you said you wanted to talk about was Rule 12b-1, which had been adopted just before I got to the staff. Everybody was surprised at how high the levels of 12b-1 fees were, and that essentially, the sales load had migrated from a front-end sales load to an asset-based sales load. Nobody had envisioned that when the Commission adopted the rule. And the staff, Kathy McGrath particularly, was all aflutter about what was going on. This wasn't what we had expected. This wasn't illegal. Were people finding it easier to sell mutual funds with 12b-1 fees because people didn't understand the expenses? Why were expenses going up when the industry's assets were going up? This seemed to be inconsistent with basic economics.

And so there were efforts to revisit 12b-1 that never succeeded, but the Commission spent a good bar of time in the eighties and nineties, all through the rest of my career, in finding ways to create better transparency to these fees in order to spur market forces, to limit the amount of compensation. That is, if fund groups competed for low expenses, price competition, the idea that the market would restrain prices, because nobody in the staff at the time, and probably now, wants to get into price regulation. That's not the Commission's tradition in history, although in response to 12b-1 and the increase in those

12b-1 fees, the SEC did support FINRA's caps on overall distribution expenses, which proved to not to be terribly effective.

WT: This was in the early nineties?

BP: This was in the early nineties for the FINRA caps. But there was still a lot of effort, the fee tables one of them, to provide greater transparency. And what's one of the interesting things is it was not until I left the Commission a few years ago, today what you see is significant price competition in the industry, and you see asset flows going to low expense funds, and you see the competitive advantage in some ways of passive funds with low expenses.

WT: It seems like there's always discussions surrounding not only the structure of the fees, but also what they pay for. So in the '90s and the 2000s you get discussions about soft dollars and things of that nature.

BP: Yes.

WT: So is that a concern as far as rendering the funds less opaque?

BP: Well, yes. It was a slightly different issue, because we were dealing in soft dollars, which I spent a lot of time dealing with over the years, with a legacy of fixed Commission rates. That was up until 1975, and Section 20 Exchange Act, which created the safe harbor, which was perhaps inconsistent with an adviser's fiduciary duties to obtain research for client treads, and the Commission struggled with ways to deal with that and make it more transparent. I don't think the Commission has ever solved that nut, because the cost is embedded within the cost of brokerage, and that cost of brokerage is not transparent in the mutual fund. We conclude there was no way to do that.

However, the cost of institutional brokerage has come down tremendously over the years, so to some extent there has been success, I think, in the Commission's regulatory front in terms of market forces, success being viewed not that Commission's or mutual fund fees are at a certain level, but rather that market forces operate to restrain prices effectively. I think that's how most people at the Commission would view regulatory success, not that the prices were at a certain level, is that the market forces determine those levels effectively.

WT: So I'm reading here that 1988, then, you became in charge of the same office.

BP: Yes, I became an assistant director in the office. So about six, seven years after I joined the Commission, I became the assistant director.

WT: I noticed you have money market funds listed down here as one of the things that you're working on.

BP: Yes. Well, two things define my career. One was dealing with the results of 12b-1, although I wasn't involved in 12b-1 originally. It predated me. Similarly, in money market funds, the Rule 2a-7, which really allowed the development of money market funds because it gave an exemption to allow them to use amortized cost pricing, which allows you to maintain a stable NAV, that had been adopted a couple of years before I joined the – no, I think it was adopted the same year I joined the Commission. It had just been adopted.

And by the time I became an assistant director, we had had our first near misses with a fund breaking a dollar, and the consequences that would flow from that, and Kathy McGrath directed us to develop amendments to Rule 2a-7 that would reduce the likelihood of that occurring. And those amendments, I think, were adopted in 1991, but we worked on through the end of the eighties. Basically, it brought greater diversification, a look at ratings requirements, and a number of other things to improve the quality, diversification and the safety of money market funds, and expanded the rule considerably in terms of the regulatory requirements to maintain a stable NAV. Little, of course, did we know in 1990, when I first started working on this, what would happen in 2008.

WT: Well, we'll definitely get to that. I know that one of the concerns not only was with the possibility of breaking a buck, but whether or not money market funds being bailed out was going to start creating certain – whether or not it was going to –

BP: Moral hazard.

WT: More and more risky, yes.

BP: Well, yeas. It created a moral hazard problem where people invested in money market funds with the assumption like it was investing in the bank, and so investors didn't impose discipline on money market fund managers who competed for higher yield by assuming, in some cases, greater risk. And this was a problem that we saw, and I was involved with this for over twenty years. Different fund groups, different fund managers assume varying degrees of risk, and there was of course the gross yield in a money market fund is directly related to the risk assumed.

And the original proposition in Rule 2a-7 was that you were able to use stable NAV, we will limit the risks that you take so that you will be in a position to maintain, or to achieve the investment objectives of maintaining a stable NAV. But funds were still buying securities that had credit risk. Maybe there was not much, but there was credit risk. And beginning, I believe it was the default of Mortgage Realty Trust that was held by two or three fund groups in I believe it was in the early nineties, we had a number of near misses in the mutual fund industry. Each time, the fund sponsor was able to come up with money to bail out the fund, to reimburse the fund for the losses. That involved an affiliated transaction with the fund that was in violation of Section 17a of the Investment Company Act, but of course it was for the benefit of the investors in the fund. The mutual fund money manager was essentially handing over a check.

And so we developed a practice that I was involved with from the beginning of issuing no-action letters to fund groups that wished to do that, to preserve the fund. It seemed in the best interests of the investors in the fund, without a doubt. What we missed, of course, and in 20/20 hindsight I can say now, was the moral hazard that was being created and how that moral hazard would be built up over the years, ultimately leading to the reserve fund. You had these money market funds that grew and grew and grew and grew, they became essentially an alternate part of the banking system, bringing together lenders and borrowers, short term lenders, short term borrowers, and the expectations over time that were created just couldn't be satisfied by the resources available.

WT: And in the nineties there is, in fact, one fund, a smaller one in Colorado, that does break the buck and basically, nothing happens.

BP: No, nothing happens, because there were only a half a dozen investors or something in it in their bank trust departments, the least risky types of investors you can have. It was a small fund, and the Commission also ultimately brought an enforcement action against the sponsors who were acting very irresponsibly, if I recall, at the time.

WT: Now, I notice you have a copy of the *Red Book* here with you. Could you tell me a little bit about that study?

BP: Well, I believe when Richard Breeden became chairman, he thought it was time to have a study of the '40 Act. It's a statute that was twenty years old. We had some studies – well, it was more than twenty years old – we had some studies in the 1950s and the 1960s dealing with asset management issues, but nothing since and he thought we should take a close look at it. Kathy McGrath was division director at the time, but she handed it to Marianne Smythe, who subsequently became division director and put together this study, which I had an opportunity to work on parts of. It laid out a great number of suggested regulatory changes, some of which never occurred, but the ones that did occur, some of them were significant in terms of financial regulation in the future, and it's an important source. It's important to remember it goes back to that.

I think the primary or most significant one from that *Red Book* were the 3(c)(7) funds, or the expansion of the private investment company hedge funds before – and that ultimately was enacted by Congress in 1996 as part of the NSMIA legislation, but the roots of it go back to the 1992 study.

WT: Did you work on that part of it?

BP: No, but I was aware of it. And so, by this time I was in the senior staff, so many of these issues were vetted among the senior staff in the division, but I didn't take pen to paper on that particular one. But without those changes, the hedge fund private equity industry really couldn't be what it is today. You can disagree with the recommendations and what's happened, but they were terribly significant.

The second area I would say that 1992 study was so important was in the internationalization of money management. The Commission and the staff had interpreted the Advisers Act up until 1992 as suggesting that a non-US adviser could enter the US market and register, but that the Investment Advisers Act applied not only with respect to its US activities, but with respect to its foreign activities, which was impossible, because, for instance, example, there were restrictions on performance fees in the Advisers Act but they were customary in Europe. And the SEC essentially, by interpreting the statute this way, which is a literal interpretation by the way, essentially had the effect of exporting our statutes to foreign countries, which we would never accept, by the way, if one of our advisers registered in a non-US jurisdiction.

There was an extensive analysis of the issue, and recommendations that the Commission and the staff ultimately implemented in a series of no-action letters. This was actually done at the staff level by changing the interpretation, with of course the approval of the commissioners who knew what we were doing, that really has made the globalization of the asset management industry possible. Our advisers have a lot of business in non-US companies. Non-US advisers do business in the United States without applying those foreign statutes, without applying US statutes to the foreign – so the non-US advisers, non-US clients. That's a terribly important part of that study, ideas that originated from that study that have had significant –

Finally, the prospectus disclosure and the advertising issues. We talked earlier about the short form prospectus, and some issues in terms of allowing greater freedom of advertising came from this study and they were very important too. They were implemented.

WT: So then it's not long after this that Arthur Levitt becomes the chairman. I know he was very interested in the investment management area, particularly returning to the perennial issue of disclosure, and by the end of the nineties you have the plain English requirements, there's the profile prospectus in this period I believe. Could you tell me a little bit about that work within the division?

BP: Well, yes, he was interested in disclosure, and there were the efforts made to improve, to use, first the profile but then the summary prospectus in there. But I must say, if I think back to the Arthur Levitt years, what I think of mostly is the Internet and how the Commission at a very early stage hitched itself to the Internet, both by making EDGAR, the system, available on the Internet, and then by developing and applying the securities laws so that prospectuses and other disclosure documents can be available to investors via the Internet. How terribly important that is today.

I think an awful lot of people, certainly almost all of the people in the next generation from me, will be getting their information that way. But he recognized before I think anybody else at the Commission did, how important this was going to be, and took steps to upgrade, modernize the laws to accommodate this. And so we can talk about the form changes and the disclosure changes and a lot of the stuff that's happened in Regulation S-K and S-X, but the real significant change was the way that information now is delivered to investors, and he's got to be given credit for foreseeing the future.

WT: And there are a number of different facets of this, too, as well. I was talking to Susan Wyderko about Internet fraud and their efforts in investor education as far as that was concerned. Of course, you mentioned the disclosure aspect, and then of course I don't know if people were doing that at the time, but actually doing investment transactions via the Internet.

BP: It eventually happened, and then there was the ESIGN legislation which came on later that the Commission was involved with. There were changes of laws, but they tended not to be securities laws. They tended to be state laws that permitted transactions over the Internet. The Commission did, however, through this period everything it could to facilitate in terms of applying the securities laws to transactions. But I'm not certain that the Commission played a real big role in that, because most of that law is not securities law.

WT: I don't know if there's more that we want to talk about in this area, but you speaking of state laws and that sort of thing just made me think that we should maybe talk about NSMIA, but I didn't want to force you on.

BP: Sure. If we're in the 1990s, in my view the most important thing that happened, at least that I was a participant in the 1990s, was NSMIA.

WT: All right. So, perhaps I'll let you take the lead.

BP: Well, the idea of NSMIA didn't come from the *Red Book* at all. NSMIA was a legislative initiative that was a product of a number of political forces here in Washington, a Republican Congress, a Democratic president, Bill Clinton. The laws that had limited private rights of action enacted by Congress and then ultimately signed by Bill Clinton, if you recall, over the objections of Arthur Levitt, and the issue is, what does the Commission do now? We've lost a major battle. And Arthur Levitt gave a very important speech, in all places, I think it was Vancouver of British Columbia, talking about rethinking federal-state relationships and federal securities laws, and particularly about preempting state laws from mutual funds.

WT: Maybe I should ask, what was Arthur Levitt's main objection to the legislation?

BP: To private rights of action?

WT: Yes.

BP: Well, the Commission, he adopted the SEC's historical position that in order to force the federal securities laws it was inappropriate to rely solely on the SEC, that private plaintiffs were essentially private attorneys general, and the SEC did not have the resources to do the job. It was a relatively small agency of the burgeoning market, and if you wanted to dis-incentivize people from committing fraud, it can't be solely because the Commission might sue them and get an injunction against doing it. There had to be much bigger cause of actions. But oftentimes, these lawsuits came in the form of class actions organized by lawyers, and there was the same objections then as there are now to class actions and to the role of the lawyers for plaintiffs in those class actions. And NSMIA, that legislation was a reaction to that.

But now of course, the SEC is responsible, and among the things they were responsible for were investment advisers and mutual funds. But the state and federal regulation overlapped in different ways. Mutual funds had become a national economic institution, but to sell a mutual fund in the United States, you had to be registered with the SEC and with all fifty States and the District of Columbia, which was an enormously costly endeavor. And some of the states were active in terms of attempting to regulate what mutual funds do and did. And so one of the developments, of course, in the 1990s was derivatives and derivatives used by mutual funds, which gets some play.

But the staff of the Commission found out one day, and perhaps it was I that discovered one day, that the SEC did not regulate the use of derivatives by mutual fund. It was the state of California. And this state regulated this aspect because some person at the state securities is interested in that place, and then there were these organizations, central states organization, Indiana and Illinois, some of those states that got together and imposed their own form of regulation on some aspect of mutual fund operations.

The mutual fund industry had been screaming for a number of years, because when you're bringing a mutual fund to market, it meant not just working with the SEC examiners, but taking comments from every state regulator. You accumulate those comments and changes and you kind of understand why, unless we solved this problem, there was never going to be simple plain English prospectus. For instance, the changes in the prospectus that was done, that would never have happened if you had had to get fifty states to approve.

WT: And I see it all fits together then, right?

BP: It all fits together. Also, in the investment adviser area where I toiled, we couldn't have amended Form ADV to do things that the SEC felt needed to be done unless we had agreement from thirty-seven, at the time, states that regulated advisers. And they would form a committee, and if you'd get one person or two people on that committee that saw the world in a different way, essentially the SEC was blocked from making those changes. And so, we at the SEC felt that we couldn't adapt to the rapidly changing markets, because we were always in meetings negotiating with the various state authorities.

But of course, we weren't allowed to make those feelings public, because they were our co-regulators of the mutual fund industry, that's what they called themselves, and the investment adviser industry. And Arthur Levitt made a speech, and what was interesting is after that speech, a chairman of the banking committee, Phil Gramm, who of course had sponsored the legislation limiting the private right of action, called Arthur, congratulated him, and wanted to talk about legislation. And we in the Division of Investment Management worked with our colleagues in Division of Corporation Finance and others in the Commission to draft legislation, roughly what Senator Gramm and Chairman Levitt had agreed to, based upon Arthur Levitt's speech. That was in the mutual fund area.

In the adviser area, the division made a different pitch. There, the problem to some extent was overlapping regulatory authority and how it impinged on the ability of the staff of the SEC to address market changes. But we had significant resource issues in the investment adviser area. There was a huge burgeoning population of investment advisers, numbers of which swelled because of financial planners, which the SEC had issued a release saying, yes, you're investment advisers, too. And so we had a barbelled industry. We had the asset managers with a great deal of industry, and a great deal of financial planners who had no assets under management, or very few. And the Commission's resources were being stretched thinner and thinner and thinner.

And so what we, the division, suggested to Chairman Levitt and Chairman Levitt suggested to Senator Gramm was that instead of simply preempting states from regulating advisers, which was what we were going to do and which the legislation would do with the mutual fund areas, instead we divided up that the states become responsible, primary regulators for the smaller advisers, which were essentially local business, and needed to be regulated at the local level and not at the national level, but the SEC would take the large asset managers, in which we had the expertise, in conjunction with the mutual funds, our regulation of mutual funds, to regulate.

Initially, that threshold was set at $25 million of assets under management, in which case I think at the time we estimated two-thirds of the advisers would go to the state and one-third of the advisers would come to the SEC, but that would have about 98 percent of the assets, 99 percent of the assets. And that legislation was enacted in NSMIA, and my office was responsible for doing the rulemaking that implemented that legislation. And I look back, long career, I feel that was one of the important achievements. But there was another part of NSMIA that was really important, too, that I wanted to talk about.

WT: I want to ask, were these conversations connected to the same conversation surrounding the creation of OCIE?

BP: No.

WT: No, okay. As far as having the resources available.

BP: No, but they were all happening about the same time. OCIE just represented a reshuffling of existing resources at the Commission. It didn't represent the addition of resources. But this all was happening about that same time. But as it turns out, when OCIE expanded considerably, there were management issues that may have made more sense to have creating OCIE as a separate entity, because while I was in the division, for most of the time the examiners were essentially controlled by the regional offices, and we had a few people in the division, half a dozen, that supervised that whole process. As the examination program grew, they upgraded the number of staff that was supervising that whole program, and OCIE now is many times bigger than the Division of Investment Management.

WT: Can you give me a sense of the timeline here? I promise we'll get back to the private funds. I think that's what you were driving at with –

BP: Well, this was all –

WT: Like I say, I talked to Barry Barbash and he said that OCIE was a big regret of his. I'm talking to Norm Champ on Friday, actually, who came on quite a bit later. And so knowing what happens in between with that whole thing is very useful to me.

BP: Yes, I believe the OCIE was a regret to me in the same time. Barry and I were working together in the division. I worked for Barry at the time, and that was very painful, and I've just explained the justification for it in retrospect because of the size it's grown. But

OCIE, the examiners were essentially extensions of the division at the time, and the examiners had the same priorities that the division did. And the senior examiners played a large role in the workings of the division and the policy.

I, as a rule writer for my years, didn't get out in the field very much. I couldn't. But I needed people when they came back from the field that could come to my office and explain to me everything that was going on so that I understood how to shape policy, how to write a release or how to write a rule. I had a very close working relationship. Perhaps the most important professional relationship I had over the years was with Gene Gohlke, who was in the division. When we needed to know something relative to something I was working on, all I needed to speak to Gene and he would deliver the information. He would reach out to the field. He had no competing priorities with me, that we were all part of the same team.

I share some of Barry's feelings that when this separated, and what made it work was that Gene was still running the program and we could still work with Gene, but we couldn't control his time or resources any longer. Over time, divisions within the agency, and this happens everywhere in government, developed different priorities and different values, and as a result I think that the division has lost – now, you remember in Dodd-Frank, a provision in Dodd-Frank required that the Division of Investment Management have examination capabilities. And I don't know who was responsible for that provision legislation. It was not the staff of the Commission or the commissioners, as far as I know, but it's my hope that the division is using those resources now to get back some of what we lost when OCIE was split off.

Yes, I can understand why Barry would have those regrets, because I felt – I still remember the day Barry came in my office and told me it was about to happen, and how painful that was. But it was a done deal, and so it was to be.

WT: When were the expansions? Was that after 2001 or 2008, or both?

BP: The expansion of OCIE came in several stages and waves, and since it didn't affect me, I wasn't keeping notes at the time – I probably would have noted – whereas my resources, our regulatory resources in the division stayed the same or shrunk at times. For instance, when there was a freeze on hiring, which happened all the time, it was applied across the boards, and so we would shrink. Then when the Commission would get additional resources, they would go to enforcement and/or OCIE. They wouldn't come to the regulatory divisions. So that was, you could see we ratcheted it down, but we never ratcheted it up. So there was extreme pressure on me and my staff at times during this period with demands to write rules or letters and exemptions. There were backlogs of exemptions. But yet, the resources were never really provided to the division, and I think the trading and markets division, if you talk to people in that period, will tell you the same thing was happening to them.

It wasn't until, I think, Mary Schapiro became chairman and obtained some significant additional resources early in her tenure, before Dodd-Frank, perhaps around the time of the financial crisis. I cannot recall exactly when. Mary, however, was, I felt, the first chairman that really understood the importance of the staffed regulatory divisions, and she got us resources that we needed, and I particularly was the beneficiary of that in the division. Without those resources that Mary gave – I'd like to say me, but she didn't know who was going to get it, I just did – we would not have been in a position to implement Dodd-Frank the way we did if the resources had been to the division what they had been when she came into office. She was the first chairman that understood that this work was important and that there was a connection between what you could do and the resources you directed to it.

WT: Well, thanks for indulging that tangent.

BP: I've talked about this with other people, but nobody ever seemed to care before, these issues. But I can ever think fondly of Mary. One of the things I think about is that she gave me the gift of the resources when we desperately needed. And it paid off for her. But the difficulty in government and business is no different, since I've been in private practice, there's always a tradeoff between the present and the future. Does a business invest today for future returns, or simply does it pay dividends to its owners, and regulation is like that, too.

We did some pretty good rulemaking coming out of Dodd-Frank in some pretty short amount of time, I feel, but it was only because I got resources not just the day Dodd-Frank was passed, but two years earlier, so that I had staff who had been at the Commission for a couple of years and were ready to do this ruling. The other thing that helped me was the financial crisis in 2008, with the contraction of the securities industry, there were a lot of good securities lawyers available that wanted to come onto the Commission, some of whom were out of work, but the ones I hired had just wanted out of wherever they were. And we got some of the most outstanding people that I ever hired in the 2008, 2009 area. Just outstanding lawyers. Some of those people are now in mid or senior level positions at the staff.

WT: That's fascinating. I had no idea.

BP: And but for those resources Mary gave us, instead of just giving them to OCIE and Enforcement, which had been the tradition, really, how the Commission is operating today reflects on those decisions years before.

WT: Okay. So back to NSMIA.

BP: One other thing that was added to NSMIA was a provision giving the Commission authority to create and operate an electronic system for filing registration statements and other documents of advisers, and that became the IARD system. It was a little few sentences tucked in at back of legislation, "You will not find any record of this in the

Congressional Record." But it was a housekeeping provision, but it was terribly important.

EDGAR system at the time was up and running for corporations, and the original EDGAR system was a business model by which users would pay for the system and finance the operation of the system. EDGAR was conceived during the Reagan years, and there were huge deficits. There were no additional monies for regulatory agencies. In fact, regulatory agencies were bad words back then. And so the EDGAR system was conceived as a self-financing vehicle. People would pay to get access to the documents, which means the principal readers like Wall Street would pay systems.

In the Levitt years, where money was more available, that business model did not work very well, and it also did not make this information available to the man on the street, the average investor who would not or could not pay for the subscription to these services to allow it to do its own financial services. And I believe under Arthur Levitt, that business model was changed so that the resources of the Commission would pay for the operation of the EDGAR system and access to the documents would be free.

The problem was, back pre-NSMIA, the advisers were still filing on paper. The paper was sent off somewhere offshore, probably prisoners in some island someplace, some Third World countries, in which they would be all scanned in or typed in or keypunched into a database, which the Commission would get base back. And there was an open secret among the staff that that database was absolutely useless. Absolutely useless. And so it was a system devised to be filled by lead pencil, you had to check the box. And the boxes didn't fit in a lot of investment advisers' businesses, and so people would write in the margins, which the machines that tried to read this, or the prisoners in Third World countries that were keypunching these, didn't read into the system.

The examination staff and I had absolutely no confidence in any data that we were getting, yet we were trying to run a federal national program on this and produce data to Congress in annual reports. This was just a secret, but not a very well-kept secret. You would query the system in the morning and it would produce very different numbers than if you queried it later in the day in terms of the number of advisers that were registered. There were a number of problems with the system, but it was basically a paper-based system.

We had no authority to create an electronic system. And not only that, but we had no business model in which to finance the cost. Everybody knew that nobody was going to pay for Form ADV. There was no market value at the time to ADV, because it was a form used by regulators, not by the public at the time. So we had to develop a different business model, and so the system allowed the Commission to charge fees and to retain those fees. If the Commission were to set up a system and pay fees before the legislation, the proceeds of all those fees would have gone to the United States Treasury and would have helped reduce the deficits, but it wouldn't have helped us finance and build a system.

So that legislation allowed us to create a system. The Commission hired NASD, now FINRA, to run the system, and it charges registrants, advisers a fee, a very nominal fee now, and that fee is used to offset the costs of FINRA in both building and administering the system. We also built a public access portal to that system so that now clients for advisers who are thinking of hiring an adviser can go into the system and find their Form ADV and get all the information they want about every adviser registered in the country. The states joined the system, so all the state-registered advisers are on the system, and it's a system that's been working now for fifteen years or so, and not a single taxpayer dollar pays for the system. The system makes a profit on these fees, a small profit, which it uses to reinvest in the system and system upgrades. So that was an important part of NSMIA and one of the things that I worked on at the Commission that I'm particularly proud of.

WT: Oh, fantastic. I didn't know anything about that either. But now, of course, you did mention earlier implemented in NSMIA was the –

BP: The split between the states.

WT: Yes, but also concerning private funds in general, and the redefinition of what was allowing the expansion and so forth. So give me perspective on what the Commission's view of this area was at the time. Before we started, you were talking a little bit about not knowing what was going on in Long Term Capital Management, for example, when it collapsed.

BP: Well, the problem there was that we didn't have jurisdiction over the managers, because there was an exemption in the Advisers Act, if you had fifteen or fewer clients, and you may have one client that's a hedge fund that has $100 million, but it only counts as one client. And so it was odd that we had a $25 million threshold for state and federal registration, but these hedge funds could have hundreds of millions of dollars, be bigger than the mutual funds we regulate, and we wouldn't have any access. They wouldn't be registered.

And so NSMIA did not solve that problem. It crystallized the problem, well, at least in my mind, through that legislation. It essentially created the problem in many respects, the regulatory problem, by facilitating the growth of the private fund industry, which made them very good for the economy. I know it was very good for the hedge fund managers that were running them, or so I read. And some of them are my clients today. But what it did was it's this huge chasm in the securities markets in which the SEC could not look into and had no access to.

And so from the time when NSMIA passed in 1996 until we were doing legislative rulemaking in this area in 2004, 2005 period, there was a huge growth of private funds. And from the Commission's perspective, many of the enforcement matters we saw during this period that involved either market behavior, insider trading, mutual fund problems, late trading and market timing, as well as other frauds, were being done through a vehicle that you might call a hedge fund. The reputable hedge fund industry in the United States I know at the time said, “Oh, those people aren’t us. Those aren’t the hedge fund.” There’s a large legitimate hedge fund industry. But nonetheless, the exception did not have a legitimacy requirement in it. It was available to anybody that had fewer than fifteen clients, from the Advisers Act. As long as you could count a fund as a single client, you were available.

This was initiated by Chairman Harvey Pitt when he was chairman, who after the Sarbanes-Oxley issues dealing with the accounting fraud, the Enron, WorldCom, and those things, calls a few of us into his office one day and said, “The next problem is going to be yours.” He said something like that. “You should enjoy what the Division of Corporation Finance is going through right now. You shouldn’t enjoy it too much, because you’re going to be next.” And he was right. But then he said, “I want you to do something about hedge funds.” So he was right. We were next. But he was wrong. It wasn’t the hedge funds that came next. What came next was the market timing and late trading deals. But let’s talk about hedge funds for a while.

One gets a sense that Harvey understood the issues in hedge funds from his days representing clients, that there was a concern that people went there to do things to get away with things that perhaps they couldn’t do in the mutual fund or the public markets because there was no transparency, either from their investors or from the Commission into what they were doing. And so when he said, “I want to do something about this situation,” the division’s response to him was that we can’t really do anything outside of the use of the Division of Enforcement, which is usually after the problem has occurred, right? At least some entity is registered with us, with gives the Commission statutory authority to take prophylactic measures, meaning to go in and take a look-see before something has blown up.

Our recommendation to him was that that be the Advisers Act, meaning not regulating them as investment companies, but simply if we had access and examination authority and require them to register so at least we would know who they were, who was doing business in the markets.

WT: I'd like to ask a question on this point, because it kind of confused me, so it's sort of a naïve question. But the discussion is always surrounding the registration of hedge fund advisers and not the funds themselves.

BP: Yes.

WT: I mean, is that just purely for – is there rationale behind that, or is it politics, or what is that?

BP: All of the above. You're in Washington, right? And this became more of an issue in Dodd-Frank, by the way, than it was at the time. At the time, the division just simply recommended that we – there was a safe harbor that allowed you to count each fund as a client, that we essentially repealed that safe harbor as it applied just to hedge funds, not to private equity or venture capital, but just hedge funds where at least from the staff's perspective most of the issues were arising. And as I explained to one conference once, why we didn't go all the way and do the other funds, our dogs were in too many fights at the time, so you have to prioritize. It's one of the things I learned as a regulator in Washington, and that the worst enemy of a good plan is the best plan. In some of your other discussions, you might have a conversation about the aircraft carrier, and that's sort of proof positive of that saying.

WT: That was right around this time, too.

BP: Oh, yes. And I sort of learned a little bit of what not to do from watching that stall. So we told Harvey Pitt that we needed to register the advisers before we did anything. Years before this issue came up and I was aware of a '92 study that a lot of the hedge fund advisers went out of their way to avoid registering with the SEC because of the restrictions on performance fee rules. And of course, anything we know about a hedge fund adviser, it's the performance fee. And the *Red Book* study recommended that the Advisers Act be amended to give the Commission authority to exempt advisers from the limitations on performance fees with respect to certain sophisticated clients.

That rulemaking from the '92 study, and the legislation had passed and was part of NSMIA, and so by the time Harvey Pitt, in the early 2000s I believe, had talked about this, the performance fee rule was not an inhibition on hedge fund advisers not registering with the Commission. So we advised Harvey Pitt that there was nothing in the Advisers Act itself that would prevent advisers from registering and operating as they do in the context of the Advisers Act, and that in fact, a number of hedge fund advisers were fully registered under the Act, but most of them were not. And so where it once had been a regulatory imperative that hedge fund advisers not register into the Act because essentially it was inconsistent with their business model, changes had been made in the regulation of advisers prompted by this Red Book study and NSMIA that eliminated those.

So I can't say how important that was, because that work had already been done by the time Harvey Pitt was chairman and asked us to do something. We advised him that there was nothing in the statute that would prevent, and that we couldn't do anything about, hedge funds or hedge fund problems until they were registered, until our examiners could go in in some future long-term capital management and ascertain what's going on there. Is this simply a mismanagement of the fund, a markets-gone-haywire risks were taken, which were assumed that just didn't work out? Or was this what came to be later known, Bernie Madoff, there were just no assets there? In the few days after Long Term Capital Management came into the headlines, we at the staff didn't know which – now, it turns out there was no fraud. There were some huge bets taken that turned out wrong, but there were no enforcement cases that I know of, no criminal investigations, even, because when we finally found out, we understood what had happened.

But from the regulators' perspective, there being a major crisis and not having access to information is a real issue. And so we talked to Harvey Pitt about this and he agreed to go forward and we worked on these rules. The notion was if you could create a safe harbor that said you can only count each fund as one investor, you surely can turn it around and said, "No, no, no. Each investor in a hedge fund has to be treated as a separate client." And we had a Second Circuit Court of Appeals decision that said for purposes of the Antifraud Rules, Section 206, you treat each investor in the hedge fund as a separate client.

We went forward with the rulemaking, and as we approached the rulemaking it became apparent that some of the commissioners in the Commission were going to be very strongly opposed to that rulemaking. Harvey Pitt, of course, was a Republican. It was his Republican fellow commissioners that opposed – Paul Atkins leading that charge – opposed the rulemaking. It became a very political, charged issue, something that we hadn't seen, or at least I hadn't been exposed to much at the Commission, which was the politics that one associates with Washington had typically not entered Commission deliberations on issues, and they were beginning to. And this hedge fund issue became one of them. The other was, of course, was the PCAOB, the accounting issue, which became very politicized also.

The commissioners opposed, and of course the hedge fund industry organized and largely opposed the rulemaking. And you'll recall Harvey Pitt left the Commission, and when his departure was announced, I simply assumed that I would no longer be working on hedge fund registration. This was a Republican administration. Harvey was alone in his support of this initiative, and I simply assumed that this would die. And was pleasantly surprised to find Chairman Donaldson, not long after he came aboard, had a meeting with

Paul Roye, who I believe was the division director by then, and he thought it was an excellent initiative and continued for us to move forward with it, which we did. There was a very contentious adopting release. There were rigorous dissents filed to the rulemaking. And ultimately, there was a lawsuit brought by Phil Goldstein that overturned the rulemaking.

Once again, when that opinion came down, I thought it was a very poorly written and thought-out opinion, but, hey, that didn't really –

WT: Do you remember the year on that? Because, of course, this is when the SEC starts to really have problems with a lot of overturned –

BP: Yes. There were like five losses, and three of them were from my rules, and this was one of them. The fund government's rules, which we haven't talked about, that's coming up, was one of them. The investment adviser IAPD rules making was overturned by the court. And this now, the hedge fund, was overturned.

WT: Were those all on the DC Circuit?

BP: Those were all DC Circuit. The DC Circuit is our Supreme Court, because when there used to be private rights of actions under the Advisers Act, cases would come up in the various circuits. And so you can go back to the 1970s and earlier and you'll see important law that was made by the Second Circuit, or say the Ninth Circuit in this area.

Today, no law is made anywhere except in the DC Circuit because there's no private action, which means when the Commission does something it's sued at the DC Circuit for any of our rulemaking, or most of our enforcement cases show up. Or administrative cases, which under the Advisers Act, large, large portions of the cases are administrative, so that's why they say the DC Circuit is like our Supreme Court. And our Supreme Court didn't like us very much, one would get a sense. Or as one commissioner said at the time, "Maybe I should wear the robes and they should come over here and pass the rules, work on the rules."

But that was a real blow, that decision. They decided that the fund itself was the client and not the investors. And they decided that not just for purposes of counting fourteen or fewer clients, but for purposes of the Antifraud Rules themselves, essentially overturning the Second Circuit in which the SEC, the enforcement division, and every lawyer in the country that represented hedge funds relied on. Even though there was no private right of action under Section 206, there was an understanding that you as an adviser had fiduciary responsibilities to investors in the fund and not just the fund. And when you think about it, if the fund is a creature of the adviser, its general partner is an associate of the adviser, so there's not an arm's length traditional client relationship between the adviser and the fund. It's its creature. And under the Advisers Act, you're required to obtain consent from your clients to conflict. Well, how could an adviser obtain consent from its affiliate for a conflict of interest? It had that it could affect the investors. This made no sense.

Contrast that to the mutual fund, where you have a fund with a board of directors that has separately legally constituted and has separate obligations under both state corporate trust law as well as under the federal securities laws. The hedge fund had none of these features on this, so who would be making decisions to consent? And the DC Circuit in the *Goldstein* case simply didn't consider the consequences, it seemed to me, of what it was doing. Not only was the rule I had spent the last year working on overturned, but suddenly the SEC had to dismiss a number of its enforcement actions against some real bad guys because suddenly we didn't have jurisdiction.

So let's say if you looted the fund, you would defraud the fund, pretty clear. But what if the fraud was an account statement fraud, that you simply misstated the assets of the fund to accountants? And that's a common fraud in the hedge fund area. Those suddenly we couldn't bring actions against, because they defrauded the investors in the fund. But we couldn't bring an action under Section 10b-5 if it was in connection with purchase and sale of a security, but what if the fund was now offering chairs during the period? So it's classic adviser fraud we couldn't bring anymore, if you intervened a fund between the beneficiary of that advice and the adviser, something that we had assumed Section 208d of the Advisers Act prevents.

But nonetheless, the loss was painful. The staff immediately had to come up with solutions initially to the antifraud interpretation, because that had the most disruption on the Commission's program by far and had the most potential impact on investors. If you'll recall, the Commission proposed and adopted a hedge fund antifraud rule under the

Advisers Act which, instead of relying on Section 206(1) and 206(2), which prohibits fraud against clients, and the *Goldstein* opinion had defined the term "client" to include the fund, Section 206(4)-4 just prohibited fraud and gave us rulemaking authority. Didn't mention clients.

And so essentially, the Commission, by issuing a rule, overturned a bunch of the *Goldstein* decision. And six years later, the United States Congress overturned the rest of it in Dodd-Frank by specifically requiring advisers to hedge funds, by eliminating the fifteen or fewer client exceptions, just taking an eraser to the statute. Creating new, more narrow exemptions, but eliminating that exemption, and swept in not only hedge fund advisers, but private equity advisers also, a much broader sweep. Left out venture capital advisers rulemaking, which we had to do. Congress, in its wisdom, excluded them. Then we had to do implementing rules.

But essentially, in a period beginning in 2000 and ending with the implementing the rules in, I think 2012, again, Harvey Pitt's goals, when it all began, of doing something about private funds and determining to register them, had through a very circuitous route, through the Commission, the DC Circuit, and then the United States Congress, basically the Commission had seen its policy goals realized.

WT: So moving to the question of mutual fund governance, I know this starts with Arthur Levitt, but the rules only come in the wake of the 2003 late trading market timing scandals.

BP: Late trading market timing. And then something started with Arthur Levitt. There are two series of rulemakings: an initial one starting with Arthur, which was significant but didn't get nearly the political opposition as others did – Arthur also, the Democrats were in control of the Commission then. There was some, but not a lot of pushback. Most of the pushback on the initial rules with Arthur Levitt was from lawyers, because among the first round of rule changes was a requirement that the independent directors of mutual fund, if they have a lawyer, that that lawyer has to be an independent counsel, which means that the same lawyer can't represent the management company who represents the independent directors, that they have discrete interests, and those interests are designed by the statute to conflict at times. The independent directors act as a watchdog, and they are paid to say no to the manager. And there was among some practices in the industry of just hiring one law firm to represent everybody, and we got along so much better that way. So most of the opposition came from the lawyers and struck me back then that their views were easily disregarded at the time.

A second round of rulemaking after the late trading and market timing scandals occurred was begun by Chairman Donaldson, and this time was going to build on the rulemaking that Arthur Levitt had done, but were to be ratcheted up by several degrees. Under Arthur Levitt, the number of independent directors went from 40 percent to a majority. I believe under the Donaldson rules we've gone up to 75 percent, and the chairman of the board had to be an independent chairman. In addition, there were several other requirements like self-evaluation and some other procedural things that survive today that weren't quite as controversial.

WT: Is it right there with the second round of rulemaking, it was the exemptive authority that was the regulatory lever here?

BP: Yes, both rounds of rulemaking were. The first round of rulemaking when Arthur Levitt was chairman, Harvey Goldschmid was general counsel at the time, and I remember meeting with Harvey Goldschmid where he explained to me what the chairman wanted to do, and I said, "Well, that's very interesting, the Commission doesn't have authority and the statute to do this." And he said, "Well, why don't you go back and think about this some more." And we went back to think about it, and I can't remember who came up with the idea, but I think it might have been Ken Berman, although he might deny it today.

He goes, "Well, we don't have authority to require every board, but we certainly do have authority to impose conditions on the use of some exemptive rules in the Commission." And, in fact, Rule 12b-1 is conditioned on its approval by a majority of independent directors. So there were some antecedents, some bread crumbs and some rules that we were aware of, by which the Commission had used a governance concept as a condition. I think there were two or three rules that had some element of governance in them. So there was some precedent for this, and so we came up with the idea of taking ten exemptive rules that were commonly used by funds and fund complexes and amending them to conditions.

This is one of the things about the creative practice of law in the government that's not so different from private practice, is a client wants you to do something, and in the government you need to take a hard look at the law and figure out – sometimes you have to tell them no, but sometimes a good lawyer can be creative, and this was our creative lawyering. And by the way, that idea was, when the Chamber of Commerce sued the Commission, they attacked that use of authority, and the second round of rulemaking worried me a great deal because we were now being sued in court. And I was very much worried that we would lose on our authority question and that it would deny the ability of the Commission to use exemptive authority to fashion alternative regulatory solutions where the statutory solution, 1940, didn't work.

And so you could have gotten a court decision – it was a very high risk for the investment management program at the Commission to get an opinion that we would have lost on that reason because of the consequences. And it would have harmed the industry significantly. Let's say a future Commission would say, "Well, we'd like to give you this exemptive authority to allow you to do variable life insurance," or variable annuities, or whatever it is, "in 2020, but I'm sorry, the DC Circuit Court opinion just doesn't say, so we don't have that broad exemptive authority anymore."

But it turns out that the Commission, when we were sued by the Chamber of Commerce, they upheld the use of authority, but they struck down the 75 percent independent directors and independent chairman on the basis that we didn't do the cost benefit analysis adequately, which was galling in its own way because we had determined that the cost of an independent chief accountant, in an accounting sense of the word, was so small that it wouldn't show up on an income statement of a fund. So even if you assumed the highest costs, since you're just dealing with an existing board and changing who could be on the board, the accounting costs on a cost benefit analyst would have said there's just no – I mean, these were fund groups that had tens of billions of dollars of assets, and instead of an inside director who was paid no money a year, you would have an independent director who was paid let's say $180,000 a year.

So those are the types of costs we are talking about, which in the case of a fund group that had tens of billions of dollars of assets, it didn't show up to a decimal point, a basis point in assets. And so we did not do as rigorous a cost benefit analysis as we might have had there been real costs associated with – or perceived to be real costs.

WT: But even the whole idea of what should constitute a cost benefit analysis, or the idea of being challenged on this basis, was very novel.

BP: Well, you know, I still deny the law requires it, because remember, the statute simply requires a technician to consider the costs. If the SEC was not subject to the same cost benefit analysis requirements as say EPA is, where that had to be a determinative outcome of the rulemaking – and this was part of NSMIA, by the way. It just said the Commission had to consider it. And there was a discussion of it, and the conclusion is there weren't that many costs involved, but the court seemed – in my view, it read into it the traditional EPA-type cost benefit analysis and said we hadn't done that.

I think the court was way overreaching there at that point. And so the drama on all this was that the legislation, the rulemaking was overturned because of this I believe a week before Chairman Donaldson was scheduled to leave office. And I received a call from the Commission's general counsel right after the decision came down, said, "Bob, the chairman –"

WT: Which general counsel was this at the time? I spoke to a number of them last year, but I can't remember when they –

BP: The Italian.

WT: Oh, Prezioso.

BP: Prezioso. Called me and said, "Can you do a new cost benefit analysis in a week?" And, you know, there's nothing lawyers can't do in a week as long as their families are willing to forgo all contact with them during that period. And so a team of lawyers spent the entire – from the general counsel's office and from our office and the economists, worked on a cost benefit analysis around the clock, practically, for a week. It was very long and very detailed. The Commission considered that new cost benefit analysis at the end of that week and issued a release which we felt met the court's requirements, which were all new to us at the time. We ended up back in court where the plaintiffs' chamber argued not only was the cost benefit analysis inadequate – one got the feeling that any cost benefit analysis was going to be inadequate – but also that we had relied on data for the cost benefit analysis that was not a part of the rulemaking record.

The Commission had always assumed based upon our cost benefit analysis, that if data was in the public sphere that we could generally rely on data, for instance, if you were looking at census data. But the court seemed to suggest that if you were relying on this generalized data, it had to be subject – you know, this is a little bit like what a court has to do in terms of a judicial record, that if it's going to state a fact, it had to be part of the judicial record. So in some respects, what the court was doing was applying the judicial restrictions on a regulatory agency, ones that it was very familiar with imposing on district courts, meaning district courts have to make decisions based upon record and they can't pick facts that aren't in the record. Regulatory agencies aren't under those prescriptions, except in the District of Columbia on the cost benefit analysis.

So we were criticized for going outside –

WT: Just to clarify, so the data question was more of – its legal status rather than if it was like properly validated by whatever means.

BP: Well, it was and it wasn't. The data wasn't subject to notice and comment, so people couldn't come in and criticize the data that we were using. And so when that second decision came down, Donaldson was gone. We had a new chairman, Cox, who wasn't interested in –

WT: That was a question that I was going to ask you, is that you knew that you had to do this quickly because you knew that Chairman Cox was going to be in next.

BP: I had to do it quickly because I had a direction from the chairman to do it very quickly. Now, I have been on many conference panels and interviewed by reporters who have suggested that the Commission overreached and we deserved to lose because of trying to get that out the door. To them I say that every chairman I have worked for at the Commission, there were seven of them, always pushed us to get stuff out the door before they left. Every administration, before it leaves, wants to finish the works that it started. The ERISA rules that came out, people are accusing the Obama administration of overreaching and trying to cram things through before they get out. Well, every administration does that. I've been here since the Reagan years, I started in government, and they're all the same. It's not politics in a sense that one point of view wants to take advantage of another point of view. Everybody wants to get their business done.

And in my view, we didn't know – I'm not sure who we knew who the successor was, but we didn't know whether he or she would have any views on that. I'm a member of the staff, the chairman says, "I want this by Friday," I say, "What time Friday?" And that's how I survived the twenty-nine years at the Commission, is meeting chairmen's deadlines.

But the chairman wanted this done before he left. There was also something personal to the fight, you get a sense, of the chairman. Because I must say, the two issues we fought over, and I've never said this really publicly before, the independent chairman and the 75 percent versus 50 percent, I thought at the time it wasn't public to say it was probably not big enough issues to go to war over. You know, it was like those two islands in the Japanese sea that people are going to go to war over. Why? But Donaldson was adamant that he was going to win this fight, and he felt, coming out of the late trading and market timing scandals, where really there were some real problems uncovered, that this was going to be part of his fix for those problems.

WT: So the politics of the whole thing are a little bit peculiar. This is the rule, if I'm not mistaken, where you have the former chairpersons who all kind of write a letter lining up behind it? Is that correct? Or was that another one of these rules?

BP: I cannot recall that one. That might have been the case.

WT: Well then there are other people, I've spoken to former SEC staffers who say, well, I don't know what they were thinking in this period, you know, coming out with these government's rules. And there will be people who say that, well, most of the funds were already at this level of independent directors anyway, so why do you need the rule. And there are other people who will say that, well, since they're already there anyway, why not have the rule.

BP: Yes, reasonable people can disagree about this. But in mutual fund regulation, we were dealing with what has always been the difficult issue, how to separate the interest of the mutual fund from the interests of the adviser, who really created and manages the fund. And the fund and the adviser have very different interests. In terms of pursuing the investment objectives of the fund, they overlap 90 percent of the time, and maybe 99 percent of the time, but where you have the market timing and late trading scandals emerge showing you when they don't what the consequences are.

And so I'd say the fund governance issues, although you could look at the ones the Commission faced in isolation and say these weren't a big deal, these were a continuation of a number of issues over the years.

Section 36(b) of the Investment Company Act, which was enacted in 1970, creates a fiduciary duty by which the adviser – with respect to the adviser, the fund with respect to its compensation. That was another effort to deal with this issue. Very controversial, still is today. There's private rights of action litigation under this section. Where you do have problems in the mutual fund industry, it's frequently because of this conflict of interests, and the rulemaking if viewed in that perspective was important. If it's viewed simply as 50 percent versus 75 percent, the independent chairman, non-independent chairman, it really isn't.

The problem is that in some cases, the investment manager dominates the board, and the board is essentially controlled by the manager, and the board doesn't perform the functions the statute calls upon it to perform. And there was some evidence coming out of the late trading and market timing scandals that the boards involved were not culpable, but they had fallen down in some levels. And this was an effort to reinvigorate and empower them, initially begun by Arthur Levitt and Harvey Goldschmid, who felt very strongly about governance issues, and carried on by Chairman Donaldson.

WT: So this is one of several things that come out of the late trading market timing scandals.

BP: Yes.

WT: Another one is the rule of compliance officers.

BP: Yes. This was again that Harvey Pitt, the proposal for compliance officers, compliance rule, and the Advisers Act and the mutual fund act, this was one of the things where he told us that another area of vulnerability we had was compliance. We kicked around a number of ways to solve this, and this was also a problem of our resource issues in terms of OCIE and its ability to visit the advisers and mutual funds infrequently. And we had a number of things we talked about. One was requiring third party audits. There were a number of other ones, but the third party audit is the one I remember most. And this is a great, great story, because it comes from the bottom up. Harvey was a really good chairman to work for in many respects. Harvey didn't tell you what to do. Harvey told you what he wanted ultimately done, and to go back and give them options.

We explored the options, and one of the things we learned about the third party audit that's being discussed today is that it had been used to sell lots of enforcement cases. You have to have a third party consultant come in and audit your compliance with the rules or the statutes that you were violating, and make sure you have a strong compliance program.

In those consents, it says that the staff has to approve of whoever you hired. And so when we were doing the third party audit rule, which was our first option that we were considering, we went out and talked to people in the regional offices who told us that but for their ability to veto the selection of these people, the compliance consultants that come in, that this thing wouldn't work because people always hire the cheapest, because they were just doing it to satisfy their requirements of the settlement. And the people in the regional offices expressed to us a great concern that this wouldn't work at all, because we couldn't approve everybody's, and everybody would be hiring Joe's Compliance, Inc., who for fifty bucks would come in and tell you you're great (laughter) in satisfaction rule.

And so a fellow who had been at the Commission years and years said, "Bob, you know what would really help? If we went into these places and somebody was in charge." He said, "Gosh that would be an improvement." And I said, "What do you mean?" And he said, "Well, sometimes we go into these places and we say, 'How come you haven't filed your form ADV for four years?' 'Form ADV? Joe was responsible for filing ADV.' 'Joe? Joe retired four years ago.'"

And so what had happened was that there was not, in some firms – in other firms, there was very fine operating, so I don't want to cast a broad net – there was just simply nobody in charge. Everybody was in charge of something, and even the firms that were attentive to compliance, sometimes this was simply an organizational issue. And in the late trading and market timing issues, the compliance guys knew what was going on and told the executives, who did nothing. And we interviewed the compliance guys, who said, "I told my boss. That was my job. That's what I did." And we realized that the compliance people had no access to the board, and the boards didn't know what was going on. So part of the strategy in the compliance rule was requiring each firm or each fund, advisory, just to appoint some guy in charge, Joe, so that when he left, somebody would take Joe's job and Form AD would get filed.

But in the mutual fund space, based upon our experience in the late trading and market timing, what we decided is to give that chief compliance officer access to the board. The debate back then was whether the chief compliance officer should be able to work for the adviser or should be outside of the adviser and work just for the board. Our concern there was that that chief compliance officer would be in the same position that the board is, they'd be wholly dependent upon people in the advisory to tell them what the hell's going on.

And so a decision was made – Paul Roye was director at the time – that what we would do is we would allow the chief compliance officer to be the adviser where the action was. Frequently, the chief compliance officer would also be the adviser, and that would be okay, but we would require that chief compliance officer to report periodically, or at least annually to the board, which would give the chief compliance officer access to the board. We would give that chief compliance officer professional responsibilities and consequences so that if they failed to report to the board honestly what was going on in the firm, that certain professional consequences would occur, as it would to a lawyer or a doctor. The idea was that you would have professional responsibilities and not simply responsibilities as an employee. I must say, of all the rules I was involved in, this has had I think a significant effect on the asset management industry and how it's played out.

WT: This is only a couple years after Sarbanes-Oxley and all that, so was that approach influenced by what was going on in the accountants area at that time?

BP: Yes. I mean, we were aware of that, and some of these same problems that occurred within Enron and those things were similar problems organizationally that were occurring within some of the asset managers, and so I think that they were influenced. But I must say the chief compliance officer and the duties and how that's scoped out was more directly influenced by the anti-money laundering rules that the Treasury was adopting in response to the Patriot Act and 9/11, in which each firm would have an anti-money laundering officer. If you go back to the money laundering rules and see how they're scoped out, you'll see some similarities to the chief compliance officer under the Advisers Act.

WT: So concerning the compliance officer, part of my preparation for this was reading Matt Fink's book and he actually mentions this as something that ICI had been recommending since the nineties and will say that the SEC wasn't listening at that time. It was only after the scandals broke that they acted on that. Was that something that you were aware of, that there was advocacy for these sorts of requirements?

BP: Yes, they were different. They were different in many respects than what we ultimately adopted. The ultimate adoption had some teeth to them. This reporting to the boards and the single compliance officer, these concepts were I think issues that were not in the ICI's proposals before. They had an idea of a self-regulatory they proposed, and Harvey Pitt was their lawyer at the time, this was a long time before I came to the Commission, but they proposed that the SEC exempt mutual funds from paying registration fees, the 6(b) fees – tens of millions of dollars today – as long as they used those fees to develop regulatory programs. An industry self-regulatory organization, I think that's what Matt was referring to.

WT: Well, I think this was actually within companies having, I'm not sure it was a compliance officer or if it was a compliance apparatus or what.

BP: Maybe. Perhaps, but I must say in the mutual fund area, compliance personnel had been in all firms as long as I knew. I don't recall the details of the proposal, but all firms had compliance people. What's really happened as a result of the rule is that the compliance person has been upgraded. When I did my first examination of a fund, the chief compliance officer I spoke to had been a clerical employee who was promoted, and there was principally responsibility just making the filings. Today now you have the professionalization of the industry. These people have auditing backgrounds or legal backgrounds. They have offices in the executive suite, the chief compliance officer. They serve on firm committees, management committees.

Back when I came into the industry at the SEC, these people were just semi-clerical people that sat at a desk and made sure the paperwork moved correctly and the filings were made. Tremendously different today – so, there were always compliance officers, always compliance people. They were just much further down the food chain at most organizations than they are today.

WT: There was a rule in 2004 concerning the disclosure of proxy activities, is that right? Was that part of this whole –?

BP: No, that arose completely separately of all of this. This is during the tenure of Harvey Pitt, and this was during the end period of his tenure, which was fraught with his own difficulties. The institutional investor industry had been after the Commission for years to do something about proxy voting, and he decided in the mutual fund and investment adviser area that we would move forward. I believe that the Division of Corporation Finance was doing some work in this area, also. I wasn't involved in that very much. But the decision was made that mutual funds would be required to disclose how they vote their proxies, and mutual funds have a lot of assets, and how those votes are cast are important.

My particular office was asked to deal with the investment adviser side of it, but not told what to do because the mutual funds were where the fight was being played out. It was really astonishing what a fight it became, and I didn't appreciate it, when the *Washington Post* had a lead editorial titled "Our Proxies, Our Votes," insisting that the agency do this. And the industry, the ICI, led a full-throated battle against it, and they were going up against Harvey Pitt, and I'm pretty sure he had at least three of the other four commissioners with him.

But there was a wonderful scene, quite a scene at the adopting meeting, because the industry had argued that proxy votes, ballots, or these reports on proxy votes would be like the size of the New York phone book. And they actually gave one of the commissioners an example that looked like this. It was from a very large index line. One of the commissioners who opposed the rule produced this thing and said this would be a terrible disaster. The staff had gotten advanced word of it, and instead of having on – reprinted the whole thing on two-sided paper without triple-spacing it, and it looked very small. And this was for the biggest fund in the country. It was quite a scene, and that was passed.

But the mutual fund proxy voting, it turns out, didn't really turn out to be really that big a deal, because the proxy votes are all, on these reports, they're all electronic and people have access to them electronically and you can go onto the SEC website. The issue really for the Commission is that advisers can expect investor scrutiny of how they vote. And do the individual investors care, probably not, but did people like affinity groups care about how mutual fund investors invest, was academics going to do studies to see conflicts of interests, and were the mutual fund managers, who were delegated voting authority, once you are aware that what you do is going to be subject to scrutiny and conflicts perceived, people tend to behave differently.

One of the things that you've seen over the years is that the mutual fund industry votes proxies today a lot differently than they used to. Remember the Wall Street rule where they just vote with management always? Because if they didn't believe in this management, why would they be in the stock. They would just sell the stock. Well, how does that work in an index fund where you have to be in the stock, or how does that work with even a managed fund where you are essentially committed to court portfolios? If you were in a tech fund, you've got to be in Apple or you've got to be in Microsoft.

And so the fund industry is, I think, and asset managers together, are much more attuned today than they were when I came into this space to voting proxies, and will vote against management. And do they vote against management often, no, because often management won't simply put proposals forward that they know the institutional investors are going to vote against, like staggered voting for directors. And so this is one of those areas like how the sun affects the tides that the Commission has done a number of things, small things over the years that has facilitated, that has made possible a much more robust proxy voting. And that, in turn, has constrained management of corporations from doing certain things that they know the institutional investors are going to oppose.

One of those things that has become a lightning rod is the Advisers Act proxy voting, which at the open meeting, I wasn't even asked a question, if I recall. It was just the voting. It was like the B side, and the mutual fund side was the A side. But years later, it's actually the adviser proxy rule that's become the issue, at least in some commissioner's mind, because of the way some advisers resolve conflicts rather than seeking consent of clients, which is really impractical in the asset management industry, is they rely on the advice of proxy advisers. And those proxy voting advisers like ISS do not always vote with management. In fact, they vote against certain types of management proposals all the time, and there was a proxy voting round table and there have been speeches by a commissioner, a former commissioner now, Dan Gallagher, decrying the rule and the proxy voting services.

But the real role, in my view, of the proxy voting service is not to make the decisions for the asset managers, but to make it possible logistically for the asset management managers to understand what's in the interest of their investors, and to vote the proxies in a knowing way. If you have a thousand different positions and you get 500 different proxy statements in a proxy season, how can you afford to sit down and have everybody read them and analyze it and understand it? Instead, you'll get a report and a summary by these services in which you'll understand what – and they might have a recommendation, they may not. You may vote based upon the recommendation or you may have your own proxy guidelines, or in fact, in some cases the portfolio managers decide and one portfolio manager will decide to vote against and the other portfolio manager of the same adviser will decide to vote for. That's okay. But you've really I think had a slow revolution over the last twenty, twenty-five years in the proxy voting and the attention asset managers pay to their responsibilities to those clients, and I think that's improved the situation in terms of corporate democracy and protecting investors and part of the Commission's mission.

The proxy adviser rule, which I was more responsible for, was inspired, of all places, from ERISA, because remember the ERISA fiduciaries were often the manager of the corporation or affiliate of the corporation, and they often owned the same corporation stock. And so conflicts between voting proxies were just acute in the ERISA area. This, we're talking about the traditional defined benefit plan from the past where you had a guaranteed pension. And so ERISA had adopted these proxy voting guidelines, to which advisers who were ERISA fiduciaries were subject. And if you read the adopting release of the adviser release, it basically takes the ERISA concepts and imports them into the Advisers Act, so now you could manage ERISA money and the adviser money in your proxy voting obligations, and your fiduciary obligations are pretty much the same.

WT: Coming back to the response to the scandals, there was one suggestion for fees on short-term trades that didn't go through, is that right?

BP: That would have been a tax proposal.

WT: A tax proposal, okay. Probably would have gotten that from newspapers.

BP: Yes. Trading taxes, they would only affect mutual funds indirectly inasmuch as the brokers – those would be paid at the exchange level and affect the cost of trading.

WT: So is there anything then that we should think about before we go on to the financial crisis?

BP: No, I think we should go there.

WT: Okay, terrific. Let's do that. So first I guess just tell me about your experience of that.

BP: Well, it was the most profound experience I had at the SEC. You were in the vortex, the abyss. I was responsible for the money market funds, at this time working for Buddy Donohue – I couldn't think of a better director to have been working for in this crisis. Buddy had been general counsel at Merrill Lynch Investment Management and had been responsible for money market funds, and understood regulation of money market funds more than any director I've ever worked for.

We felt it coming in 2007. There were pressures. There was a large fund associated with an investment bank that nearly broke a dollar but for a huge, huge bailout. The SPVs, the special purpose vehicles, were being affected by the problems in the real estate market. We could not understand how – one finds it difficult, or I was surprised that problems in the real estate market would manifest itself in money market funds. It turns out that these real estate vehicles would issue commercial paper in order to finance the purchases of the mortgages, and essentially the commercial paper would be the leverage by which these vehicles existed. They were over-collateralized, but if the value of the real estate ownings, or the real estate-related securities ownings goes down low enough, the vehicles collapse and the commercial paper is defaulted on, and that's what was happening with these SPVs.

I had never heard of SPVs before. We had gone through several rounds of rulemaking since the money market fund Rule 2a-7 was adopted, each time dealing with the crisis that had just abated, and the crisis had abated because people had written large checks with the SPV. But in almost all of those crises, they were temporary in the sense that the bonds ultimately paid off, the commercial paperwork. When the California Public Utilities went into default, a number of funds bought out that commercial paper from the tax-exempt money market funds. But ultimately, the utilities paid off and the fund managers were made whole again. And the funds were smaller, and so the checks tended to be smaller.

But by 2007, the fund industry was nearing $3.7 trillion of assets. The funds were enormous. The positions were enormous. And the positions in the funds were highly correlated. You go back to 1991, the first rulemaking I was involved in, money market funds, we were interested in diversification of assets so that if in one position there was a failure or a default, the asset manager would be in a position to write a check because it didn't amount to that large money. Or if there was a decline in value, it wouldn't affect the ability to maintain a dollar.

By this time, it wasn't diversification, but correlation. That is, the real estate market had seeped into lots of different holdings, potential holdings of money market funds, all of which were losing value at the same time. And so the issues that I worried about twenty years earlier were a bit irrelevant. At the same time, the funds had grown so large the question was whether the sponsors had bank accounts big enough to make them whole. And so the first several funds that did this – and with the knowledge that once these SPVs blew up, there was never going to be any payoff. They were bankrupt now. Their creditors were being paid off and the no-holders weren't going to get any money back. Nobody was going to get any money back from these things.

And so the sponsors, some of which were public companies, had to figure out what their fiduciary obligations were and how they would put their money together, which was being pressed for other purposes if you were a banking institution right now. And so we got all the way to the Reserve Fund with people writing very large checks, and the staff worked with them creatively in order to give relief that permitted this to happen, because we were concerned about further destabilization of the markets. Since all the funds held similar paper, if one fund started dumping everything, it would affect everybody else.

WT: And so we're now in September 2008.

BP: So now we're in September 2008, when we were getting lots of phone calls because of Lehman Brothers, because of Bear Stearns, and we were just starting to get calls about AIG, although they hadn't gone under yet. I had formed a strike team that just simply did this. I had one woman who worked for me that just was dealing with these issues full time. I came into work early one morning, it was about 7:30, and I got a phone call by a lawyer who's startled that I answered the phone. His name was Joel Goldberg, and he was the division director who hired me many years before, now in private practice.

WT: I've spoken to him, actually, as part of this series.

BP: Now in private practice at Willkie Farr & Gallagher, where Barry is, but he retired just this year and he was a partner of mine at Stroock. He left Willkie and he and I were partners together at Stroock for six months or so. Called and he said, "Bob, what are you doing?" I said, "This is my office you just called, Joel." He goes, "It's 7:30. Why are you in?" I said, "Joel, because I knew you were going to call and it would have been rude to give you the answering machine." He goes, "Well, Bob, we've got to get serious, Bob. It's going to happen today, the Reserve Fund. I've got a fund. It's going to break a dollar today."

Buddy Donohue was on vacation in Wyoming at the time and I was the senior-most person in the division. I took down as much information as I could, and it was Lehman Brothers, we knew that. And the Lehman Brothers had, over the weekend, gone bankrupt, right? Had become insolvent, announced I believe it was Friday, and this was Monday morning if I recall. What we didn't know was who else held Lehman Brothers paper. And so as soon as the staff arrived in, we started an inquiry to find out who else had Lehman Brothers paper, but we didn't know. We had quarterly reports, which funds issued that have their portfolio schedules, but in the commercial paper world those reports are irrelevant because they could be overnight repos.

And so we had staff spending the morning trying to figure out what the exposure of the industry to Lehman Brothers. I scheduled to meet with Chairman Cox at noon about this, and Erik Sirri, the director of trading and market regulation back then, and the Commission's general counsel, to discuss what they were going to do and that they were going to be asking for or they may have been asking for. The details are a blur as to what exactly they had asked for at the time. And by the way, what I'm telling you now is pretty much in a public record because there was litigation that came out afterwards.

They needed an order to suspend redemptions, because they were hemorrhaging, because apparently everybody knew that they owned all of this Lehman Brothers paper. At the same time, the owners of the Reserve Fund were looking for a white knight, somebody to come in and buy. There was Florida municipal funds that had gone insolvent a few weeks or months earlier, and they were scooped up by another manager, I think it was ultimately Federated, and ultimately ended up managing them. So the Reserve Fund people were off looking, trying to sell out, and I believe they were unsuccessful at doing that.

So we began meeting with chairmen and commissioners, to let them know the seriousness of the situation. The Reserve Fund's position of what they wanted and what they were going to do changed over the days and then events occurred during that period that led to the ultimate litigation as to whether the reserve fund misled their investors regarding exemptive relief to do a transaction that would right the ship. That was a dispute in the litigation, because they had posted something on the website suggesting that basically they all but had their relief, when, in fact I, who was in charge of granting such relief, had not received any documents to that effect, and that was part of the litigation that I personally was caught in later.

Ultimately, the Reserve Fund did get relief from the Commission to suspend redemptions and it broke a dollar and then went into a liquidation proceeding that took over two years. It was the most painful thing I've ever seen, because there were a lot of people in this fund that would call us or call others or talk to reporters and, you know, that was their life savings, or a business who couldn't meet their payroll because they were using this.

Now, the problem is that the Reserve Fund was one of the highest yielding of all money market funds, and they were being sold based upon that high yield. In order to get that high yield, the fund took high risks, and they took it within the confines of Rule 2a-7, which, in my mind, demonstrated our regulatory inability to constrain risks like this, that tradeoff I talked about earlier in our conversation, that said you get to maintain stable NAV we limit your risks. But the rule never anticipated some of the instruments that those money market funds invested in.

And then the rest of that week after that, it was a series of steps that we thought were leading to Armageddon, because pretty soon calls started coming in from managers wanting to do bailouts for exposure to other financial services firms that everybody thought was going to be exposed. Who was next after Lehman Brothers? Was Merrill Lynch going down, AIG? The day when Lehman Brothers called, we or I, I'm not sure who, received a call from the Treasury Department wanting to know what the exposure, money market funds with Lehman Brothers, and we had no idea.

The SEC is not set up to be a supervisory agency like the bank regulators are. We didn't collect that data. We required that data to be disclosed quarterly or annually to investors. Remember, this is the corporate model, not the banking model, and so we didn't collect this data, ever. And we didn't know. Our ignorance was – people thought we knew all this, but there's a $4 trillion industry and there was like a few people doing this stuff, or understood what the rules and the regulatory implications were.

So all that week we marched towards this regulatory Armageddon, and I was able to keep in communication with the chairman and Buddy and ascertained that AIG was going to be a profound effect on – if AIG were to default, the implications to the money market fund industry would make Lehman Brothers seem like a walk in the park. And at this time, we were able to communicate this both to the Treasury Department and to the Federal Reserve Board when their staff talked to us about that.

So the Treasury Department and the Fed, whatever information they had about what the consequences of the Lehman Brothers bankruptcy would be, we were able to provide them much more about the implications of AIG. So when you hear a debate – I'm not saying this made the decision of why these were treated differently, but I'm saying we understood simply from the phone calls that were coming into the office from the fund groups in terms of the exposure to AIG, not only directly issued paper, but they were liquidity providers, they were guarantors, they had this huge role in large amounts of commercial paper-type products that were owned by the money market funds at the time, and that basically the whole short-term markets were going down the tubes if AIG were to default. We could ascertain that fairly certainly by the end of that week, where we didn't have information about Lehman Brothers at the beginning of the week, and that was communicated at this time to the Treasury.

The other thing, too, is that the Treasury Department, the Federal Reserve Board, we did not at the time have working relationships. There were meetings from the President's Working Group that I attended and others attended from time to time. There were disputes that we had to work out over issues from time to time. But we had no ongoing working relationship, because unlike the banking agencies which always had to do some things together, the SEC didn't regulate the banks; the banking industry, they didn't regulate the securities markets. That presented a real problem in terms of Washington coming together and dealing with this crisis, because ultimately people who found me as the money market fund guy didn't know me, and they went through the switchboard until they finally found the guy who knew something about money market funds.

So that's one of the things that Dodd-Frank tried to correct for, and the President's Working Group was reinvigorated and started dealing with these issues, and so I spent an awful lot of time in my last two years at the agency with counterparts at the other agencies in developing working relationships in which we could overcome the really serious turf issues, which most of our interactions have been fought over in the past, to work together towards these issues. As I used to point out to people all the time, we had regulatory authority over the money market funds, but we were the regulator without a checkbook and we couldn't make these issues go away. We didn't have the resources or the tools the way the Treasury Department and the Fed did in these large market issues. It felt like the money market funds were like a small ship sailing on the sea, being rocked by some heavy waves.

So now to the next part of our story, and this is absolutely the most interesting point to my whole crisis –

WT: Before you get onto that, I just want to ask, throughout this period that you're talking about here –

BP: One week.

WT: One week. Had the threat of runs on funds manifested itself at this point?

BP: Yes. Well, there had been threats all during the previous year and one run on a large fund that was written, an investment bank wrote a $7 billion check to buy out all of the asset-backed securities out of the fund.

WT: It was in the consciousness.

BP: It was in the consciousness. And don't forget you had now, at the beginning of the week, fund suspend redemptions and we knew that there were funds throughout the industry experiencing very heavy redemptions because everybody said if it happened to the Reserve Fund, how do I know it's not happening to my fund? Well, you'd call them up and they said, "Oh, everything's fine." Oh, sure. Nobody believed anybody, and this is what happens in a panic. Nobody believes everybody. All people knew is that there were two classes of investors to the Reserve Fund: people that got out before the fund suspended redemptions and people who got out two years later from the fund. What prompts a run is the knowledge of that position. There are no costs to getting out today. Tomorrow, who knows? And that's just very similar to a bank run.

So, Thursday night, about 6:30 in the evening phone call. “Bob? I’m Tony Ryan. I’m Assistant Secretary of Treasury, and you’re on a speaker phone with about forty people in a room.” I called the chairman, but he wasn’t in. (Laughter) “We have some questions here.” And he said, “First of all, you have to keep this confidential.” I said, “That’s what I do. That’s okay.” And he goes, “Tomorrow morning at nine o’clock, the Secretary of Treasury is going to step out into a conference room and announce that the Treasury Department is guaranteeing money market funds, and this is how we’re going to do it. And Bob, I need to know whether there’s anything in the federal securities laws that will prevent the Treasury from issuing the plan, because the Secretary of Treasury does not want to be made a fool of.”

I don’t think he used the word “fool.” I don’t want him to send it out if I have to put out a press release later in the day saying, oops, I can’t do it. And he wanted an answer now. He goes, “He’s going out tomorrow morning, Bob.” I told him I thought there was nothing in the federal securities laws, and if we did, the SEC would be able to deal with it. There was no opportunity to either think about it or to consult with colleagues, and I had just learned that the chairman was not available.

And the next morning, the Secretary of Treasury, Hank Paulson, came out and gave that announcement, that the Federal Reserve board would open up liquidity lines that the funds would have access to through the Federal Reserve banks, which would try to normalize liquidity of the markets. And the amount of redemptions the funds were experiencing immediately began to recede, and that was just, you could see the power of government work to stem the tide.

This the thing about bank runs. It's not like private entities can stop bank runs. Only a massive exercise of national authority at times of distress can create the confidence that if the Secretary of Treasury steps out in the microphone and says "we will," that is good as law. But I didn't realize until later that day, when the then-assistant Secretary of Treasury called back, that well, this was great, but we don't have the guarantee. We've got to figure out how to write one. We've got to figure out what's going to provide. He goes, "Could you come over to the Treasury for a meeting?"

Because in an emergency – and I truly respected these people. This was the Republicans, with the Bush administration still, and there was no time. They needed to figure out if they had plausible authority to do this, and there was some very creative lawyering and risk-taking going on, but the stakes to our economies were so enormously high. Buddy Donohue got back to the office by then, and then we were helping Treasury craft a guarantee contract and help them understand money market funds. We were the experts that were brought into Treasury. We were an independent regulatory agency and there was a series of long meetings and drafting sessions, usually starting on Sunday morning and going into Sunday evening sometimes, where the guarantee contract and the details of the whole system were hammered out.

Treasury then came to us and said, “Would you help us administer this, manage this system? You know, we don’t have very many people over here.” And she goes, “But Treasury has thousands of people.” Oh, yes, but they’re all over at the IRS or the Secret Service and they can’t – so we actually administered, helped them administer the program and worked very closely through the crisis with Treasury, some lesser extent with the Federal Reserve Board, but a lot of talking in terms of managing that crisis. Meetings in rooms where most of the people in Treasury would be, or many of them, would be political appointed levels just below the secretary, and Buddy and I would be the civil servants showing up. But in a crisis in a foxhole, you know what they say, everyone prays? Those distinctions and the nature of the different agencies we worked for and the statutes we administer all of a sudden went away.

It was one of the most interesting and exciting, even though exhausting, experiences of my professional career. Which later led to the development of the FSOC when Dodd-Frank passed, which led to the involvement in issues dealing with money market funds post-crisis by the Secretary of Treasury and the chairman of the Federal Reserve Board themselves, where we or the staff made presentations to them in terms of the states of the markets and the regulatory initiatives that the SEC were proposing to deal with the fragility of these markets. At the same time, the Treasury Department and the Fed consulted with us before they did things to make sure they understood the money market fund industry, how whatever they did would affect or be affected by the statutes that regulated money market funds.

WT: So this then begins a protracted process of developing new rules for money market funds.

BP: Well, the first thing that happened is a new chairman came in. Mary Schapiro, after this crisis, came in and the first thing she said to us is, "I want rules, amendments, and I want them next week." I exaggerate, but she recognized immediately she was not an expert in money market funds by any means, although she would become one over time, but she also recognized that this had profound implications on the Commission's regulatory program and the Commission as an agency. This was pre-Dodd-Frank. People were talking about folding the SEC into other regulatory agencies. This was clearly a space in which we had responsibility for, and it had not gone well in 2008, and she wanted us to come up with recommendations to her and she wanted rulemaking done with posthaste, which again, like lawyers, as long as their families don't care to see them very much and don't care about weekends, they can do anything.

Proposals were up to the Commission and proposed in 2009 and adopted in 2010. At the same time we were all working on Dodd-Frank and drafting parts of that, we were writing these money market fund rules. The rules were proposed and I don't know if they were adopted before, but about the same time that Dodd-Frank was, and one of our goals was that Dodd-Frank not have a section that dealt with money market funds.

WT: Yes, I wanted to ask about this. This separation, why wasn't it part of –

BP: Because the SEC was – and this was really brilliant, Mary Schapiro understood this. I did not. I must tell you, at the time all I knew was I wasn't going to have as many weekends home as I would like to have, and I was exhausted as a result of the crisis that had finally abated. But I think Mary understood that the Commission had to move first, or Congress would do so in a way that both harmed the SEC as an institution and probably would just screw things up anyway if it comes out of some committee, and that if the SEC came forward and were thoughtful, that we could argue to Congress that we had things under control.

But the problem was that we didn't, frankly, know what to do because the issues were so profound and they were so tied into the stable NAV and the use of money market funds as alternatives for bank accounts. It's nothing you can write a rule and change overnight, and there are so many options and so profound consequences for the markets and for investors and financial markets, what we did, we decided to do the rule in two parts. This was somewhat of an ill-fated decision, as it turns out. The things that we knew we could do, we knew we needed to do, and the things that we could do, we would do first. And the more profound structural changes that contributed to the instability of money market funds, we would do second, once we figured out what to do.

Because remember, we had lost these court cases. We had to do a cost benefit analysis. We had to have empirical data, and there was nothing at this point. I remember George drafted the rule, we got in comments from the general counsel's office wanting a footnote for essentially what were market observations of what was going on during the crisis, and

I had to explain to the lawyer in the general counsel's office that we are writing history here; I have nothing to footnote. You know? This is what we saw. That was hard for them to get their arms around.

But we were writing rules to correct a system, but nobody had fully analyzed the crisis and understood, and the academics who would be writing papers debating these issues had not begun to put pen to paper, and I was not ready and I don't think Buddy was ready to say what the solution was. So we did it in two parts. The first part was done. And then of course, once it was done the industry used the successful completion of the first part and said, "Oh, there's nothing more that needs to be done in the industry." And as you know, those rules, ultimately, I believe it was in March 2010 that Schapiro ultimately had to withdraw those rules. They were never proposed.

WT: The second round, right?

BP: Yes, the second round, that the industry recovered quickly from the crisis in the first round, and developed quite a powerful pushback against any further changes.

WT: Now, the first round was primarily amendments to 2a-7?

BP: Yes. But they didn't structure. The money market funds looked pretty much like they looked before. They still had a stable NAV. They still were redeemable on demand. The structural characteristics of the money market fund that contributed to there being a run didn't change. There were more liquid securities in them, so it could sustain more of a run than it did before. But once a run starts, there was nothing there to stop the run. It just took a little bit longer until the assets were gone. And who knew what the next run would look like, in any event?

So we knew we hadn't made the structural changes that were needed, and we essentially – I expressed to the industry a number of times at conferences, and we had entered into a protracted negotiations with the industry to try to come up with solutions which everybody could agree, but we never were able to achieve that. Mary decided to go forward, Mary Schapiro, and it was going to be a 3-2 vote, because the Republicans had already announced that whatever she was going to do they were going to be against. And then one of the Democratic commissioners announced that he would not support even a proposed rulemaking, which is highly unusual, because typically the tradition of the Commission is that you may be highly skeptical of a proposed rulemaking but vote for it because I want to hear comments. And if you're of the same party as your chairman, it would be unheard of to vote against a proposal. He could have simply announced, but I suspect that there were other issues that were in play here that were personal.

WT: Now, the outlines of the proposals were public. I mean, there's the idea of the floating NAV and –

BP: Well, yes, the options, I have spoken in industry conferences and we had meetings where the range of options that was in front of us was clearly transparent. We didn't used to do this rulemaking this way, but we needed input from participants to understand what we were going to do. We didn't feel we could do this in our secret rulemaking laboratory and then just spring it. So we socialized our options extensively with the industry, that being a very good government thing to do but perhaps strategically a blunder, perhaps, because the industry then could go to the commissioners individually and draw doubts, whereas in the past they wouldn't have known. It's kind of hard to go and argue against a proposal when you don't know what it is. It's after the proposal goes out when you'll have your opportunity to do that. Here, because we were so transparent, there was opportunity before that.

And we had been losing lawsuits, because everybody was threatening to sue also, which has become Washington game now. And we had pressure from the FSOC and the financial regulators, who essentially, the Treasury Department and the Federal Reserve Board had to bail the SEC out from its money market funds the last time and certainly didn't want to be in the business of doing that again. Congress had passed two separate pieces of legislation, the TARP and Dodd-Frank that restricted the ability of the Treasury Department to do a bailout like this. That was in TARP. In the Dodd-Frank, it restricted the ability of the Federal Reserve Board to provide those liquidity programs that it did.

So from my perspective at the SEC, whatever safety net of money market funds there was 2008 had now been eliminated. And so there were two proposals. One was to go to a real floating NAV, so the idea is that they'd treat them like the stock funds and the bond funds. The other idea was to create some capital like a bank has, so if a mutual fund were to issue a subordinated class of debt they would be the first losers. They would be the risk capital, and the rest of the investors would have to pay out of their yield the cost of that capital. But the institutional investors who would own the risk capital and would be subject to first loss exposure would supervise the investment adviser.

Part of the problem with money market funds is everybody owned the risk and nobody owned the risk. And therefore, the Reserve Fund investors didn't ask why am I being paid the highest yield, they were simply enjoying it without looking and understanding the risks that were being assumed, because after thirty or forty years of advisers just writing checks to bail out the funds, why should an investor inquire into the risks when I can expect, like all the other investors, to be bailed out. This is the moral hazard risk. So what we would do in the proposal is to transfer that moral hazard and pay somebody to accept it that had those risks, with the assumption that those people would exercise supervisory authority over the manager.

So the Reserve Fund went from being a very risk-averse fund to being a very risky fund over a two-year period. If you had a subordinated class of shares that bore those risks, it would have demanded greater returns on their capital, a greater risk premium. What we wanted to do was to structure money market funds in such a way that the markets imposed regulation rather than SEC regulators, trying to anticipate the next financial crisis. In addition, we had some other risk capital on investors that if they redeemed and the fund went bankrupt, more like the Reserve Fund, there would be a living will, and the investors who stayed in the fund would get a greater portion of the assets that are left, and the ones that participated in the run would get less because they contributed to the losses, as opposed to the ones that stayed. A lot of people in the industry didn't like that.

But I think what the tragedy is it should have been proposed and vetted. The industry didn't want any rulemaking, and they believed I think in the Romney administration that there wouldn't be rulemaking. That didn't play out exactly, and so now they've got the floating NAV and they got the fees and gates that are going through now.

WT: So should we do any more with this particular topic?

BP: No, because I left the Commission shortly after. (Laughter)

WT: Right, right. I was thinking that we were getting about to that time.

BP: So my last year was spent finishing all of the rulemaking of Dodd-Frank. I stayed there, and during this period I was completing, the money market fund rulemaking blew up. But there were three or four important pieces of rulemaking which I did, which is the registration of the hedge funds, which is very big, very complex rulemaking; the NSMIA II, which is the reallocation of advisers back to the states now from 25 million to 100 million; and Form PF, which is the form that collects systemic data from hedge fund managers and others, and so all of the rulemaking, pretty much from Dodd-Frank, all that was done. The money market fund regulation had blown up, didn't look like it was going anywhere. Mary Schapiro had not announced but was about to announce that she was leaving, and I decided that I had done everything that I could do in this career. So I actually was eligible to retire, and I did.

WT: I wanted to ask, did the Madoff scandal shape the rules in any way, or did it make the going easier because of the apparent need for regulation particularly in the private fund area?

BP: We didn't talk about the Madoff scandal, and it's kind of a big event that occurred before Dodd-Frank. That was one of the most traumatic events that I saw, and to the Commission, because we didn't find it and we came close. On the other hand, you read any of these good crime novels or even true stories about the FBI, how close they come to busting some cartel or some gang and they missed it just by –

There was the disastrous testimony of the Commission staff before the House Committee, in which we were berated. There were consequences in Dodd-Frank that were unfortunately, the independence of the SEC was almost lost. There were provisions in Dodd-Frank that penalized the SEC in some respects, and our political position in that legislation was significantly weakened by Madoff. But the morale of the agency was seriously, I think, shook by Dodd-Frank. The agency, particularly the examination program, had a serious management problem now. If you were going to examine advisers, it was inevitable that you were going to miss something. How would we persuade our examiners ever to close an examination if they were afraid someday of being interviewed by CNN in their grocery store? You know, aren't you afraid, I mean, it was just traumatic. Not only that, but some people were hiring lawyers, and people were being called to testify by the inspector general.

And so all of this was going on, and I was called in to testify to the inspector general. I didn't hire a lawyer. Maybe I should have. And there were these congressional inquiries going on, and so it was traumatic. How this affected me in our program, Madoff was a broker-dealer who was conducting this Ponzi scheme for twenty-five years, the last two of which he was an investment adviser. And he had to register as an investment adviser because of one of the rules that the Commission adopted having to do with broker-dealer and investment advisers. We didn't have a chance to talk about it and we're going to have to pass on that one, but it said, basically, that brokers with discretionary accounts have to treat those accounts as advisory accounts and register as advisers. That caught Madoff, because FINRA, everybody knew that he had discretionary brokerage accounts, but they didn't have to be registered advisers. He registered as an adviser, and by the way, the court overturned that rule, too.

Anyways, the scandal blew up and to this day, I believe – and the question is who is responsible for this failure, and fingers were pointed all around. Was it a broker-dealer scandal? Was it an adviser scandal? He said he was a hedge fund, but he really wasn't a hedge fund. These were equity-funded brokerage accounts. And so if they're really brokerage accounts, they were FINRA's and trading and market's responsibility. If they were the hedge funds, well, whose responsibility was this? He's a registered adviser, but it was only two years. We never got around to examining him as an investment adviser.

The Enforcement Division had been in, didn't find anything. FINRA hadn't found anything. Examinations hadn't found anything. They missed obvious things. There was that guy who submitted the – Markopolos, who submitted his bill of accusations, which are now taken as gospel truth. I never saw it. The problem was it never got to the headquarters of the SEC so that people that understood these markets could read them. But if I had gotten them on my desk, the first two pages, the guy seemed a little unhinged, and I suspect that's the way the people who read the memo took him. He was unhinged and they didn't understand. If they read past the weird things he was saying in this first page paragraph, and they understood the markets, they would have understood that there was trouble in River City. But, that's not history.

But anyway, Chairman Schapiro, who had been in charge of FINRA, announced that this was an investment adviser regulation failure, and we had to tighten up the custody rules because the problem was that he had custody of all this money. Well, how did he have it? Somebody else should have had custody. And so we had the investment adviser custody rule, which had been completely revamped in 2003, six years earlier, I now had to rewrite to make much more rigorous. And today, in private practice, I deal with the legal consequences of how easy it is to violate the custody rule, even by people who are meaning well, because it's a complex and difficult rule to deal with. So that's how, in my world, it played out. But I think the agency, it was one of the biggest missteps the agency I think had ever made, and it was painful.

WT: Well, I think we've covered the highlights here. I'll just ask you in closing, you spent almost all of your career at the SEC. Some people move in, move out, and they'll discuss the utility of seeing things from the private sector side and then seeing things from the public sector side. Could you discuss the utility of having people who are there long term, what they learn, what they in particular bring to the table?

BP: I think it's terribly, terribly important that you have a mix of both kinds of people at the SEC. First of all, you have the new people who are coming out of law school or just people who are junior lawyers coming over, but also that you have people that come over for some time who have industry experience to teach those people, but the long-term staff has the institutional memory of when things were tried and it didn't work, or where the bodies are buried, or how to get things done. And people who were in my role still at the SEC, they have new division directors that come in from various places. Rarely these days are division directors elevated from the staff. And they're relying on the experienced career professionals to explain to them what their options are under the statutes that they administer, and how their ideas fit into everything else.

During the crisis, the senior staff at the SEC provided the infrastructure of the decision making. We didn't make the decisions, but the commissioners, the chairmen, division directors that come in from the outside understood what the scope of our authority was, where various issues rub up against each other, and what are the types of options to do the statutes and all the precedent we have provide for them to make decisions. That's why I felt it was a very important and fulfilling role, and my successors are providing that.

Now, you know, and you hear this all the time in the criminal justice system about career prosecutors, somehow they're treated as – but, you know, career regulators play a very similar role, although mostly they're kind of considered faceless bureaucrats who don't know anything. But yet, I'd like to think that the career staff at the SEC provides – it's often a moderating influence, also, on – commissioners, say, tend to be Democratic commissioners who believe the agency can do, or government can do more than it really can.

On other commissioners sometimes, more frequently recently Republican commissioners, who may not always appreciate the successes the Commission has, and the Commission really views itself as the umpire in the markets, that the two teams are going to play ball. But the participants in the markets, a good-functioning market, just like a good functioning baseball game, needs an umpire, and that sometimes it's more important that you have an umpire than the umpire calls every ball and every strike correct, because if you've ever tried to play baseball without an umpire, it's not a very enjoyable game.

WT: All right. Well, thank you very much. Just for the sake of anyone reading the transcript of this interview, I'd like to just note your positions at the SEC, just so they have the facts there. So you were assistant director of the Division of Investment Management from '88 to '96. We covered that. Then you were associate director of the Division of

Investment Management from 1996 to 2011, and then deputy director from 2011 to 2012. Then, at that point, you retired and came here to Stroock?

BP: Yes.

WT: All right. Well, terrific. You've given us a lot of marvelous material, good insights, and I thank you very much.

BP: I appreciate it.

[End of interview]