

Securities and Exchange Commission Historical Society
Oral History Project
Interview with Mark Fitterman
Conducted on February 21, 2018, by Kenneth Durr

KD: This is an interview with Mark Fitterman for the SEC Historical Society's Virtual Museum and Archive of the History of Financial Regulation. I'm Kenneth Durr. Today is February 21st, 2018. We're in the offices of Morgan, Lewis & Bockius in Washington, D.C.

Mark, thanks very much for taking some time to talk today. I want to start with some background, and in doing my overview of your early education, it looks like you're from Ohio, or something like that.

MF: Yes, I grew up in Dayton, Ohio, and went to college at Oberlin College. When I graduated there, I spent some time at the Sloan School in Boston, but did not finish there, completed my MBA later. I then spent two years at the First National Bank of Chicago in their trust department doing securities analysis and portfolio management, then worked for a small broker-dealer firm in their Dayton, Ohio, office. When that firm failed financially, I decided to go to law school. Went to Georgetown in 1971 and graduated in 1974 from Georgetown. After that, I joined the SEC directly after graduating from law school.

KD: Now, you were a student assistant while you were at school, right?

MF: I did a couple of things while I was in school. First, I was a member of one of the law journals at Georgetown. It was their international law journal which I think was called *Law and Policy in International Business*. During that period of time, we helped write an article for Manny Cohen, the former chairman of the SEC. Then in my last year in law school I was a research assistant to Professor Jeffrey Bauman who has taught securities law and corporate law and was a former SEC staff member. We had a number of interesting projects at that time, and he helped get me involved with the SEC, going to work for the SEC permanently after law school.

KD: Okay. So the assistant program then was really sort of working at Georgetown rather than over at SEC?

MF: Working at Georgetown although I did spend two summers at the SEC as, in effect, a law clerk. The SEC at that point in time, and I think is still the case, wouldn't take you as a summer law clerk unless you had two years of law school. But because I also had an MBA, they took me after my first year as a financial analyst in what was then called the Division of Corporate Regulation, now the Division of Investment Management, and I was involved in reviewing mutual fund registration statements and proxies and things like that.

During my first summer at the SEC, they reorganized the division and created the Division of Enforcement, sent the mutual fund processing branches to Corp Fin. So I spent the rest of that summer and the next summer in Corp Fin, which gave me the

opportunity to work on regular registration statements in addition to mutual fund registration statements. And then when I graduated, I was offered the opportunity to go to several places within the Commission, but I picked market regulation because I felt there was a lot of activity going on there.

KD: The backdrop to all of this would have been the congressional hearings, the talk about unfixing commission rates. Were you aware of all that?

MF: Oh, yes. The first thing that happened when I joined the staff, which was in, I believe, August of 1974, was the 1975 Act Amendments which was a significant statutory change, and it did a number of things. It directed the SEC to take steps to establish a national market system. The SEC had put out some stuff before, but this was the first statutory authorization to do that. It also had a number of changes in the statute, itself, one of which changed the way stock exchanges and the NASD adopted rules. Prior to that time, there was no provision for the SEC to review and approve rule changes.

There was an informal process where they would send the rule change into the SEC and if the staff didn't object then it would become effective automatically, but 1975 Act Amendments changed that to create a requirement that rule changes be put out for public comment and approved by order, which was a significant change. And one of the first things we did after the '75 Act Amendments was adopted, was we were required under the statute to review all the rules of all the SROs, in effect, to bring them up to date in terms of them having been reviewed and approved by the Commission.

KD: So that would have been a pretty big job, to take stock of the SRO rules after the '75 Act Amendments.

MF: It was. There was a team of people that was assigned to do that, and that was one of the interesting things we did. The other thing that we did was, the '75 Act Amendments created the Municipal Securities Rulemaking Board. All of the SEC rules had to be reviewed to add the MSRB, where applicable, and so a small group of people including myself and Kate McGuire, who just retired from the staff after more than forty years, was involved in that project as well. But most of what I did the first years at the SEC was work on what we would call the National Market System or market structure.

KD: Right. And these are the things the '75 Acts Amendments started in place. The things like the consolidated tape, was that part of that?

MF: Well, I think it needs a little bit of background first. Prior to the '75 Act Amendments, and prior to the SEC's National Market System program, the markets were mainly different. The New York Stock Exchange was the preeminent market, accounting for 85 to 90 percent of the activities. There were regional stock exchanges such as the Chicago Stock Exchange, the Boston Stock Exchange, the Philadelphia Stock Exchange, the Pacific Coast Stock Exchange which had two floors, one in San Francisco and one in Los Angeles, but they didn't have the same level of visibility that the New York Stock Exchange had. Their trades were not really reported. Their quotes were not really

available, and so they had a tough time competing with the New York Stock Exchange for business.

And one of the things that the SEC's rulemaking program attempted to do was to try to level the playing field. So a number of rules were adopted. There was the consolidated tape rule which is now part of regulation – most of these things are now part of Regulation NMS. The consolidated tape basically required all the markets to funnel their trades for reporting purposes into a central location which turned out to be the processing center of the New York Stock Exchange and then put out on a tape. Well, there are two main differences. One, it was consolidated so that you got to see all the trades from all the markets on a single data stream. The second was to create what we call a high speed line.

Prior to that, the tape was a slow ticker tape. You may have seen physical tickers with glass domes and things like that. That was with the technology that existed prior to that, and so it only worked at 900 characters per minute. So in busy time periods the tape would run behind, and you would have to wait for it. When the high speed line came into place, information was disseminated immediately.

The other thing we did was the quote rule which required markets to publish their quotes and to be firm, which was a major change, to require firm quotes. We also adopted what was called the vendor display rule, which is still in effect, which was a rule that was designed to increase the visibility of quotations from markets other than the New York

Stock Exchange. One of the requirements was that the primary information that you got, your first inquiry, would be consolidated. So instead of going to your quote machine and punching in a symbol and getting the New York Stock Exchange quote, the vendor display rule required that you first got the consolidated quote, and then you could request the New York Stock Exchange quote.

KD: Okay. And my understanding is the transaction reporting was a fairly straightforward thing to do. It wasn't that complicated. The quote rule on the other hand –

MF: Well, it was not complicated, but there were issues. The primary issues, and these issues remain out there, were revenue issues with respect to the tape, because the exchanges asserted proprietary interest in the tape. Let's say you were a large retail brokerage firm and you had lots of offices and you had quote machines in each of these offices, each of those quote machines would generate revenue. The New York Stock Exchange had their tape. The American Stock Exchange at that time, it's now part of the New Stock Exchange network, but they had their own tape, and then there was NASDAQ. So each one asserted proprietary interest and collected revenue. That still is the case. There still is Tape A for the New York Stock Exchange, Tape B for AMEX, and Tape C for NASDAQ, and that has not totally been resolved even forty years later.

KD: So it wasn't simple. But what were some of the complications for the quote rule, because I do believe that was implemented a while later?

MF: Well, a lot of it took time because we wanted to achieve consensus on what was the right thing to do from a technology standpoint, from a regulatory standpoint, and we had a small staff devoted to market structure, so you couldn't necessarily do everything all at once.

KD: How big was your staff at that point?

MF: Oh, the market structure group was probably four or five people. It included George Simon, Mike Simon. It included Rick Ketchum, and Brandon Becker, obviously.

KD: Was Lee Pickard in there at that point?

MF: Well, Lee was the division director when I joined the staff.

KD: Okay.

MF: So he was over all of us. I was part of the office of Market Structure and Trading Practices, which was headed up by Andy Klein. And then within that group, we had people who did market structure, people who did trading practices. In those days, the rule was 10b-6, 7, and 8. Those rules were ultimately cast as Regulation M which is still in effect. And so we had two halves of that office, and we had a staff that did 10b-6 letters. 10b-6 is a rule that basically says, you shouldn't be in there buying the security while you're trying to distribute it because the worry is that you're going to manipulate

the market to make your offering look more attractive, and so there was lots of history about 10b-6. But because I was on the market structure side, I really didn't get to work on 10b-6 letters.

KD: So did you work closely with personnel from all the exchanges when you were putting these rules together and vetting them?

MF: Yes. I mean, we would be involved with the various markets and discussions with floor people, upstairs people. One of the things we worked on was the so-called Intermarket Trading System which was the first attempt to physically link the markets, so you could be on the floor of the New York Stock Exchange and send an order to the floor of the Philadelphia Stock Exchange, for example. The issue was to try to make it easy for someone to find a better quote on another market. Because the original concept of a national market system, at least some people had of a national market system, was for it to be a so-called CLOB, a central limit order book.

Everybody would put their orders into a central and the computer would sort it out and figure out who was trading with who, and that's not sort of the way it turned out. It turned it into a linked market environment, first with the Intermarket Trading System, and now with the idea of Regulation NMS and the trade-through, which, in effect, forces you to do what the Intermarket Trading System permitted you to do, which was to go out and seek better bids and offers if you're going to do a trade. So if you want to do a trade of ten, and there's a better bid away, basically a trade-through requires you to go after it.

KD: Right. Competition, I guess, and my sense is that this Commission didn't want to sketch out the whole market. It was really waiting for the markets –

MF: Well, there were always competing views of what the National Market System should look like. Should it be a central limit order book, one big monolithic computer, or should it be linked markets that would allow markets to compete with each other, brokers to compete with each other? The idea of the National Market System under the '75 Act Amendments is to encourage trading without the intervention of a dealer. So historically, the New York Stock Exchange was an auction agency market as opposed to the over-the-counter market, which was primarily a dealer market. So the idea was to try to make the markets more auction-like, agency auction-like, as opposed to being dealer. Now, what that did was it made it hard to integrate the over-the-counter market with the exchange markets.

KD: So did you spend the rest of the seventies working on National Market System rules?

MF: Well, yes, I think most of the period, my first, I guess, eight to ten years at the SEC were spent on market structure issues and National Market System initiatives including, as I said, the tape rule, the quote rule, vendor display rule. We also had a "plan rule" where markets could come together and come up with a plan. There are plans since then, there is, for example, the UTP Plan for over-the-counter securities to have a tape that would include securities that were on NASDAQ, but also traded on exchanges to have a

combined tape of those things. That was one of the things that was done under the plan rule.

KD: The NASDAQ couldn't go on the ITS?

MF: It did, but that was different than creating a tape for the over-the-counter market because there are two ways of getting things traded on an exchange. One is to list on the exchange. Okay, the exchange has listing fees. The other is what we call unlisted trading privileges, so if something is listed on one market, another market can apply for unlisted trading privileges. It used to be you applied and the SEC would approve it under an order. Today, unlisted trading privileges is automatic, which is why you will see if something lists on the New York Stock Exchange, immediately it's traded on all the other markets pursuant to unlisted trading privileges, all of the former past exchanges which are now CBOE exchanges, as well as the remaining regional exchanges.

KD: Okay. Now, how did you move from market structure to oversight and surveillance which is during the next step?

MF: Well, in – I believe it was 1984, I was offered a promotion to head up the inspections office. The previous head of the inspections office, Ed Kwalwasser, left to join the New York Stock Exchange, and so that left a vacancy. At that point I was a deputy associate director in another office, and so I was selected to be promoted to associate director. The office at that time was the Office of Inspections and Financial Responsibility. We had

responsibility for all the financial responsibility and record keeping rules. That was under the supervision of Mike Macchiaroli, who's still there, and so we would have the SEC's net capital rule, the customer protection rule, and all the books and records rules.

Then on the inspection side, we had responsibility for conducting inspections of exchanges in the NASD and the clearing agencies as well as coordinating the broker-dealer examination program. The broker-dealer examination program is, and continues to be, mostly functioning out of the SEC's regional and district offices. All of the offices are now regional offices, but there used to be regional offices and district offices which reported into regional offices, but each of the offices had responsibility for examining broker-dealers that were headquartered within their respective geographic jurisdiction, and so our job was to coordinate that process.

We would work with each of the offices to set examination goals at the beginning of the year to evaluate the quality of their program, to review examination reports and comment on them, to provide training for examiners, and to have periodic meetings with the regional staff to share information that we had in terms of trends in the market, new rules, and things like that.

KD: These are the broker-dealers you're talking about?

MF: Yes, we had responsibility for the broker-dealers. There was a comparable group in investment management headed up by Gene Gohlke who had responsibility for examining investment advisors.

Well, I'm getting ahead of the OCIE story. But the difference, in terms of broker-dealers and investment advisors, is that the SEC had, and still has, too many investment advisors to have a reasonable inspection cycle. For broker-dealers, there were the SROs, the New York Stock Exchange, and the NASD who performed routine examinations of broker-dealers, so the SEC didn't have to do that, necessarily, and so our examination program during those years was primarily an oversight program. So the New York Stock Exchange would go and do an examination of, say, Merrill Lynch, then our team would go into Merrill Lynch and look at how well the New York Stock Exchange did their exam. We would also do normal things, net capital computation compliance with the customer protection rule, and things like that, but it was mostly to evaluate the regional office program and the programs of the SROs.

KD: And the regional offices are really kind of looking over the shoulder of the SROs?

MF: That's right. Today the examination program is much more a direct examination program, and they don't necessarily do oversight exams anymore. They do cause exams and exams that are based on risk. So if the staff thinks broker X may have regulatory risks because of the nature of their business, they will schedule an exam and go out and do that.

KD: So in a sense you're really looking more at the SROs and thinking about their effectiveness than that of the broker dealers.

MF: Yes, during the period I was there. Today there's much more direct involvement. The same thing is true on the surveillance front. We used to examine the SROs for their surveillance program because they had the first-line responsibility for conducting market surveillance. Things have evolved, so you now have the development of what's called the CAT, the consolidated audit trail, which will give the SEC much more direct ability to conduct surveillance, itself, in addition to whatever the SROs do.

KD: Yes, and that's much more recent.

MF: That's much more recent. That's something that was approved within the last year and is in the process of being implemented. There are some issues associated with implementation.

KD: So you're getting into oversight and surveillance and dealing with broker-dealers. In the mid-1980s, and this is the financial buccaneering days on Wall Street, did you see any changes in broker-dealer behavior or patterns of conduct?

MF: Well, I think the main thing that happened in the 1980s was the development of financial futures, and the increase in automation in terms of being able to send orders and develop

orders. That was one of the things that we found after the market break of 1987 when the Dow fell 22 percent in a single day, and when we did a comprehensive report, we did a report of the staff.

There was also a commission. Former Senator Brady headed it up, and he came to, I think, similar conclusions that there was a link between the futures market and the stock market – because of the presence of financial futures which had much lower margin, people could take synthetic positions in stock with much less capital. And so a lot of what happened during the market crash, people were selling futures, and when futures got out of line with stocks, people would then buy futures and sell stocks. So the decline started in the futures market, but was exacerbated in the stock market, and so that was one of the main factors that led to the decline.

KD: Okay. Was there concern about high-pressure sales, things like that?

MF: Well, sales practice was always something that was on the plate of the examiners. And there were always issues, suitability and churning and things like that were always things that are on our plate. So sales practice was a major aspect of what the examiners do, particularly the examiners from the SROs.

KD: But you didn't see a rise and fall in that during the eighties?

MF: Well, I think it's cyclical, and particularly with respect to things like penny stocks and microcap stocks. You would see rises and falls and abuses in that area. So it was always a constant. Sales practice was always a constant, so we didn't see huge increases. I mean, the number of cases that were brought year-to-year were pretty much – we always had insider trading cases. We always had sales practice cases that we were involved in.

KD: Okay. At some point, the title is the Office of Inspection and Financial Responsibility, and inspection is pretty simple. Tell me a little bit about the financial responsibility part. Net capital is part of that which is also relatively easy to understand. What else?

MF: Well, it was primarily the net capital and customer protection rule, and the books and records rule, and those rules are probably the two most important financial responsibility rules because they sort of link-up to the SIPC program, SIPC being the insurance program for broker-dealers that fail, and assets are missing. So the theory is that if broker-dealers comply with particularly the customer protection rule, which requires you to have possession and control of customer fully-paid securities and to segregate net monies owed to customers, that it would be much easier to liquidate a broker-dealer because SEC's net capital rule proceeds from the assumption that the broker-dealer is failing, and has to be liquidated, and so the rule requires broker-dealers to take what are called haircuts to reflect what would happen if there was a forced sale of assets.

On the customer protection side again, you're not allowed to use customer assets except to finance other customers, so you can't use them to fund your proprietary activities. So

if those rules are complied with, conducting a liquidation of a broker-dealer is much easier.

KD: Okay. So the haircut, is that set by the SEC rules?

MF: Yes. They are set based on the nature of the asset, the risk, and the liquidity of the assets. For example, common stocks would carry a 15-percent haircut, government bonds range from 0 to 6 percent. So depending on whether it's a risky asset or a non-risky asset, there are also other potential charges that you have to take under the capital rule depending on whether the stock has a liquid trading market or not, or whether you have a position that's too large to be liquidated in the market.

DK: Okay. Now, did you have groups within your organization that would just handle these particular issues?

MF: Yes. One of the things we did during the period that I was head of inspections and financial responsibility was to change the minimum capital requirements. Used to be that a carrying firm had a \$25,000 minimum net capital. We raised it to \$250,000. It hadn't been raised in years and years and years, and we felt that given the growth in the industry, we needed to have higher levels of capital.

KD: Was this in the early nineties?

MF: Yes.

KD: Okay. I seem to recall that the failure of Drexel, or something, had –

MF: Well, Drexel failed, I think, earlier than that, but I think that was one of the precipitating factors, the fact that Drexel Burnham Lambert, which at the time was the, I think, third most highly capitalized firm, failed mostly because its parent, which was an issuer of commercial paper, ran into financial difficulties, and that translated down to the broker-dealer. The broker-dealer, in turn, was well-capitalized, but then they tried taking capital out of the broker-dealer until the New York Stock Exchange intervened, and that led to another rule that we adopted, a portion of the net capital rule, which requires notice to regulate significant withdrawals of capital.

KD: Okay. Now, when it comes to doing something like setting a net capital rule, is this where you call on economists?

MF: Well, the economists play an important role at the Commission, but they're in a separate group, so if we had a proposal, we would run it by the other divisions and offices within the Commission including the economists. Now, they've upped the ante, I would say, in terms of the role of economists and financial technicians, and they have a separate unit which has much more stature within the agency. We did interact with the economists in terms of trying to set these standards, but it was mostly our staff.

KD: Because it's got to be a delicate balance between making sure they can use their capital wisely, and that enough is sequestered so that they're –

MF: Well, the net capital rule is designed to deal with the capital of the broker-dealer, the proprietary assets of the broker-dealer, as opposed to customer assets that they're holding. That's what the customer protection rule is designed to do. So the question is, what kind of capital does a broker-dealer need to do the kind of business it had? So if you're just an agency broker, then you don't need a lot of capital. If you're a market maker, you need much more capital. So the rule is designed to handle capital from the standpoint of what the nature of your business is.

KD: Okay. So one of the things that you mentioned is that you're working closely with the regional offices, for instance.

MF: Yes.

KD: How is that structured exactly? Did you go out and visit the regional offices, did you have people coming in and talking –

MF: All of the above. Well, as you know, the SEC has offices throughout the country and we would do a number of things. We would have conference calls. We would visit the regional offices. One of the things that happened to me was it put me on the road much more often visiting the offices because it was important to talk to them in person and sort

of get the lay of the land because each of the regional offices, in effect, had a different personality in the sense of they had a different mix of broker-dealers. They had a different emphasis in terms of their examination program. Some of the offices were focused more on the capital rule; some of the offices focused more on the customer protection rule. Some of the offices had no New York Stock Exchange members, and only the NASD members, which meant that they had a much simpler task from a capital standpoint, but they had a much more difficult task on the sales practice side.

KD: Can you give me an example of that, like Chicago versus the Pacific?

MF: Well, New York was the largest region. They had the most New York Stock Exchange member firms. They tend to focus on the customer protection rule more. The Chicago office tended to focus more on the capital rule.

KD: Why?

MF: Why? I think it was a function of the staff people that they had and their personalities and what their interests were. They all did the job with respect to checking the various aspects of the rules, but when you're looking for regulatory issues, I think if you're doing a big clearing in customer business, you tend to want to be looking at the customer protection rule more. If you have firms that don't have a lot of customer business then you tend to look more at the capital.

KD: Okay. And the other thing is state regulators.

MF: State regulators were one of the things that was within my portfolio. Each of the offices had a liaison. Each of the offices within the SEC had a liaison to the state regulators. As you're aware, each of the states has their own securities regulator. They used to be much more involved in the issuance of securities, had merit regulation. They also regulated broker-dealers and investment advisors, and so one of the things that we did was we would meet with the states through their organization NASAA to discuss issues of common interest, and we would have periodic meetings with state regulators. We would work with various committees. One of the things that I was most involved with was the registration forms for broker-dealers and registered reps, and the development of a computerized database for registration of securities professionals, now called the central registration depository.

KD: CRD.

MF: CRD.

KD: Is the big issue there trying to bring consistency and get everybody on the same page?

MF: Well, yes. Ultimately the goal was to have uniformity. It was easier said than done because each state had their own regulator, but we tried to work with them to get more uniformity in the process. And that's what the registration form project was designed to

do, was to have a common set of forms that everybody would use, and a common system that everybody would use.

KD: And most of the states are merit states as you said.

MF: Well, actually merit regulation was eliminated, and so now you have, for the most part, states are out of the registration business, but they still have jurisdiction over fraud. They still have jurisdiction over investment advisors and broker-dealers. On investment advisors there was a division between the SEC and the states over time so that some advisors are registered only with the SEC; some are registered only with the state.

KD: Insider trading. Is there an exception for that?

MF: In what sense?

KD: As far as keeping a database?

MF: Well, insider trading was part of the surveillance operations of the various markets, and what would happen is, let's say there was an event, a tender offer, a market-moving event. Generally what the regulator would do is look back some period of time, request information from the various firms. The requests were called blue sheets. In the day, they were requested, and it was printed on blue paper. Now, it's all electronic, so if the New York Stock Exchange had an issue, they would do blue sheets.

If the people they were looking at were customers, they wouldn't have jurisdiction over the customers, so they'd have to refer that to the SEC. It would go to the Division of Enforcement, and they would do an investigation, and so we were involved in the surveillance side of it. Enforcement was involved in the investigative side of it and the SROs developed databases to keep track of people who kept showing up more and more. So that made it easier to look at these things. Eventually the blue sheet process was made electronic as computers were brought more to the floor and so you have those kinds of things being done more efficiently and quickly.

KD: Were you still using blue sheets back in the 1980s or the SROs using blue sheets?

MF: You were using blue sheets, but I guess starting in the late 1980s and the early 1990s, it became an electronic system. We still call it blue sheet because of the historical connotation.

KD: Okay. Well, we've been talking about the structure, the regulatory structure, and I think you've laid out a lot of good material, but I want to go back and hit a couple of stories before we move on. And one is the market observation and surveillance system which showed up in my research, something called MOSS. Can you tell me a little bit about where that came from?

MF: Well, MOSS was a project that involved responding to significant congressional inquiries. Congressman Moss sent a large volume of questions to the SEC, and my recollection is that it occurred when I was a young staff person at the SEC.

KD: When the hearings were still going on and that kind of thing?

MF: Right. I think it was in connection with some hearings he was doing. It's been a long time since I heard about Moss. But the then Chairman, Ray Garrett, the executive assistant to the chairman, Harvey Pitt, and others directed that there be a task force assigned to responding to these questions; I was one of the members of the task force that was assigned to respond to some of these questions. In those days we didn't have, really, word-processing equipment, so what they did was they took a large room, and they drafted twenty to thirty secretaries with typewriters to type all of this stuff up.

As I said, we did not have computers. We did not have word-processing equipment, so we had to do it the old-fashioned way. When you were operating in that environment when you would make a change in something, you either had to retype the whole page or you would use white-out and tape to tape over. So you would have pages that were a quarter-of-an-inch thick because they had tape, and tape on top of tape when you xeroxed it, so that was difficult.

One of the things I remember about the Moss report was there was a staff person whose name was Bernie Wexler who was a really good writer. One of the things he did was a

history of the SEC; it was more tongue-and-cheek than anything else because it discussed the period when the SEC, during the Second World War, was sent to Philadelphia. I think he described it as, we were sent to Philadelphia to do nitpicking registration statements, things like that. It was a very clever job. That's the one thing I remember from the Moss report, but we produced a voluminous series of responses. I don't know whatever happened to them once they left us and went to the Hill.

KD: Do you remember who came up with the acronym?

MF: I don't remember who came up –

KD: Because obviously the whole point here is that you've named the project after the congressman.

MF: Oh, yes. That's right. But I don't remember who did it.

KD: Okay. The other one is, your office had some involvement in unwinding Ivan Boesky's firm after he was convicted.

MF: Yes. When that case was brought, his firm which was called Seemala, had huge positions. The commissioners and the chairman and division director were concerned about how to unwind these positions without disturbing the market. So our job in market regulation was to oversee the people who are unwinding the positions, so we would have

almost daily calls with them, you know, how much did you sell today, what prices, and those kinds of things. That was a very interesting project because you got to be involved in the actual liquidation of a large portfolio which normally those of us who just did the regulatory work don't get to be involved in.

KD: So were you just looking for signs that the market was moving, that the market was picking up this liquidation?

MF: Not so much that, but to try to move pieces in a way that did not disrupt the market, so selling smaller pieces, pieces that are more liquid first. You know, we deferred to the industry professionals who were involved in actually doing it, and then we kept tabs on them, and we had regular communication. They were successful in ultimately liquidating the portfolio.

KD: How long did it take?

MF: I don't remember precisely. I would say months.

KD: Okay.

MF: Because I think it was a billion-dollar portfolio, which in those days was a large portfolio. I mean, today it would not necessarily be viewed as a large portfolio.

KD: Right. Okay, and I think that was around '87 or so.

MF: I believe that's right.

KD: Yes, and it would have been, maybe, crowded out by something else that happened in '87.

MF: Well, we had a very large market decline, and I don't have that much precise recollection this many years afterwards, but what I do remember was, particularly not so much October 19th, the first day when the market was down at least by Dow standards 22 percent, but the next day when the decline continued, and there was concern on our part, "our" meaning the SEC's part, that the exchange might have to halt trading. That, I think, would have been a major issue in terms of the confidence that investors had in terms of the market, because before the market crash, there were no such things as circuit breakers, so you could halt trading in an individual stock. If it was an imbalance of buyers or an imbalance of sellers, you could halt trading in an individual stock –

KD: The SEC could.

MF: Well, generally the markets could. There were several types of trading halts. First, there is an order in balance halt, and that would be the New York Stock Exchange, the primary market. If there was a large imbalance of orders such that you couldn't maintain a fair nor orderly market, they would halt trading and try to do a restart and try to get an

equally fair price. The next kind of trading halt is a regulatory trading halt. So let's say, a company issues news. You want to give investors an opportunity to digest the news and determine where the stock should move if it's going to move. And there were protocols in terms of when you would reopen the stock. Normally you would put up an indication of interest and then you would wait a certain period of time before the stock would be open.

The other kind of trading halt is an SEC trading halt. Now, the SEC can halt trading for up to ten days; usually it's because of absence of current information in the market. Prior to the late seventies, the SEC would continue to tack on trading halt after trading halt. So you do ten days, and then you would do another ten days, and another ten days, so it could be indefinite. The Supreme Court put a stop to that, saying, "No, you can't do successive ten days. In order to have a new ten days, you would have to have new facts." So the Commission stopped issuing the successive trading halts. Now an SRO, the New York Stock Exchange, can halt trading indefinitely, but the SEC cannot.

KD: And this was the situation in '87?

MF: Well, in '87, the situation was the SEC could halt trading in an individual stock. The SEC could not halt trading market-wide, and still cannot halt trading market-wide. What happened afterwards was the markets, in conjunction with the SEC, developed circuit breakers. Originally the circuit breaker was based on the Dow Jones Industrial Average. If it was down X amount, the market would halt for, I don't remember, thirty minutes or

something, and then it would reopen, and then if went down more, it would halt for a longer period. If it happened close to the close, it would close for the rest of the day, that kind of thing. Since then the circuit breakers have been changed to the S&P 500, and they're very rarely have been used. As a matter of fact, I can't think of a situation in which the major circuit breakers have ever been triggered.

KD: Were the circuit breakers tied to the Dow before?

MF: Initially they were tied to the Dow. Now they're tied to the S&P, but it's the same thing.

KD: Why the change?

MF: Why the change? Because I think that the Commission, in cooperation with the markets, determined that the S&P 500 was a broader reflection of the market. I think today it's a 7 percent decline, so the declines that occurred more recently didn't even come close to that, and while they were large market drops in absolute terms, in percentage terms they were only, I think, around 4 percent. The reason the October 19th, 1987 was a concern is we had never had a decline anywhere like a 22 percent decline in the market. But I think there were some declines way back, I think before the development of the SEC, where markets would go up and down by large percentages, but nothing like this, and it was very disconcerting.

Fortunately, from a regulatory standpoint, things went relatively smoothly in the sense that we only had, I think, one firm that was under capital as results of the decline on October 19th, but the concern was that a market decline would continue. And so after that market decline, the division was instructed to do an investigation and a report which we did trying to analyze the reasons for the market crash or break.

KD: So did you split this up among the different parts of market reg?

MF: Yes. I mean, most of the people in the division worked on the report.

KD: Okay. So what was the piece that you ended up with?

MF: Well, my job was overall coordinator, and I think in terms of personal responsibility for the drafting. I mean, various offices drafted various pieces, and what we tried to do is put them all together. I think Chapter 3 which was mostly of findings, was the chapter I had the most involvement in drafting.

KD: Okay. And this is where you talked about the futures market?

MF: We talked about the futures market, we talked about portfolio insurance, and we talked about the impact of futures markets on equity markets because the thing that was different in the eighties was, as I said earlier, the advent of financial futures, futures on the major stock indices, so that you could buy synthetically the S&P 500 as a future with

much less margin than if you were going to buy the individual stocks in the S&P 500. First of all, it would cost you a lot of money, and you could only get 50 percent leverage, whereas in a future you can get much greater leverage, so the result of that is, it injects the potential for greater volatility in the market. It also injects the potential for greater ability to hedge in the market because you could hedge a stock portfolio with futures cheaper than you could hedge a stock portfolio with, let's say, government bonds or something like that.

KD: What was the long-term result of this look into the '87 market then?

MF: Well, I think the most significant impact was the development of the circuit breakers, because after that happened, we didn't have any more of these types of major events until in more recent times, the so-called flash crash of, I think, 2010, and there was a mini flash crash just weeks ago. But those, I think, were somewhat different in that in recent years, there's much more algorithmic and high-frequency trading, and so what happens in some of these flash events is that the buyers dry up. So there are only sellers in the market and so you could have the market move significant amounts on relatively little volume.

KD: Now, something you spent a good bit of time on in the nineties was this large trader rule. How is that related to what followed the '87 crash?

MF: Well, there were a couple of things that came out of the market crash on the legislative front. The SEC asked Congress for authority to adopt a large trader rule, and the reason for a large trader rule was to try to give the staff and the commissioners better tools to analyze market trading because it was very labor-intensive and time-consuming to try to reconstruct trading even on one day. And because the market has become more institutionalized over time, it's more important than ever to be able to understand who's in the market and what they're doing. So we felt that if we had a large trader reporting system, we would be able to analyze trading better.

The problem that we had with the large trader rule was the logistics of actually doing it from a regulatory standpoint and developing a system that the industry could build and comply with, and so we found it too difficult at that time to be able to do it. Now, more recently, the SEC did adopt the large trader rule, but it used a different method to attack the issue, which was much easier for people to comply with.

KD: Well, what's the method? Are we talking about technology? Is that the thing that was in the way?

MF: Well, no, it was trying to identify all of the accounts that somebody had because people would have accounts in different roles at different firms, and while we had something to model on – the CFTC for a long time, had a large position reporting rule, and there's a large position reporting rule in the standardized options market – this was much more complicated because of the myriad ways in which people can hold stocks and being able

to identify all of them in a way that allowed us to put everything together. So what they did in the large trader rule that they adopted was to say, okay, viewing people as having discretion over trading.

If you have discretion over trading, then what you're supposed to do over enough trading – and they picked a fairly large number as the threshold, which was another problem that we encountered when we tried to do this before – if you exceed the threshold, then you're supposed to file a form with the SEC, get a large trader number, give that large trader number to each of the broker-dealers where you have an account. So there wasn't reporting on a regular basis, there was, hold the information, and if we need it we'll call you, and you'll send it in. Sort of like what the Treasury Department does with respect to its large position reporting for government bonds. So that was sort of the model that they ultimately settled on. I don't think we're aware where they've actually called for the information yet, but it's there as a tool for them if they want to do it.

Let me just finish, because you were asking about what did we do as a result of the market crash. The other piece of the puzzle, and this also tied into what we were discussing earlier with Drexel Burnham, was risk assessment. We requested from Congress and got authority to adopt a risk assessment rule, and the risk assessment rule enables the Commission to require certain broker-dealers to report information not only about themselves, because broker-dealers are required to report their financial information regularly to the regulators in the form of what are called focus reports, but they're not required to report information about their affiliates. And so what the risk

assessment rules do is require broker-dealers that are subject to it, which are basically all clearing firms and any other firms with capital of \$20 million to report information about their material associated persons.

The only problem with the rule when we drafted it was we didn't define what a material associated person is. We gave guidance as to factors to consider, so it's a "you know it when you see it" kind of thing. But the rules been in effect now for a long time. There are only about 250 filers, and the SEC, originally when the rule was first put into place, had only one staff person reviewing all this information. Now they have a decent size staff in Mike Macchiaroli's office that reviews the risk assessment information. They check based on focus filing, to see if there's a firm that has twenty million in capital to go out to them, and say, gee, you have twenty million in capital; how come you're not filing risk assessment reports? And so that's how they catch potential new filers.

KD: Okay. So, has this actually been used?

MF: Oh, well, I don't know how they use it because I'm not on the staff anymore, but I do know that our clients who have to do this spend time thinking about which of their entities have to report, and what information needs to be reported, and those kind of things, so we don't get a lot of questions about the risk assessment rules, but we get some.

KD: Anything else we should talk about in the nineties before we have the creation of OCIE?

MF: I don't think so. The other thing that was in my portfolio as head of inspections was my enforcement liaison hat. I was the enforcement liaison for market regulation for broker-dealer kinds of cases. I was involved in any significant broker-dealer case that was brought by home office enforcement or one of the regional offices, and so we had some very significant cases that were brought. I can't remember them precisely because all the time merges after a while, but we had some fairly significant cases, some of which involved cases where there was not only an SEC action, but there was also a state action. The states often would put together a task force of multiple state regulators that would be involved in the state aspect of the enforcement action.

KD And what would your role be there? Would it be to sort of walk them through some of the material facts?

MF: Well, there were a couple of things. One is they would approach us on theories. You know, do these facts violate the rules? We would discuss theories; we would discuss sanctions. We would assist them by reviewing some of their memos because in order for enforcement to bring a case, they would have to not only conduct the investigation and take testimony and review records, but they would have to draft a memo to the Commission because they would need authority from the Commission to bring an enforcement action whether it's an administrative proceeding or a injunctive proceeding. That would have to go to the Commission, and the Commission would have to approve it, and so those memos were reviewed by the other divisions including the General

Counsel's office who had a role in it. If it was a broker-dealer case or a market manipulation case, we would review it as well.

KD: So we've been talking about this function within market reg that was the oversight inspections; is there a sense of why the decision was made to kind of pull this out and to form OCIE?

MF: I'm not quite sure. It was the idea of then Chairman Levitt to break out the examination and inspection functions from the divisions of investment management and market reg and create a new unit whose sole job it was to do inspections. One of the effects it had was to separate the substantive regulatory functions within two divisions from the examination function, which I think was more problematic at least initially, for investment management than it was for market reg in part because investment management historically had used their examiners not only to conduct examinations, but also to gather industry information.

So by having them separate, that gave them less useful information. Also having the examination of function separated made it a little more difficult to have input from the examination side on regulatory proposals. But over time, OCIE developed a mind of its own, if you will, a unique identity, and I think now it's been in place since 1995, and so it's probably a permanent fixture. Although if I had my personal druthers, I would not have created OCIE and I would have kept those functions within the division.

KD: Your time there, you would have been building this thing up, sort of coming together with your counterparts.

MF: Well, in order to create OCIE, it was not that difficult. All they did was transfer all of the staff people who were in the inspections office, my inspections office, and the people who are in Gene Kohlke's office into OCIE.

KD: And nothing really changed?

MF: At least at the headquarters office. In the regions there was still separation between the branches that did investment advisor and investment company examinations and the examiners that did broker-dealer and transfer agent examinations, so in the regions it was not as much of a change as it was in the home office.

KD: Okay. And you left late '95?

MF: I left in December of '95. I think OCIE was created in March of '95, and my decision to leave was partly based on the fact of the change to OCIE and change in my own personal portfolio at the Commission, because I had to give up my NASAA role; I had to give up my enforcement liaison role. But also because we had additions to our family, and so we looked at our family finances and decided that it was time to make a change.

KD: Often happens.

MF: Yes, so we decided as a family to stay in Washington. That resulted in my getting involved with a law firm here in Washington as opposed to going to New York and working for a broker-dealer, which I had the opportunity to do, but chose not to because neither my wife nor I wanted to live in New York. Notwithstanding all the wonderful things about New York; we liked living in Washington.

KD: So did you come to Morgan Lewis right off then?

MF: Yes, and in fact that was one of the mistakes I guess I made, is that most people, if they have an opportunity, take some time between jobs to decompress, but Lloyd Feller, who is the person who was responsible for bringing me here, said, “Oh, we need you, we need you, we need you. We have a project for you.” So on Friday I left the SEC and on Monday I started here. I’m not sure if it was the first day or the second day they sent me to New York to do a review of a broker’s broker, one of our major broker’s broker clients. And so now I’ve been here at Morgan Lewis; this is my twenty-second year.

KD: Okay. And have you been mostly doing market structure in your practice?

MF: Actually, no. There aren’t that many clients, other than exchange clients, who really are involved in the market structure debate in the sense of hiring outside lawyers to do things for them. We have some of our clients who have interest in some of the market structure rules and we’ve interacted with the staff on some of that. We have a number of clients

who run what we call alternative trading systems. There is an SEC rule called Regulation ATS, which was adopted after I left, I think in 1998, which treats broker-dealer systems as – they define them as exchanges, but allow them to function without registering as exchanges. So we were involved in a number of those kinds of entities, but we don't do that much in pure market structure.

Most of what we do is responding to regulatory questions, counseling clients on investigations and broker-dealer examinations. The one thing that I would mention that really has changed a lot since I came here is we get many, many fewer pure trading questions. So if somebody wants to put on a large trade at the close, in the day, they would call us up and say, "Oh, we want to do A, B, C. Is that okay?" Now, because of the advent of algorithmic trading, many of the trades that would have been done as negotiated block trades are done by chopping orders up into little tiny pieces and executing them electronically, so they don't call us because the computer is executing the trade.

KD: Yes, I think a good place to wrap up is, you have an interesting perspective because you were there at the '75 Acts Amendments, and then you're on the other side working in your practice when you see Reg ATS go through and especially Reg NMS. A little perspective on the way market structure has turned out, what do you see that you kind of could have anticipated back in '75, and what do you see that you never would have anticipated?

MF Gee, I don't think we could have anticipated the high-frequency trading in 1975. I think there was a view at the time that what was needed was to go to a centralized electronic system and, in effect, get rid of exchange floors and have everybody put all their orders into a system. Instead we have linked markets, which is a fine model, but it's not, I don't think, the model that we really contemplated at the time. But it's a model that has worked over time. They're able to trade billions of shares in a day today. The settlement period has been reduced first from T+5 to T+3 and now from T+3 to T+2, so all of that is due to the use and advent of computer technology. But I don't think I could have predicted where it actually came out when we were doing it initially.

What we were doing initially was, we were trying to get a more competitive marketplace and allow competitors other than the New York Stock Exchange in the door, and to deal with the impact of another major factor which was the elimination of fixed commission rates which was the other seminal kind of thing that happened in the seventies that changed the way markets work and firms interact with customers, development of online brokers and discount brokers which couldn't have happened in an era of fixed commission rates.

But I don't think we could have really anticipated exactly where we are, and of course the story continues in a sense that the Commission just finished a stint with an advisory committee on market structure and has some proposals that were put out for comment some years ago that may now see the light of day, and have now shifted gears to a market structure analysis with respect to fixed income and has created an advisory committee on

fixed income market structure which is a very interesting development because for the most part fixed income was, one, a dealer market, and two, a market with a million CUSIPs, and so a difficult market to put together as opposed to saying we're going to trade Microsoft on ten different exchanges.

Now, the question is, how do you do ten million bonds? Each individually may trade by appointment. How are you going to get that all linked together, and technology is, I think, a major factor there with the development of alternative trading systems for bonds. The question is, what do you do with them, do you link them? Then you have trace, which is another new thing since I left the SEC, but it's the FINRA reporting system for fixed income, and now not only corporate bonds but mortgage-backed securities, and more recently government bonds. So that's a whole new area of market structure which I think is extremely interesting and we're, I think, very much interested in seeing where that all comes out.

KD: Sure thing. Anything else we should talk about that we haven't touched on?

MF: I don't think so. We didn't talk too much about fixed commission rates, but it is something that we were involved in it in the Division of Market Regulation. The Commission, as I'm sure you know, unfixed commission rates gradually starting with institutional size orders. The '75 Act Amendments dealt with fixed commissions by eliminating them, but the SEC adopted a rule eliminating fixed commissions at about the same time, and we were involved in that. Prior to that, some institutions felt they had to

recapture, and in a fixed commission rate in order to reduce their trading costs had to become brokers themselves, and that in turn, created a regulatory issue of, gee, who should be a member of an exchange?

The SEC adopted a rule called 19b-2 that basically created an 80-20 test. You had to be doing a public business in order to be a member of the exchange. That rule was subsumed in the '75 Amendments with adoption of statutory provisions that in effect created a 100-0 test that you really had to do a public business in order to be a broker-dealer member of an exchange. We're still seeing the effects of fixed commission rate because it created much lower commissions for consumers. You know, when you can do a trade on an exchange for \$4.95 as opposed to the old commission rate was 2 percent of value. You can see how much cheaper it is to do trades in this environment than it was before fixed commission rates were eliminated, and that was probably the biggest thing that the Commission did which benefited individual retail investors.

KD: Right. And appropriately enough kind of happened just at the time of the '75 Acts Amendments.

MF: Yes. I mean, the '75 Amendments eliminated fixed commission rates, but the Commission had adopted a rule at the same time, so even if the '75 Amendments hadn't done it, the SEC did it.

KD: Yes. Well, I appreciate your talking to me about all the things you did at the SEC during your career.

MF: Well, thank you, and thank the Historical Society for giving me the opportunity to be part of the database.

KD: All right.

[End of Interview]