5-20-2004

The Third Annual Albert a. Destefano Lecture on Corporate, Securities & Financial Law - Panel Discussion: Celebrating Thirty Years of Market Regulation

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Fordham Journal of Corporate & Financial Law, Vol. 9, No. 295

LECTURE

THE THIRD ANNUAL ALBERT A. DeSTEFANO LECTURE ON CORPORATE SECURITIES & FINANCIAL LAW

PANEL DISCUSSION: CELEBRATING THIRTY YEARS OF MARKET REGULATION*

MODERATOR:

*Kenneth M. Rosen***
Assistant Professor, The University of Alabama School of Law

PANELISTS:

Brandon Becker
Partner, Wilmer, Cutler & Pickering

*Robert Colby****
Deputy Director, Division of Market Regulation, U.S. Securities & Exchange Commission

* The panel discussion herein was held at the Fordham University School of Law on April 2, 2003, for the third annual Albert A. DeStefano Lecture on Corporate Securities & Financial Law. It has been edited with the assistance of the speakers.

** Professor Rosen served as the first Fellow for the Fordham University School of Law Center for Corporate, Securities and Financial Law during the 2002-2003 academic year.

*** The U.S. Securities and Exchange Commission ("SEC" or "Commission"), as a matter of policy, disclaims responsibility for the private statements of its employees. Accordingly, the views expressed herein by Mr. Colby, Ms. McGuire, and Ms. Nazareth are their own and do not necessarily reflect the views of the Commission or their colleagues on the staff of the Commission.

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President & Deputy Chairman, The NASDAQ Stock Market, Inc.

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Director, Division of Market Regulation, U.S. Securities & Exchange Commission

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WELCOME & INTRODUCTORY REMARKS

DEAN TREANOR:[1] Good evening, everyone.

I am Dean Treanor, the Dean of Fordham Law School. On behalf of the entire Fordham Law School community, I would like to welcome you to the Third Annual Albert A. DeStefano Lecture, "Celebrating Thirty Years of Market Regulation."

I thank our distinguished panelists for graciously being with us tonight and for sharing their expertise and insights on the various aspects of market regulation and related issues.

I especially thank the law firm of Becker Ross Stone DeStefano & Klein for establishing this lecture series honoring Mr. DeStefano, who is currently Of Counsel to the firm, and for the support you have given to our Center for Corporate, Securities and Financial Law and to the Law School's overall educational mission of providing a forum on corporate issues for our students and for members of the larger community.

[****] Since the date of this lecture, Mr. Ketchum has served as General Counsel of Global, Corporate & Investment Bank of Citicorp Inc. Recently, Mr. Ketchum has been appointed by the New York Stock Exchange as its Chief Regulatory Officer.

1. William Michael Treanor is the Dean of the Fordham University School of Law.

Mr. DeStefano, in whose honor this lecture series is named, was a member of the Fordham Law School Class of 1947, where he graduated with honors and served as Recent Decisions and Comment Editor of the *Fordham Law Review.* He also holds an undergraduate degree from the College of the City of New York and a Master of Laws Degree in Taxation from NYU Law School, where he was Graduate Editor of the *NYU Tax Law Review.*

As with many of our most esteemed alumni, he has continued to be a presence at the School long after graduation. From 1973 to 1983 he taught a very popular course in corporate acquisitions as a member of our Adjunct Faculty. We are pleased that he continues to be a presence at the School through this outstanding lecture series.

Tonight's lecture represents one of a number of special events presented by the Fordham Center for Corporate, Securities and Financial Law. These programs include public events; roundtable discussions among academics, practitioners, and policymakers; and our Business Law Practitioner Series, which has introduced our students to leaders in the field and to cutting-edge legal issues.

The Center is aided in its mission by Fordham's specialized business law journal, the *Fordham Journal of Corporate & Financial Law*, which has published the proceedings of many Center programs. The most recent issue, which is now available, contains the proceedings from our Symposium on Derivatives and Risk Management, which took place this past fall. Support for the Center's many initiatives is drawn from the leadership of a distinguished Board of Advisors, as well as the active participation of our many distinguished alumni in the business and financial law areas.

The Center's programs enjoy the generous support of a variety of donors, including the law firm of Morgan, Lewis & Bockius, Becker Ross Stone DeStefano & Klein, the General Electric Company, and Eugene F. Murphy. Also instrumental in the projects of the Corporate Center is Professor Jill Fisch, who serves as its first Director. Professor Fisch teaches in the areas of corporate and securities law, and her scholarship includes work on corporate law, securities regulation, and federal courts. Her writings have appeared in a variety of publications, including the *Harvard Law Review,* the *Columbia Law Review,* and the *Cornell Law Review.*

Professor Fisch, who has been a member of the Fordham Law faculty since 1989, served as Sloan Visiting Professor of Law at

Georgetown University Law Center in 2001. A graduate of Cornell University and Yale Law School, she has also served as a trial attorney with the Criminal Division of the U.S. Department of Justice. She was also associated with the law firm of Cleary Gottlieb Steen & Hamilton, where she practiced commercial securities litigation. She is somebody I have known since law school, so I'll just leave it at that. I have always been impressed by her as an extraordinary legal thinker and someone with remarkable vision.

It is my pleasure to now turn things over to Professor Fisch.

Thanks very much.

PROFESSOR FISCH:[2] Thank you, Dean.

It is a pleasure to be here and on behalf of the Fordham Law School community to join the Dean in welcoming you to the Third Annual Albert A. DeStefano Lecture.

I would like to express our School's deep gratitude to the firm of Becker Ross Stone DeStefano & Klein for their generosity in establishing this lecture series, and of course our gratitude to Albert DeStefano both for giving them cause to do so and for being such a loyal and active supporter of the School.

As you know, this lecture forms one of the crown jewels of Fordham's new Center for Corporate, Securities and Financial Law. In just three years, we seem to have created something of a tradition with this lecture, in bringing in top people in the field to talk about an important and timely event. In the past two years, we had discussions, first, on SEC Regulation F-D, and then last year on the collapse of Enron.

Tonight, as we continue to struggle with the fallout from various corporate governance scandals, including most recently HealthSouth, the topic of market regulation is critically important. Tonight's panelists bring you a wealth of experience and expertise in the field of market regulation. They range from, at the far end of this crowded table, Lee Pickard, who was the Division Director thirty years ago, to Annette Nazareth, at this end, the Division's current Director. Collectively, they offer an unparalleled opportunity to understand the challenges faced by the Division in the past, and through that understanding, to appreciate

2. Jill E. Fisch is a Professor at the Fordham University School of Law and is the Director of its Center for Corporate, Securities and Financial Law.

the manner in which the Division must continue to evolve and respond to meet the new challenges of today.

It is my great honor to introduce the panel to you.

Lee Pickard, as I said, all the way on the end there, was the Director of the Division of Market Regulation from 1973 to 1977. He is currently Senior Partner of Pickard & Djinis, a Washington, D.C. law firm that he formed in 1978 to specialize in securities and corporate law and related litigation. Mr. Pickard has an A.B. from Colgate University and an LL.D. from Harvard Law School.

Next to him, if I'm getting things right, is Andrew Klein, who was the Director of the Division of Market Regulation from 1977 to 1979. Mr. Klein started at the Securities and Exchange Commission (the "SEC") in 1973. He is currently a partner at Schiff Hardin & Waite, where he concentrates his practice in corporate and securities law with special emphasis on federal securities law disclosure, regulatory compliance, and enforcement matters. I have to think that has got to keep him busy about twenty-seven hours a day right now. Mr. Klein holds both a B.A. and a J.D. from the University of Chicago.

Next to him is Richard Ketchum, who was the Director of the Division of Market Regulation from 1984 to 1991. He currently serves as President and Deputy Chairman of The NASDAQ Stock Market, Inc. I am delighted to inform you that starting this fall he will also be joining the Fordham Law School faculty as an Adjunct Professor, so those of you in the audience that are first- and second-year students, you will have the opportunity to get more details on his thoughts by signing up for his securities classes next year. Immediately prior to assuming his current position at NASDAQ, Mr. Ketchum served as President of the NASD. Before he joined the staff of the SEC in 1977, he was associated with the law firm of Milbank, Tweed, Hadley & McCloy. He holds a B.A. from Tufts and a J.D. from NYU School of Law.

Brandon Becker was the Director of the Division of Market Regulation from 1994 to 1996. He is currently a Partner at Wilmer, Cutler & Pickering where he heads the firm's broker-dealer practice. He started at the SEC in 1978 and worked his way, as I understand it, through the ranks. He holds a B.A. from the University of Minnesota, a J.D. from the University of San Diego, and an LL.M. from Columbia University.

Catherine McGuire, next to him, is the Chief Counsel and Associate Director of the Division of Market Regulation. During her career with the SEC, she served primarily in the Division of Market Regulation in positions of increasing responsibility. She has a B.A. from the University of Michigan and a J.D. from the University of Kansas.

Next to her, Robert Colby has been Deputy Director of the Division of Market Regulation since 1993. Prior to that he served as Chief Counsel of the Division and Branch Chief of the Division's Office of Market Structure. Mr. Colby has a B.A. from Bowdoin College and a J.D. from Harvard Law School.

Finally, Annette Nazareth is the current Director of the Division of Market Regulation, a position she has held since March of 1999. Prior to joining the Commission, she was Managing Director and Counsel at Salomon Smith Barney where she was Deputy Head of the Capital Markets Legal Group. She also previously served as Senior Vice President and Senior Counsel of Lehman Brothers, and prior to that was associated with the law firm of Davis Polk & Wardwell. She received her A.B. from Brown University, something that my husband would be very happy to hear, and her J.D. from the Columbia University School of Law.

Last but not least, I would like to introduce your moderator for this evening, Kenneth Rosen. Ken serves as the current Corporate Center Fellow, a position that he has held since this past July. Ken came to Fordham from the SEC, which is, I guess, how he knows about all these people and about the Division of Market Regulation, since he served as Special Counsel in the Division of Market Regulation. Prior to that he was associated with Fried Frank Harris Shriver & Jacobson. He has a B.S.I.L.R. from Cornell University and a J.D. from Yale Law School.

I would particularly like, before I turn the program over to Ken, to acknowledge Ken's pivotal role in organizing tonight's program. It was Ken's idea last fall to focus on market regulation, and I don't think he could have selected a better subject or assembled a stronger group of panelists. He really was the leader in structuring this program, coming up with the idea, and getting all of these good people to join us tonight.

I know you want to hear from them and not me, so without any further ado let me turn the program over to Ken.

PANEL DISCUSSION

PROFESSOR ROSEN: Thank you, Jill.

Let me add my gratitude to our panelists for joining us this evening, despite their busy schedules. I know Annette, for example, actually had to come from testifying on Capitol Hill today and had to make her way to New York to join us. We thank her and everyone else who is here as well.

It would be, as Jill suggested, difficult to imagine a panel better prepared to discuss market regulation issues. Together, our panelists have accumulated decades of experience on these matters.

Tonight we will explore some highlights of the history of the SEC's Division of Market Regulation ("Market Reg") and the challenges ahead for market regulators. Now that the Division has celebrated the thirtieth anniversary of its inception, it is especially significant to recognize the importance of the Division's history and its impact on market structure in the United States. Were he to assess the Division's past and current challenges, Yogi Berra might observe, "it's *déjà vu* all over again."[3] So many issues seem to continue to resurface, and the past efforts to address those issues may reveal solutions to current problems.

When I worked for the Commission, I quickly realized the value of studying prior staff action when addressing a new problem. While reviewing past staff efforts, it amazed me how prescient the staff could be. Sometimes a release would identify and reserve an issue that would become critical years later, or it would present an approach to a particular problem that could be reapplied at a later date.

I think our discussion tonight will be revealing, not only in providing a sense of the significance of the Division's work and its accomplishments, but also in shedding light on some of the challenges ahead that we will consider later this evening.

With that, it is probably best to start at the beginning. Some of you may know that prior to the Division's creation, the Division of Trading

3. Although this expression is commonly attributed to the former New York Yankees catcher Lawrence Peter "Yogi" Berra, Berra himself denied originating this expression and other popular expressions commonly attributed to him. *See generally* YOGI BERRA, THE YOGI BOOK "I DIDN'T REALLY SAY EVERYTHING I SAID" (Workman Publishing 1998).

and Markets ostensibly dealt with a wide range of issues, including market regulation and other matters. In the 1970s, the Commission decided to reorganize the staff and to divide up functions between operating divisions. Chairman William Casey at the time explained that:

The Commission believes this new structure will provide a sharper focus on the priority tasks of the Commission, more effective use of the Commission's resources, and the development, through closer supervision and broader avenues of advancement, of effective and leadership capabilities for the future as more of the younger staff assume specific operating responsibilities.[4]

My guess is that some of the people on this stage earlier in their careers might have been the types of babes in arms to whom the Chairman was referring. This is a copy of the Release from August 1, 1972 announcing the reorganization. It is a short document, but I am sure that its length does not denote the complexity of the thinking that went into the reorganization.

I thought that we would start with Lee Pickard. Maybe you can give us some insight into the thinking behind the process for creating a separate Division of Market Regulation.

MR. PICKARD: Good evening.

Bill Casey, of course, was Chairman of the SEC at the time that the Division of Market Regulation was formed, and you all probably remember him for his reorganization efforts at the CIA. He actually was Chairman of the SEC for some period of time, and I was Special Counsel to Bill Casey.

He was concerned at the time that perhaps the combination of regulation and enforcement was not working as well as it should work. I suppose the predecessor to the Division of Market Regulation, Trading and Markets, had been around for probably in excess of two or three decades. It was his notion that there should be a separation of the enforcement and the regulation functions.

A lot went into that: the notion that regulation concentrates on investor protection, competition, and burdens of regulation, whereas enforcement as a function tends to focus on compliance, deterrence, and the ease of enforcing laws. Therefore, I think Bill's notion was that the head of both of these functions was not as operative or as successful as it

4. Securities Act Release No. 5,287 (Aug. 1, 1972), *available at* 1972 SEC LEXIS 98, at *1–*2.

could be, so he would separate those two, which thereby gave rise to the Division of Market Regulation.

I think he had other concerns, and so did the Commission as a whole, because he consulted with other Commissioners on this. He was interested in a redeployment of assets and a more pointed and focused enforcement group. Of course, that is what he achieved when this happened.

However, he wanted the concentration of efforts in these particular areas to be led by different people. Therefore, the separation occurred. Market Regulation essentially took the functions that were in Trading and Markets — mainly, the regulation of broker-dealers, exchanges, self-regulatory organizations, SIPC,[5] and financial responsibility — and the enforcement was deposited with the new Division of Enforcement.

Over the years, if you look back on that functionality, it is interesting to see how it played out, because I don't think anyone would ever suggest that the two be recombined. It did, in fact, prove to be a very effective reorganization. The Division of Enforcement went on to achieve fame in itself, and of course Market Regulation had its platter filled from that point on.

PROFESSOR ROSEN: Now, Lee, early on it seems like the new Division was not lacking for any business, even though it was new. There were so many issues being bandied about that remain very salient today, thirty years later. There was the formation of the listed options markets, as well as the Uniform Net Capital Rule.

Can you give us a little bit of a sense of what was driving the agenda and the setting of that agenda back at the time?

MR. PICKARD: Well, Ken, you know, what drives an agenda of any Division probably is primarily determined by external factors, and that certainly was the case back in 1974 and 1975.

The most pressing issue that we had before the Division at that time was the fixed commission rate issue. There were two pressing issues, to be more complete about this. There was the unfixed commission rate issue and there was the financial responsibility issue of the broker-dealer community, both of them driven by events that were developed in the past.

5. The Securities Investor Protection Corporation was created by the Securities Investor Protection Act of 1970 (SIPA), 15 U.S.C. §§ 78aaa–78*lll* (2003).

The unfixed commission rate era, of course, was something that started in 1792, which is when rates were first fixed. It was not until perhaps a decade or two before the rates were unfixed that we began to see cracks in that scheme or in that process.

The SEC essentially was passive in the role of unfixed rates for so many years and was forced to become more active as the New York Stock Exchange and others pressed to hold the fixed rates in place as economic factors were driving them apart. Essentially the SEC did not have an effective program to measure, implement, or operate fixed rates. As the third market, give-ups, and cracks arose in the methodology for determining rates, there was a pressing need to do something about that.

The Division's role at that time was one of hearings, inquiries, and coordination with the Congress and with the Commission, in an effort to come up with a solution. The obvious solution became apparent as we continued to press this issue, and that was that the rates no longer could be sustainable.

We consumed an enormous amount of time on that issue. It probably took up 30 or 40 percent of the resources of the Division—and that is just supporting the Commission in what it was trying to do. We were trying to predict, first of all, what we could do; secondly, what would be the consequences of that act.

We also had to deal with the industry. The industry in this case was comfortable with fixed rates. It is like any other business—slow to change and apprehensive about what might occur, and perhaps unreasonably apprehensive. As time went on, and as the commission rates were eventually phased out, it became apparent to the industry as a whole that fixed rates were perhaps a drag on their profitability and their success, as opposed to a basis for their profitability and their success. So that was a major issue that we had to deal with, Ken.

Another major issue, again driven by external events, not by our own agenda, was the financial crisis in the late-1960s. The industry was confronted with the inability to process trades on a timely basis, to deal with the record-keeping brought about by the precipitous increase in volume, and the demise of approximately 100 different firms. This caused us, the Division, to launch into a serious inquiry as to the net capital bases of these firms and the need for better methodologies for completing trades. All this occurred as the Division was formed and during the early years of the Division, coupled by the fact that the Congress had passed a SIPC law which guaranteed, in essence, the value of customer securities in custody to the extent of $500,000[6], which was a serious impetus upon us to do something about it.

Those were, in a broad sense, Ken, some of the major issues, but there were others as well. Because of the fallout of the fixed rates, there were market structure issues. The industry was innovative with products at that time. They came in with the option exchanges, which I am sure Andy can articulate to you all. And so we never had a lack of a program or problems and issues before us.

PROFESSOR ROSEN: Thanks.

I think that you tell a story where there certainly was a lot of action early on, and I suppose on some level perhaps one can say you were rewarded with more authority as a result of the early work of the Division at that time and of the Commission simultaneously.

One of the watershed events has to be the passage of amendments to the federal securities laws in 1975,[7] which really beefed up the Commission's authority and, I think, by relation the Division's authority.

Maybe, Andy, you could talk a little bit about what the role of the staff was in the promulgation of those types of changes to the securities laws, and also the reaction of industry once the Commission started to actually exercise this authority.

MR. KLEIN: I'd be happy to do that.

I would like to continue from where Lee's story ended and elaborate just a little bit, because it does not come naturally to one to think of all of the things that fixed rates of commissions did to the structure of the markets and to different segments of the industry and investing public, and how slow the Commission was to catch on to their interconnectedness—everybody was.

You have to go back to the Securities Exchange Act[8] before it was amended by the 1975 Acts Amendments[9] to see just how tiny and narrow the Commission's authority was in several enormously important respects.

6. *See id.* § 78fff-3.

7. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975) (codified as amended in scattered sections of 15 U.S.C.) [hereinafter 1975 Acts Amendments].

8. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a–78mm (2003)) [hereinafter Exchange Act].

9. *See* 1975 Acts Amendments, *supra* note 7.

There was a whole menu of things in old Section 19 of the Act at that time that gave the Commission very limited power to fiddle with and change exchange rules.[10] One of the things on that list, however, was the ability to ensure that exchanges had rules fixing "reasonable" rates of commission. Well, after decades, somewhere in the late-1960s or early-1970s, the Commission began to say, "Well, we don't have any idea what a reasonable rate of commission is." The Commission then held endless hearings where people came in to defend and to attack the fixed rates, during which various things were learned about market structure that startled the Commission. The Commission learned that the markets of the early 1970s had come a long way since the Special Study in 1963 done by my partner, Milton Cohen.[11]

Problems emerged about who could be a member of an exchange. Why was membership so important? Foreign membership, my goodness, that was a whole separate issue. Further, the securities industry objected vociferously to the idea that institutions could becomes members of exchanges. Then you start to think about why foreign broker-dealers and institutions would want to do this. Well, one reason was the absence of a discount from the fixed rate for non-members of the exchanges—even for broker-dealers. Why, wondered the Commission, don't we have that built in there? Along the way, a move in this direction was made, but the fixed rate system couldn't be saved.

Institutions, like investment companies, were being sued by people because they hadn't formed a broker-dealer to join an exchange to take back a portion of the enormous amounts of fixed commissions that they were paying. They were spending billions on commissions for no particular reason other than the fixed rate. Plus, we had institutionalization of the market. People didn't know what that meant. We had a gigantic amount of institutional trading that all of a sudden had overtaken the markets. The small trading by individual retail investors was understood to be important, because we've got to take care of retail investors—since it was assumed that they cannot take care of themselves—but institutions thought that at least they could take care of themselves. Nonetheless, they had to pay the same thing for doing a

10. *See* Exchange Act § 19, 15 U.S.C. § 78s (2003).

11. *See* Report of Special Study of Securities Markets of the SEC, H.R. DOC. NO. 88-95 pt. 1, at 482. (1963) [hereinafter Special Study].

50,000-share trade as I did to do a 100-share trade. This made no sense. Here, you just multiply the rate times the number of shares traded, and that's what you have to pay—you know, a fixed rate. Well, it was absurd.

The pressure that fixed rates exerted on what people wanted to do as a competitive matter was extraordinary. The regional exchanges said, "Well, we can't compete. No one wants to buy our last-sale information. We make better markets, but no one can even see them." You know, that kind of complaining. There was something to that. They began to admit institutions to gain their business.

After looking at the anticompetitive effects of fixed commissions, the Commission also began to look closely at other anticompetitive things that were going on. What about that funny Rule 394 of the New York Stock Exchange prohibiting off-board trading?[12]

We collected comments and had to do a study about the effects of off-board trading rules after the 1975 Acts Amendments were passed because the statute commanded it. I think we collected comments in a room at the SEC—it was Room 394. The Commission began to put all of this together.

Even before the 1975 Acts Amendments, Irv Pollack, who had been the head of Trading and Markets before it was split into the Divisions of Market Regulation and Enforcement, had already promulgated two fairly forceful ideas. One was that there should be a consolidated tape. The other was that there should be a consolidated quotation system. These would collect and put out to the public last sales and bids and offers from all markets on a consolidated basis.

Industry advisory groups were formed to address these two ideas at a time before there was a Federal Advisory Committee Act.[13] As a result, dialogues with the staff about such concepts took place in complete candor. Leaders of the industry got behind both ideas, saying "Look, we really need this thing. We've got complicated markets here. There are increased liquidity demands due to institutional trading.

12. NYSE Rule 394 was renumbered as Rule 390 on March 31, 1976. Rule 390 prohibited members of the NYSE from trading, as a principal, any listed securities in the over-the-counter ("OTC") market. The SEC approved the NYSE proposal to repeal Rule 390 in 2000. *See* Order Approving Proposed Change to Rescind Exchange Rule 390, Exchange Act Release No. 42,758, 65 Fed. Reg. 30,175 (May 10, 2000).

13. Federal Advisory Committee Act (FACA), Pub. L. No. 92-463, 86 Stat. 770 (codified as amended in scattered sections of 5 U.S.C. app. (2003)).

We've got to lace this stuff together in some fashion that produces more liquidity, more connectedness, and keeps the whole pricing structure straight. So we've got to start to integrate these things."

Out of those advisory group studies came the affirmation that there should be a consolidated tape and that there should be a consolidated quotation system. I've forgotten now, but they also had something produced suggesting an overall rule for dealing with block trading as well, I think.

MR. PICKARD: Clearing.

MR. KLEIN: Meanwhile, committees in Congress were studying these things. Plus the Commission was doing it from the vantage point of its hearings on fixed commission rates.

Finally, the Commission produced—it may not have if it had not been forced to do it by market distortions resulting from fixed rates—papers, like in 1972 "The Future Structure of the Securities Markets,"[14] saying that we should do away with prohibitions on foreign membership and at least adjust fixed rates of commission. Then, they produced the Commission's wonderful White Paper on the Structure of the Central Market System.[15] When I got to the SEC, the handy phrase was "a *central* market system," not a "*national* market system."

The White Paper set out some very good ideas: we want to integrate and expose to each other all buying and selling interest in the country through technology; we want to have a public preference rule, preferring public orders over dealer buying and selling interest; we want to have time and price priority governing the way everyone's orders interact; we ought to have a fair system where it doesn't make any difference where the order originates or goes in the country for execution—it will be executed in a national queue. Wouldn't that just be great?

The authority that the Commission had to do any of this was nonexistent before the 1975 Acts Amendments. At that time, the rules that were promulgated to create a consolidated tape and a consolidated quote system were under Section 17(a) of the Exchange Act, which then, as now, gives the Commission the power to require broker-dealers and

14. SEC, *Statement on the Future Structure of the Securities Markets*, 37 C.F.R. § 6286 (Feb. 2, 1972).

15. *See* SEC, *Policy Statement of the Securities and Exchange Commission on the Structure of a Central Market System* (March 29, 1973).

exchanges to file reports with the Commission.[16] Nobody imagined that meant you could force those guys to adopt systems of consolidating last sale and quote information, or force the Exchange to share its monopoly dominion over its last sale and quote information. The New York Stock Exchange (NYSE) was not a great fan of either idea.

There was quite a lot of back and forth between the NYSE and the Commission staff arguing, "Yeah, you are really going to have to do this," and the NYSE responding, "No, we don't," "We will sue you," and "You don't have the authority." The Securities Acts Amendments of 1975 were intended to end that debate, adding to the Commission's authority. It was clear that the Commission was on somewhat weak ground in trying to get where it wanted to go from a regulatory standpoint without additional power from a revised statute. Further, Congress had now held its own lengthy studies of the securities industry and wanted to produce something. I think the Senate was really the side that was more interested in something like a central market system and what that might be about. The House was more interested in the SEC having increased authority over self-regulatory organizations like the NYSE.

The exchanges didn't even have to file rules with the SEC before the 1975 Acts Amendments were passed. Rules used to come in, and there was some sort of "no action letter" non-disapproval process. I mean, it was tremendously weak. The SEC did not have a grip on the financial markets of this country and had virtually no authority to gain such a grip.

When the 1975 Acts Amendments were finished, the Commission had acquired plenty of authority, and it really kind of knocked the industry on its behind. First, the securities industry got socked in the head because the Amendments did away with fixed commission rates. Fixed commissions were ridiculous and falling apart anyway, and they simply had to be done away with. Then, the whole structure supported by fixed rates started to collapse, leading to massive consolidations in the securities industry.

Soon thereafter, somebody came up with the idea, I guess, a little bit later—I can't remember just when that was started—of being a discount broker. Everybody started to say, "Okay, there are no fixed commissions, but we are still going to charge a lot of money for our

16. *See* 15 U.S.C. § 78q(a) (2003).

brokerage services." Then, somebody took out an ad saying, "Well, I won't. I will charge you a really cheap rate and get all the business." That was Charles Schwab, I think. These were very profound things.

The way the amendments made by the 1975 Acts Amendments were structured was amusing. I keep talking about institutional membership on exchanges in part because one of the great things in the 1975 Acts Amendments' legislative history was the Senate Committee telling the SEC that its old Rule 19(c)(2), which Harvey Pitt, who then was the Chief Counsel of the Division of Market Regulation at the time I arrived here—

MR. PICKARD: He was the first Chief Counsel of the Division of Market Regulation.

MR. KLEIN: That's right.

—was a disgraceful act by the Commission, one that should never be repeated. Harvey had written a huge tome, at Chairman Bill Casey's request, to support a rule that was going to keep institutions off exchanges and preserve exchanges as public markets rather than private clubs and all that sort of great stuff.[17] But underneath, driving all of this, is money, okay? If institutions got on the exchanges and recaptured their affiliates' commissions, that would be the end of fixed rate. It was, as my Chief Counsel Roger Blanc put it one day, "If you pray hard enough you can make water run uphill." We managed to get by that.

MR. COLBY: That Release was totally incomprehensible to everybody.

MR. KLEIN: No, it's not incomprehensible to me. I will explain it.

[Laughter.]

The most important thing that Harvey's Release really did is to utterly change the manner in which releases are written at the SEC. If you look back at the old releases any time before 1972, you will find that SEC releases were a couple of pages, and they sort of said, "Well, we're doing this and here's the text of the rule," and, you know, that's it. Well, Harvey wrote an encyclopedia to explain Rule 19b-2—trying to make water run uphill.

17. *See* Proposal to Adopt Securities Exchange Act Rule 19b-2 Concerning Membership on Registered Securities Exchanges for Other Than Public Purposes, Exchange Act Release No. 9,716 (Aug. 3, 1972), *available at* 1972 SEC LEXIS 479; Adoption of Securities Exchange Act Rule 19b-2 Concerning Membership on Registered Securities Exchanges for Other Than Public Purposes, Exchange Act Release No. 9,623 (May 30, 1972), *available at* 1972 SEC LEXIS 428.

MR. COLBY: It was incomprehensible.

MR. KLEIN: It was a masterful thing.

[Laughter.]

MS. NAZARETH: Masterfully incomprehensible.

MR. KLEIN: Ever since then, if anybody was writing what they regarded as a serious or important release at the SEC, it has to be long with lots of footnotes, and they have been that way ever since. There is, after all, an Administrative Procedure Act to pay attention to.

Anyway, after all that Senatorial criticism of Rule 19b-2, what do we find in the 1975 Acts Amendments but a new Section 11(a)! That section, as was the case under Rule 19b-2, prohibited members of exchanges from trading for their own accounts, accounts of affiliates, or for their managed accounts.[18] In short, absent an exception—and there were some in Section 11(a) just as there were under Rule 19b-2—members could not effect transactions on an exchange for their own accounts, the accounts of affiliates or for the accounts of money managed by them. Congress didn't apply that same principle to the over-the-counter market, but the Commission was given authority to do that.

Why is Section 11(a) in there? Well, the surface chatter was: "That is in there because it is just terrible to combine brokerage and money management; that is just a great evil." You may notice now, though, if you look at that Section, that Congress, two or three years ago, passed something leaving most of it in place but taking out the part about managed money,[19] which formed the entire rationale for installing Section 11(a) in the first place. However, that was never the real reason for enacting it. What it really was about was that no one knew at the time whether commissions were really going to be unfixed. The New York Stock Exchange and those guys were fighting to the last man to keep fixed rates in place. They were running around to every Congressman and everybody who would listen, saying, "Grass will grow on Wall Street if you unfix commissions. You must not do this. It will be the end of the world as we know it."

So proponents of fixed rates had built the anti-institutional membership provision into the 1975 Acts Amendments as a legislative stopper to prevent institutions from joining the exchanges—the very

18. *See* Exchange Act § 11(a), 15 U.S.C. § 78k (2003).

19. *See id.*

thing that Rule 19b-2 was designed to do—in the hope that rates would remain fixed. Of course, before all this, as I noted earlier, institutions had been joining regional exchanges anyway (on the regionals), and they had been cutting into fixed rates by capturing what their institutional affiliates paid. And rates were unfixed in the end anyways. Thus, the thing was not what it appears to be on the surface, as is in so many cases with changes in the law.

How do they put the 1975 Acts Amendments together? Probably by using their heads and saying, "What we're looking at as a market structure now just sounds preposterous." You know, my cat would know that most of the stuff they were looking at was artificial. It is hard to understand how the old market structure managed to last as long as it did. But the Commission did not have tremendous power to do much about it until those Amendments were passed.

There was a lot of product in terms of industry study and input—good thinking coming out of the industry and good thinking by academicians—that fed into the staff's knowledge and way of looking at the problems, all of which Congress attempted to address in an omnibus way in what became the 1975 Acts Amendments. Then, of course, after they were passed, there was the problem of implementing them. But that is another and a longer story.

Now, armed with the power to have a National Market System—and I can speak with some emotion about this because I was doing most of it—the Commission really could do what it thought was right. And so we went along proposing what we thought was right: we've got the consolidated tape up; we are going to have a consolidated process and we got that up.

Then we said that the next problem that we really need to address is limit order protection. We are going to have to do something where best execution becomes feasible for people wherever they are in the world. We are going to have to have an order rating system so that people don't pick markets for bad reasons. And, by golly, we are going to put all of this monopoly stuff (like off-board trading rules) out of business. Well, that lasted about as long as maybe the first six months of my being Director after you, Lee.

We had a rule proposal out there to do away with off-board trading rules.[20] Well, that became the next "the world will come to an end if

20. *See* Off-Board Trading Restrictions, Exchange Act Release No. 13,662 (June

you do away with off-board trading rules." I remember Chairman Harold Williams[21] calling me up at home one night and saying, "Andy, are you really sure about this? I'm not so sure about this." It was the beginning of the end, because my certainty about doing away with the rules didn't really matter when other guys from Wall Street started talking to him.

MR. PICKARD: Don't you think in large measure, having received all this authority, that basically the SEC has stepped back and said, "Okay, the industry can evolve and develop its own mechanisms for trading?" And, in fact, they have done a fairly good job of doing that.

Most of the things that you've talked about—best execution, protection of limit orders—are essentially being accomplished today, without the Division having been actively pursuing it.

MR. KLEIN: One has to start with what Congress said has its reason for passing those National Market System provisions. The reason was because fragmentation of the United States securities markets into separate, unconnected pieces is bad for the collection of liquidity, bad for the production of narrow spreads, bad for executions, and so on.

I thought we were making progress there for a while about getting rid of fragmentation. I am going to leave it to my successors to explain how in God's name we've gotten from that point to an even more fragmented state now than anyone ever could have imagined in 1975. So I will pass it on to them.

MR. COLBY: It is merely illusion.

MR. KETCHUM: Well, I only have to ask one question, Andy, because there was one thing that, after Harold Williams made that call, you did end up working through approval, and that was the ITS, the Intermarket Trading System.[22]

23, 1977), *available at* 1977 SEC LEXIS 1441; Off-Board Trading Restrictions, Exchange Act Release No. 13,802 (July 25, 1977), *available at* 1977 SEC LEXIS 1190.

21. Harold M. Williams served as Chairman of the Commission from 1977–1981. *See SEC Chairmen & Commissioners*, Securities and Exchange Commission Historical Society, *at* http://www.sechistorical.org/museum/museum_chairmen.php (last visited Jan. 26, 2004).

22. *See* Development of a National Market System, Exchange Act Release No. 14,416 (Jan. 26, 1978) (noting progress on implementing ITS), *available at* 1978 SEC LEXIS 2339.

Just out of curiosity, as you approved that, would it have been your bet that it would remain the primary linkage system for brokerage securities in the year 2003?

MR. KLEIN: The only reason there is an Intermarket Trading System is because the New York Stock Exchange came up with it. We had them on the run. They were definitely on the run, because we were going to do preposterous things to the way they were doing business. You know, we were going to change it, and we had the power to change it. They knew we had the power to change it, so things were going to hell, and they had to come up with something.

I remember that Ralph Ferrara, who then was Executive Assistant-Legal Counsel to the Chairman, came down, closed the door to my office, slammed a memo we had written knocking the ITS idea down on my desk, saying, "Harold wants to know why you can't be more cooperative. Why can't you let these guys do what they want to do? It's like Vietnam. Just say, 'We see the light at the end of the tunnel' and end the war. You know, forget about it."

MR. BECKER: It was like Vietnam.

MR. KLEIN: I said, "ITS isn't going to work. It would be preposterous." Well, of course, it was at least a beginning. It is now and ever will be only that. It doesn't fix the problem, and it doesn't do much of anything.

MR. BECKER: Is it irrelevant?

MR. KLEIN: It is totally irrelevant. Nobody uses it. I mean, the good underlying idea—and built on the ITS, of course—is that trade-throughs are bad. Rules to prevent them actually might protect better bids or offers that are outstanding in the country so that you don't execute at an inferior price and pass that guy up.

But there is no discussion anymore about the idea of time priority, which was and remains a fairly key idea. Maybe that will come up again someday. But at least you weren't supposed to do a trade anywhere in the country at an inferior price. Trade-throughs threatened to become a maelstrom that could wind up in the court system. But the trade-through rules said only you are to "avoid" trade-throughs—and they're all self-regulatory organization rules, not SEC rules.

What happens if you don't "avoid" a trade-through, and you do one? Well, the other guy can complain, he sends a message through the system, they take it upstairs, they play jacks with it, and three minutes later, you'll find out whether or not you got satisfied. The markets never moved that slowly, and they sure don't today, so it's become a worthless system.

PROFESSOR ROSEN: Well, Rick, maybe you want to pick up a little bit, now having a different perspective—from that of working at an SRO as opposed to talking to an SRO—on what the relationship was with self-regulatory organizations as these National Market System principles started to be expanded in their application over time, for instance, by adding to the list of National Market System securities.

MR. KETCHUM: Sure. Thanks, Ken.

You know, as you can hear now, this is about the time that Market Reg stopped getting interesting. In fact, I still remember—I spent a few months in Market Reg and went off for a year on a special study of the options markets,[23] and I came back because it was more fun being there.

I guess, Ken, something that you had pointed to, and that probably is a good example of the interaction with self-regulation, was the first step that the Commission took at the other end of that story Andy talked to you about, to expand the types of securities that would participate in the National Market System.[24] In non-code terms, that meant that the Commission for the first time expanded the breadth of the National Market System rules away from securities traded on the New York Stock Exchange and the American Stock Exchange—of, if you will, what then would be called listed securities—to securities traded on NASDAQ.

To understand some of the context of the 1970s—because all of you know NASDAQ is this incredibly vibrant and extremely important market with the most significant securities in American on it now—

MR. PICKARD: Was that your view when you were Director?

MR. KETCHUM: That wasn't NASDAQ then. That wasn't so much NASDAQ in 1975, or 1973 when it started, or even 1977 and 1978. NASDAQ was small—basically trading about a tenth of the volume on a dollar volume standpoint of New York Stock Exchange securities. Interestingly enough, at that point, there was even less volume than the American Stock Exchange, and the market cap of the securities traded there, with very few exceptions, was extremely small.

23. *See* SEC, 96TH CONG., 1ST SESS., REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKET 183–89 (Comm. Print 1978) [hereinafter Options Special Study].

24. *See* 17 C.F.R. § 230.146(b) (2003).

There were, however, large securities beginning to develop and stay on the NASDAQ market in the second half of the 1970s. Those companies ranged from companies that were there for less than appealing reasons, such as their CEO wanted to maintain voting control and use non-voting stock, to a variety of companies in sort of the first wave of technology companies, which felt more comfortable with a market maker system and recognized the type of support that market makers could provide. Enough advertisement.

That led to a refocus, because the NASDAQ environment was very different than the New York Stock Exchange environment, and it evolved from a very different place. It evolved from the pink sheet market through the 1960s, which really had no real-time information available of it, to the creation after the Special Study[25]—an indication of how studies can have significant impact on the securities markets—in 1971 of NASDAQ[26] and the first automated quotation system for those securities not listed on an exchange.

But from that 1971 period, and up close to 1979, NASDAQ was still a pretty curious market. The availability of the quotes of competing market makers was only available to professionals, generally indeed only available to other broker-dealers. The information out to the public was, curiously, an average price—call it a representative bid and ask—one of the best things ever gotten rid of by the SEC, which basically meant that customers couldn't even know what people were willing to pay to buy or sell their securities.

There was no last sale reporting. So outside of watching the movements of the quotes and outside of persons who had access to those quotes, being able to really effectively monitor the market or to be able to monitor the quality of your execution was tough. That led the Commission to move down the road of including NASDAQ securities. One of the good things that Andy and other SEC staff did in helping Congress with the 1975 Amendments was build a great deal of flexibility in how the Act could operate, as well as a lot of inconsistent and confusing and complex provisions that told people to do different things.

25. *See* Special Study, *supra* note 11.

26. For a description of the evolution of NASDAQ, see *About NASDAQ*, *at* http://www.nasdaq.com/about/about_nasdaq_long.stm (last visited Sept. 1, 2003).

One of those things was to give the Commission wide-ranging ability to define what a National Market System security was, certainly with respect to all equity securities—and, for that matter, even for standardized options. The designation then of securities was about moving some NASDAQ securities in that direction and choosing not to move standardized options in, but to operate separately, through separate authority, to try to impact that market, which took a few years thereafter.

I guess to try to directly answer your question, Ken, the interaction with SROs, I think, was pretty interesting here.

For those of you who are law students, if I can leave you with one thing from the standpoint of being an effective advocate for your clients, it is get to know the sociology of the agency that you are attempting to deal with. Get to understand what matters, what makes its heart beat, and the fundamental premises and things that the agency cares about.

With the SEC that tends to be things like disclosure and transparency, and tends usually, fortunately, not to be efforts to dictate on a very tight basis each step in which people operate in trading in the market. The SEC, and Market Reg in particular, as part of its sociology, which I'm pleased has survived to this day, takes a pride in actually trying to understand how the markets work—something about which it also has a strong, quiet belief that nobody else in the Commission has the foggiest clue about. That is again important from the legal standpoint to understand, because the fact that—

MR. BECKER: We all enjoyed the HealthSouth trading halt. It was a lot of fun for everyone involved, and we weren't consulted.

MR. KLEIN: How many guys have you had call in and ask, "What's a trading halt?"

MR. KETCHUM: Forget training the law students.

MS. NAZARETH: It's a problem.

MR. KETCHUM: I think I'll stay away from that one.

With that understanding of how the markets work, there is, I think, a risk averseness to Market Reg that has existed, at least since Andy, that has impacted the way Market Reg tends to solve problems. The National Market System Security piece is instructive in that, and the relation to the NASD in moving it is also instructive in how SROs ought to work when they are working well.

The first piece is, in picking up Andy's theme of destruction of Western civilization, designating NASDAQ securities as NMS securities.[27] Requiring last sale reporting for NASDAQ securities was the next step in the road of destroying Western civilization as we know it. I thought back, and in my almost fourteen years at the Commission, we destroyed Western civilization as we knew it eleven times and proposed to do it eight others.

MR. KLEIN: Now grass grows on computer screens, though.

MR. KETCHUM: Now I do worry about Western civilization being destroyed.

[Laughter.]

But within that context there were genuine worries. This was a market of illiquid securities, a market in which there wasn't a central place where orders came, a market which defined itself—and, indeed, built something unique in the United States—through market maker sponsorship and connection with the fact that those dealers also were involved in having customers and selling securities to those customers.

If you will, if there is one thing that has separated the U.S. over the years, I think historically, both for the good and the bad, it has been the willingness of dealers to take positions, and the incentives that have been built into markets like NASDAQ to encourage them to do so. That has had huge benefits in allowing smaller companies to be able to go public much earlier than they would have otherwise. It has also had some costs from conflicts of interest, which we will probably talk about in the next hour and a half.

So the call was really much more a question of not whether there should be last sale reporting, but how many securities and how badly would we screw up if the whole market turned up and died and there weren't any market makers the next day.

SROs at their best are reasonably good interpreters of the "Western civilization dying" question while still representing one of their constituencies, having some concern about their issuers and some concern about the markets as a whole. Working with the NASD basically led to the rollout of NMS securities.

It began with the forty largest securities, and then, after a fairly quick period of time, the NASD figured that this was the greatest thing since sliced bread, because institutions actually would begin to trade the securities. They had some confidence now that the market worked, and

27. *See* Designation of National Market System Securities, Exchange Act Release No. 17,549, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,826 (Feb. 17, 1981).

companies stayed. I think that was one of the key steps in really expanding NASDAQ into a genuine competitor to the New York Stock Exchange.

In short, Ken, SROs can, when they provide balanced advice, contribute to effective policy development, and that was basically how NMS securities began.

PROFESSOR ROSEN: I think that one of the other issues raised by the philosophy behind NMS was just trying to make markets work better in general.

Maybe we'll move on to Brandon and talk a little bit about the efficiency of the clearance and settlement of securities trades in the United States, which is something that has worked remarkably well, when we talk about distinguishing ourselves from other systems. Maybe you can talk a little bit about how the Division was able to get the industry to significantly reduce settlement time during your tenure.

MR. BECKER: Sure.

The issue was a relatively straightforward one. When you buy stock, you have to exchange, in effect, cash—good cash—versus the value of the securities—good deliverable securities.

It used to be that if you did a trade today, it would be five days before the cash moved against the securities. Every day of delay is a day that something can go wrong, and mathematicians can quantify the risk that is attached to that. It was reasonably clear to the world that there would be less risk if you moved the cash against the securities in three days instead of five.

The issue was how to move an industry with a very elaborate, embedded infrastructure, dominated by doing things the way we did it yesterday, from a "T+5"—"T" being trade date, five being settlement date—environment to a "T+3" environment.

That process was one that, in terms of the technology of change, if you will, is one that the Commission has replicated over and over again. First, it starts putting out releases, so-called concept papers and white papers to begin a debate. Second, it starts having advisory committees. The advisory committees are generally peppered by various industry participants. The advisory committees' duties are two-fold: they are both to gather information and to make the case for the proposed action, hopefully generating buy-in from the various industry leaders at the same time with respect to that process.

There is a parallel process, particularly in this context, that also occurs frequent at the Commission—it reaches out to other government agencies.

In this case, Chairman Greenspan and the Federal Reserve Board agreed that the move from "T+5" to "T+3" made sense. Along the way, picking up the New York Federal Reserve Bank as well as the Treasury Department was equally important because as a result of this, a lot of people were going to have their stock certificates either dematerialized—that was the European word for destroyed—or otherwise immobilized. That is really hard. It is a very hard generational thing. A lot of people believed that the value of what they have is the value of a piece of paper—it is what they have in their stock certificate.

We still have something very special in the United States—at least we had it until the year 2000. This is that we have a broad individual investor participation in our markets. That is very helpful on a lot of fronts, so it's not something that you want to put at risk. If you contrast that with the European market or an Asian market, where you are always basically going to a universal bank to raise debt, it is a nice thing to have a deep, liquid, individual investor market where you can raise equity money. So you don't want to put those individuals at risk, but at the same time, you've got to move to a more efficient, less risky environment for settlement.

So what is that process I am describing? You try to get the buy-in of the various industry groups. Then, you try to identify what are going to be the problem children in terms of the technology and the infrastructure. Next, you try to get other governmental agencies to be supportive of the exercise.

There were within the industry some firms that, for whatever reason—usually self-interest and their own archaic computer systems—that didn't want to move. Then, there were a few academics who wanted to go to "T+1"—that would mean settling on the next day—to allow for better harmonization with some of the derivatives markets that were in a "T+1" environment. But if you were to go to "T+1"—and that is still something the industry is trying to work through—that would push much harder the other infrastructure and the comparison process on the floor of the New York Stock Exchange.

So we ended up with "T+3." The SEC ended up adopting the rule. As Milton Friedman—I think it was he—said: "The only ways in which monopoly can last is when it has government backing."[28]

One of the things the SEC does is moderate industry disputes. What it did in this case is it put its thumb on the scale and said, "We are going to 'T+3,' and you recalcitrant firms who do not want to get there are coming along with us. We are not going to take you to 'T+1,' but we are going to 'T+3.'"[29] That gets repeated in lots of different places—limit order display requirements,[30] where the leadership within the industry may be moving in one direction.

But the only way to get there is to have the SEC adopt a rule, and there the gain for the SEC—and the important judgment, the reason why we want Annette and Bob and Caite to be experienced and have good judgment, and hopefully have political appointees who listen to them—is because you've got to make choices, or you are just having the dominant voices in the industry trying to use governmental power to enforce that power for whatever their business objectives are. There is a lot of potential for abuse.

The dominant voices are big, know how to work the system, understand the sociology of the agency, and can hire people like me to dress it up. It is a way that things can be pressed upon the Agency. You need experienced staff that can sort that self-interest from when the industry needs to move to "T+3," and when there is actually a legitimate safety and soundness aspect.

Now, in bringing along other aspects of the government—without trying to front-run either Caite or Bob, one of the other stories that we have not developed thus far on the panel is that the SEC exists within a governmental milieu, and that, while it often is characterized in the press as "turfy," creates a lot of pressures about how things get done.

The unfixing of commission rates cannot really be told in its entirety unless you understand that in *Silver v. New York Stock Exchange*,[31] the New York Stock Exchange woke up to a potential

28. Bruce Sullivan, *Friedman Slams DOJ for "Societal Regulation"*, Conservative News Service, *at* http://www.conservativenews.org/InDepth/archive/199905/IND19990525d.html (last visited Sept. 9, 2003).

29 *See* Exchange Act Rule 15c6-1.

30 *See* Exchange Act Rule 11Ac1-4.

31. 373 U.S. 341 (1963).

application of the antitrust laws, and the Department of Justice was bringing a series of litigation, putting at risk the fixed commission rates.[32]

You cannot tell the whole story of what has gone on in the oversight of the derivatives markets, and in particular the creation of new regulatory structures at the SEC, without knowing that the Federal Reserve Board has been very protective of the banks and their balance sheets. It has tried to retain a vertical oversight of that regime, so that what the SEC has done has always been in the shadow of a bank regulatory structure that in many respects is very different than the broker-dealer regulatory structure.

You cannot tell that story of margin and whether or not changes were made to margin without understanding what happened to derivatives and the competing pressures from the Commodity Futures Trading Commission.

You cannot tell the NASDAQ story today without looking at the Department of Justice and its re-innovated antitrust fascination, as well as its fascination with the options markets.

So, on the one hand, those other forces can be allies, and they can provide an institutional framework for the Commission's action and show some broader support so that it is not too parochial. On the other hand, they provide a discipline and a counterbalance to the Commission.

The short story on the back-office side, where the SEC is really trying to preserve safety and soundness is often that the SEC must act through uniform rules and standards. The Commission can be helpful in setting standards so people can rely upon that. I think they have done that over the years, and they have to maintain some ability to make internal decisions in the future.

PROFESSOR ROSEN: Before getting to that intersect between the different regulators, maybe we can just talk about one more thing from your tenure. Here in an academic environment we are particularly interested in the impact of studies on policymaking. Really one of the great market regulation studies was the "Market 2000 Report."[33] Maybe

32 *See* Maryanne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. REV. 475 (1984).

33. SEC Market 2000 Report: An Examination of Current Equity Market Developments (1994), *available at* 1994 SEC LEXIS 137.

you can just talk a little bit about why that report went forward and what its impact has really been in terms of setting the agenda on market regulation issues that followed.

MR. BECKER: There is an old saying, I think, in Washington, "promise them anything, but give them a study." Generally, when you want to do a four-corner stall, you do a study. Hopefully, it is not entirely cynical. You might actually do a study because these are complicated issues, you want to reach out to a broader community and get their input, and as a result of that, hopefully, come to a more informed and balanced judgment. The process of writing it and getting people involved and working with the Commissioners helps form the value consensus for what you do on individual issues.

MR. KLEIN: No!

MR. BECKER: It's academia. They have to believe this.

[Laughter]

MR. KLEIN: What are you smoking?

MR. BECKER: How can they sit in the library if they didn't believe this?

[Laughter]

MR. KLEIN: Okay. Okay. Go on.

MR. BECKER: So that's an important value accomplishment for a study. In the market structure area, I think the studies have been most successful, going back to the Special Study[34] from the 1960s, when the Commission has done its own homework and gotten smart about a topic. Then, when Harold Williams says to Andy, "Do you really believe it?" and Andy says, "Yes," he can say it credibly, and Harold is prepared to take the heat because they do have confidence in their own judgments. Contrary to the caricatures in the press, most of the people who make these decisions are worried about getting it right and are very concerned about getting it wrong and the collateral consequences of getting it wrong. Their ability to make a decision and implement it is enhanced, I think, by doing the studies and developing an empirical base that gives them confidence about the integrity of their judgment as well as the ability to persuade others.

The successful study, I think, then moves beyond—if you had to contrast the Special Study with the Institutional Investor Study[35]—

34. *See* Special Study, *supra* note 11.

35. *See* SEC, Institutional Investor Study Report, H.R. DOC. NO. 64, 92d Cong., 1st

generalizations to action items. We've got to end up with some concrete things that aren't suggestions for further study or another regression analysis, but now we will require limit order display and move away from eighth-point markets. There has to be something that then has some legs to it and moves forward from that.

If anything, the one problem with some of the more academic studies is they are more generalized in input, and they do not try to focus on a particular action item at the end of the report. It is always a "request for further study." I think the studies can be helpful, although they do sometimes stall out.

The other thing that we need—and Lee and Andrew did this, and the staff there now is doing it—is some real leadership when you do these studies, because the advisory committees in the studies just replicate the self-interest within the industry. You always have to have a balanced advisory group, and then they all fight about their economic self-interest and replicate that among the advisory group. That is useful for the staff to understand the depth and nature of the individual issues, but it doesn't get you anything out of the study unless you have a strong leader who can then try to frame action items and move the thing forward, in my view.

PROFESSOR ROSEN: We will now move on to Caite and Bob and pick up on that other issue that you raised, which is the presence of multiple regulators. It really seems that another one of the major changes in the U.S. financial markets is an increased ability of financial intermediaries from different sectors to compete to provide similar services and products. Much of this was inspired by recent financial services legislation.

Maybe, Bob and Caite, you can tell us a little bit about the Division's role in the drafting, in particular, of the Gramm-Leach-Bliley Act[36] as well as the Commodity Futures Modernization Act ("CFMA").[37]

MS. McGUIRE: Do you want to take the Gramm-Leach-Bliley Act?

Sess. (1971).

36. Pub. L. No. 106-102, 113 Stat. 1338 (1998) (codified as amended in scattered sections of 12 & 15 U.S.C.).

37. Pub. L. No. 106-554, 114 Stat. 2763 (2000) (codified as amended in scattered sections of 7 U.S.C.).

MR. COLBY: Sure.

First, I need to make an SEC disclaimer. We are required to tell you that the views we express are not necessarily those of our colleagues at the Commission or on the staff, and they are not ours if we get quoted on them.

I wanted to contrast two different things that we did to show you what I think worked well and what worked badly, if that's okay. The first is Reg ATS.[38] This is a Rule in which we designed what the requirements were for markets that might technically be viewed as exchanges. It was designed to address a problem that had been lurking for many, many years. It was possible in an environment that was new, because the Congress had given the Commission broad exemptive authority from the statute. We weren't locked into a statute that had been written thirty-forty years before; we were able to tailor it.

In that context, the Division took a group of its hardest-working and smartest staff from the Office of Markets and sent them off for a very long time to go and think about it. They went off and read everything written on the subject. They talked to all the global thinkers on the topic, and then they wrote memos on every issue. Then they finally came up with a proposal that said "we think that one way to go about it is this."

It went out as a Concept Release.[39] Everybody in the industry commented from their own economic interest. It had two parts: one was international, and one was domestic.

The Commission staff took those comments—took what I think were the valid ones, discarded the ones that were purely self-interested—came up with a proposal,[40] and put it out for comment again. The Commission got another round of comments. Some people got tired after the first ones. They thought we were going to go back and reread them—ha, ha. But there was another round of comments, after which the Commission adopted this.[41]

38. Regulation Alternative Trading System, Exchange Act Release No. 39,884, 63 Fed. Reg. 23,504 (Apr. 29, 1998); *see* Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844 (Dec. 22, 1998) [hereinafter Reg ATS].

39. Regulation of Exchanges, Exchange Act Release No. 38,672, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,942 at 89,360 (May 23, 1997).

40. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 39,884, 63 Fed. Reg. 23,504 (Apr. 29, 1998).

41. Regulation of Exchanges and Alternative Trading Systems, Exchange Act

It was extremely long, which meant that some parts got more close scrutiny from the Commission than others. It was something that I think, except for the parts added by other divisions, has stood up well to the test of time. It is in operation today.

Let me contrast that to the Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act was passed by Congress. It was the culmination of four or five bills. I know there were other bills which died in the process.

Some sections of Gramm-Leach-Bliley were negotiated in a broom closet underneath the Senate. There were some sections that were written in the hall. Now there it is. Now it has been enacted, and it has to be implemented in all its glory. Someday, somewhere, Congress will get back to revisiting this, but in the meantime we have to live with this.

MS. McGUIRE: I guess a similar thing, in terms of working with the staffs and the other agencies, has been the creation of the President's Working Group,[42] which was a response, I believe, to the first market break. Rather quickly, that group moved to the issue of derivatives.

Over-the-counter derivatives can take many forms. They are contracts. The Commission had actually started looking at them with the first interest rate swap in 1980. These were not public studies. These were the Chairman saying: "Something new is happening here. Is it a security? Should we be regulating it, or should we allow the over-the-counter markets to innovate?"

The Federal Reserve always knew the answer: the over-the-counter markets should innovate. The SEC wanted to know more. We also didn't want to undermine the options market, because an option is a kind of derivative that the SEC clearly has authority over.

Meanwhile, back at the ranch—and I am working backwards really—back in 1974, they created the CFTC,[43] and they defined a commodity as a series of agricultural things—anything other than onions. So a security is a commodity too, and an over-the-counter derivative could be a future if it was structured in a certain way.

Release No. 40,760, 63 Fed. Reg. 70,844 (Dec. 22, 1998).

42. The President's Working Group on Financial Markets was established by Executive Order. Executive Order 12,631 (March 18, 1988), 53 Fed. Reg. 9,421 (March 22, 1988).

43. The Commodity Futures Trading Commission ("CFTC") was created by the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974) (codified in scattered sections of 7 U.S.C.).

So this created, as lobbyists coined the phrase, "legal uncertainty." This crystallized for the President's Working Group. We worked together—the staffs of all the agencies—to come up with a Working Group Report on the OTC Derivatives Market and the CEA, or the Commodities Exchange Act.[44] In that, we recommended basically that the legal uncertainty of the futures overlay be removed. The uncertainty threatened to say that all over-the-counter derivatives really only should be traded on futures exchanges registered with the CFTC. This seemed ludicrous. In the process of doing that, that became a part of what is known as the Commodity Futures Modernization Act, which was enacted in 2000.

In order to move a bill, there had to be tradeoffs and other things added. So there were three things that were added to move the bill. One, which is not relevant to the SEC, is reform of the oversight of commodities exchanges, actually sort of moving back to the way Andy described the pre-1975 Amendments authority of the SEC in some ways.

But there are two that were relevant to us. First of all, we had to reach an agreement that replaced what had been known as the Shad-Johnson Accord.[45] There was a "no man's land" between the SEC and the CFTC. The SEC regulated securities, including options on securities; the CFTC regulated futures on broad-based indices. However, no one regulated futures on single stocks or narrow-based indices, and no one was allowed to trade them. They were prohibited.

So we had to resolve that, which involved an amazing integration of the two laws for a market which, I think, trades very little. What it did do was it put us on a pro-innovation theoretical discussion with this diverse set of regulators who were all saying, "There shouldn't be a gap just because there are two regulators, so products should be able to be developed."

With respect to over-the-counter derivatives, the CFTC's authority was clearly not applicable. Then, everybody said, "Well, what about the

44. *See* President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act (Nov. 1999), *available at* http://www.ustreas.gov/press/releases/docs/otcact.pdf (last visited Sept. 9, 2003).

45. The Shad-Johnson Accord was an agreement reached by the chairmen of the SEC and the CFTC to divide jurisdiction over options and futures. This agreement was passed into law as part of both the Securities Acts Amendments of 1982, Pub. L. No. 97-303, 96 Stat. 1409 (1982), and the Futures Trading Act of 1982, Pub. L. No 97-444, 96 Stat. 2294 (1982).

SEC?" We said, "Well, we weren't part of this deal." But at the end we were.

What happened was very intelligent. It worked out quite well, for no really good reason. It was one of these serendipitous things. Well, I hope it worked out well. It may be too soon to tell.

It was made clear that if certain securities-based derivatives were not options, they were not securities. But by the same token, the principal provisions of the securities laws that regulate over-the-counter markets in private placements, which is what OTC derivatives currently are, were made applicable. So the anti-fraud and insider trading provisions were applied, without defining the instrument to be securities. It was interesting.

This law represented the most "take one from column A, two from column B" decisions that have ever been made by the Congress. What became evident from my perspective in working on the legislation since the 1975 Amendments is a trend that each deal is more specific and more highly negotiated. It makes the statute much harder to read, and it undercuts the flexibility to deal with future problems broadly.

MR. BECKER: Is that because of less trustworthy agencies, do you think, Caite? I mean, is the Hill just trying to cut its own deal?

MS. McGUIRE: I think it's because there are more highly paid lobbyists. I think in the 1975 Amendments, the only person who could afford a lobbyist was the New York Stock Exchange, and now every major firm has one. With the increasing number of financial conglomerates, which has been brought forward by Gramm-Leach-Bliley, there are ample lobbyists and competing trade associations. I always thought with Gramm-Leach-Bliley that the lobbyists could put their kids through school, and they were far enough along that they could put their grandchildren through school. It was a twenty-year legislative thing.

So the good thing about the CFMA was that it actually passed in one Congress.

MR. PICKARD: Caite, as you presently view those lobbyists, is that a burden on the Division or is that an asset to the Division—the fact that there are so many more trade groups and lobbyists approaching you?

MS. McGUIRE: Both. It is really contextual. Good lobbyists give information, and they facilitate reaching agreement. They bring people together to accomplish their goal. If their goal is to frustrate you, then it is not good. If their goal is to actually make something happen, and they are willing to make compromises, they can be helpful.

But with every person—Andy's idea of just being able to sit and say, "What's right? What do I think is right?" is not something that would describe our experience today. We are very aware of the people around us who have views, and they have to be taken account of. So the releases get longer, the footnotes get denser, but I still think we are able to act and to move ahead.

PROFESSOR ROSEN: Annette, one of the amazing things is at the same time that the Division was dealing with the legislative process for the CFMA and Gramm-Leach-Bliley, and subsequently with the implementation of those statutes, the Division also redoubled its efforts vis-à-vis the National Market System, really trying to help with the integration and transparency of securities markets.

Could you share your thoughts on a couple of these efforts, such as improved disclosure of order execution and routing practices, as well as the development of linkages between options markets?

MS. NAZARETH: I'll be happy to.

I think one of the most interesting aspects of this panel is the color that you have been getting in terms of the difficulties in actually achieving what is on our collective wish lists for the National Market System.

Andy asked a good question early on, which was, "How can it be that after all this time we still have fragmentation?" I think that is a very appropriate question.

I think certainly one of the lessons that I have learned—and I think I learned it first from Arthur Levitt[46] when I first arrived at the Commission—is that there are sometimes opportunities that arise that you do not expect that give you the chance to make your case at a time when the industry may be in less of a position to object. Certainly, those are the times that you want to seize the moment. Certainly, with NASDAQ there were a number of changes that we saw in the marketplace that came out of the settlement.

46. Arthur Levitt, Jr. served as Chairman of the Commission from 1993–2001. *See SEC Chairmen & Commissioners*, Securities and Exchange Commission Historical Society, *at* http://www.sechistorical.org/museum/museum_chairmen.shtml (last visited Sept. 1, 2003).

With the options markets, it was actually somewhat more market-driven, and somewhat driven by the Department of Justice. We had had many years of options markets in which they were certainly permitted to multiply list. In fact, we were under a rule that said that there should be no action taken that would limit the multiple listing of options products on different markets, but in fact, we really had overwhelmingly separate options markets that each traded their own products. In that case, obviously the fact that the Department of Justice took some interest in it and was looking at the issue prompted the options markets to think again about how they were conducting their business.

Probably equally important was the fact that the Commission, for I guess the first time in about twenty-five years, was in the process of registering a new exchange. In this case, it was the International Securities Exchange, which was to be the first fully electronic options exchange.[47] There is nothing like good, old-fashioned competition to shake everybody up, so here you had a new electronic marketplace that was poised to come on board and that intended to multiply list the top 600 options in the markets, and so there was sort of a general panic. Therefore, the options markets started multiply listing. That obviously was, I think, very good news in general for investors, because now you have competition and a narrowing of spreads and the like.

With that came some complexities. We actually got to work on some of the unfinished business that Rick probably had worked on in his Options Study,[48] going back a little ways. We actually started thinking about implementing some of the National Market System principles to the options markets, including linking those markets.

Again, it was a situation where the markets were all complaining about how they couldn't reach each other to get to the best prices in the market, and there was a lot of concern over best execution. On the other hand, it is fair to say that they were dragging their feet in endless meetings on National Market System plans on how they were going to link.

It took very aggressive steps by the Commission to basically say, "Either you come up with a plan, or we will implement a plan." Again,

47. *See* In the Matter of the Application of the International Securities Exchange LLC For Registration as a National Securities Exchange, Exchange Act Release No. 42,455, 65 Fed. Reg. 11,388 (Mar. 2, 2000).

48. *See* Options Special Study, *supra* note 23.

that is what makes our authority so important. We do try to a large extent to leave things to the marketplace. Although we consider ourselves experienced, we think that they are in the best position to know for the most part what will work. When push comes to shove, it may be that we think we can put our heads together and do it ourselves.

That really is, I think, one of our recent successes that probably hasn't gotten quite that much attention, but the linkage of the options market is now fully operational.

The other sort of good news we got just the other day. We had been fighting for quite some time to get a national best bid and offer (NBBO) in the options market, which is remarkable that in 2003 we do not have that. It is a fundamental condition of the equity markets that you know what is the best price offered in the marketplace at any time for a particular security. It is pretty embarrassing that it took this long, but we were told that one of the major market vendors was starting to offer NBBO for option products starting this week. Therefore, we have made some progress.

The other thing that, as I said, Andy mentioned was this issue on how could it possibly be that there are such fragmented markets this far into the process. As you know, at our peril—and we still have the bruises to show for it—we had the audacity to raise the issue in, God forbid, a Concept Release about fragmentation in the marketplace, and whether it was a problem. I personally did not know there were that many lobbyists in the free world.

We took a tremendous amount of heat for even raising the issue, and really I thought we had a fairly balanced Concept Release[49] that asked the question: "Is fragmentation a problem, given that we have so many markets?" Market competition is a great thing. We have multiple competing markets but, you know, at some point, when you have these pockets of liquidity that aren't interacting with each other, it really, as a market structure issue, probably doesn't lead to the best price.

We asked if there were ways that we should consider linking the markets in a more effective way, virtually or otherwise, and had a range of possible things to consider. It started with the very modest thought

49. *See* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 42,450, 65 Fed. Reg. 10,577 (Feb. 23, 2000).

that perhaps great transparency about execution quality in the marketplaces might be a good thing for investors. It went all the way up through the sixth option, which was the dreaded virtual central limit order book.

We came out of that experience, as I said, with a lot of people using terms like "central planning" and "socialist systems," but we did ultimately implement what was again the most modest of the proposals. This was the Execution Quality Disclosure Rules,[50] which I think have added transparency and discipline to the markets. We now have the market centers reporting on a monthly basis their execution quality statistics, stock by stock, at particular sizes.

Although I do not think it gets a lot of attention at the investor level, I think that the broker-dealers who are routing orders are keenly aware of the statistics. They, I believe, now, more than ever before, engage in more rigorous review of where they are directing orders; and if they do not, I hope they feel that they are doing that at their peril. At least there is more discipline in their feeling that they should have obligations as an agent to be routing orders to the market that is offering the best execution for their customers.

The other thing that I could talk about a bit is, as you know, and as Rick is probably most painfully aware, we do have an awful lot of unfinished business, including National Market System business. One of the things that we did recently—partly because, as the panelists have indicated, it is very difficult for the Commissioners to synthesize all of this information and to be able to some extent to tell not only who is telling the truth and where people are acting in their own best interest, but sometimes it is hard for them to remember from one meeting to the next how what they are being told is inconsistent—because of that, and, interestingly, probably coming directly out of our experience, as Rick is painfully aware, with the intense negative lobbying that went on about super-montage, we thought that with respect to the other major market structure issues that it might make sense to literally get all of the Commissioners in a room and to get all of the key market players who had disparate views on the issues to talk about them in the same room at the same time, so that literally, on a contemporaneous basis, we would have one person saying something and the person with the opposite view would immediately be able to make their point. It would give the

50. *See* 17 C.F.R. §§ 240.11Ac1-5; 240.11Ac1-6.

Commissioners an opportunity to really get a better flavor and to ask questions.[51] I think that was really quite successful. I think that was a very good educational process.

Having said that, we now are going to have to actually move on and, noting the issues that were raised at the hearings, we are going to craft basically recommendations for the Commission on further action. It goes to a number of issues that are a problem in the marketplace today.

Again, starting with our earlier speakers' comments, market data is a tremendously successful tool that we use here, but under the National Market System plans the way that market data revenues are split and the means by which market data fees are charged is really coming into question. I don't know if I would weigh it up there with fixed commissions, but it is causing massive distortions in the way people are now executing and printing transactions.

Originally, I think, the intention was that market data revenue was going to be used for regulatory purposes. We now find that sometimes as much as 80 percent is being rebated to market participants who direct orders to particular markets. The way some of the formulas work basically rewards markets for the number of trade prints, so you now have some splitting in some circumstances between where the transaction is quoted and where it is printed. That again is something that was not contemplated certainly in how this works. It leads to reporting of market data showing transactions as occurring in places where really the orders did not interact in that venue at all. Some would say it is misleading.

It calls into question the fairness of the market data fees because if they are fair—and the statute requires that they be "fair and reasonable"—why is it that 80 percent of it can be rebated? That is just one of a number of issues that we are dealing with and that were discussed at the hearings.

PROFESSOR ROSEN: Being in New York, I think it is particularly appropriate when reflecting on the Division's history and going forward to think back to September 11, 2001. I was at the Commission at the time. I think that people do not realize that this was really the major

51. *See* SEC Press Release 2002-148, Commission Sets Dates for Market Structure Hearings (Oct. 15, 2002), *available at* http://www.sec.gov/news/press/2002-148.htm (last visited Sept. 9, 2003).

market stoppage in U.S. history. The markets got back online so quickly, despite the fact that there were really such close personal ties, I think, between people on the Division staff and in the industry and obviously people here in New York, with individuals who were lost.

Maybe you can tell us a little bit about that day and really how the Division helped and worked with industry to get the markets going again, and also comment on how the industry is working now perhaps to deal with future market stoppages, perhaps by any future terrorist events?

MS. NAZARETH: I think it is a very different world today certainly than it was before September 11th. I think a lot of us who worked over that period actually felt quite privileged to be able to work on the reopening of the markets. I know in Market Regulation it seemed like the whole staff really wanted to be involved. Even those who continued to work and to shoulder the burdens of those who were diverted to working on the market reopenings really put in a tremendous effort.

As you know, the Commission had emergency procedures in place certainly. I think, largely as a result of all of the preparedness for Y2K, the Commission actually was really even that much better prepared in terms of having emergency numbers for all of the major market players, the markets themselves, the clearing agencies, the major firms, and other regulators both domestically and abroad. There was a tremendous amount of communication and coordination to determine the readiness of the markets to reopen.

I think largely the success was also due in part to the fact that the marketplace came together and came to a joint decision on the readiness to reopen the equity markets the following Monday. There was a lot of effort that went into ensuring that the systems could be up and running. There certainly was a feeling that the worst thing that could happen would be to attempt to come up too soon, and then have the markets go down.

There were a lot of changes in the way we had reviewed our role at the Commission, in terms of having our staff automation specialists and the like who could work with the people at the markets over the weekend in the testing phase and all. It was very helpful to us as regulators to have some of our own people who were there side by side with the technology people at the markets to be sure that we would be ready to come up.

You know, there have been a lot of lessons learned from the experience. I know Bob has spent a great deal of time working on a lot of the business continuity issues, if you want to talk about the White Paper or anything like that.

In general, I think we are working with other financial regulators, including the Fed and the OCC and the New York State Banking Department, on a White Paper on best practices and how to strengthen business continuity across the markets.

These are things that I don't know if some of my predecessors had to spend a lot of time on, but it is really quite a new world. We are having meetings with the New York Stock Exchange and the NASD on reciprocal backup contingency plans and the like. This emphasis on readiness, backups, and continuity, I think, is probably something that is much more of a focus today than it was for my predecessors.

PROFESSOR ROSEN: I think that one of the interesting things over the last several years has been the fact that — you mentioned, Annette, the International Securities Exchange — all of a sudden there are new entities coming into the Commission seeking to register. I know this is an issue near and dear, I'm sure, Rick, to your heart.

Do you have any ideas for the staff in terms of how to deal with new exchange applications?

MR. KETCHUM: Sure. The SEC should be flexible, like they have been over the years.

I would just say one thing on what Annette said before. Again, if you want to look at what works and does not work with respect to the structure of expert agencies in the United States, September 11th was a perfect example of what worked. I think it worked both with respect to the self-regulatory system and with respect to the SEC.

The SEC had the ability to have people involved who actually understood the markets. They were able to act as intermediaries between an executive branch that was understandably desirous of making a statement for the country that markets were up and would work, and with people who understood that the worst thing that could happen would be for markets to go up and not work. This was not terribly written about, but I think it was really an incredible contribution of the SEC, and one that they can feel very proud about.

With respect to exchange definitions and registrations and the like, I guess I will take a little bit more of a historical perspective to show that it is not totally self-interested. I think the way that the SEC has dealt with the definition of an exchange has been good over the years. Actually, if you look at the things from all our times that have worked, albeit in ways that have driven me out of my mind in my second life, flexibility has been important. Probably the most important place that the SEC showed flexibility was with respect to automated transaction systems, now defined as ATSs—things that back then were not thought of a lot but had names like Instinet.

When the SEC first started to deal with entities like Instinet,[52] they were dealing with extremely small entities with an environment in which competition between markets, as Andy so unreasonably chose to remind us today, had not evolved to perfection. There was not the level of limit order display and ability for investors to directly interact in the market that exists today.

The Commission took advantage of what is a very broad-ranging definition of "exchange" that could have been used to just slap down any innovation with regard to trading systems in the United States. I say "could have" because if you look throughout the rest of the world, you realize that the rest of the world figured out how to do exactly that. For periods of years, only gradually unbending over time, the rest of the world's rules basically did not permit trading systems to operate outside of exchange registration, and often did not permit more than one exchange to operate. The more I keep talking about this, the more I think that would be really a good idea.

[Laughter.]

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52. "In 1969, Instinet began operating a computer/communications network to be used by professional investors to effect large block trades." Proprietary Trading Systems, Exchange Act Release No. 26,708, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,406 (Apr. 11, 1989).

> Instinet currently is a subsidiary of Reuters Holdings PLC, a London-based news and financial data company. As originally operated, the Instinet system allowed subscribers to enter offers to buy and sell securities, as well as acceptances of such offers and counteroffers. All information was entered into the system anonymously through code numbers. Although the Instinet customer base primarily was institutional, Instinet made its services available to anyone who was "financially responsible," including broker-dealers. Any security could be traded through the system, and there were no market makers, floor brokers, or other traditional "exchange-type" participants. Instinet continues to allow its participants to accept "live" orders, and, in addition, has expanded its system to initiate a "crossing network" in which buy and sell orders for portfolios of securities are matched with one another.

Id. at n.9.

But that wasn't the way the Commission went, and instead, even though—

MR. KLEIN: It did do that, though, ten years ago. I mean, it took it ten years to figure it out and agree with me.

MR. KETCHUM: You're right, Andy.

Instead, the Commission went down the road of taking a definition that could pull in just about anything that broker-dealers do as far as putting a purchaser and a seller together. Instead, they took what some would call creative, and others would call lawless, stances in defining things that did put things together with respect to electronic systems as not requiring registration as an exchange. That led to, I think, interesting levels of innovation, from things like Instinet, which spawned the ECNs[53] and automated trading systems of the day, to things like ITG[54] that provided the initial single-price auction type of environment existing in the United States. There were also a host of other things that did not work as well but gave lots of people something to think about over the years.

MR. COLBY: May I just say that, in case you are not putting it together, the process I said was really good Rick just called lawless.

MR. KETCHUM: No. That was ATS.

MR. COLBY: That's what I said.

MR. KETCHUM: ATS was sort of the next step on the way, which was actually really good at the time—

MR. COLBY: Oh, okay. I'm sorry. Go ahead.

MR. KETCHUM: —because over time these entities grew dramatically and became a significant part of the market structure, and yet they were operating separately. That led to real problems—

MR. KLEIN: Which we enjoy today.

MR. KETCHUM: We enjoy it in a different way today, such as firms executing orders for retail investors at very different prices than they executed their own orders.

53. "Electronic Communications Networks, or ECNs, are electronic trading systems that automatically match buy and sell orders at specified prices." *See Electronic Communications Networks (ECNs)*, U.S. Securities and Exchange Commission, *available at* http://www.sec.gov/answers/ecn.htm (last visited Sept. 8, 2003).

54. ITG is a confidential electronic trading system for institutional investors. *See About ITG: The ITG Story, at* http://www.itginc.com/about/itgstory.html (last visited Sept. 24, 2003).

MR. KLEIN: You left out that part about all those OTC market makers eating their customers' limit orders for centuries before they finally put them into that.

MR. KETCHUM: It's got to be a short story, Andy.

MR. BECKER: None of this has anything to do with what is an exchange. It does have everything to do with whether the SEC is going to adopt rules or otherwise set standards for how people handle customer orders irrespective of the legal framework in which it occurs.

MR. KLEIN: That's quite right, because the main problem now has been—and it would have happened no matter what had happened with the definition of an ATS as an exchange—the enormous tension between floor-based, open-outcry systems of trading and electronic markets and how to connect them. That is a problem with this entire—

MR. COLBY: But that goes back to eighteenth-century scholasticism about legal form, which has only obscured the question of the quality of the execution and the standards of the execution.

MR. KETCHUM: Okay. I am going to tie it together in three paragraphs, because I think you guys are, as usual, both right and really wrong.

The SEC showed flexibility in the definition of exchange when they should. They stepped in and tightened it up—maybe not in the right way necessarily, but at least bringing back linkages and avoiding egregious situations of firms marking prices differently, through Reg ATS, and that was good. That is probably, in my view, a pretty good way to go—although I would note that they made one egregious error, which I hope they are going to address this year. This is that they allowed one set of broker-dealers to charge access fees while the rest of the broker-dealers could not. That has fundamentally warped the markets over the last three years, but that is a different conversation.

Nevertheless, I think the basic structure was a step in the right direction. It did not discourage innovation, and I think it has led to a competitive environment that kind of works. I will disagree with Andy because when you have automatic execution, it actually does kind of work.

They should do the same thing with exchange applications today. There is something called NASDAQ that the SEC in Reg ATS said is obviously an exchange but doesn't need to register as one because we have the same authority. They were right then, and they should take that action now.

The good thing about things like the definition of National Market System securities and the definition of exchange is you don't have to have a single set, you can have subsets. What one would hope is that with respect to NASDAQ, that the SEC chose to regulate them in the way they did because they liked a competing environment. They liked an environment that more and more provided automatic executions, and they chose incrementally to make sure that environment did things in a way that protected investors better. One would certainly hope they would not decide to do it one way or another based on whether it happened to be an exchange or not an exchange because the impact on investors would be exactly the same either way.

I hope that the SEC will take that key and recognize that there can be subsets of exchanges, just like everything else they have done. They should continue to regulate the NASDAQ the way they have before and continue to regulate other entities in other ways, where they have floors and give people second looks and hours to decide what to do with their orders and regulate them differently.

MR. KLEIN: Does this come under the caption of what Bob was talking about, which is people arguing all these different things in their economic interest?

MR. KETCHUM: No. It comes under the caption of providing honest, independent advice.

MR. COLBY: I do think it comes close to that, Andrew, because there is a policy issue, which has to do with whether or not the SEC wants to require that broker-dealers executing their customers' orders provide some sort of facility for those orders to interact with the orders of customers of other broker-dealers and, if so, under what circumstances.

MR. KETCHUM: That wasn't the policy issue. That was the whole basis for where we started thirty years ago, and something that we did away with.

Andy is still frustrated that the rest of us didn't listen to him all those years ago.

MR. COLBY: That issue is a real issue that the Commission should do something about. Does the Commission want to address the issue in the context of clean crosses, or does it want to do so in the context of over-the-counter dealers and how they interact with their customers' orders? It has nothing to do with the formal recognition as an exchange or not an exchange. There is a substantive policy judgment.

It is the same way that the Commission used Reg ATS[55] to finally get limit orders displayed. It could have amended its Quote Rule and required the display of limit orders. Instead, it used legal form to accomplish an objective result, and that's fine. They do that all the time, but the clarity that is lacking is an ability to address the underlying policy issue and then set standards across broker-dealers so that they are held to the same standard—or at least the investors—with the same quality of execution.

MR. KLEIN: I was going to tell the group that for the period that I spoke of, another way of going to get a little read of what it was is go back and look at the House Report, the "Five-Year Status Report on a National Market System."[56] That really tells you all you need to know.

You will hear all of this stuff that you are hearing now, then. You will find the House saying, "You know what the problem is here? The Commission lacks will. They will not use the powers we gave them to take on and resolve these problems." That was true then, and it is true now.

In the report—the Democrats were in control of Congress then—the Republicans wrote a nice piece at the end of this Report that says "We think the Commission is doing just great. They should be congratulated. They have kept their hands off this thing and they have let the industry." All of a sudden, I think we're talking politics instead of the other stuff.

MR. COLBY: One footnote. You did make a reference to the European markets and the rest of the world. If you go down and get involved in this stuff, treat the rest of the world with care and suspicion. Those markets are dominated by universal banks. Their electronic equity markets are basically little subdivisions for these global banks and generally owned by these global banks.

MR. KLEIN: Those are the ones that are not the envy of the world. Are those the ones you are talking about?

MR. COLBY: Yes, those, right.

It is just not apples and oranges—well, it is apples and oranges, but it is not a fair comparison. You will see that in the literature every now

55. *See* Reg ATS, *supra* note 38.

56. *See* SEC Commissioner Paul S. Atkins, Remarks Before the American Enterprise Institute (May 7, 2003) (citing five-year status report on the 1975 amendments), *available at* http://www.sec.gov/news/speech/spch050703psa.htm (last visited Nov. 10, 2003).

and then someone will find some small auction electronic market in an emerging Eastern European country. Since it does four trades a day using a particular auction technique, they say that the New York Stock Exchange should adopt it. Don't go there.

MR. KLEIN: You've got to admit that the IRC is impressive, though.

MR. KETCHUM: At the risk of maybe going there for a second, those are the very same markets that have dramatically wider spreads than the U.S. markets. They have tried to figure out for the last five years how to get dealers back in a marketplace that is no longer profitable for them to operate in.

MR. PICKARD: Aren't these issues really going away? If you look at a major broker-dealer trading operation today, you walk into the trading room and see computers and software that are going to bring those traders to any liquid source in this country almost instantaneously. I've got three or four clients that have shown me these operations. If you've got four or five ECNs, you've got several trading floors, you've got upstairs market makers, they are all—the interconnection has already resulted. A lot of these issues are not issues any longer from an economic standpoint.

MR. COLBY: Some of the issues, Lee, are coded in when they try to capture the regulatory rents. They designed the smart router to capture the print rebates that they can get from individual markets. They also designed the smart router to take advantage of opportunities for internalization in individual markets.

MR. PICKARD: That's a cynical view. I mean, these mechanisms are designed—

MR. COLBY: Is that the same as accurate?

MR. KLEIN: Harsh reality.

MR. PICKARD: Yes. They are designed really to give the best possible execution to their institutional or retail clients. I mean, at least that is what they purport to do. Now, maybe they are deluding themselves, but that is what they do. You have all these software companies and computer companies that are offering these services that provide instantaneous access and execution to virtually any liquid market in this country, and they are all in place.

MR. COLBY: I agree with you. I'm just saying that there are—

MR. PICKARD: Let's go home.

MR. COLBY: —some embedded regulatory costs that the Commission needs to address whether they should be part of that. Take rebates—internalization opportunities come to mind. It's fine. The routers are designed to try and capture and pass some of that stuff on—access fees, who has them, who doesn't have them.

MR. KLEIN: How about just knowing what a price is when depth has disappeared at any particular price point? I mean, nobody has any. Then, when you went to decimals, all of a sudden the percentage of the quote is 200 shares. I mean, that is an exaggeration, but the depth that is available at the pricing points of an eighth are not there, so you don't know what the price is anymore from moment to moment. You see narrower spreads for smaller size and say, "Gee, we're saving you a lot of money"—except try to go trade. You can't trade at the size that you could with certainty.

MR. PICKARD: This is an example of the type of thing that goes on in Market Regulation.

PROFESSOR ROSEN: Actually, that may be a good transition to a question of interest down at this end of the table for our first four panelists, which is: given all of the experience that you have gained since leaving the Commission, there is some interest on this side of table as to if there might be one thing you would have done differently when you were Director, if you knew then what you know now?

MR. PICKARD: Well, I've heard that somebody said experience is something you learn right after you need it. So, Andy, I'll let you respond to that question.

[Laughter.]

MR. KLEIN: The one thing I would have done if I had understood what I was getting into is I wouldn't have accepted Harold's offer.

[Laughter.]

MR. KETCHUM: I think the best thing about the Commission is that you always have alumni around to tell the staff, and particularly audiences like the one here, about how miserably they're mucking it up now, unlike "back in the good old days when everything worked perfectly." So it would be wrong for me now to say where we screwed up then. That's for other people.

MR. PICKARD: You know, there is one thing I can add. I was absolutely surprised over the years with the success of the net capital and the segregation rules and how the broker-dealer industry has really survived the turmoil without any serious demise or investor loss. That program, which we were all struggling at the time trying to put together, not knowing really where it was going to go, turned out to be almost unassailable in its effectiveness.

PROFESSOR ROSEN: Actually, there are, I think, some regrets down on this side of the table now, so there is a request to know what you think was the best accomplishment of your time.

MR. PICKARD: I think inadvertently that was my best accomplishment, because I just wasn't sure about the wisdom of it, and it was a day-to-day struggle fine-tuning that. The application and the workings of that program have been just remarkable. I mean, there have not been any serious financial bankruptcies or loss where investors have lost money since the inception of that program. There have been a few, but not many.

PROFESSOR ROSEN: What I would like to do is stop there and go to a tradition, which we don't have that much time for, which is to go to the audience for one or two questions for the panel, and then conclude and go on to enjoy the reception.

Are there any questions from the audience?

QUESTION: If you could give us some insight from where you all sit, from history down to now, as to what the level of sophistication is. Where are we in terms of derivatives and the need to regulate them or not? Also, with respect to the international side, we all know, which you've alluded to, that you can open up an office in Shanghai somewhere and have tremendous impact on credit derivatives, equity derivatives. These are not interest rate derivatives anymore.

I was interested in maybe getting some insight from both practitioners and current regulators as to what is the level of discussion going on now at the SEC as well as among the other regulatory agencies? Are we just talking about "Well, that's your business; that's mine?" Is it territorial?

MR. BECKER: I'll take a quick shot at two observations.

One, in my experience, the agencies work just splendidly when they are dealing with a common objective and a common crisis, and they work cooperatively even going forward. With 9/11, when you've got somebody of the caliber of Peter Fisher at the Treasury and people like Chris Cummings at the New York Fed, things are going to get done. It is going to be done in a professional manner, with a common objective, and they are going to do just an outstanding job working together for the same government with the same objectives. They are also going to do a good job working together on business continuity planning and have shared objectives. They will do less well working on some of the regulatory capital issues.

Then you hit the seam, and the seam is something like derivatives, where you implicate their respective jurisdictions. Unfortunately in my experience, I think the turf impedes the conversation—good fences, good neighbors. If the turf question had been resolved, they could deal with it just as a question of professionalism. But because it does not get resolved, it tends to get too wrapped up in the jurisdictional issues. I agree that that is still a long-term risk for the markets.

MS. McGUIRE: Speaking from the perspective of now, I think that we do work well together. Right now where we are on credit derivatives is we are letting the industry sort itself out, which is a tried and true mechanism with respect to over-the-counter derivatives.

The Group of 30 was responding to the early crises. Over time, the industry has successfully redone documentation, reorganized itself, and refocused, with the goal, in part, of maintaining the independence of having market supervision.

It is really not a fully organized market yet. If it becomes a price setter, as some of the newspaper articles have said about credit derivatives, then I think that is what will trigger a refocus.

What the President's Working Group really decided was that none of the current systems would be right to regulate a derivatives market. It should not be a commodities futures exchange, and it should not be a securities exchange. If at some point the market becomes too organized, it may need to be regulated. It probably cannot be divided between things that bank supervisors supervise and things that they do not. The bank pull-off will not work if you are talking about a market.

Those are the things that I think we all knew, but we did not know what probably we are going to solve. Warren Buffet says that he has decided to get out of the OTC derivatives market. Well, he is already in a lot of other businesses that have a lot of risk. Whether the risks can be managed or not, I do not know. I am hoping the bank regulators are looking carefully because they are interested in the safety and soundness of their institutions.

We will look also in terms of assessing the risks of the broker-dealers that we supervise. Right now, that is what we are doing. We are trying to make sure that the players that we work with are stable. Whether we should be doing more, the whole issue goes back to the beginning of the time of market regulation. Should you regulate the institutional trader, should you regulate the hedge fund, should you regulate the market participant, or can you regulate the intermediaries? Those are really hard questions with OTC derivatives.

And so it seems that—I am not ready to grapple with them. Maybe my boss is.

PROFESSOR ROSEN: It looks like Annette may want to take a pass.

I think that is a great way for us to end.

I would just like to thank our panel again for a fascinating discussion.

Thank you all for joining us this evening. We hope you will be able to join us outside for the reception. Thank you very much.