

Securities and Exchange Commission Historical Society
Interview with Richard Ketchum
Conducted on April 17, 2008, by Kenneth Durr

KD: This is an interview with Richard Ketchum on April 17th, 2008, in New York City, by Kenneth Durr. Let's start out with some background. You went to Tufts?

RK: I went to Tufts and NYU Law School. After NYU Law School, I worked at Milbank, Tweed, Hadley & McCoy for a couple of years. This being the end of the Vietnam War, and my draft number being 26, I was in Navy JAG. Somewhere around 1974, or at the beginning of my third year of law school in '75, the war was winding down, and they looked around and said: We would want that many lawyers in the Navy for what reason? So I found myself looking for a job fairly quickly. I ended up in a large firm, Milbank, with some great people, in large part, doing a variety of loan agreement work for Chase Manhattan Bank, which was Milbank's largest client at the time—still is to some degree. That didn't feel like what I wanted to do for the rest of my life. No dramatic or profound inclination to securities regulation. Probably the reason that it tweaked an interest was two things: first, I did take a securities regulation course which I really enjoyed in law school, taught by Marty Lipton.

About the only work that I did at Milbank that particularly intrigued me, in the midst of all the loan agreements, was—this was in '76 or '77, shortly after the '75 Act amendments: the Securities Reform Act with the enactment of the National Market System and the Commission's proposal to in various tranches remove off-board trading restrictions that were in place for the New York Stock Exchange and restricted upstairs trading. A client of Milbank, Tweed was the New York Stock Exchange. I spent some time analyzing some of the early releases, and putting together pieces of their preparation for a comment letter on a couple of the proposals, running up to when I left Milbank in the summer of '77. I immediately got dropped into [the SEC's Division of] Market Regulation, where I split time between what was then a single office: the Office of Trading Practices and Market Structure; half of which was interpretative work, which was great to really begin to understand how the industry and capital raising process worked; in particular, interpreting Rules 10b-6, 10b-7 and 10b-13—all now re-numbered, of course.

KD: So, you're interpreting—

RK: Half of it was interpreting things with respect to trading around offerings in other areas where there might be particular manipulative risk. And half of it was the Market Structure Office, which was essentially the office in Market Regulation given responsibility for implementing Section 11A of the Act—essentially the things that came out of the '75 Act Amendments. One of my first market structure memories was taking notes as the grunt in the group for the discussions at the National Market Advisory Board and the public hearings relating to the Commission's proposal to rescind exchange off-board trading restrictions. And again, getting an early introduction into understanding

markets better, and understanding the fascinating issues that were posed by the Commission getting involved with market structure issues, an area that previously, putting aside the gradual unfixing of commissions during the few years before, had never really been a part of the Commission's mandate.

KD: Tell me a little bit about this National Market Advisory Board. Who were the people sitting on that?

RK: The National Market Advisory Board was set up immediately after the statute was adopted in '75 and it involved representatives from the securities industry. Perhaps most notably remembered were Don Stone, who later became a vice chairman of the New York Stock Exchange, and was generally considered to be a very articulate voice for the specialist community—he owned a specialist firm—and a voice for auction markets. Don Weeden, who had created Weeden and Co., and was one of the most outspoken people, if not the most outspoken people on a variety of issues, ranging from unfixing of commissions to moving to a computerized trading environment, as opposed to a floor-based exchange environment. And then a range of other people in the industry. But Stone and Weeden were fairly famous for long dialectics between them, including shouting matches on occasion. There were basically two contributions to my education in that year. One was the Advisory Board. And the other resulted from the Commission's proposal of the complete removal of off-board trading restrictions, what was then Rule 19c-2—a proposal never adopted. And again, as one of the young attorneys in this joint office, I spent time essentially summarizing testimony with respect to the public hearings the Commission had on it, throughout the late summer and early fall of '77.

KD: Was the testimony resoundingly negative? Is that why it ended up not being adopted?

RK: Yes, the testimony was resoundingly negative. Yes. Not totally negative. Obviously, people like the NASD were quite positive about it. But there was relatively little support in the industry for the risk-taking involved in what would have been a dramatic single step change in trading environment, in a time when computerized trading was still in infancy, as opposed to when you saw all these things roll out decades later. One of the famous letters was a letter from the City of New York, in which their quote was that the result of the Commission's action will be, "there will be grass growing on Wall Street."

KD: This is in regard to Rule 390?

RK: This is regard to 390, New York Stock Exchange Rule 390. Without jumping ahead of the story, what the Commission did over a period of years—which I think really set forth much of the competitive philosophy with the Commission for the next twenty years—was come to a fairly solid compromise—first it pulled back from 19c-2, took no action immediately; but then adopted Rule 19c-3, which basically, on a prospective basis, didn't permit the application of off-board trading restrictions. So essentially, for new listings, off-board trading restrictions couldn't be applied. And while that had no significant

impact initially, it began to create the environment and the opportunity for trading away from the Exchange.

KD: Was that done in the late '70s?

RK: Rule 19c-3, I believe was done, yes, I think it was 1979. If it wasn't 1979, it was 1980. But I think it was '79. It was in a time of really pretty substantial ferment. The Commission did a variety of significant things then. It adopted the Firm Quote Rule, that has been really one of the significant building blocks of modern trading market structure. It required, for the first time, for NASDAQ securities that they actually have trade reporting, and eliminated something called the Representative Bid and Ask, with respect to quotations. Hard to imagine that just thirty years ago—and obviously, the NASDAQ market was much, much smaller; and was mostly relatively small companies, with a very few exceptions in that time, way before the computer revolution basically gave the NASDAQ a base to become a much, much more significant competitor. But nevertheless, hard to imagine that NASDAQ market at that point—you didn't know when trades had occurred, when they were reported. And the quote that the public saw, as opposed to the quote that competing market makers saw, was an average quote. It wasn't the actual best bid, and the best offer. It was an average in between. And averages are never as competitive, and so it basically built in an increased profit versus the price that the public would get, versus the price the dealers could go replenish their liquidity at out in the marketplace. So the late 1970s saw the first tranche of the National Market System Program. Something called the Vendor Display Rule also was adopted, in which it was required that a consolidated picture of quotations, or at least the consolidated quote, was required by vendors to be displayed so that it was accessible to investors—again, something that never occurred before. So, great action in quotes. For the first time in NASDAQ, you had trade reporting; and you begin the process of the Commission encouraging competition. So that gets ahead of my story. But anyway, that's how I rolled into the Commission by accident, fleeing a large law firm, with respect to something that had tweaked my attention and fascination.

KD: Who did you work for?

RK: Andy Klein was my director. Andy became my director a few weeks after I got there. Shortly after that, Lloyd Feller became my Associate Director—again, both long-time Commission employees. They both have had extremely successful law firm careers afterwards: Andy at Schiff, Harden; and Lloyd at Morgan, Lewis & Bockius, and now is the general counsel of Jefferies. It was an incredibly exciting time in Market Regulation.

Market Reg during that time was really asked to rethink the Commission's mission, in a variety of ways. The Commission, properly so, has been honored as fundamentally a disclosure and enforcement agency, and with that, an investor protection agency. For the first time, with the issues that came through from everything from the Special Study to the Institutional Investors' Study, to the Act in '75—ranging from the question of unfixing commissions, to the question of how market structure should be designed—for the first time, the Commission was being asked to play a role in market structure design;

while choosing not to micro-design how the market system should work, the Commission created a set of rules that set the boundaries in which how competition would incur; and for the first time, with a very clear pro-competitive objective, albeit one among others that had to be balanced. And if you look at Section 11A, you see it as this exercise in addressing somewhat contradictory goals that have to be balanced in taking action. And you saw it in other sections of the Act coming out of the '75 Act Amendments as well, that the Commission's job was to ensure fair competition; and, where appropriate and consistent with other goals of the Act, to eliminate burdens on competition. Not that the Commission didn't worry some about these issues before, but you suddenly had a whole different approach, from the standpoint of the Commission's responsibilities to be a pro-competitive agency, albeit one more balanced and different than the FTC, or the Justice Department. Competition wasn't the only thing to worry about and keep in balance; you had to be worried about the structure of the markets and protecting investors. And to try to look to the structure that would best meet all of the Section 11A goals. And those goals basically were to be more transparent in things like trade and quote reporting, to provide fair competition against the dominant and entrenched exchanges, such as the New York Stock Exchange and the American Stock Exchange.

KD: Well what about convergence of all of the exchanges? When you say National Market System, you think of bringing all these disparate units together.

RK: Well, that was really the debate, and continued to be the debate until, arguably, where you are today when the SEC has created through Reg NMS what you could argue is a virtual convergence of markets.

KD: But there was a sense back then that somewhere in the future this was a desirable outcome.

RK: Well, yes. There was certainly a sense in the staff. But it was a statute that, as I say, was embedded with contradictions, and many different visions of what that meant. And remembering: you're at a time of less complete computerization, to say the least, and much increased cost with respect to development. If you go back through the legislative history, you'll see even conflicting legislative history running from everything to encouraging complete convergence through the development of a consolidated limit order book, in which all the priced orders had to be together in a single book, to more rudimentary linkages. And Exchanges, which of course back then were all Exchange floors; and the NASDAQ market, which of course back then was really a light connection of competing market makers who put out quotations in various offices of competing broker/dealers. So your one vision, not accepted by many, was a consolidated limit order book. Another vision was just open-ended competition, where upstairs firms would have the ability to compete and hold onto their orders by internalizing those orders—and that was one of the issues with respect to Rule 19c-2—even though essentially the linkages hadn't been put together. So you had two radical visions: one of which was a total consolidation, the other was somewhat of a total fragmentation. And without getting into the arguments whether it was good or bad, and what conflicts of interest there might have been, and the rest; the third vision was a more pragmatic, incremental vision of

encouraging consolidated quote and trade information and trading linkages, a vision which the Commission prodded the markets to take action and played referee on how to resolve disputes. This pragmatic and incremental approach helped the Commission to gradually move the exchanges along the path to a national market system.

And that third vision was basically what the Commission adopted in the late '70s, which was to say: Okay, we're not ready to take radical action. I find it interesting from a governance standpoint, because it is an interesting question of how much risk a regulatory agency is willing to take and expose to an important industry in the United States. There was a beauty with respect to consolidated book, and pulling it all together, and a fundamental fairness, a complete transparency of all interests; yet it would have arguably completely eliminated the ability for the exchanges to operate and provide separate markets. It would have basically turned on its head the existing market structure, and moved to something else, which you would have had to take in faith was going to be better.

KD: Right. And you wouldn't know.

RK: And it would be hard to know. Unlike today, where you look and say: Well, I see those all over the world; there was no example out there. And so what the Commission said is: "I see a lot of things here in 11A that make sense to me: I want to encourage competition; I want to have more complete trade and quote information, so that people can make better decisions. But gee, I also want to control my risk." So what the Commission did was a combination of rule making and linkages. It pushed the linkages through the exchanges and NASDAQ, so that there would be a trading connection between markets, linking so that you could go out and get to better prices; but with nothing other than best execution requirements initially governing that. And then a set of rules that said: Okay, we're going to have consolidated quote information; we're going to have consolidated trade information. We're going to eliminate off-board trading restrictions on a prospective standpoint so it doesn't all happen in a big bang. And we're going to bring NASDAQ into an environment that has the same sort of trade and quote information that the exchanges have historically had. So we're going to take the huge differences between the NASDAQ environment and the exchange market, and without demanding one market structure or another, we're going to pull together from the standpoint of transparency. And the last piece was questions with respect to the definition of an exchange; the last piece was some creativity with respect to the definition of exchange that led the Commission staff to do a series of no action letters that permitted trading systems like Instinet to operate without being required to register—something that didn't occur in most of the rest of the world. And with that, it began from a very minimalistic standpoint, but then, obviously, growing to be hugely important in the late '80s and the '90s—an environment where people could innovate with lower cost, and without the same restrictions you had with an exchange.

KD: Was the fear that if you didn't take this no action approach, that these things would just be strangled?

RK: Yes, absolutely. And in fact, they died for years in the rest of the world, other than the United States; partially because the U.S. capital markets are so huge, but also partly because they were allowed to operate without exchange registrations, and the like, so that their cost and flexibility were great. Now that led to many competitive issues as they grew and thrived, which led to things like Reg ATS.

The other key area of the early piece of my Commission career—and kind of rolling into the other major development, which characterizes the '70s and '80s from a financial market standpoint and from and SEC market regulation standpoint—is derivatives, obviously a subject of some interest even today. And that was probably my biggest break of my career. As I said, I got dropped into this office that first allowed me to start learning—that had as a fundamental culture and ethic, partially driven by the new legislation, of a fascination for how markets worked, and how the industry worked. After doing that for a relatively short time—about six months—at the very same time, the options markets imploded. There were very significant sales practice concerns as well as market structure issues. Standardized options, with a central clearing counter party, began with Joe Sullivan and the CBOE in the early '70s, exploded, other exchanges had joined; and suddenly firms were selling these things all over the place without people really understanding or receiving proper disclosure of what the risks of options were.

And also, there were market structure issues as to whether there should be multiple trading of options, as well as other contentious issues. So, Harold Williams, Chairman at the time, and the Commission, declared a moratorium on options expansion; an action of perhaps somewhat questionable legality although the options exchanges abided by it. And along with that moratorium on expansion of the options business, he created an Options Study, that was headed by Marty Budd. Staff were drafted into the Options Study from each of the relevant Divisions: an interesting cast of characters, some of which you have either interviewed, or I'll bet you'll interview over time. Gary Lynch and Marianne Smythe were on the Options Study—as two notable division directors going forward. And I was. The Options study was a wonderful experience. First, it was a great time; and it was a wonderful piece of my career, because the great thing about a study is, for the first few months, the senior people in the study think deep thoughts, talk to senior people, and write outlines. So that the rest of us just didn't sit around twiddling our thumbs, we were set off to learn. It was the first time I ever got to read the Special Study, the Institutional Investors' Study, a variety of treatises on options pricing theory—and then we got dropped on trading floors, at the New York Stock Exchange, at the CBOE, on the American Stock Exchange, and up on the trading floor of Merrill Lynch. And then for the last six months, for better or worse, we wrote the Options Study, and it moved the Commission on its path towards how options should be regulated. I came out a year later, not knowing a hell of a lot about derivatives; but compared to virtually everybody else at the SEC, knowing a ton. Given the fact that once the moratorium was lifted, both options and futures began generating a huge rush of new products, including options and futures on stock indices, currencies and debt.

KD: Who's running the study?

- RK:** Running the study was Marty Budd, essentially with guidance from Chairman Williams' office. A guy by the name of Rick Weingarten, who had been the Executive Assistant to the Chairman, was my boss. Gary Lynch, I believe, was the head of one piece of the study on the enforcement side. Marianne Smythe and Rich Morrissey with respect to sales practice issues. And it was Rick Weingarten and I, basically, looking at the market structure issues.
- KD:** How much direction did you get? You're getting to look at the other studies, how those were done. And they dropped you on the exchange floors. But were you given an ultimate direction that you were supposed to be going in?
- RK:** We had an outline. The Commission, in its moratorium, and then in the release that followed the moratorium, basically outlined the issues. And the issues ranged from sales practice concerns to disclosure concerns and risk concerns, with respect to the product; supervision concerns as to how broker/dealers oversaw their account executives sales of options to investors; and then the market structure concerns, including whether there should be multiple trading in the marketplace? And there were different models of trading in options. There were competing market maker models, and specialist models. And basically, we looked at all that. A significant amount of things came out of the Options Study, out of the problems; particularly on the supervision side—very specific supervision requirements with respect to options, that to this day in the exchange rules and differ from the more general supervision rules applicable with respect to other products; a disclosure document that has now been whittled into something more rational, but ensured much better disclosure of the risk. There had always been a disclosure document, but refocusing that on the risk, and really focusing firms on providing much better disclosure and suitability with respect to people buying this type of leveraged product. So yes, the Commission basically identified the areas, and then we were kind of on our own to write the Study.
- KD:** Did the Study come out while Harold Williams was still in there?
- RK:** The Study did come out while Chairman Williams was still there. The Study began in January of 1978, was issued right around the end of the year, beginning of 1979. I returned to Market Regulation at that point—now completely in what was the Office of Market Structure, no longer worrying about trading practice interpretations. And as I say, that dropped me right back into a number of Commission actions like adopting the Firm Quote Rule, requiring trade reporting for NASDAQ securities—one of the things I worked a lot on, vendor display rule, and a variety of other pieces that were being considered at that point. It was a pretty neat time. Then, 1980 happened. President Carter was defeated by Ronald Reagan, and a somewhat different regulatory philosophy was shifted to the SEC. This was just after I had been promoted to Associate Director, after George Simon left to go to a law firm. He had been one of my mentors and a very respected person in the securities bar throughout the years afterwards. With the Associate Director responsibilities, I moved from just the narrow focus on the market structure issues and the national market system issues to a broader responsibility for

oversight over the whole self-regulatory rule filing process; and with that, the options rule filing process.

To tell one anecdote, with respect to Chairman Shad: here we are, beginning the Reagan administration. I think it would be probably fair to say that many of the senior people in market regulation were more on the Democratic side of the philosophical aisle, and certainly were, by nature, reasonably activist and enthusiastic about programs like the national market system program, et cetera. Obviously, Chairman Shad, who was formerly vice chairman of E.F. Hutton, had been brought in with a clear mandate to de-regulate. And the first time I met Chairman Shad, who became a good friend, and somebody that I dearly loved—despite the fact that we didn't agree on many things—was after a Market Reg softball game. I headed back to the office to pick up my stuff, at about eight o'clock at night. And the name of our team was the "Regulators"—short for Market Regulation. So here I am: the first time I meet John Shad, getting in the elevator, with this burgundy shirt, grubby from playing a couple hours in a reasonably hot climate, with "Regulators" sitting on the front of my shirt. John looked at me, clearly didn't recognize me; pointed at my shirt, and said, "What's that?" I tried to get out as quickly as I could, without identifying my name.

KD: The new uniform for the SEC.

RK: Well, in retrospect, I should have said: We had a game with the CFTC, and we won it. So we got to keep their uniforms. Anyway, that shift, as I became Associate Director, really was fortuitous for my career again; because in a deregulatory environment, we stopped doing rules with respect to the National Market System for a period of years, with the one exception of completing the requirement of trade reporting for NASDAQ securities. And the real shift in focus was now driven by the exchanges, with respect to the ferment and growth with regard to the options market and the futures market. And for the first time, the concerns that survived for the rest of my SEC career, and then live through today with the Treasury blueprint just published proposing again the merger of the SEC and CFTC, were really spilling out; because of the huge growth of futures in the financial side, and particularly with respect to stock index futures. And with that, the ferment of developing products on the futures side, ferment of developing products on the options side, the issues with respect to jurisdiction regarding those products; and then the concern of the impact of futures on trading in the underlying securities; and the issues of having two different regulators with very different statutes; led to a number of controversies.

KD: Did Market Reg have any input on the CFTC—on the Shad-Johnson Accord?

RK: Yes. You may have heard something about that with your interview with Dan Goelzer, because Dan was the lead negotiator in that. The Director of Market Regulation in that time was Doug Scarff. And I basically supported Doug, with respect to Market Reg's support of the Chairman in those negotiations. Then as time went on—and you can always trust General Counsel to get out once the glamour's done—Market Reg was really the division responsible for the application of the Shad-Johnson Accord. Addressing

things like questions of what was a narrow-based, versus a broad-based index, what were permissible futures products under the Accord.

KD: Did the two agencies have responsibility for narrow and broad? Were those split?

RK: Well, it was not so much split. There was no limitation on the type of index that could be traded in the options market, because the SEC had jurisdiction over all securities. While the definition of futures was quite broad, and resulted in the SEC losing a variety of lawsuits over the years past—the CFTC basically, to avoid a jurisdictional brawl, agreed to a limitation in the Shad-Johnson Accord that they would only authorize broad-based futures. And the theory of that was that narrow-based futures started to look more and more like futures on an individual security, which were also prohibited, in order to avoid concern of the impact of two different regulatory structures, and the impact—which was perceived as undue impact—of futures on the trading of securities. So, a good deal of what we did in the next few years, in a fairly deregulatory time—at least in this area—was really looking at options, new products, and deciding what—this all sounds rather bureaucratic and unfriendly from a competitive standpoint—but deciding what type of futures products would be permitted and not permitted. And just to carry that thought through, that sort of rose you up to the issues approaching the 1987 market crash. Because notwithstanding the restrictions, the really popular, successful products were index options and index futures, particularly broad-based index futures, particularly the S&P 500.

KD: And here you've got the problem where the options trading and the trading of the securities is somehow related?

RK: Well, that's right. The index futures and options are fundamentally derivatives of the basket of securities. You can essentially create with options trading the equivalent of a stock position. But mostly, they react to one another. And under perfect theory, they react to changes in the stock price. But with the development and the huge popularity and liquidity of index futures, that product began in a variety of times, when markets got volatile, to drive the prices of the stocks that were included in the basket; and because those were the biggest stocks, tended to drive the whole stock market. The reason for that is sort of easier to understand by analogy. If you think of the stock market as a huge aircraft carrier, and the index future as a very small PT boat, the wake required to turn a PT boat is obviously much quicker than the wake to turn an aircraft carrier. To turn the entire stock market takes time.

This was a time when program trading was really beginning; and where electronic trading basically was very limited. So the net effect was that if you really wanted, on a market-wide basis, to quickly become long or short, the most efficient way to do that was to trade index futures. And index futures started to have more and more of an impact on the underlying securities. Simultaneously, we were, for the first time in a very long time—from the '70s on—in a bull market. And with that bull market came more and more aggressive strategies to be able to use derivatives to take advantage of price movements. And with that, recognizing—rightly or wrongly—that there were lower margin

requirements for futures, professional traders were able to take larger, more leveraged, positions. You see this today, with the ability to provide great leverage with respect to over-the-counter derivative products. There was greater ability to attain leverage and higher profitability in the futures market than you could in the stock market. And those were really the seeds of the variety of issues that resulted in the crash occurring so quickly and so dramatically, without saying, of course, that there weren't fundamental economic reasons why the market was overvalued.

KD: And the New York Stock Exchange, at some point in here, applied to trade options. Is that right?

RK: New York Stock Exchange applied to trade options. At each of the other exchanges, options had become a very successful product. The Exchange applied to trade options. That led to questions of: "Gee, how do you operate with respect to the primary market in an environment where there was a great deal of market information available on the floor of the Exchange? And what type of restrictions do you need to deal with that?" And effectively, what occurred there—which had occurred in a smaller amount in the other options exchanges that also traded stocks—was a wall. The exchange options were traded in a different room, with very clear exclusions.

KD: Was that the SEC's idea? Or did the Stock Exchange say: This is what we'll do.

RK: Well, it was a discussion, but certainly the SEC had been very actively, from the beginning in options, trying to create a separation from market information standpoint between the stocks and the options. Indeed, the initial walls that were created at the American Stock Exchange, the Philadelphia Stock Exchange, and Pacific Stock Exchange, were referred to as Rappaport Walls, referring to the Associate Director of the division—the position I had later on—during the '70s, a guy named Shelly Rappaport. So yes. It was very much SEC driven. The Exchange went right down that road. Separately, in sort of a similar timeframe, for the first time it was worked out how specialists on the New York Stock Exchange would be able to trade options. They were both physically separated from them, and there were very clear, very strict, very prescriptive standards—certainly looking backwards, way too prescriptive standards—vis-à-vis how they could options to make sure that they were not only hedges, but very conservative hedges, and couldn't be used in any way to front run the market or to manipulate the market.

KD: How long did it take to feel out those rules—the walls and the rules—and bring things down to some kind of reasonable settlement?

RK: Well, the walls really started before my time when I was over in Market Structure, while Shelly was the Associate Director. And it was hauled out as part of the proposals in the '70s for each of the exchanges to operate. Specialist trading of options was, I think, as I recall, a multiple year effort to reach agreement between the Exchange and the staff, in a way to be able to design this and begin to accept the fact that these markets were interlinked, while not taking too great risk from a manipulation standpoint.

- KD:** And there's a point here where you're looking at a system to link four of the five exchanges in trading options, with Philadelphia standing alone, for some reason.
- RK:** That's right. By the late '80s one of the things that had come out of the Options Study was initially a continuing moratorium on multiple trading the same option among options exchanges. That was gradually unwound in the late '80s. And with that, an effort was made to create a linkage system that would emulate the type of system, or hopefully be better than the type of system that ITS had become for equity securities. And the Philadelphia Stock Exchange did stand alone in its opposition to that. All the exchanges would have loved for there to be no multiple trading at all, and the Commission went through a series of economic analyses to basically demonstrate that multiple traders enhanced the quality of the market for an option - there had been grandfathered multiple trading. The SEC basically studied the multiple trading that was occurring in the grandfathered issues, and did a number of economic analyses to determine that multiple trading, indeed, resulted in better markets, and narrower spreads.
- KD:** And in some respects, this is coming back to the National Market System idea.
- RK:** It absolutely winds back together. It's the same goals of Section 11A, that the purpose of the Commission is to remove burdens of competition, unless there are darn good reasons not to, from an investor protection standpoint, or a market efficiency standpoint. With this action, the rules and the structure of the options markets started to converge with the rules and structure of the equity markets; though still, obviously, not with application of Regulation NMS, and other significant differences that remain today
- KD:** Well you pointed out that, you know, this has a lot to do with getting to the '87 crash. Let's take a break and talk a little bit about internationalization; because I notice in my research that, all of a sudden in 1986, there's all kinds of talk about internationalization. You were involved in a number of initiatives. And I want to get some sense of where that all came from in the mid-1980s?
- RK:** Well, it's an interesting question. The SEC began to become actively involved in IOSCO in the early '80s. But you had a variety of things gradually developing that forced us to pay greater attention to the international issues. People started to become very creative from a law violation standpoint: engaging in insider trading; using Swiss accounts, or using accounts out in the Cayman Islands, and the like; and a variety of other countries, where there was difficulty accessing records because of secrecy laws. And that didn't just come from sort of the notorious countries, as a reaction to Nazism, secrecy and blocking statutes existed across Europe, and still do. The E.U. confidentiality requirements are far more restrictive than those in the United States. So, a key piece, as we moved into the second half of the 1980s, was trying to build a more efficient process to be able to exchange information for enforcement investigations. And then more broadly were the questions that are just coming to fruition now, of how do we get to an environment where you can move to mutual recognition?

So, with the bull markets in the U.S. for the '80s, for the first time people in a wide variety of foreign countries became less risk adverse, less focused on debt instruments, and began to participate in the U.S. securities market. So you had law violations resulting from that activity, and securities firms suddenly cared a lot about how entities could deal with U.S. customers when they weren't registered as broker/dealers. And that led to a number of things that are really very current today, and are being thought through again. The first was the initial Memorandum of Understandings for the sharing of information. The initial one was done with DTI, Department of Trade and Industry, in the United Kingdom before there was an FSA. That was something that Gary Lynch, Mike Mann and I were very involved in negotiating—along with the CFTC.

KD: Now this would have been the early '80s, right?

RK: The initial one was in the mid-'80s. I think the initial MOU was mid-'80s. And that sort of served as a model, first going country-by-country. Mike Mann was a tremendous leader in all this, from the International Office. Gary Lynch has been very active, and then Bill McLucas picked it up when Gary was done. First country-by-country, setting up these MOUs for information exchange, that led eventually to what now is the common parameter, the IOSCO MOU model, and IOSCO-wide agreements of countries reaching agreements to share information. The other piece was beginning rule activity with respect to how unregistered broker/dealers could operate, to some limited degree, in the United States.

That occurred through the adoption of Rule 15a-6, now being reconsidered by the Commission, and hopefully being substantially expanded, to deal with a new world with a new environment. But at the time, 15a-6 was the first effort of the Commission to allow a limited ability for unregistered foreign broker/dealers to interact with institutional investors in the United States. A very high standard was established as to what an institutional investor was, with a lot of additional requirements, including that there be chaperoning by a U.S. broker, or the U.S. affiliate; back-to-back books and records requirements; and a variety of other requirements that are now properly criticized as way too burdensome. But it was the first step in allowing unregistered entities. And it basically has been the way unregistered affiliates have dealt with U.S. institutional investors over the last fifteen years. It was sort of a milestone moment of the Commission, really beginning the process of trying to grapple with the fact that markets were now becoming global, access to markets, and demand for markets were very much becoming global—both from the standpoint of good things, to encourage access and efficiency; and bad things, from the standpoint of law violations.

KD: What was the effect of the big bang on the London Exchange? Did that make the SEC sit up and take notice, and think: What are we going to do in this case?

RK: Well, yes. You took an extremely hide-bound market in the United Kingdom—albeit still the largest market in Europe—and changed it into a much more invigorated, electronic marketplace, that had many growing pains to be able to get to a point of being truly competitive; but for the first time more electronic and more competitive. Moreover,

the LSE began looking outside of England for many of its listings. So that the whole issue of international listings, and the questions of the various impediments to listing in the United States, became more and more significant. This is really the beginning of the story of what now faces the United States twenty years later—of equivalent markets existing in the world that are attractive to investors, and attractive to people to raise capital; as opposed to the world that existed before where U.S. markets were the only choice. Because of everything from competitive restrictions to the development of the markets, to the lack of regulatory requirements such as insider trading protections and the rest, European markets before tended to be very regional, not very competitive to the United States, and really not providing a meaningful competitive opportunity for large companies outside of the companies that existed in their own country. And big bang pushed, not in a simple step, but basically created the push—big bang’s sort of a good analogy, because if you really think of it, it took a while for the universe to spread out—that made the London Stock Exchange much more of an equivalent competitive market—a competitive alternative to the United States. And so again, it is a central marking point for how regulatory philosophy had to change, because competitive realities changed; just as regulatory philosophy had to change, with things like National Market System because the capabilities of technology and computer communication changed so much. So, you’re right to ask it. I think it was a big effort. And results coming out of that were the information sharing agreement with the United Kingdom that started things off, Rule 15a-6 and changes in Corp Fin review procedures to encourage foreign listings.

KD: And that was you and Gary Lynch?

RK: And Mike Mann, the head of International. And all the things that Linda Quinn then became involved with after that, particularly through the Arthur Levitt years, of trying to make the U.S. markets more attractive, without changing the fundamental requirements of GAAP that are now being dealt with through convergence with IFRS. All of that is a great example of how competitive realities change, and you have to make changes in your regulatory structure, to be able to deal with the changes.

KD: The argument’s always made that the U.S. sat by while all of this has happened, and nobody really took seriously that this could happen; that so much of the securities industry would go offshore. Would you say that that was the case at the SEC? Or in the Commission at all?

RK: No, I think the Commission in the mid-‘80s to late-‘80s, through Richard Breeden’s time, and—you know, through certainly Arthur Levitt’s, and the rest, took it quite seriously. All the things I rattled off are examples of how they took it seriously. What you’re right in saying is: We still perceived the risk as limited. And we perceived the tremendous engine of capital-raising that was the genius of the U.S. system as providing us a special position. And while we were correct in noting that a well-regulated, honest market was absolutely critical to attracting capital, we probably didn’t recognize the speed at which other markets would begin to develop a meaningful regulatory system. And of course, the variety of macro economic things that happened to their economies, and the competitive flexibility that was provided, such as big bang in the United Kingdom, and

changes in access requirements in Europe and the rest that allowed people to compete more, and started to move Europe and Hong Kong, and to some degree the Tokyo Stock Exchange, into positions to really truly compete in ways that hadn't existed before. So, no; the Commission was very focused on it, as I think they have been every step of the way. The challenge is: Where are you willing to take risk that may harm investors, versus the balance of trying to ensure you have an environment that is competitively attractive, so those very same investors have access to product? And that's always been the balance the Commission has wrestled with. Sometimes we got it right, and sometimes we got it wrong. But I don't think the history speaks at all from the early '80s on that it wasn't very focused on it, and the Commission didn't make conscious efforts to gradually expand, and make the U.S. markets more accessible. Maybe it wasn't done quickly enough. And maybe that's sort of the lesson of history in the last twenty years. But it certainly was a big focus.

KD: Well, the SEC, institutionally, wants to err on the side of protecting American stockholders, right?

RK: And the SEC is fundamentally an investor protection agency. And that has been to the great benefit of, I think, both of investors and the U.S. markets from a confidence standpoint. And all of that's to the good. But sometimes it makes the SEC a little slow in recognizing a change in competitive realities, that's the other piece of ensuring you have great markets. And that's perhaps the lesson of the last twenty years. Though there's always been the effort to continually open it up.

KD: Something else going on here. Congress actually mandated the 1987 Study of the International Securities Market. Now, were you involved in that from a Market Reg standpoint?

RK: Yes. We were. I've got to say I don't have more specific recollections of it though. A lot of it was on the Corporation Finance side, a little bit on the Investment Management and '40 Act side, where there were very clear restrictions on access issues and the rest. And so, we were a smaller part. But all that sort of spun out. And that helped the effort with respect to Rule 15a-6, et cetera.

KD: Great. Well, getting toward 1987, I want to touch on computerized trading some more. We talked about some of the early electronic trading systems very briefly. I wonder if we get into your becoming aware of these mini crashes and market drops. And I know that a lot of this is driven by the rise of the options market.

RK: Sure. You moved into a bull market. And you got into an environment where there was far greater use of derivative index products. And it became apparent that the impact of all that, and the speed—again, not being pejorative at all, but the speed at which you could shift positions and trade positions on the futures side, and to a lesser side on the index options side, had changed markets a lot. Markets' short-term volatility—intra-day volatility—became far more pronounced in the markets as we moved into 1986 and the beginning of 1987. The term 'market break' began to be used. There became more

concern heard from Congress. A lot of the concern was focused on trading strategies that were basically reacting to the fact that the futures market can move more quickly, and price more quickly, than the stock market.

KD: And that's the PT boat.

RK: Yes, we're back to the PT boat and the aircraft carrier. What that means from a pricing standpoint is that if major players in the market think that the market should be going up, the futures will rise quicker than the stock market. So the futures price will be relatively higher than its fair value, versus the bundle of stocks that compose the indexes. That provides an opportunity for something called index arbitrage, which is—it's pretty simple. If you have equivalent products: a basket of stocks on one side, and a stock index future on the other side; and the stock index future is, relatively speaking, priced higher than the basket of stocks; if you can sell the stock index future, and buy the basket of stocks; over time, once you move past this price movement, those prices will converge. And so you will have bought the basket of stocks cheap, and you will have sold the future dear; and you will have made money. And particularly, as the strategy was initially really focused on, those spreads and the time to take to close that up were pronounced. And they made a lot of money. So it became something done a lot.

KD: Do you mean that there was plenty of time to make those moves?

RK: Relatively speaking as compared to today. The time was then minutes; but today it would be a couple of seconds. And the breadth of the difference, the breadth of the spread, was more; because stock markets were less efficient. I won't go into detail on that, a useful supplement to this is the panel on the 1987 crash last year. But it's sometimes hard to imagine at this point that the New York Stock Exchange in 1986 and 1987, while it did allow for electronic transmission of orders down to the post where the specialist was, most of the trading was still done face-to-face by floor brokers. And the electronic transmission of orders was printed out on a manual printer—not on a computer screen, on a manual printer. A clerk tore them off; and when the specialist got around to it, it got executed. Even this was a substantial increase in speed than what had ever occurred before. I'm not trying to make fun of it. This was an incremental step to much more efficient markets, but it obviously could get overloaded. And it was still slow. So there was sand in the gears. And prices diverged, and index arbitrage became very significant. So people focused a lot on index arbitrage, which was really fundamentally the messenger—nothing more—to the fact that the futures markets could rise more quickly than the stock market, because it took time to execute all those stocks on the stock market side, to sort of catch up with the market center.

KD: So is this where you're getting these little market—these tiny little market breaks?

RK: Yes, you're seeing the tiny market breaks. You're also seeing it because—just as each time you get something that provides greater liquidity, people tend to overdo it. And futures and options offered two things to people that they had not had before: the ability to buy and sell a lot of stock equivalents very quickly, at relatively low cost; and the

ability to have higher leverage because margins on the futures side were designed very differently than margins on the stock side—still dealing with Depression concerns and the like. And so the leverage was much greater. All that might be good; might be bad. But what it does do is, in that type of environment, suddenly price movements that would occur in a long time period now started to be condensed into a much shorter time period. And the other thing is, until people developed controls, this increase in leverage and increase in speed started to create what was referred to—if you look at the Brady Report and the Market Regulation Report on the crash—as illusions of liquidity. Probably the best example of illusions of liquidity—something which we’ve been fated to repeat again and again in the last twenty years in more sophisticated fashions, such as what happened to Long-Term Capital Management, is something called portfolio insurance. Portfolio insurance was a basically logical theory that said: If I have to buy puts to hedge a stock position, or buy calls to become bullish or bearish in the market quickly and efficiently, that’s nice; but that costs a lot of money, because I have to pay a premium for a put and I have to pay a premium for a call. But I can do something called portfolio insurance, and instead I will just program through baskets of securities to sell enough futures and enough stocks as the market goes down, or as the market goes up, to simulate, as if I had bought a put, or if I’ve bought a call; but do it at much less cost, much less transaction cost, than if I paid the premiums for all those puts and calls.

KD: And this is in the program trading?

RK: This is part of program trading. You would do it through programs. Now there was only one problem with that theory, an error that we’ve done again and again—we, the financial industry—for twenty years. That’s all nice until the market suddenly becomes volatile and people get scared. But a basic rule of markets is that when liquidity disappears, it disappears completely. And suddenly the theory that you can sell a certain amount of stock at each price level as the market goes down—when the market goes down really fast, as it did a little bit in the times coming up to ’87, but as it did dramatically on those days on Friday and Monday, October 16th in 1987, the liquidity disappears. And suddenly you have people on a rote basis selling large amounts of stock into the market that continue to cause a snowballing effect of the market going down and down and down. Not by any means the sole cause of 1987, but evidence of what happens, particularly early on when you bring in a new innovation like stock index futures with new capabilities, but then people make the error of assuming that they have unlimited amount of liquidity.

KD: Now, you knew what was going on with the index futures, and in the market. And you’d seen these little breaks in ’86. Did you know about this portfolio insurance?

RK: Yes, we were following it a great deal. We spent a good deal of time talking about it with people in the industry. There was testimony before Congress. As you move into the summer of ’87 this is when David Ruder came on, after John Shad went off to be ambassador of the Netherlands. And we spent a great deal of time talking about it. David, I remember, made a speech about this at the Chicago Bond Club, I think it was, on the same day that the market went down over a hundred points for the first time. And it

was very much a focus. You'll see from the archives that Market Reg was doing studies with regard to the impact of futures in these kinds of mini market breaks for the time going up to the crash.

KD: Well, take me to the market crash. What were you doing on, I guess, it was October 16th?

RK: What was I doing October 16th? On October 16th I was actually out at Denver at the SEC Regional Conference. At that point it occurred every year, run by Bob Davenport, the Regional Administrator of Denver, and a wonderful guy who managed to pull us all out there, we could never quite figure out why, except that we loved him. I, then, went home; spent much of the weekend talking with my staff, and some people in the industry. I was in New York on Monday morning, where I was supposed to be participating in a conference talking about one of the other little disasters of the 1980s, which was the failures in the government securities repo market that led to the Government Securities Act, and with that the initial regulation of government securities dealers for the first time. The conference started at 8:30. I was moderator. I gave initial introduction, excused myself, and called Mark Fitterman and Brandon Becker, who were two of my senior people—Brandon, obviously, later on became Director of Market Regulation. They told me that they'd been canvassing the industry, and both the firms and the indications from the New York Stock Exchange suggested it was going to be worse than our worst fears had been. Obviously, over the weekend, there had been a series of incredibly negative articles in the press with respect to how leveraged the market was, et cetera. And so they said it was going to clearly be way down at the opening.

So I bid adieu to my panel on government securities regulation. I went down to the Exchange, where I met with Bob Birnbaum, who was then president of the New York Stock Exchange, under John Phelan. Phelan was overseas that day. You'll note from the histories that he came back that night, I think. Bob took me down to the floor, where I stood with Don Stone. My relationship with Don ran back from the National Market Advisory Board and Don was still the chairman of his specialist firm. And I can remember what Don said as we were watching—and this was now—the markets had opened and the markets had fallen dramatically; and then they were hitting a pause some time in the period around ten-fifteen, ten-thirty, where you'd hope that they were going to rebound up. And I can remember what Don said to me, which is, "My guys were heroes on Friday. They took huge positions. We don't have this kind of capital. We can't stand in front of this train." And I left with those words ringing in my ear.

I went back upstairs with Birnbaum. The market started precipitously falling again. I talked to Dave Ruder, who had been doing a speech that morning—somewhat famous within the context of this for one thing Dave said. I talked to Dave; talked to my staff again; and thought: I'm in the wrong city. And so I headed to the airport, because it was clear to me that this was just going to keep going. I headed to the airport to get back to Washington. I got back and stood with my staff. And again, a picture of the SEC at the time: The SEC—the Chairman's office had literally no market terminal, absolutely none. So, Market Reg—as primitive as our setups were with our couple of Reuters and Bloomberg terminals—were the focal point. Dave Ruder came down; Ed Fleischman,

Joe Grundfest, three of the Commissioners at the time, sort of gathered around us. I remember the spooky feeling between three and four where, in silence, you watched the market just go down. In today's terms, there was never any green ink on the screen. It was always red. Every trade appeared to be down from the trade before. And you just basically sunk in a free fall to an unheard percentage loss on a single day. And it was terrifying.

That night we spent our time trying to identify where the risks were; sweeping to understand what the firms' losses were, what their biggest exposures from customers were, working with the CFTC to understand the exposures on their side; working with the Options Clearing Corporation, which had some significant risk issues, particularly with a firm called First Options, which was then owned by Continental Bank. The Chicago Merc had some questions and confusion where, for a period of time, it was unable to deliver with respect to its marks. Our effort was really to try to pull together information, and understand exactly where and what the risk was. And the other piece was, we put out that next morning, after talking with the firms and what they needed, an interpretive position that—with respect to what was then Rule 13e-2, which is the safe harbor with regard to issuer repurchases. And if there was any natural buyer left in America, it was the corporate issuers who now may have felt that their stocks had been trampled upon, and were dramatically underpriced from what they viewed as value. Yet, you had the safe harbor that didn't let people purchase at the opening—didn't let people purchase in the last twenty minutes, maybe even thirty minutes at that point of the day; and couldn't purchase on an up tick—very restrictive.

And so we put out an interpretation to emphasize that there were a lot of very good non-manipulative reasons for issuers to be in the market, and a safe harbor was what it meant, and that there would be no negative presumption taken with respect to issuer purchases. And in fact, issuer purchases on Tuesday were a significant part of the support that came through. Tuesday, of course, was, to me, the most terrifying day of the crash. You started—partially because of the issue of repurchases—the market jabbed up a hundred or more points instantaneously off of the opening, and then started to sink. And by noontime, it had lost all the points that we gained. And you really were in a point—about the only thing you could say about this time was literally every preconception you had about how markets operated, what were floors, how far the market would fall, had disappeared. If you want to think analogously, with respect to the fear that has taken control and frozen credit markets in existence today, suddenly you had a lack of understanding of where the bottom was, where value truly was. And you watched it go like that.

It was at that time that John Phelan called up Dave Ruder—again, one of the controversies of the time—and said that the Exchange was effectively closed, because there were no buyers; and that he was going to do everything he could to keep the market open, but there might come a point where that couldn't occur. He also talked to the White House. Whatever exchange occurred, it was quite clear that the White House did not want to see the New York Stock Exchange close – interesting commentary on that point from Chairman Cox in last year's program. It was a quite interesting piece that I

don't think had been part of history before. And then, for whatever reasons: issuer repurchases coming in, God is good, who knows? The market bounced, and went back up. And while you then went through numerous days of afterquakes, and of volatility, things stabilized.

KD: So obviously you knew a lot of what was precipitating all of this. You didn't know what it would feel like when the market behaved the way you never imagined it would. When you went in and did your Market Reg study in the aftermath, what did you find out that you didn't know?

RK: We found out there was quite a significant focus of selling by a reasonably small number of individuals—some of that portfolio insurance. We found that there had been a variety of areas where the markets had not performed as well as they could. In the NASDAQ market, whether for technology or fear, there was a large incidence of market makers not answering their phones. And their nascent electronic execution system, called SOES—famous for other reasons later on—basically stopped working; because at that point it was a voluntary system, and all market makers pulled their quotes from it. On the New York Stock Exchange, the environment I described, dependent on printers, became completely overwhelmed. And so there were large delays in executing orders. And with that, the fear of not understanding really what happened to your order and whether it was executed. Any time you have lack of knowledge, lack of understanding and fear, it results in more selling, because markets hate uncertainty. So the Exchange wasn't able to handle the explosion of volume. Many good things also occurred: the exchanges and people kept trading. Market makers, with exceptions, basically filled their role, from the standpoint of buying securities on all of this, and the like. The other thing you found out—which we knew early at the time—was specialists were profoundly undercapitalized; they were not part of large holding companies as they are today. And there were many specialists at the end of Monday and Tuesday morning who were on the edge of bankruptcy, or on the edge certainly of being out of net capital. That led to Merrill Lynch—the first large firm ever being part of the New York Stock Exchange floor—purchasing a specialist; a new regulatory environment that allowed, with severe restrictions, holding companies to own specialists, which has been an important set of requirements. A large part of the analysis from the Report pointed to the question of whether it makes sense to have two different regulators and two different margin structures and other rules, operating, when certainly if nothing else was proven and clear—and we knew this already—the markets were fundamentally linked.

And then the last piece was that mostly because of technology problems, arbitrage basically stopped during the day. And the futures price diverged farther and farther from the stock price, and went down farther and farther. Does that mean that the futures caused the crash? No. But it did underline what happened when the markets became unlinked. And that led to the decision made by the President's Working Group that was set up as a result of the crash—the beginning of the President's Working Group—and recommendation by the Brady Commission that circuit breakers be put in place for these cataclysmic days in which there was so much uncertainty and lack of knowledge that there were no buyers; but that those circuit breakers always be on a system-wide basis.

So, you know, the focus was in taking steps to make our clearance systems more resilient, in taking steps to ensure that the exchanges and NASDAQ dramatically upgrade their capacity and technology capabilities so that the type of technology problems that occurred never occurred again; and then system-wide circuit breakers—these were some of the things that came out of it.

KD: You'd been talking about circuit breakers in advance, though, maybe it was a different term, but—

RK: Boy, you did do research. I'm impressed. Yes, I had given a speech before the crash, at the Futures Industry Association, in which I raised the possibility that system-wide circuit breakers might be one way to deal with extraordinary circumstances.

KD: So you got your circuit breakers.

RK: We got our circuit breakers. For better or worse, we got our circuit breakers. I'm glad they haven't been used very much.

KD: Let's get to the end of the SEC. I want to touch on one more thing that came out of all the upheavals in the early '80s, and the M&As, and all that, is the one share/one vote, which I know you were involved with.

RK: Yes, I cared a lot about that. That was, again, one of the moments I felt strongly about in my career, albeit we didn't win the lawsuit. You were in an environment in—obviously, as you moved through the '80s, of the real expansion of hostile takeovers. For better or worse—perhaps responding to a lack of effective corporate governance, or whatever else—the U.S. had a relatively flexible system at that time, for allowing such things. The result of that was a variety of steps taken by companies, most of which have been dealt with by Delaware corporate law, things like poison pills and the rest, that raised a variety of controversies. But one of the issues was efforts by companies to build on what before had really been a phenomenon of only family-owned companies, where the family didn't want to lose control as they went public, of issuing multiple classes of stock, to cement management control while still raising capital. The New York Stock Exchange had always had a requirement, consistently employed except for Ford—it was just called too big to say no, I guess—of one share/one vote—neither the NASDAQ or the AMEX, as the other two listing exchanges, had it. The AMEX had some restrictions, but nothing like one share/one vote. None of that had previously mattered a great deal.

But suddenly it began to matter more. The Exchange began to feel very pressured to permit multiple classes of securities because of the competition, particularly from NASDAQ. And more and more companies were trying to create these multiple classes of stock. And the Exchange, as I recall, filed something like a moratorium, with respect to this one share/one vote requirement, saying that it had to do it from a competitive standpoint. That led us to propose Rule 19c-4, which was an effort to try to draw a line, a line that eventually was more or less implemented in the Chairman Levitt days, with a voluntary effort across all listing exchanges. This was an actual Commission rule that

would have not said there could only be one share/one vote, it would have grandfathered companies that had multiple classes of stock before they went public; but said that you could not, through issuing stock, take any action that would disparately impact in a significant way one class of shareholders versus another class of shareholders. It would have effectively tried to deal with the various defensive things companies were trying to do with two classes of stock. We conducted a hearing. It was an exceptionally controversial rule, with strong feelings with respect to both sides; really one of the first corporate governance efforts.

KD: Did you help prep for the hearings on Capitol Hill?

RK: Absolutely. All of that was prepped during my time. I mean Market Reg basically did it, with support from John Huber and Corp Fin. But because we were essentially amending Exchange rules, this was our rule proposal. And the impressive thing was the willingness, with a great deal of negotiation, to find a point in which Ed Fleischman and Joe Grundfest, who were both quite concerned about burdens on competition, and generally deregulatory in philosophy, were willing to join on with regard to the proposal. And we reached that point with the final design. And I think it was quite a good rule. Sadly, the D.C. Circuit reached a conclusion that it wasn't consistent with the Act, and it went beyond our authority to basically impact exchanges' rules that didn't run to regulating members, but ran to restricting issuers. So the rule was abrogated by the D.C. Circuit, and that then led, shortly after my tenure, to Arthur Levitt's initiative to basically solve that Commission jurisdiction issue by encouraging strongly all the listing exchanges to adopt the common rule. Arthur deserves tremendous credit for having shepherded it through. An interesting irony: the AMEX was the primary protagonist in being unwilling to move to a system of one share/one vote during our 19c-4 efforts—and there was a significant change in Arthur's views as he became Chairman of the SEC. But really a great effort on his part to get something accomplished.

KD: Well, one more big landmark here is the Market Reform Act is coming in at this point, around 1990 or so. And again, were you involved with framing, with helping to provide the input for this legislation?

RK: The other piece of legislation that I felt quite good about that came out of the crash, and out of the failure of Drexel—not something we've talked here—was a piece of legislation that for the first time gave the Commission some minimal authority with respect to holding companies of broker/dealers. And I think that may have been part of the Market Reform Act.

KD: Yes.

RK: I think that was a part of it, as I recall. I just can't remember the name. I'm pretty sure that's it. That was another roll out from the standpoint of the crash, from the standpoint of the failure of Drexel Burnham—until Bear Stearns the largest failure of a major firm in U.S. securities history, or certainly since sort of the days of the paperwork crisis. The

key part of that was the beginning of holding company regulation that now has evolved to the Commission's position as a consolidated regulator for major firms that are not banks.

KD: And the SEC could go in and sort of assess the health of a company.

RK: Exactly.

KD: Yes. Okay.

RK: Could assess the health of it. Minimal reporting requirements, and the ability to assess the health of the holding company; because much of the learning with respect to Drexel Burnham, which obviously exploded in importance as firms became more global, and as they pressed into more unregulated products like over-the-counter derivatives and swaps, was that much of the contagion when a firm started to get in trouble was really occurring outside of the regulated broker/dealer. And if you didn't have the full picture of the holding company you didn't know what was going on. And that was—you know, you did a great job of research because if I were to hit yet another mile post that meant we're done in the '80s, that led the way to where the Commission's gone in the last seventeen years, that would be the last one, the beginning of our holding company regulations.

KD: Perfect place to stop. Thank you so much.