Securities and Exchange Commission Historical Society
Interview with Andrew M. Klein
Conducted on October 15, 2002, by Richard Rowe

RR: This is an SEC oral histories interview with Andrew Klein, former Director of the Division of Market Regulation at the Securities and Exchange Commission. Andrew, we're glad to have you here. Today, by the way, is October 15, and the time is approximately 2:40.

AK: I'm delighted to be here.

RR: Andy, why did you choose to come to the SEC out of private practice and when was that?

AK: I came from a small firm in New York that was heavily involved in what used to be a staple for law firms, Securities Act practice, representing reporting companies, putting together underwriting documents for them, dealing with offerings, mergers, acquisitions, that sort of thing. A substantial part of that work, in terms of reporting obligations, preparation of proxy materials and periodic reports, had been in the hands of outside counsel for some time, but public companies began to internalize that work, and I think it dented my old firm and, I'm sure, a number of others.

An exciting part of that period for me was being involved in one of the very early takeover efforts by a client of ours, General Host Corporation, which went after Armour and Company. At that time, Skadden, Arps wasn't much bigger than my little firm, and we worked with them on that deal. Armour, of course, did not want to fall into the

clutches of the dreadful little baker and sold itself to another enterprise, but it was quite an adventure and an enormous expenditure of effort, covering new territory under the then barely formed takeover laws. So, I loved that stuff. I loved the SEC work that I got to do at that firm. As securities work began to drift away from it, however, I found myself up to my neck in leveraged lease financing of very large liquid gas carriers [tankers] for Japan Lines, and that sort of thing. This did not romance me at all. Fortuitously, a friend of mine had moved to Washington to becomes a legislative assistant to Congressman [Robert F.] Drinan. His brother was a staff member of the SEC.

I visited Washington to see how my friend was getting along in his work for Congressman Drinan. This was just prior to the days when President [Richard M.] Nixon got into real trouble. My friend's brother introduced me to John Liftin indirectly. John at that time was Associate Director of the newly created Division of Market Regulation, which had been part of the Division of Trading and Markets when enforcement and market reg split. John was looking for more New York-type lawyers to bring down to the staff. I was working on some tanker financing stuff in London. My then wife was beating me over the head about staying in London too long, threatening to come over, pregnant as she was, on the next flight to Heathrow, and I was going to have to do something about it. About the same time, John called me in London and told me that they wanted to hire me and had gotten me cleared as a GS-14 something or other. I

remember sending a telegram back to my wife, saying, "Don't come. Rent house. Find one in Washington." That's how I came to Washington.

RR: Your experience up until then had been in what I would call '33 Act [Securities Act of 1933] work and some takeover work and the esoteric of tanker leases.

AK: Exclusively.

RR: And you ended up in a new division, the Division of Market Regulation, which was dealing with or would eventually deal with a new statute, which was, I think, probably by then wending its way through Congress.

AK: In pieces, it was.

RR: In pieces the 1975 Act Amendments, so it's an entirely new area that you're getting into.

AK: It was all that. The only thing I knew about the New York Stock Exchange was the Department of Stock List, where I had dealt with Mr. [Richard A.] Grasso, who was then in charge of that department. That was it. That was my whole contact with securities trading. Well, and, of course, the impingement on trading activities during underwritings that the Rule10b-6, 7 and 8 series imposed, but I had never really had to be involved with that in great detail. It was brand new to me. It was fascinating. The position that I had was Special Counsel under John Liftin, as Associate Director, who was in charge of

market structure. John, I gather, although there may be other claimants to this, said that he was the author of the infamous white paper of the SEC on a central market system. That's quite a piece of paper, actually, and I read it avidly. I also was given Harvey [L.] Pitt's Rule 19b-2 masterwork, a release that transformed how the SEC wrote proposing and adopting releases for SEC rules. He put that together while he was Chief Counsel for the Division of Market Regulation.

We were fussing around with questions like foreign access to exchangesCthought to be an enormously complex and controversial topicCand institutional membershipC something that Bill Casey had thought he's put to bed with Rule 19b-2, but that got involved in litigation with the Philadelphia Stock Exchange, which had permitted broker-dealers with institutional affiliates to join that exchange. Fixed commission rates were under attack. These were matters that rarely showed up in newspapers, but that were fairly significant issues. They arose under an establishment set of rules on the exchanges and an historical reluctance on the part of the Commission to tamper with things coupled with serious constraints on SEC authority under the then [Securities] Exchange Act [of 1934]. It was a lot of brand new material to read and to start to deal with, and I did that with some gusto. It was pretty interesting. It's interesting still.

RR: Bill Casey. Was he still there when you got there?

AK: He was out. We were between Chairmen. I think this was in the [G. Bradford] Brad Cook disgrace period. There was no Chairman. We were anxiously awaiting the arrival of Ray Garrett [Jr.] from Chicago, who became a wonderful Chairman of the Commission and whose fellow Commissioners all were a distinguished group.

RR: And was Lee thenY

AK: Lee Pickard was Director of the Division. He had, I think, two Associate Directors. One was John Liftin, and I have forgotten whoCI guess Sheldon Rappaport was the other Associate Director, and was the one most intimately involved with such oversight of the self-regulatory organizations as the SEC maintained at that time, which was on feeble legs. It was not an elaborate program. You'll recall that the SEC had a rule of questionable validity that required exchanges to file rules with the SEC after they had been adopted. There was a curious practice of writing letters of non-objection to rules that the exchanges sent to the SEC. There was no procedure such as the onerous onesCthat is, onerous compared to prior practiceCnow applicable, where SROs [self regulating organizations] are forced to file their rules for approval by the Commission, and a rule either has to be approved as consistent with the Act or rejected as not consistent. All that apparatus was lacking.

There was a little limited menu of things that the Commission could become involved in with respect to the rules of exchanges under old Section 19. One of themCand it had

taken years and years for them to figure out that they weren't doing a good job of itCwas that the Commission could do by order whatever was necessary to assure that there were reasonable rates of fixed commissions.

RR: You used the word, "Fixed."

AK: Fixed. There were lots of hearing on the topic predating my arrival at the SEC. We were in the middle of another one when I arrivedCand it became the last one. It turned into a hearing not just on commission rates, but on market structure. I think the conclusion at the staff level was, and ultimately the Commission's conclusion was, that they couldn't find a reasonable basis for fixed commissions. It's amazing to think that it took from 1934 until 1974 to figure that out, but it did.

RR: Although someone has said recently that the demise of fixed commission is the cause of a lot of our problems in the market today, because that took away a great source of income and pushed the firms over to investment banking and other more lucrative ways of making money, and . . .

AK: It's hard to come up with a defense for why there should have been fixed rates of commissions. It's particularly hard to figure out why an institutionCas it was in the old days before there was a discountCif you recall, we went to unfixing commissions in a staff here finally there was something resembling a volume discount for

institutionsCtrading 100,000 shares ought to pay the same commission per share as someone doing 100 shares. It wasn't a sufficient explanation to say that there was much more work to do the 100,000-share trade. Of course, there probably was a great deal more work to do the 100,000-share trade, but it was hard to put your finger on something that said these people ought to be paying the same rate per share. It was just not a very rational structure and hard to defend.

There's no doubt but that there was an incredible consolidation in the securities industry after fixed commissions were eliminated, but there was consolidation in investment banking as well. There used to be a number of relatively small underwriters. I'm not sure they were living on fixed commissions, but perhaps they were. But the "big firm" became the answer to how to do capital markets business, takeovers, mergers and acquisitions, and I think finance became concentrated in New York to a degree that probably had never been experienced in the United States before. But it's hard to blame it all on the unfixing of commissions.

The unfixing of commissions became a popular banner, waved by all. You know, one of those things where it became very unpopular to defend fixed commissions, which were seen as monopoly rates charged by a monopoly institution, the New York Stock Exchange. There weren't fixed rates for people trading over the counter. One wondered why fixed commissions were thought to be necessary to sustain life, why grass would grow on Wall Street just because you unfixed commissions. In fact, grass did grow

everywhere else once commissions were unfixed but not on Wall Street. So that was a key economic element in breaking up the way the securities industry was structured before, no doubt about it. But there were other elements as well. I mean, the admission toCwell, I suppose I should, instead of getting off on those separate issues, simply say that the Securities Acts Amendments of 1975, composed of separate pieces of legislation on the Senate side and one unwieldy mass in H.R. [House Resolution] 5050 in the House, did get at, in one way or another, all of the thorny issues in the deck. Institutional membership used to be a big deal. I've referred to it before as a way in which an institution, by forming an affiliate broker-dealer and joining the exchange, would basically beat the fixed rate, because they'd internalize their orders and put all the business through that affiliated broker. Foreign access was a big deal.

Well, as soon as you decided that you had to have rational standards of membership and not be discriminatory in giving people access to membership, it was impossible anymore to keep foreign-dealers-dealers out if they were willing to subject themselves to U.S. broker-dealer regulation. It got at fixed commissions because they were barred by statute unless the SEC made certain findings, and the findings were impossible to make. It sort of has to be, "You can't have fixed commissions back only if that's the sole way to save the known universe, and you have to find this in an on-the-record proceeding." Well, no one's ever taken up that challenge. The new law also totally changed the way self-regulatory organizations worked, forcing them all to file their rules and to bear the burden of enforcing the Act, the Commission's rules under it, and their own rules, absent

reasonable justification or excuse, something that the Office of Compliance Inspection and Examinations] just loves these days. I think they're going around telling all exchanges they're not doing a good job of that.

But there was no such lever under the old Exchange Act. Enforcement of self-regulatory organization rules had never been within the SEC's jurisdiction. They didn't have enough direct power over self-regulatory organizations, enough hooks on how they made changes in or enforce their rules to really get them to do anything until the '75 Acts Amendments were passed. The changes were necessary, as I think Stan Sporkin would have put it, because the SEC had to leverage its influence through others B those who could hire more people than the government could to do this job. I think that SEC oversight of the self-regulators has been much more effective since the passage of the '75 Act Amendments. There are only really two securities regulators, in addition to the Commission today, that's the New York Stock Exchange and the NASD.

RR: And Elliott Spitzer.

AK: And Elliott Spitzer, who is playing an interesting role in New York. But it turns out that not all of the self-regulatory organizations were ever actually asked to shoulder that enormous burden of regulating all of their members. They were able to farm responsibility out to the NASD and NYSE by agreementCthat is, to self-regulators who had more money and more people to throw at the problem. There are residual regulatory

responsibilities in the regions, where the regional exchanges are still responsible for regulating their own floors and inspecting and enforcing with respect to that. All the rest of the business of the member firms is something that the NASD and the New York Stock Exchange must and do oversee. But before, no one was enforcing those self-regulatory organization rules in any rigorous or regular way, and there was no satisfactory government oversight prior to the 1975 Amendments. So that law brought about very significant changes in the infrastructure in the regulatory system for the American securities markets.

It was tremendous to be in on that at the outset, dealing with those separate pieces of legislation and helping to write comments on them. In fact, I think I probably wound up ultimately being one of the lead writers of all of the Commission's comments and testimony on those bills and on the '75 Amendments into which they finally were merged. Then it became my job on the staff, with Bob LewisCJohn Liftin had leftCto implement them, and merrily set about doing that. Of course, one of the great and mystical causes in the '75 Acts Amendments was the creation of a national market system. There is a wonderful set of principles meant to animate that system laid out in Section 11(A) of the Act, each of which would seem to be in conflict with each of the others. All of them somehow or another express the purposes of Congress and embrace the idea of a national market system. We went on to try to solve these problems. Some of them were informational, that is to say, getting a consolidated tape of last sales and getting up a consolidated quote system. Those were ideas that had been in the hopper when I arrived,

but they had the most slender of holds on authority and the thinnest of explanations. I think [Irving M.] Pollack was probably behind the initial drafting of those rules. We wrote somewhat more complicated rules, and went through a long war with the NYSE to force them one way or another to figure out how to work with the other exchanges to produce a consolidated collection of last sale information and to disseminate it on a real-time basis. We went through the same exercise with quotations. Both objectives actually got done.

We were concerned about where brokers directed orders, something that preoccupies everybody to this minute. We had initially through that maybe there was a way to force broker-dealers to take into account and be guided byCwe were very naïve in a lot of waysCthe best bid or offer prevailing at the time they sent orders off to be executed. There were impediments to that, however, that were finally made clear to us. How the business "actually" works is something that staff can eventually be persuaded of, but the staff often will start out with ideas of its own, and probably should.

RR: Yeah. When you came there, you and most of the other people in the division, which was a new division, were reasonably young and not experienced in this kind of regulation. Shelly Rappaport was probably the institutional member in the division.

AK: He was and Marty Moskowitz. They were. There was, of course, the 1961 Special Study [Special Study of Securities Markets] produced by Milton Cohen to rely upon, and there

was a good deal of interesting material there. And what was true in 1961 was very much still the case in the early seventies. But there was also later stuff to read. There were people who had published this or that article, economists and academicians, trying to kick the machine one way or another into a more rational future. There were all these popular targets: fixed commissions, the lack of adequate market information in the hands of anybody but the people on the inside, bloc trading, problems of exclusionCpreventing people from being able to participate, at least as membersCfrom the markets. The other old sawhorse was off-board trading rules, which constrained competition by members of exchanges by preventing them from transacting in listed securities off-board.

That last one took up quite a lot of time to try to unlock. It has been unlocked now. Those old rules finally have fallen away, almost of their own accord, after decades of feuding over whether or not such rules served some valuable purpose. At the same time, the over-the-counter market grew enormously as Nasdaq came on and you saw the disappearance of independent brokers over the counter. Everyone internalized their order flow, dealing only with their own customers and giving them whatever execution they could get away with that maximized their over-the-counter profits.

It's those latter problems, the problems of internalization and the problems of best execution that I think have preoccupied the Commission in the decades since I left. We thought that there might be a meaningful solution, when I was back there, if we could figure out how to compel brokers to direct their orders to the best market.

Well, how were you going to know what that was? You worry about how to define itCdefine best execution, that is. That began serious chewing on those issues. If they had been simple, I would have thought they'd have been solved earlier than now. I don't think they've been solved today, but people are farther ahead, I think, in addressing them. Technology had to catch up. We thought technology might be able to do everything in the seventies. Well it probably is almost capable of doing everything now, but it certainly wasn't then. So the ideas were a little ahead of realityCahead of what was feasible to ask for at that time. But gosh, it was a great adventure.

RR: How many Chairmen did you serve under while you were there?

AK: Well, as Director, only under Harold [D.] Williams, and before that, let's see, Ray Garrett became chairman after I arrived as special counsel. Who did we have in the middle there? I've forgotten who succeeded Ray.

RR: [Roderick M.] Rod Hills.

AK: Who?

RR: Rod Hills.

AK: Rod Hills, exactly, and then, I think, Rod was succeeded by Harold. So yes, I worked under Rod Hills as well.

RR: Well, Ray Garrett wasn't a market person. He had actually come out of the public utility holding company group, when he was at the Commission. Did he just sort of give Market Reg its head and let them go, or . . .?

AK: Well, that would be putting it too strongly. As I mentioned, as a result of the fixed commission rate hearings and market structure inquiries that were ongoing before I even got there, and the whole process of formulating the Securities Acts Amendments, there was enormous complexity and growth associated with all of these ideas. There was some resolution and some direction in the Securities Acts Amendments of '75, but no menu of complete answers. It was hard to come on board as Chairman with all that a Chairman has to do and somehow suddenly become expert in all those things. I mean, that wasn't realistic to ask for.

I've often thought of asking Harvey Pitt—but I'm not sure I'd get a candid answer even though he must remember being there through much of all of that stuff—whether he regards himself, to this day, as an expert in all those things. I think it must be hard, even for him, as a Chairman, to have a handle on the complicated, interlocking things that are going on in the securities trading markets. And the Division, young as it was, seemed to have such experts as there were, people who'd thought about those things longer than

other people. There was intellectual conflict within the Division and the Commission's staff as a whole at that time, when I was with the staff, and productive conflict.

Everybody could take a shot at any idea. That was true throughout the staff. For how many years did cross memoranda, written by all the Divisions about any idea that interested anybody, go in front of the Commission? There was a sort of a discipline in the staff where you didn't run off and try to do wild things in the Commission's name without having the Commission's direction to do so that I'm unsure prevails today. Sure, there was delegated authority, but perhaps not as broad as the authority that has been delegated in the last ten or fifteen years.

Communication with the Commission, with the Chairman and the Commissioners, on tough issues generally happened with some frequency. When there was an issue where you really had to go one way or another, you'd do your best to explain it to the Commission and get direction. Everybody had a crack at it, and it wasn't perceived that a Chairman's direction as policy setter was much needed. In market regulation, most of the relevant policies had been worked out before and the SEC had finally just gotten new authority to implement them embodied in a statute. I don't supposed the first thing a new Chairman who didn't know anything about the topic thought of doing was to say, "Well, I actually have some different principles in mind. Maybe they shouldn't be the ones Congress just spent time enacting." People were sort of reading from a Congressional script, and there hadn't been enough time yet for things to be worked out to such a degree

that one could say, "Well, you know, there's another way to construe that provision and another way to try to administer that section.' And certainly Rod Hills was not in a position, I think, to do that. And then we got a fellow like Harold Williams, who was a brilliant man. His great contribution to market structure was to decide early in his chairmanship that the most important issue we should be dealing with was definitions of what 'qualified securities.'" were. There's a piece of the Exchange Act that says that only securities qualified for trading in a national market system should be traded thereCthat they should, the whole bunchCbe subject to a new set of common rules and principles that should apply across all markets once you knew what a qualified security was. Well, this led to some disorder among the over-the-counter-market people, who were absolutely certain that not all of their securities would be viewed as qualified. Well, no kidding.

But they initially got very upset about that. They successfully, as far as I can tell, lobbied Harold Williams, saying, "Everyone will join an exchange. We'll be discredited if you don't do something to make those securities that are traded OTC [over the counter] into "qualified securities." So I think the very first national market system thing that Harold ever asked me to do after appointing me Director was "You've got to have a definition of national market system securities that will include most of these OTC securities." And you would say, "Well, Harold, that's a very funny end of the problem to go at first. You don't' even know how you want to force these thing to trade, okay? Why would you want to say, 'Okay, you're not a toad, you're a prince, and you're a prince, and you 're a prince,'

but you don't know what kind of trading we're going to have to support?" Well, that didn't seem very important to him, and that was somewhat remote, whereas the NASD pressure to get all of their companies designated as "qualified" was very powerful and immediate. So, we got off on that sort of a footing. Also, we were well advanced, I think, in pulling the slats out from under Exchange off-board trading rules. That's another thing the New York Stock Exchange, not alone, but signally, did not want to have happen, and I think Harold got the feeling that getting rid of those rules was going a little too fast. I seem to remember that he, at a hearing, perhaps on the House side, reviewing the implementation of the Securities Acts Amendments of '75, was questioned harshly about, "Why aren't you making more progress on this and that?" and particularly, "Why haven't you gotten rid of those off-board trading rules?" He replied, "Look, I'm not going to be Chairman of the SEC and go do something radical that I'm not sure is going to work or understand completely, and then come back to you and say, 'I'm sorry the wheels fell off.'" Well, that was a reasonable admonition, although there were those of us in the Division who were quite willing to pull the wheels off and thought everything still would be just fine. We seem to still be just fine after the rule disappeared, so I'm not sure it was worth twenty years of delay. But there it is.

RR: Well, it sometimes takes twenty years to reform, and then by that time, the industry is so far ahead of you that you've got to reform something else.

AK: Absolutely.

RR: Do you have fond memories of your days at the SEC?

AK: I do. My jobs at the SEC were the best I've ever had. I enjoyed the work, the client–the public interest–those with whom one had to contend, either on a friendly or not-so-friendly basis, but all pretty able and unselfish participants in the process. It was a wonderful process, rule making and dealing with the stuff that's in the Commission's charge. I'm not sure I'd like it as much today as I liked it then. I have a feeling that things are more compartmentalized now within the Commission, and the Divisions seem to have less to do with each other, feel less free to criticize other people's ideas, and there's a kind of a set-piece quality to the way things are presented to the Commissions today that was not characteristic of the way the Commission worked before the advent of the Sunshine Act [Pub. L. 94-409]. For all I know, dealing with the Commission in enforcement matters, which are conducted behind closed doors, is the same sort of food fight we occasionally got into back in the seventies, but that was part of the fun of it, and that seems drained out of the more formal rule-making and interpretive processes that now take place in public.

But I enjoyed it very, very much, and have told anyone who's ever considered working there that they will enjoy it, I hope, as much as I did. It's not often you get to represent an unselfish client that gives you almost as much time as you could ever need to solve things, and that's what the SEC usually has.

RR: It seems that these days they don't have as much time as they need to solve problems. They're sort of reacting to what's going on in the marketplace and corporate America.

AK: Well, there is a certain shrillness about that, because amateurs have taken up the cudgel. I can't imagine what people actually think. Do they think that everybody just became a crook like last year, or that just a couple of years ago, business life during Bill Clinton's years was different? I don't know what they think, really. Much of this, I'm sure, has been going on for a long time. Much of it should have been foreseeable. If big pension funds, for example, are going to start to become critical of how things are run and start pounding the desk about how executive compensation ought to be linked to stock performance, I mean, what greater invitation to cook the books to drive stock performance could you have? But no one seems to have even thought of it. Now they're perfectly willing to hammer any regulator that gets within their gun sights and say, "Well you should have thought of it, and done something about it in advance."

Popular ideas often get propelled into reality without careful thought. It's not the Commission's job to do that. The Commission is not the regulator of executive compensation. We don't have a federal corporate statute. We don't have common standards. We seems to have somnolent states in charge of those things, and boards of directors seem not to have taken their responsibilities very seriously, and chief executive officers, a number of them, seem to have felt that they could steal with both hands as long as they couldn't be thrown out of their jobs.

Wall Street's always had a little taste of that in investment banking, and that doesn't surprise anybody either. There, the SEC and the exchanges perhaps can be faulted. Exchanges don't really regulate the underwriting process. That's always beenCthe NASD does, but only to a marginal degree, and only with respect to who gets the goodiesCif it's a goodyCand how much compensation is too much, but there' some sort of fundamental ethical failure in marketing deals that were internally ridiculed and sold to people anyway. So somebody's to blame for that, but probably there's been enough blame about that to go around for the last couple of decades, maybe back extending to my time.

RR: I was going to ask whether there were similar problems back in the days that you and I were at the SEC.

AK: Well, it's hard to imagine that there weren't, but I found when I left the CommissionCa reason for leaving, in addition to finally deciding that my kids were so old that I couldn't figure out how I was going to possibly give them the education that I wanted to give them on a government salary, was that I found I was becoming a bureaucrat. Here is my little definition of a bureaucrat: a guy who has an agenda, maybe a very powerful agenda. He may believe in it very deeply, but nothing else can get on the agenda, because he's got thing one, two, three, four, five, six, seven already on there and those things he absolutely wants to get done. And you tell him, "There's really something else that ought to be number two." You stop listening and become unreceptive to that. That's a bureaucrat.

Well, I thought I was getting there, and that was part of the reasons for leaving. So on my agenda, at least, this sort of problem never got on the radar screen, for me, and I don't think for any of my fellows on the staff. It's not that we believed that the investment bankers were men of sweetness and goodwill, or that corporate executives were just sort of naturally not thieves. I just don't think we knew quite how to get at it. The accounting—I guess worrying about accounting was something that was part and parcel of your old Division, but not of anybody else's, and the Office of the Chief Accountant was sort of a remote, distant, cold place that none of us understood. So it was hard to get involved in those ideas. Maybe it's just as hard today.

RR: Well, I remember—this may have been before your time, but Nick Wilson, who was and may still be a professor at the University of Connecticut, I think Law School, and I ran some hearings on so-called hot issues securities markets, and in a very small universe, there were a lot of the problems that you see today, the way hot issues were being marketed. Not that the Commission ever did very much with that, but the study was there.

AK: Well, it does seem shocking when it takes the Attorney General of the State of New York to come up with a list to show you how multimillionaires made multimillions more giving investment banking business to firms that, in turn gave them hot new issues. I mean, it does make you feel kind of dumb it that's been going on all this time, but no one noticed, no one told us, no one tipped us off. Because that doesn't smell right, and I

suspect that if that had come to the attention of the staff in an earlier day, something would have been done about it. I just don't think it did.

We were told about lots of stuff. It always took pros on the Street sometimes to say, "You know, let me tell you what's really going on here, how this works," and there were plenty of people willing to do it. I don't want to call them informants. It's not that they were informants. They were people who saw practices in the brokerage industry, in professional trading rules, that they thought were wrong. They had some good reasons, and enough courage to put knowledge into the staff sufficient to generate debate, to turn over the idea of whether a particular practice was right or wrong. It surprises me if there weren't people like that on the corporate finance side as well. And, you know, the staff's got to learn this stuff somehow, somewhere.

We don't run special studies, like the '61 study anymore. You can't hire a huge professional staff and pay it well enough, give it a couple of years to go write things up for you, and get the sort of information that was obtainable back then. You read the Congressional hearings on the operation of the stock markets back around the time the Exchange Act was adopted, and you read what those witnesses had to say, and you just say, "Doesn't this guy have a lawyer? He really shouldn't' be saying that sort of thing. Couldn't a lawyer, like, figure out how to tell him how to say that differently?"

I feel maybe some of the same sort of thing was going on in '61. A little less of it when we did the Options Study while I was there, and maybe today everybody's smart enough to just keep their mouth shut, but Street people used to be a good sources of information. Here, somehow or another, the synapse never got closed.

RR: Yes, it used to amaze me when Gene Rotberg was with the Commission, who had worked on the special study. He could get the old monarchs of Wall Street to tell him how things were really working.

AK: Sure, Sure.

RR: It always amazed me that they would tell him, because either they felt that the Commission was a paper tiger and it didn't matter whether they told him that or not, or they were public spirited. I don't know which.

AK: Well, I hadCyears ago, I've forgotten, maybe the fiftieth reunion of the SEC or something, one of the people attending was a specialist form the New York Stock Exchange, and he came up to me and said, "You know, Andy, this is a really a great occasion, because at the New York Stock Exchange, before there was an SEC, we were really nothing. We were just nothing. We were just people who collected a good living. Now we're important. Now we have standing. Now we have authority. And it's all happened under the aegis of the SEC." Well, I think that's probably true, and things

haveCthere were always people in the industry, I think, who said there's a way to make money, but there's a right way to do it. Morally, when things started to fall too far out of bed, some of them couldn't stand it and really thought it ought to be done differently. Who better to talk to than your friend at the SEC, whoever that was? And I hope that's the case today, but, gee, some of these stories are frightening. What's frightening about it is how many different linked people doing different things it took to get the end of the money line for these characters. It wasn't just a CEO, it was the CEO and the CFO and the Treasury department and the underwriters and the accountants and the lawyers, and it took them all, all . . .

RR: And the commercial banks.

AK: . . . to get there. And without the cooperation of all of themCjust one guy spotting the stuff and deciding, I can't stand this, it all would have fallen apart. We don't seem to have that one guy. That's unbelievable to me. I don't' think that was true in yesteryear, but it sure seems true today. I don't mean to sound bitter about it. It just surprises me. How could so many upright guys close their eyes and put on blinders to such a degree as to make this possible? Someday someone will explain that to me, but I don't get it now, and I don't think it was that way in the securities industry when we got a much broader, tougher regulatory grip on them in 1975 than the Commission had had before. I think Street people still were pretty forthcoming.

RR: Do you recall humorous moments at the SEC?

AK: Several, although I'm not sure that they should be publicized. I'll tell you a little humorous vignette. Harold Williams did say to me, somewhere early in his Chairmanship and my being Director, that he understood that the Cincinnati Stock Exchange was in deep trouble and was going to go under and he didn't want to have an exchange go under on his watch, and I should do something about it. Well, at that time, [Donald E.] Don Weeden, who may be remembered as the gigantic gadfly of Wall Street, and who by teaching the Commission so many lessons about how important competition was and everything else, functionally destroyed his own business because the people he criticized responded by becoming more competitive. Then there was no more Weeden. But he enjoyed it.

But one of his last cracks at staying alive in the trading markets world was a trading system that he had developed. He said, "It's so simple. You know, you can really arrange trading systems to do all this trading. You don't need all these people, all this stuff." And he had worked something out with the Cincinnati Stock Exchange where they would use his automated auction trading system. The CSE was so busted they couldn't have lawyers, and they had to deal with all this stuff themselves. They had to write some rules and get all this down on paper. So the staff was, how shall I say, of assistance in getting that done.

Kathryn [B.] McGrath at that time was Associate Director in charge of SROs, and by golly, they formulated their rules, put them in, got approval, and turned on their machine to the consternation of all the rest of the securities trading worldCbecause the idea of machine trading was just anathema to all the other exchanges. And I remember a small bunch of roses showing up for Kathy's desk that I'm sure came from Don Weeden, though I was never sure that he was the person from whom they came. Within the year, Harold said, "I wish I'd never said that to you," because the Cincinnati Stock Exchange caused so much trouble, from market structure standpoint and from some sort of social acceptability criteria within the securities industry.

But there were a few others. I remember we got new authority over banks and the municipal securities area, and we're supposed to be cooperating with the bank regulators, of course, through consultation. The staff had decided to go in and do an inspection of some bank up in Buffalo. So we're all ready to have the guys drive over there in the car and walk in and say, "Give me your records. I want to see all the stuff going on." And we called up to the Controller, or whoever it was, from the Chairman's office. I think Harvey was in on this call, and we said, "We're consulting with you. We're going to send inspectors into this bank up here. We're going to do that this morning." [Laughs] They said, "You're going to do what?"

We said, "We have the authority to do that under the Exchange Act and we're supposed to consult you, and we are consulting you, you know, because will share the information

with you." And they said, "Well you're not going in there." And we said, "Yes we are going in there." I cannot remember whether the inspectors were turned away at the door or what, but that was the very first chapter in SEC bank-regulated cooperation in the municipal securities area. It was a complete flop. There was no cooperation whatever. So I remember that. I'm sure there were many more funny stories, but they are of a more private nature.

RR: Well, we needn't go into the private ones in this discussion.

AK: No.

RR: Ultimately, you decided that you would leave, and I think you're probably pretty well covered that.

AK: I did.

RR: Did you have misgivings when you left?

AK: Oh, misgivings in the nature of a job not finished, not well done, haven't won all the arguments, didn't know what would happen now, didn't really know who my successor would be. I think, by that time, Lloyd [H. Feller] had left.

RR: Lloyd Feller?

AK: Lloyd Feller had left. Kathy had left. Harvey, of course, had left years before. Ralph was, I think, still there as General Counsel.

RR: Ralph Ferrara.

AK: Yes. You'd left. Lot of folks who I considered to sort of be the heavyweights that I grew up with or admired when I got there, had departed. It was time to go. I didn't know who that next generation was going to be or what it would be like, but it worked out. I also wasCgee whiz, I spent college and law school out in Chicago, and I really was very attracted to Schiff [Hardin & Waite] because Milton Cohen was still active as a partner and, of course, had directed the Special Study. These guys had given birth to the Chicago Board Options Exchange and the Options Clearing Corporation. Back in the seventies, the idea that you might have market regulation as the main string to your bow and try to go into private practice was probably an odd idea, and it was odd in most firms, but Schiff was not one of them. So I did join them and moved out to Chicago again for two years before I got to return to Washington. I had more trepidation about moving to Chicago, probably, than anything else, because, like it or not, I'm an easterner, and I belong here.

RR: Okay, is there anything you'd like to add?

AK: No, Haven't I . . .

[End Tape 1, Side A]

[Begin Tape 1, Side B]

AK: . . . series of things that have happened in the last two years affecting the markets that seem to me to be wrong. The first thing that was really wrong that they've done is decide that it's perfectly all right for an SRO to become a for-profit business. That is a dreadful mistake. A profit motive should not be what a self-regulatory organization is about. An SRO is charged with quasi-governmental power over people, and self-regulation always meant something whether the members of the organization have some sort of ultimate role in how the thing is running itself, under principles laid out in the statue. But if things became too expensive to the members, they could throw out the managers, find somebody else, replace them. It was a notion of there are standards in the industry, and the SRO's are the maintainers of these standards. If we can't do that by ourselves, there won't be any.

And they're running a disciplinary system with teeth, so I think it's been a terrible error to decide that you can somehow have people in there that own the thing and take the revenues and that sort of stuff, that the money is a good reason for a self-regulator's

existence. You try to bundle up and protect the regulatory and enforcement process, but I don't think it can work quite the way it is supposed to under these circumstances. So, I regard all that as an error. I regard the creation of ECNs [electronic communication networks] as an error.

I have to tell you that Burt Ruseman of my firm and I wrote a letter to the SEC twelve years ago, when they first did the Security Pacific no-action letter permitting a little mechanized computer-driven trading system, that was to do OTC option on government bonds, to do so without being regarded as a securities exchange. We wrote it because we thought that was such a terrible idea that such a system should be allowed to operate without being subjected to all the responsibilities of an exchange. You can't just be an exchange because you decide to open one in your garage. There are very elaborate principles governing what an exchange has to do, and the idea that this was a way around and out of all of that seemed absurd. It seemed to me to kick the arch stone out of the Exchange Act.

Well, the staff and the Commission vigorously defended that decision over the course of the next ten years, I think, through litigation in the Seventh Circuit and with the Board of Trade, and the decision was 2-1 against the idea that the Commission shouldn't have tolerated such a thing. The Commission ultimately was forced indirectly to make a finding that Security Pacific wasn't an exchange, a bad finding, in my view. Anyway, the Commission dug in its heels to defend a decision made at the staff level in a no-action

letter. That, of course, was reversed eleven years later when they adopted Regulation ATS, which defined these things as exchanges. The light finally dawns. But then they said, "But never mind, you still don't have to really be an exchange, as long as you obey this other little set of rules we've worked out." Well, they're inadequate. They don't establish a level playing field with the SROs, and they have given rise to other horrors.

The idea thatCI mean, Island is a client of my law firm, so I don't wish to speak against its interestsCbut I can't help but comment on how odd it is that Island should not be compelled to obey the trade-through rules of the NASD just like all the other children and how it can have a huge percentage of total market share in certain securities without being forced to put their quotes in the consolidated quote system. What kind of a world is that? So, that's wrong. The rebates of fees from market information, that used to be a discount from a bill that was sent to you by the SRO, but now they'll send you a check, is all wrong. How hard is it to start to think about what that does in a tremendously liquid issue that a spread of two or three cents? You can earnCwhat is an Amex [American Stock Exchange] print worth today?

RR: Twelve dollars, twenty dollars.

AK: Per print? You can trade all day long and lose on the trades and pick up those discount and still win. Is that what ought to be the reason for trades that occur in our markets today? These are obvious things. Nothing's been done about it. Someone should do

something about all those things. There are other things, but it is hard for me to regard market regulation today as succeeding in advancing the public interest in ways I can understand.

It is clear that they are trying to work out business deals between conflicting systems of trading and trying to accommodate everybody rather than make decisions about outcomes based on what's best for market participants. If they'd look to the statute for what those outcomes should beCif they don't feel they've gotten proper direction there, go back to Congress again. But the idea of doing nothing about some of these things is wrong, to me.

RR: Well, you've said they probably can't afford another special study, but could they? Is it time for another special study?

AK: Well, I don't think these things are that hard. I doubt very much that they're that hard. You've got enough staff that understands enough about these things. It's not for lack of facts that you don't know how to proceed. It seems for lack of being able to make a decision. Well, as we all know, that's making a decision. Competition's a good thing, but no one ever intended competition to take over in the markets as a raw idea. It was always supposed to be 'fair' competition that actually has a meaning. People shouldn't be afraid of it, but there's a lot of stuff gong on out there that I can't believe is invisible, and that I can't believe it's taking so long to address publicly and forcefully in a way that's correct

for the markets. I don't have suggestions as to what's right. I just think that what I've just described ought not to be the case.

RR: Well, thank you, Andy.

AK: You're welcome.

RR: It's a pleasure having you here for this interview, and we'll close up at about 3:45

AK: Thank you very much for having me.

RR: Thank you.

[End of interview]

Index