**Securities and Exchange Commission Historical Society**
**Oral History Project**
**Interview with Edward A. Kwalwasser**
**Conducted on November 30, 2009, by Kenneth Durr**

**KD:** Interview with Edward A. Kwalwasser, November 30th, 2009, in New York City, by Kenneth Durr. I want to start with how you came to the SEC. I don't have any information about your educational background: can we start with where you went to school?

**EK:** Sure. Kindergarten or—

**KD:** Let's start with college and law school.

**EK:** Okay. I went to City College of New York Baruch School. I majored in economics, and then I went to Cornell Law School.

**KD:** Was it fairly unusual for an economics major to go into law?

**EK:** I decided in my last year that you had to be a really good mathematician to be a good economist, and I wasn't going to make that. So then I thought I would do something that I could actually do, and law seemed like an interesting endeavor.

**KD:** Now did that point you towards securities law and things like that?

**EK:** Well, during the summers when I was in college, I worked for several securities firms. So as an economics major and as someone who was just interested in the market, I was interested in it.

**KD:** Tell me a little bit about that experience, your internships or the positions you held.

**EK:** Well, they were hardly internships in those days. I worked for an over-the-counter firm, and there were really just three people. And so, though I wasn't registered or anything, when somebody was out, I, essentially, had to do whatever had to be done. Sometimes I had to trade the stocks or make markets. And then I worked for Bache and Company in their over-the-counter department at a time when Harold Bache was still there.

**KD:** Did you specialize in securities law at Cornell?

**EK:** No, they really didn't have any specialties. They didn't even have a course in securities law. Again, the securities field was something that I was interested in. When I got out of law school, I actually did something entirely different. I worked for a small firm that was engaged in entertainment law. I did copyright work, and dealt with mostly rock and roll acts—sort of strange. But I read—actually in the *Wall Street Journal*—that the SEC was looking for people, so I applied. In those days, you needed to take a test. You'd go down to Washington and take a test, which I took, and I guess I did well enough that I got hired.

**KD:** Now was this in the early 70s?

**EK:** It was '67.

**KD:** '67, okay. Was it the Division of Trading and Markets then?

**EK:** I actually was working at Opinions and Review when I started.

**KD:** Tell me a little bit about the process of coming in, interviewing and looking around. You had this complete other experience. Tell me a little bit about getting into the SEC and what was involved, what was the learning curve like?

**EK:** It turns out that Opinions and Review—we didn't fit, because I was a lot more aggressive than a judge should've been and I was sort of rooting for the home team. That probably wasn't appropriate, but you got to read all of the cases that the Commission had brought in the years before it in order to be able to write an opinion. It was a great learning curve for me in that I got to learn all of the things of which I actually knew nothing. I did know about the markets and I knew how to read, so I could read the statutes, but reading how the Commission interpreted those, and how the courts interpreted them was a really great learning experience for the rest of the time that I was at the Commission.

**KD:** And these were rules having to do with every aspect of the Commission?

**EK:** Yes. Whenever Enforcement brought a case against someone, there needed to be an opinion written. It could be fraud, could be market manipulation—there was an options trading case—they were all different kinds of cases, so it gave at least the broad view of what was going on.

**KD:** Was this in the General Counsel's office?

**EK:** Well, at that point, Opinion and Review was a separate office.

**KD:** Okay. So that gave you a pretty good perspective on everything, I guess.

**EK:** Right.

**KD:** So how did that lead you into Trading and Markets?

**EK:** Well, it's a long story. I actually went to the Washington Regional Office, which at that time was in the home office. And I was doing the Regulation A work, work related to the '33 Act. At some point, I went to Corp Fin and doing Williams Act regulation. The Williams Act was just approved, and I guess they didn't know where to put it, so they put it there. I learned about the Williams Act and tender offers and such. Then I was asked by the Washington Regional Office to come back and be the Chief Regulatory Attorney. At that point, I was head of broker-dealer examination program, the investment company examination program, and the investment advisor examination program in the Washington region.

**KD:** Okay. You did Corp Fin work as well as '33 Act work and then you suddenly made this transition into broker-dealers and things, which you obviously stuck with. Tell me about that change, and the kinds of things that you were looking at when you made that change.

**EK:** Again, going back to Opinions and Review, most of the cases that the Commission brought were dealing with broker-dealers, so I had a pretty good idea of how they operated and what was going on. Also, I had worked for a couple of them when I was in college, so I had a fair idea of what was happening. One of the important things in dealing with broker-dealers is the net capital rule. It's hard to get lawyers to really be interested in that, but somehow I became interested in it. I knew a great deal about that. Between all of those things, it was pretty easy to step in.

**KD:** Was this a reorganization or a new capacity that the SEC was setting up?

**EK:** I think I was the first chief regulatory attorney. They reorganized the office and had a chief enforcement attorney and a chief regulatory attorney.

**KD:** What was driving that change?

**EK:** I don't know.

**KD:** I noticed a couple of things that you were involved in in that area. One was working with broker-dealers in all kinds of things, but generally, regulating broker-dealers.

**EK:** Right.

**KD:** You've got things like examinations. Did you go in and do investigations, things like that?

**EK:** Yes. We had an examination program, so one of the things that we did was to develop a syllabus for the examiners to go in—what questions to ask, how to deal with this and that. We did the same for investment advisors and investment companies because the Washington region had Baltimore with T. Rowe Price, and they also had Philadelphia and Delaware where they have a number of investment companies.

**KD:** At this point, are you in the headquarters, or are you in the region?

**EK:** Well, the Washington regional then moved across the river. But because we were so close, we also commented on a lot of things that were being proposed in the broker-dealer area and the investment company area. We had done examinations, both for investment management and for what was Market Reg at the time. Both thought it was valuable to get our input into what was going on because we actually had been into broker-dealers, investment advisors, investment companies, and those people hadn't.

**KD:** Right. That was something the regional offices did?

**EK:** Right. And they still do that.

**KD:** Did you work with other regional offices and compare notes?

**EK:** Yes. Well, Jim Clarkson, who's still at the Commission, became sort of a coordinator for the regional offices. We did get together. He got everybody together, and we were able to compare notes and do other things. But there were some small offices, big offices, and then there was the New York regional office, which carried a lot of weight.

**KD:** At some point, the SEC, the regional offices are administering all of these exams. Is that right?

**EK:** Correct.

**KD:** Did any of that responsibility ever flow down into the self-regulatory organizations?

**EK:** Well, there is no self-regulatory organization for investment advisors or investment companies. That was always only done by the Commission. With respect to broker-dealers, self-regulatory organizations did have the primary responsibility. Most of, but not all the examinations that we did were for cause. If you got a complaint or if you heard there was something wrong, then you would send examiners in to look at whatever was going on. We always figured we were better than self-regulatory organizations.

**KD:** Really?

**EK:** Of course.

**KD:** Did you feel that way when you were on the other side of the table?

**EK:** Oh, absolutely not.

**KD:** [Laughter]. Tell me a little bit about net capital rules. This appears to be something that only an economist—

**EK:** Well, it used to be administered by the New York Stock Exchange, and then in the late '60s when all of the broker-dealers were going out of business, the Commission determined that the New York Stock Exchange wasn't quite regulating in a fair and even-handed manner. They were letting people go, and that's because broker-dealers were going out of business, and so Congress passed something called the Uniform Net Capital Rule, which is administered by the SEC.

**KD:** Did this go in about the time of the '75 Acts?

**EK:** Yes, around that time.

**KD:** What was different about the Uniform Net Capital Rule?

**EK:** It was uniform. The SEC set the guidelines and everybody had to follow them so that New York couldn't say, "Well, we'll pass on this. We know you're a good fellow, so we'll give you some more time to get into compliance." Everybody had to comply with one set of rules.

**KD:** But the net that they had to hold back would've been proportional to the amount of business they did, I would assume.

**EK:** Well, it changed. We got more aggressive. This is a little later on when I was head of that area at Market Reg. There are two different kinds of requirements. Either you keep a certain percentage of your capital in good assets, or you have a certain percentage of the amount of money that customers owe you, and you need to keep that amount, and that determines whether you're in compliance with the capital rule or not.

**KD:** So at some point, it appears that there was—I wouldn't say a loosening up—but an adjustment of net capital rules in order to bring more resources to bear.

**EK:** It really was whether they were too tough, being too safety conscious to the point where firms had to hold a lot of money—essentially useless in their business—when it wouldn't have caused many more failures to have them hold less money. Much like the bank reserves today, where people are saying, "Well, you need to have 8 percent instead of 6 percent." But at that time, it was determined that from 4 percent, we can go to 2 percent without having any great increase in the loss of broker-dealers or loss of money to customers.

**KD:** Did you do a study? How was that determined?

**EK:** That's a good question. There was some study of the broker-dealers that went out of business, but there wasn't any great economic examination. I don't think the Commission had an economist at that point.

**KD:** So this is just kind of rule-of-thumb stuff, somebody saying, "Well, I guess we can drop the percentage a little bit?"

**EK:** Yes. People commented that it was too much. Some people wanted 1 percent, some people said 9 percent. You could run the numbers and see if we went to 2 percent, would anybody be out of business. And the answer was, no, we wouldn't have lost any additional broker-dealers with the change from 4 percent to 2 percent. Some guys will go out of business even if they're minus 100 percent, so it's not really a problem.

**KD:** Looking back at the records, it seems like there's a general concern about smaller broker-dealers at this time, not worrying so much about the big guys but trying to make sure that things are—

**EK:** Right.

**KD:** Tell me a little bit about that, where that might have come from, what was going on.

**EK:** Every Friday afternoon at the Commission, we would put a broker-dealer out of business. At that time all of the Commissioners lived outside of Washington except for one, so they would all leave. There would be one left Friday afternoon. We would meet in his office to get the authority to put a broker-dealer out of business. Because of the way the rules work, essentially a broker-dealer had a week to sort things out without having to tell anybody. At some point, they have to gather up all of their customer assets and lock them up. They have to make that calculation as of Friday.

So by Friday, they know they can't make it. They come in and you find out that they're out of business and they need to be liquidated. So, clearly, there were a lot of small broker-dealers who are going out of business because they didn't have the needed capital. And then you would find fraud because they're trying to do everything they could to get money, and one of the easy ways to do it is take your customer's money.

**KD:** So these were the kinds of people that were coming in and meeting with you.

**EK:** Right.

**KD:** Were you turning these people up from examinations?

**EK:** Some of them from examinations, some of them because they were required to report. Some of them because customers were complaining they can't get their money out.

**KD:** Tell me a little bit about the transition then from Washington Regional into the headquarters.

**EK:** Then the headquarters was coming up with something which is now called OCIE, which then was part of Market Reg. And one of the persons who was supposed to head that went to the CFTC instead and they took me.

**KD:** What does OCIE stand for?

**EK:** Office of Compliance Inspections and Examinations. It was, as I said, part of Market Reg at the time.

**KD:** You were brought in to get OCIE up and running.

**EK:** That was really a coordination effort of all of the regional offices. At that time, it was only the broker-dealer examination program. It wasn't the investment advisors and investment companies.

**KD:** About when is this?

**EK:** '81, I think.

**KD:** Did you become an associate director at that point?

**EK:** Harold Williams wouldn't make me an associate director because he wanted me to go up and run the Boston office. My wife's from Boston, and she wouldn't go under penalty of death, so I said no. So he thought I wasn't a team player. I guess I was an associate, but I wasn't paid as one. Then John Shad came in, and that was one of the first things he did.

**KD:** How did administering this OCIE process pan out? Did you build it up over time?

**EK:** Yes, we built it up substantially. It became the largest part of Market Reg. At some point, the net capital area was added again because I was the only lawyer who was willing to deal with it. That was part of the office at one time. We also had transfer agents, and depository oversight added to the office, so we did all of those things.

**KD:** Essentially you're compiling information and evaluating it all the time?

**EK:** One, we're looking to see if there are problems; and two, we look to see how we could make things better. We also did a lot of different things. For example, the Boston Stock Exchange had a clearing agency, and most of the small exchanges had clearing agencies, which were one of the only ways they made money. But Massachusetts wanted to close the clearing agency. They didn't pay taxes or something like that. We actually went to Massachusetts and explained why it was important to keep the clearing agency because without it you wouldn't have the Boston Stock Exchange, which is something that's good for Massachusetts. We were able to save the Boston Stock Exchange. We moved most of the work to the Depository Trust Company. They kept track of all the securities, so we weren't worried about them losing them, but Boston still got paid some percentage, so they were able to keep the exchange afloat.

**KD:** That's not the kind of thing you think about when you think about compliance.

**EK:** No, no.

**KD:** Normally you're thinking much more in terms of punitive action. Was there some of that too?

**EK:** Well, because we had a good grounding in broker-dealer activity, every time Enforcement brought up a broker-dealer case, they would pass it through us to see if we would object. They knew the Commissioners would ask us what we thought, so it was smart of them to get us on board before they went to the Commission. We would also recommend that broker-dealers go to Enforcement if they violated or didn't comply with all of the rules, or if they were repeat offenders, we would make an enforcement referral or have the regional office make an enforcement referral.

**KD:** How often would a broker-dealer come in and say, "Hey, we're not in compliance. Call enforcement on us."?

**EK:** Never [laughter]. But when they're out of money, at some point they're either going to steal the money or they have to give up the ghost.

**KD:** Do any notable examples of working with enforcement through one of these broker-dealer cases stand out?

**EK:** Well, one of the largest—until Madoff—the largest SIPC liquidations was a firm called Bevill, Bresler in Toledo, I believe. The New York Stock Exchange had been in there for years. They never found anything. Our Chicago office went in there and, literally within ten minutes, they found that the head of the firm had taken all of the money, which was at that time I think about $64 million. There was a lawsuit, the guy went to jail, the Chicago office closed down the broker-dealer—it was a big SIPC liquidation.

At that point, we also got involved with SIPC because they didn't want to pay because SIPC pays if you have money in the broker-dealer for securities transactions. Well, this guy was able to get a lot of money by, essentially running a bank, by telling people that he would pay them interest on their credit balances, and so people would have money in the broker-dealer for years, and years, and years. They would never do a securities transaction, but they'd be getting maybe 5 percent interest on their money. And so SIPC said they weren't going to pay.

We and the securities industry had to convince them that they should pay because otherwise people would not have faith in SIPC, and they wouldn't know whether they were going to get their money or whether they're not going to get their money. The large firms came down to Washington, and the Commission, and we all pushed SIPC to pay under the circumstances. They still do.

**KD:** You talked a little bit about the transition from Harold Williams to John Shad. Was there a strategic shift in any of the things you were doing, or any of the things that you were focusing on with that change?

**EK:** Not really. The first thing that happened within a couple of weeks was a firm called Drysdale Securities went out of business, and they were a government securities dealer. We were able to interface with John to help explain the difference between broker-dealers and government securities dealers, and who's responsible, who's not responsible. We had a good rapport with John. He essentially let us go. Certain people had problems with him, but we never did, or I never did.

**KD:** Was the implication that Harold Williams didn't let you go so much?

**EK:** No, not at all. But John, who came from the industry, had an idea about who you should sue and who you shouldn't sue, and what was appropriate and what wasn't appropriate and where the SEC ought to spend their resources—which was doing insider trading and not to sue companies, but to sue individuals. Same thing that's happening now, essentially. That was one thing. One big thing actually did change. I don't know if you've heard of MOSS. That's Market Oversight and Surveillance System. Under Harold Williams, Congress had authorized what was at that time a lot of money, $12 million, for the Commission to build a computer system to oversee all of the markets.

They didn't think that the exchanges were doing a good enough job. That was also under my jurisdiction.

When John Shad came in, he wanted the self-regulatory organizations to do it. John Phelan, who was head of the New York Stock Exchange at the time, stepped up and said the New York Stock Exchange would develop a computerized system, and they would let all of the other self-regulatory markets use that system so that there would be a single audit trail for all the markets, and there would be a computerized surveillance system.

**KD:** How well did this MOSS system work?

**EK:** It never worked. We started out setting up criteria for the system. Within a few months, Harold left and John Shad came in. We had to report to congress every six months, and we would report what we were doing and what the SROs were doing. Originally, it looked like the SROs weren't going to do it, and they really didn't want the SEC overlooking their shoulders on all of the market trading. So the New York Stock Exchange came forward and said they would do it; they did it.

**KD:** This is part of the whole national market system push?

**EK:** This was a push for the SEC to oversee everything. That would've essentially made a nationalized market oversight. And, obviously, the market didn't want to do that, but it's expensive. $12 million wasn't going to make it for sure, even in those days. New York must've spent $150 million by the time they got finished, but they were willing to do that.

**KD:** What was their system called?

**EK:** ISIS. It's our system.

**KD:** Talk a little bit about the transition from the SEC to the New York Stock Exchange.

**EK:** As a result of that case I was telling you about, we sent a very critical letter to the New York Stock Exchange about Bevill, Bresler, saying, "You guys have been in there for years. What, are you stupid? How come you didn't find this?" And at least my understanding, the first thing that New York did was they wanted to have a private investigator investigate me because I must've been, obviously, some Communist or something like that. The New York Stock Exchange had a lobbying office in Washington, and they got back to New York and said, "No, we think this is a real criticism."

John Phelan came down to Washington, and we met with him and my staff and a few other people. Evidently, he went back to New York and had a big speech to the staff about what I told him. A month later, they had some headhunter call me up. “Interested?” “I don’t know.” Then they made me an offer which I refused, so they made me another offer. Then I went down there, or rather up here.

**KD:** What was the gist of your talk with Phelan as to what the problem was?

**EK:** It was a cultural problem. The staff of the Exchange was actually very good technically, probably better than the Commission people because they had people from the industry and they had people who had been there a long time. But they were afraid of the industry, and so they backed off. They would listen to the people without pushing further ahead asking the hard questions. Sort of like the Madoff thing where they never asked the follow-up questions. These people never asked the follow-up questions. So we told them you need to change the culture of the place if you want to have a good regulatory program. If you don't want a good regulatory program, then you'll have these things coming up all the time.

**KD:** These are the big brokers that they're not asking the questions to?

**EK:** Just about any broker. But clearly the big brokers. The big brokers, they were on the board, they would be able to walk into Phelan's office, they had access, and regulatory people didn't.

**KD:** Was there surveillance on the floor at that point?

**EK:** Market surveillance and member firm regulation were the two regulatory areas. They then created a separate enforcement division, so they then had three regulatory divisions.

**KD:** Okay. So that preexisted your coming in.

**EK:** Yes.

**KD:** Okay. So you had the setup, but there was a cultural problem.

**EK:** Right.

**KD:** Tell me a little bit about how you dealt with that when you came in.

**EK:** Well, when I first came in, actually, I set up something called regulatory quality review, which is sort of like OCIE. It would, one, see that the regulatory divisions were doing what they said they were doing; and then two, see that they doing what they should be doing. I did that for about a year. We set up a group, we made comments, and we made changes in how they operated. Then at one point, member firm regulation and enforcement were together. Then they broke it up and the head of member firm regulation left, and they asked me to take that over. Then we fired the head of enforcement, so I took that over. And then the head of the whole regulatory area left, and I got the whole thing.

**KD:** This happened over a period of quite a few years, though.

**EK:** No, about a year.

**KD:** Okay.

**EK:** A little over a year.

**KD:** What was going on all this time that people are coming in and out like that, mostly leaving?

**EK:** Well, it was only a couple of people. It was the head of member firm regulation who really couldn't manage very well, and the head of enforcement, who shouldn't have been the head of enforcement. Real turnover was of the staff in enforcement. We had to do something to deal with that. Market surveillance was pretty stable.

**KD:** Who was running that?

**EK:** I believe Don Solodar at the time.

**KD:** Did you put more resources into this?

**EK:** We put a lot more resources into it. The first thing I had to do was explain to everybody that I would be the only one who was on the hot seat and that they needed to do the job. If Phelan was unhappy, he would call me, not them. The only person they had to answer to was me, and I expected them to do the kind of job I expected them to do. That was one thing. We set up a lot more standards, so some of the people who had come there to retire retired because they didn't want to do all of the work that we now set up for them to do. And rather than just hire people out of firms who were, essentially, ready to retire who had great knowledge—

**KD:** Is that what had been done before?

**EK:** Yes.

**KD:** That's an important point.

**EK:** We started a training program. We would hire people right out of college, and we'd give them a year's training before we would send them out. It took a while because they had to learn, but they learned the way we wanted them to learn, and so it became a much more aggressive force to deal with.

**KD:** What kind of people did you look for to bring in and put through this training program?

**EK:** We hired accounting majors, economics majors, people who seemed smart, and were interested in the work, so there wasn't any particular major that we were looking for. We were looking for smart people who had some idea about securities but were not necessarily extremely knowledgeable.

**KD:** So they weren't the types who might've ended up working on Wall Street anyway and maybe making a lot more money.

**EK:** They might not have been.

**KD:** That's one of the things that I'm always wondering about: when you've got somebody in this enforcement role who could be making a lot more money not being in enforcement.

**EK:** The white hat syndrome is important. People like to be doing good and get paid a reasonable amount. It's not that you're making nothing. They did okay, and the

Exchange had very good retirement programs. It paid for them to go to school if they wanted to go to law school, or graduate school, it would pay for them to do that. If you worked there for ten years, they took care of your medical for life. So there were a whole bunch of things—compensating differentials that made up for the amount of money that you could make.

**KD:** So you started with member firm regulation, and Don Malawsky, I guess, came in there.

**EK:** Yes.

**KD:** More or less about the same time you did?

**EK:** Same time, same day, I think.

**KD:** He was the one who was looking over all three enforcement branches?

**EK:** No, he was only looking over enforcement and member firm regulation. Dave Marcus was the other guy.

**KD:** And then very quickly all of the above came under your purview.

**EK:** Right.

**KD:** So what was your title at that point? Was it a vice president?

**EK:** No. I started as a senior vice president. At some point, I became executive vice president, and then group executive vice president, but I'm not sure exactly when.

**KD:** The ‘80s—we had the big market break in '87 and there was a lot of technology coming in. How did those kinds of things affect what you were doing?

**EK:** We tried early on to add a lot of technology to member firm regulation. In those days, it was a lot harder. Laptops weighed about thirty pounds. You couldn't carry them out. It took several years, but eventually, we were able to put what we called the examination program on the computer, which when it was in paper was about 130 pages of things that the examiner needed to look. It was able to link up the computers with the home office so that if they had questions or needed advice, they could get back through the computer and they could show what's going on with the broker-dealer to the people back at the office.

That became a lot more automated. At the same time, market surveillance became totally automated. Doing a billion shares a day, it's hard to look at a piece of paper. We actually had—and they still may have, though probably not—two MIT statisticians on as full-time consultants to come up with various statistical measures of for insider trading, for whether a specialist is doing a good job, all those kind of things that the Exchange was interested in. We came up with various different formulae and computerized systems to deal with that.

**KD:** Were you building on top of ITS that was going in at this point?

**EK:** No, ITS was just a line among and between all of the exchanges. This was just for the New York Stock Exchange. We would use the audit trail that was among all of the exchanges, and we had certain formulae. For example, if stock trades 1,000 shares a day, it trades 1,000 plus X—whatever X is, it's something we want to look at. Another example—the average price movement is 2 percent. If it moves more than 4 percent, that's something we want to look at. And if it doesn't hit either of those criteria, but if you combine them and it does something, then we want to look at that.

Those systems would start pulling all the things we were interested in together. We would also, if there was a merger, then go out to the companies and ask them for all of the people who knew what was going on. The lawyers, the accountants, the chairman of the board, whoever it was. We would then go out to the broker-dealers and ask them for all of the names of the customers that traded.

We built a system that would match all of the people who traded against all of the people who knew, but the system would also go into things like if they didn't have the same name, did they live in the same zip code, did they go to the same college, were they in the same clubs together, were they on interlocking boards? As much information as we could get to determine whether X person had access to information. And if they did, we would write it up and send it to the SEC, and the SEC would bring their insider trading cases.

**KD:** What were some notable examples of when your program caught some violators that way?

**EK:** Well, of course we had Boesky. The only problem with Boesky was that he had so many positions that it was hard to say which was at issue, but we kept on finding them. Almost all of the SEC's insider trading cases come from the exchanges.

**KD:** Getting into the ‘90s, the idea of front-running starts to come up. I first noticed it in something involving Raymond James, Florida.

**EK:** Yes.

**KD:** Tell me a little bit about that. It wasn't really heard of much in the ‘80s. Why did it become the hot issue in the early ‘90s?

**EK:** Because there were larger trades going on. They weren't trading in hundred shares any more. For instance, we found one where—the Morgan Stanley people—had a billion dollar trade for a client. And they would trade it during the day, but in the last half hour, they would trade it for their own account, then sell it to the client. We also saw—because of the options market, people were able to go into the options market when they had an order, a larger order in the stock, because they knew that it would move the market, and so the options had more leverage than the stock. We also were in the stock option front running, you might've seen some of the releases that we put out.

**KD:** So the idea being that you're not going to make that much by front running a few shares.

**EK:** Right.

**KD:** So it has to be a lot or options.

**EK:** Yes.

**KD:** Okay. And that was what was becoming more commonplace in the early ‘90s.

**EK:** We certainly thought that it could. We saw some instances, and we thought that it was appropriate to deal with it on a proactive basis rather than to wait till there's a huge dustup.

**KD:** Right. Well, you got a huge dustup with the Oakford folks. That would've been the first one.

**EK:** Yes.

**KD:** Tell me a little bit about how you found out about that, and how that process played itself out. With Oakford you had some floor traders who were basically working with a small company.

**EK:** That was a long twisted process. We saw that there were some floor traders who were getting paid what looked like a percentage of the profit in a transaction. We went and tried to outlaw that. The members didn't think that was a good idea. They said that lots of members do it, it's okay, so we had a large task force, upstairs brokers, people from the floor, floor brokers, specialists trying to come up with some criteria that people could look to to see whether it was appropriate or not appropriate.

What we didn't know is that, as it turns out, at least some of them were also, when they lost on the transactions, paying part of the loss to Oakford. The committee came up with a formula as to what was appropriate and what wasn't. We filed it with the SEC—we actually sent the SEC a copy of the report that the committee made detailing what was going on, though the SEC still won't admit that they ever looked at that, but nevertheless. At some point, though, the IRS found that Oakford was cheating on their taxes.

**KD:** That was where it sort of got into the public.

**EK:** Right. We sent people in to look, and they found a lot of non-time-stamped order tickets. Because before when we went in, it looked like they had sent the order down five minutes before the execution. But when we went in at that time, we were able to find a bunch of order tickets that were not stamped so, obviously, they were stamped after. That's when the whole thing started to fall apart.

**KD:** Then the SEC did an investigation. The New York Stock Exchange did an investigation as well, right?

**EK:** Yes.

**KD:** What did you do? Did you bring on a consultant?

**EK:** They were investigating us. The SEC was investigating the Exchange. The Exchange was investigating the floor brokers. We did share information on the floor broker investigation, and we brought a number of cases, and the SEC brought a number of cases.

**KD:** What did you learn? What did this process show you about what you could do to tighten things up?

**EK:** You can't blindly trust floor brokers. It's very hard because you don't see what's going on upstairs, so they could put phony time stamps on the orders. If you asked for copies of the orders and they had them with phony time stamps, it would not be possible to determine that it was an on-floor trade. Really, that was the gravamen—the floor brokers were making the decisions on floor so that they had some time and place advantage over everybody else. The one thing we could do was we started to examine all of the floor brokers on a two-year cycle. Before we didn't think they could get in much trouble. So there wasn't a very systematic examination of these guys. When you examine them on a two-year cycle, you could look at how you're getting paid and see if there was any sharing of commissions with the upstairs broker or anybody else. And that's all, essentially, that we really could do.

**KD:** On a two-year cycle.

**EK:** Yes.

**KD:** Okay. One would think that it would be natural to speed up the cycle.

**EK:** Well, we had no cycle before. And it really was a resource thing. Would you think it more important to go into Merrill Lynch, or you think it more important to go into some floor broker. And there were hundreds of floor brokers. When we say a two-year cycle, we did one and, say, half one year, half the next year, then half again.

**KD:** Because the big brokers, you would look at those every year, right?

**EK:** Right.

**KD:** So it's really a matter of catching these in-between folks.

**EK:** Right. Usually you don't turn up the same problem you had before. People are smart. They'll come up with another way to game the system.

**KD:** When you looked at the floor brokers, did you turn up things that the SEC missed, or vice-versa?

**EK:** Well, we just had more of them. Anyone could see who Oakford was dealing with, so you knew all of those people, but there were several others that we saw that we turned up that the SEC didn't.

**KD:** Different firm?

**EK:** Yes.

**KD:** I turned up references to the large firm project, which the SEC basically did a big study of brokerages and things like that. And you, apparently, worked with them a good bit on that. Can you tell me a little bit about that?

**EK:** We—the New York Stock Exchange, really the only people who actually knew how to examine a large broker—would send five or six people into Merrill Lynch, and they would be in there for maybe three months. They would find things that the 200 auditors—their accountants who were there all the time—couldn't come up with, because we were looking for certain things that would alert us, whereas it might not be material for an auditor of Merrill Lynch. Our theory was that if it was off by 10 cents today, it could be off by $10 million tomorrow, so we wanted to know why it was off by 10 cents. The amount of money that something was off was really immaterial to the process.

We had developed a whole series, a 130-page examination program, where our people would go in and look at things that, from a regulatory perspective, we thought were important. The SEC really doesn't have people who are trained to do that. They have a few people in New York, but that's about it. You couldn't send FINRA in—well, now you could because they have the New York people—but you couldn't send FINRA into Merrill Lynch and ask them to do a complete examination. They wouldn't know how to deal with Merrill Lynch's net capital, $7 billion. We worked very closely with the SEC on all of their special exams. We would go out, sometimes with SEC people on the same examination team to look at whatever the thing of the day it was.

**KD:** So, essentially, you're doing a lot of the legwork for the SEC, helping to get the kinds of information.

**EK:** Right.

**KD:** Did the New York Stock Exchange benefit at all from the findings after these big studies were done and the intellectual work was done?

**EK:** The enforcement people would bring enforcement cases several ways. The bigger cases came on referrals from member firm regulation where they went in and said for example, we found that Morgan Stanley didn't send out prospectuses for three years because they got screwed up on something. Then enforcement would bring a case. We also had a system set up where firms are required to self-report on certain things, and they filed those through enforcement, so enforcement had a group that would look at all of those filings to determine whether there was something that we should follow up on.

**KD:** I'm trying to get a sense of development. Something like the large firm project—the idea was not just to find people, but to somehow build a more effective program, and to keep pace with the change in the industry.

**EK:** Well, the rationale was that the SEC wanted, literally, to go into examinations. They wanted more resources. That was an excuse frankly, to go into 50 percent of the large firms rather than 25 percent of the large firms, based on nothing that I could ever figure out other than they wanted to do that because they wanted to be involved from the get-go. A lot of those things are really meant to increase the resources of the SEC as opposed to the SROs.

**KD:** So there was no great sort of strategic insight that came out of all of those?

**EK:** Not that I know of.

**KD:** Okay. How about on your own? You've been doing this then at this point for ten or more years.

**EK:** One of the major things was derivatives—so we could understand what the firms were doing with derivatives, and how that affects their capital. We went to all of the major firms and we asked them to put on classes for us so we can understand it. And most of them were pretty accommodating. You understood it at least while you were in the room. But Congress sort of took that out from under us by saying that swaps were not securities, not equity securities, and they didn't have to be under broker-dealers. Almost all of the firms moved those out to special entities that weren't under our jurisdiction.

**KD:** Another big change was first the Exchange moved to sixteenths, and then moved to decimals. And I assume that that really changed the way that things were done.

**EK:** Well, it changed business both upstairs and on the floor because market makers could no longer make money, so it was a big deal. Upstairs firms made many fewer markets because you made the money on the spread. If the spread's a penny, it's not such a great deal. And it also, as any economist would've told you, as the price gets closer, the quantity gets smaller. If I'm willing to sell 100,000 when there's an eighth market, but I'm only willing to sell 2,000 when it's a penny market because if I put 100,000 in the penny market, it would go down to there.

It became harder for institutions to buy because the quoted market became very small. The average spread went down 50 percent; then the average quoted size went down 75 percent. And so it surely changed the market and how people, from a business perspective, operated but it didn't change much on the surveillance side. When the spread was an eighth, we made our surveillance criteria consistent with movements in eighths, when the spread was sixteenth, we made it consistent with that.

**KD:** Given this big shift in the way the market worked, did you find that people were doing different things, or trying to game the system in different ways?

**EK:** Not so much game the system as not do such a good job in that they weren't putting up big quotes. They wouldn't take positions that they had taken before.

**KD:** Specialists?

**EK:** Yes. Specialists before might've been willing to carry an inventory of 100,000 shares of something. Now they may only be willing to take 10,000 shares of something. So it was more from the business side, the business people had to deal with the specialists. We dealt with that, to some extent, when we determined whether the specialists were doing a good job. Our criteria: does a specialist stand up when somebody comes in with 100,000? One of the things we measured was the movement per X number of shares—shouldn't have much movement.

The best market is no movement. If somebody comes in with 100,000 shares, want to sell at 10, you sell 100,000 at 10. If he ends up selling 10,000 at 10; 20,000 at 9.95; 70,000 at 9.90, that's not such a great market. Those are the things that we looked at, but it really wasn't from a regulatory point of view so much as from a business point of view.

**KD:** But there were implications of that in that you started to pick up the specialists doing front-running, getting in between trades, things like that.

**EK:** Yes. I would love to say that that was a result of decimals, because we looked, but it wasn't, to my surprise. We said "it must be because of decimals." Nope. They seemed to be doing it before decimals.

**KD:** Okay. Was there a notable case that led to unraveling those threads?

**EK:** One of our analysts picked up something in analyzing one of the specialists. He had a complaint about something entirely different, so he decided to look at what the specialists did that day, and he was able to see that the specialist was coming in between market orders, which should be matched off against one another. We took that and we decided to examine all of the specialists, which we then proceeded to do. Then one of the firms fired one of the specialists who was the specialist for GE, and that got in the paper before we were able to really complete the investigation. That's when the SEC came in.

**KD:** Sort of the same process as ten years earlier.

**EK:** Yes.

**KD:** Again, were there any systematic changes that came out of that process that you learned?

**EK:** Yes. The NYSE changed the ability of the specialists to step in electronically. The orders would be matched off so that specialist didn't have the ability to step in, unless the specialist put some note in the system. Sometimes the specialist might've done a trade on the floor, where the market really should've moved but did not have the time to update his quote before an electronic order came in, but the specialist would have to put a note in the comment section of the system in order to do that. It would be easy to follow every time there was a note.

**KD:** So you turned to the technology to make this impossible to do.

**EK:** Yes. Originally, we didn't think the specialists would do that, frankly, because the market orders would show up in yellow. So all you had to do when you saw the yellow at the bottom of the book, was match the orders, and that was there before. So we were able to then put in a systemic fix to prevent them from not matching them. We always figured the specialists made enough money that they didn't need to nickel and dime people.

**KD:** Not the same as the floor brokers.

**EK:** No. Floor brokers are a small business. Specialists are a big business. The specialists are Goldman Sachs, Bear Stearns, various different other big broker-dealers. It turns out, somebody who wants to make more money will find a way. The specialists got paid on the amount of profit they made in their stocks.

**KD:** Well, looking back on your time at the Exchange, you're trying to figure out different ways people are trying to make money. Was the whole enforcement capability reoriented in any way, or was it really just the same thing from the mid-1980s to the mid-2000s?

**EK:** Well, when you talk about enforcement, are you really talking about enforcement, or are you talking about regulation?

**KD:** The whole structure—regulation, surveillance, enforcement, everything that you were doing there.

**EK:** Certainly we became a lot more automated. We tried to put everything that we could into an automated system. We substantially increased the enforcement division. When I took over, it had fourteen people; when I left, we had 140 or 170 people. We had a lot of ex-assistant district attorneys, and people with great experience in bringing cases and trying them. We were very successful at the number of cases that we brought and won. We got a much more powerful enforcement deterrent. We had bigger fines and threw people out of business. If a member refused to testify, we would automatically throw him out of the business—an incentive for them to come forward.

On the market surveillance side, as the business changed—the major market surveillance concern was inside trading. We kept on getting more sophisticated insider trading algorithms to use. In this Galleon case, they talked about, "Oh, the SEC has this great thing where they have smart investors," but we had that from the late ‘80s. People who you couldn't tie in, but would be in four or five deals. You'd say, "I just can't tie them in," and you send the names to the SEC and say, "These are really smart investors." That's really nothing new. We've had that for years.

On the member firm side, there are fewer and fewer broker-dealers out there, large ones. There are only about 100 clearing firms, so they carry all of the accounts for all of the other broker-dealers. That's where we put most of our resources are on the clearing firms because they have all the money, and they have all of the stocks. If there was to be a problem, it would be good to try to get it before it blew up.

**KD:** You talked about this process early on of bringing the administration of the stock exchange together with your people, and maybe some of the big broker-dealers and trying to figure out where the threshold is. And that suggests that there's sort of gray area, and you have to figure out where to go in that gray area.

**EK:** We also had this thing called the financial surveillance committee, which was made up of members—CFOs, and heads of firms of all different kinds of firms—and we would meet monthly. We would show them which brokers were not doing well. We had criteria that if you lost money for X amount of months, or if your capital went below Y or various other criteria. They would give us advice on how to handle it, these brokers, and sometimes the brokers would have to come in and meet their peers who would tell them that, "You got to bring yourself up to speed or else you're going to be out of business," and also they would keep us abreast of what was going on, what were the big things that were happening in the industry.

**KD:** You're talking about giving advice, having people self-report what's important, what's happening. That suggests that there is some room for interpretation here, and some room to decide where to draw lines. One of my questions would be the administration, the chairman's office and the direction from the top, did that ever make a difference as far as how much you pushed or how far you would go or where you draw the lines?

**EK:** The various chairmen that we had never once told us not to do something. And if they told us anything, it was to do more of what we were doing. During our years, the only part of the Exchange that grew was regulation, and it grew substantially so that we had almost 700 people by the time I left. And it started from the beginning because I told Phelan if he was serious about regulation, then I'd come. If he wasn't, I wouldn't want to be there, and he wouldn't want me. And Donaldson was fine. He was worried we were going to get in trouble some time, so he wanted to make sure that we were looking over everyone. And when Dick came in, he was just like John.

He thought it was a good selling point to have good tough regulation. He would use me as a prop sometimes. He would sit there and say, "You know, if you don't do this, regulation is going to get you." He never once said, "don't do this." He encouraged us to put tough rules in the research area, even though some of the firms were against the changes.

**KD:** That's the post Sarbanes-Oxley stuff?

**EK:** Well, we actually were before.

**KD:** Okay. And you're looking at the research analysts.

**EK:** Right.

**KD:** Tell me a little bit about that because that's a pretty important event.

**EK:** Well, unlike the newspapers who would tell you that it's all Eliot Spitzer, we and the SEC were working on rule proposals, not as extensive for sure, before Spitzer came out with the Merrill Lynch thing. A lot of the rules we were working on are the rules that went into effect. We were aware that there was a problem with research, and that the disclosures weren't either enough or accurate enough for someone to pick it up to understand what conflicts were involved.

Then we got involved with Spitzer, and we and the SEC and he had meetings – the Italian Gun Club or wherever else we would have meetings. And we came up with an outline set of rules, and then we met with all of the large firms—we, the SEC, Spitzer's people and the NASD, and we came up with what we came up with. Most of our rules predated Sarbanes-Oxley, and then Sarbanes-Oxley came in and we had another set of rules where we had to change the definition of research report because we originally had in there that it had to be a recommendation, and Sarbanes-Oxley didn't have that, so we took it out. No use having two different definitions.

**KD:** You retired from the Exchange in '04. Is that right?

**EK:** Yes.

**KD:** In those few years there's a lot of tumult. NASDAQ, NASD had already done its split off. Did you ever think that that would be what would happen with the New York Stock Exchange?

**EK:** Not if Dick stayed there. He was very much against that because, again, he believed that having trust and confidence through regulation was a big selling point for the Exchange. He didn't want to give up regulation, even though for many years it was a substantial cost. Some years we actually had a profit because we charged a percentage of the gross revenues of the firms as a regulatory fee, so when years were really good you got a lot of money.

**KD:** Tell me about the decision to step down. Was that 65 retirement, or how did that work?

**EK:** Well, I was, but they were changing. John Reed came in, and I didn't get along with him. Although I did get along—John Thain and I were both on the DTC board for awhile and I got along with him—but it just seemed like it was the time.

**KD:** Things were really changing.

**EK:** Yes, they were.

**KD:** Okay. Rick Ketchum came in after you. Is that right?

**EK:** Yes.

**KD:** Did you work with him at all, or talk to him at all about this is what you're getting into, and discuss some of the longstanding issues?

**EK:** Yes. We overlapped for four or five months, and he and I were both at Market Reg for quite a while, we were both associate directors. So I’ve known Rick for a long time.

**KD:** Is there anything we've left out that stands out to you?

**EK:** No. I think we've covered the waterfront.

**KD:** All right. Terrific. Thanks very much.

[End of Interview]