

Securities and Exchange Commission Historical Society
Interview with Steven Wallman
Conducted on May 15, 2015, by William Thomas

WT: This is an interview with Steven Wallman for the SEC Historical Society's virtual museum and archive of the history of financial regulation. I am William Thomas and the date is May 15th, 2015, and we're in McLean, Virginia. Thanks very much for talking to us today. We usually start with a little bit of biographical background, where you're from and I guess I'd be very interested in what led you to MIT, especially.

SW: I was born and raised in New York City, and went to MIT because I wanted to be a scientist and discover things about the universe, and try to make the world a better place.

WT: Did you have any particular field that you were interested in when you went there? What was your major?

SW: I was primarily interested in theoretical physics. While attending MIT, I did take a heavy concentration in physics, but I ended up with a lot more in what we call the soft sciences: urban studies, political science, economics, things of that nature. MIT is a very interesting institution. It allows you to have an awful lot of flexibility and freedom, and you can put together your own degree from various courses. So, it's a great place. I really loved it. And at the same time, I took a lot of management courses at the Sloan School, and the year after I was awarded my undergraduate degree I was awarded my graduate degree from the Sloan School.

WT: What sort of concentration did you pursue at the Sloan School? I know that there was a lot of things in options pricing, and that sort of thing, that came out of that milieu.

SW: I was at Sloan in '76 and options pricing was just sort of starting to come to the fore then. My field of interest was actually not in securities or that kind of economics at all; it was more in the, again what I would call the soft parts of it, leadership-related issues, how to think about organizational development, and organizational behavior.

WT: Were there particular professors you'd like to recall?

SW: Yes, Professor Jonathan Van Maanen, —he is a brilliant professor who has focused on a lot of organizational development activities and implications for real world activities. For example, my thesis ended up being on the police and how the police interact with communities and what you can do to change the leadership perspective of the police within a community, to make a police presence that works with a community, instead of, in some cases, as we've unfortunately very recently seen, works against the community.

And a lot of the ideas that were developed and studied at that time, such as community policing, getting police out of police cars and back onto the street, and having them be a part of the community itself, have been time-tested now and determined to be really excellent. But, for whatever reason, they continue not to be used in many jurisdictions. And we are seeing the results of bad policing concepts in those jurisdictions today, and

the headlines recently prove the point.

When you have a police force that's estranged from the community it's supposed to be protecting, the police feel more like occupiers, as opposed to protectors, and the result in the community is an adverse reaction. Unfortunately, we learned a lot, we know the answers, and for whatever reason they're not being pursued and implemented.

WT: Right. So then, after that you went to get a law degree. Had that been your intention, or what made you decide to do that?

SW: Actually, I went to law school at the same time I was finishing my graduate school program. So when I left MIT as an undergraduate, I matriculated to Columbia Law School and started law school. But during that first year of law school, I also finished my graduate degree at MIT from the Sloan School. So the law school degree, '78, the graduate degree from MIT, '76, and undergraduate '75.

I went to law school because at the time I was at MIT, there was something that we now know in history as Watergate that was beginning. From the Watergate hearings it seemed like if you really, really wanted to change the world you could do it by being involved in government or by being somebody who understood the law and to be able to use the law in a good way. I thought having a law credential and going to law school was not a sufficient, or necessary, condition to being able to do really good things, but it would be a helpful degree to have to influence the world.

WT: Did you think you would go into public service, then, straight away? I noticed that you went to Covington & Burling, from your resume.

SW: I did think I would go into public service. I thought it would be important to have a couple of years, at least, of some private practice. At the time I was ready and wanting to go into government, in the '80s. My party leanings and affiliations were as a Democrat, so at the time some of the opportunities were more limited because of the politics of the time. I was not able to go into government when I wanted, and my law career continued to do well, so it made sense to continue to do that.

At Covington then—and I suspect Covington and most big law firms today—the road to partnership was usually a six, seven, or eight year effort. Once you're reasonably down that road, and once the prospects look reasonably good, most people I think might make the decision, as I did, to stay the course and seek the partnership.

WT: Okay, so then you ended up in the corporate law area once you started in there.

SW: I did. At Covington, we had a number of interesting clients. One of them was the National Football League. And, at that time, the NFL was increasingly engaged in what would be referred to as corporate activities, thinking about how to help finance the teams themselves, obtaining centralized loan facilities, and things of that nature. They were using Covington for their labor, antitrust and related activities, and the opportunity came

up to see whether or not Covington might be able to also help on the corporate and securities side. I was asked to start to think about some of those issues and ended up having the privilege to really work with some really great people at the NFL. Some of the team owners were really fantastic individuals, larger-than-life personalities and very smart, very capable people who were very kind enough to let somebody a little bit junior have a chance to actually do some interesting things.

I started to become more involved in higher-profile corporate activities. In addition, Covington also had another client named, at that time, Scott Paper Company, and they were in the midst of some potential takeover battles. I was on the team that was looking at some of those issues and started to become very interested in corporate governance.

One of the things that I was able to do was to rethink some of the basics of corporate law in this country and rediscover the notion that a corporation really is a series of constituencies. It's really not only just shareholders, but it's also employees, vendors, suppliers, customers, the environment, the community in which they operate, et cetera. It's a wide range of actors that a corporation impacts and that comprise a corporation.

And the board of directors' duty—in at least my view, and I think now enshrined in the corporate law in a majority of the states in this country and by case-made law in many jurisdictions that don't have it by statute—is really to the corporation, not just to the shareholders, in the context of taking corporate action. And that duty is to maximize the long-term wealth production capability of the corporation, not simply to maximize the

short-term value of the stock. That's a real distinction in terms of mindset and culture as to how a board and a corporation ought to operate. I was in a position to be able to think through some of those issues, draft some model statutes, and actually see them enacted across the country.

WT: Was this manifested mainly in the question of takeovers, which was of course a very big issue at the time, or was it more widespread throughout the question of the governance of companies?

SW: My view is it's a widespread question and ought to be something that's consistently considered when taking corporate action. The place where the rubber meets the road is primarily in the takeover context. When you don't have a takeover, most often the board is thinking about how to maximize the long-term value of the corporation, which includes, almost by necessity, how to also make sure employees are happy. How do we retain them? How do we obtain them in the first place? What benefits do we pay? How do we make sure they're increasingly well-trained, increasingly respected throughout the organization and able to grow?

Most companies, I think, consider employees as their primary asset, not as a cliché but as a fact. Because of that there is, I think, a general view that if you're going to build a company for the long-term, you have to care about how your employees are acting and how you're treating them in the short, intermediate, and long terms. So that part, I think, is pretty clear.

With regard to how you treat your customers, it is the same thing. Treat your customers poorly in the short-term, you're not going to have them in the long-term. Treat them well in the short-term, hopefully you'll have them in the long-term and you can continue to grow the company. The same thing with suppliers: if you keep squeezing them down to the point where they can't work with you anymore, they won't.

There's this traditional and consistent balance in most day-to-day corporate operations of looking at the long term, thinking about the various constituencies and making sure things are balanced and reasonably fair. When it comes to a takeover all of that changes. Suddenly, that balanced and reasonably fair consideration of the various constituencies is replaced with a single-minded pursuit of the highest immediate share price. In the view of some still today that remains the only goal I think it's unfortunate, I think it's wrong, When somebody says I can increase shareholder value, everything then switches to nothing but how do you increase shareholder value in the short term. I think it's a terrible mistake, it's bad for the country and it's bad for corporate governance generally. In addition, I believe it's bad for capitalism in particular. These statutes were designed to ensure that, when the rubber meets the road, boards feel empowered to be able to look at the long term, as opposed to simply the short-term stock price.

WT: Would that tend to show up in defense against takeovers, or is it more complex than that?

SW: It should be more complex than that. Again, the obvious place would be in defending

against a takeover, where somebody is saying, “I’m offering a premium for this company’s stock.” How can the board say that that does not require them to concede?

The intent of these statutes was to enable the board to address that argument by saying a premium is obviously excellent, and it helps the shareholders in the immediate term. But, an obvious question is where does the premium come from?

If the premium stems from true synergies, to add value to the corporation as a whole, to build it better because the acquiring company has greater reach, greater marketing prowess, greater intellectual property that they can add to the mix of what the target company has, or other kinds of assets to bring to the transaction, then clearly you might have a truly wealth-producing, wealth-maximizing transaction with which to proceed and that makes sense for all the constituencies.

On the other hand, if the reason they’re offering the premium is because they can bankrupt part of the company, lay off a whole bunch of employees, shut down other activities, and do things for the very short term that will let them pay off debt, make money for themselves, but in the meantime destroy communities and destroy relationships, then it’s not wealth-production capability nor is it wealth-maximizing. It’s actually wealth-minimizing. Simply put, it is the violation of implicit contracts for the personal gain of the acquirer.

That’s, therefore, a difficult set of calculations to go through and understand the real values and detriments and to come to a conclusion as to whether or not the transaction is

long-term wealth enhancing or a detrimental activity that hurts many for the benefit of a few.

WT: In a totally different context, I've run into the use of an ESOP as a defense mechanism, but, of course, that also entails increasing employee ownership. Did that show up in your work in this area?

SW: Not in particular. ESOPs were and are certainly a tactic to put control of the company into the hands of a constituency, in this case the employees, and that has the effect of making a takeover more difficult.

It doesn't necessarily mean that all deals are embraced – or not. It's a separate issue. ESOP's in this context are more of a structuring issue than an answer to the overall question.

WT: And your interest in the impact of technology on market structure, did that begin to develop in this era, when you were working in law?

SW: My interest in technology began long before I was in college. But, my interest in market structure did not develop until much later, when I was at the SEC. The things that continued to develop while working in the law at Covington related more to corporate governance, takeovers, and related matters. As I became more and more interested in the public policies underlying corporate law and the securities laws, it reinforced my initial

view from years earlier that I really did want to go into government and wanted the opportunity to serve in government.

WT: Another thing from your bio is that you mention the National Football League, but also the Business Roundtable, which is a very interesting organization from the securities regulation standpoint. What was that work about?

SW: Some of the activities that I had engaged in started to resonate with certain of the leaders of the Business Roundtable, such as the state corporate constituencies statutes and various examinations of how boards of directors and others can best implement the concept of maximizing longterm wealth production capabilities for a corporation within the context of caring about the environment, communities, employees and others., At the time, they were looking at various issues being raised by folks like T. Boone Pickens who were suggesting that the law really ought to be made clear that the sole duty of the board is simply to maximize share price, period.

And to their credit, a number of the Business Roundtable leaders back then—and I suspect it's not a tradition that has died out and that people continue to believe this—thought there was more to it. They were intrigued by some of the work that I had done in this area and asked if I could also help represent them with corporate governance activities that the Business Roundtable itself engaged in as an organization.

In addition, I also worked closely with the AFL-CIO on these same kinds of issues,

because, as you might expect, they also had a strong interest in thinking about whether or not corporations owe some duty to employees or how employees' interests can be best taken into account in the context of corporate decisions, whether takeovers or otherwise. I had the chance to work with some very thoughtful leaders at the AFL-CIO, who I greatly respect. They're not with the AFL-CIO anymore, but there were absolutely terrific people there, just as there were terrific folks at the Business Roundtable.

The National Football League work provided the opportunity to represent an extraordinary group of people on some very complex banking, contract and corporate work – although it did not involve much SEC related work.

WT: Is there anything else from your time at Covington & Burling that you'd like to emphasize before we move on to your time at the SEC?

SW: You know, there were so many interesting times, people, matters and representations at Covington, including the opportunity to work with many small, entrepreneurial companies. Covington's practice at that time was generally the representation of very large companies or large organizations. Covington had a sterling reputation for being one of the best, and it remains one of the best firms in Washington D.C., and it was also interested in starting to expand its presence in other areas.

This gave me the opportunity, for example, to be one of the people to open the first office, I think, Covington ever had outside of the downtown Washington area, in

McLean. The concept was to see if we could start to build a practice around smaller companies, startups, entrepreneurial companies that were beginning at that time to be a bigger part of this geographic area.

That provided me great visibility into the problems that small companies had with capital formation, such as raising capital and compliance with securities laws that are really designed for much larger organizations, have not been put to the test in terms of how they impact smaller companies and issuers, and seemed designed to protect large, incumbent broker-dealers and their franchise as opposed to assisting issuers who wanted to engage in capital formation.

It was interesting to see it from that side -- and to see the difficulties. Clearly, some of the roles that were imposed for intermediaries to play really seemed to make little sense and to be more methods of maintaining the roles of gatekeepers, their franchise, and their fees, as opposed to really facilitating capital formation or investor protection .

WT: Was it a pretty continuous line from your work in that area to your decision to create the company where we're sitting in now, Folio, in this area? Was that a kind of continuous interest of yours in this particular area, which is known as the Washington, D.C. tech startup area?

SW: There are two parts to your question, perhaps. One is whether geography relevant from that time to now? Geography is relevant in the sense that, quite honestly, I live here and

have lived here for a long time, all the time at Covington and all the time at the SEC, and so when I left the SEC and started a company it seemed to make sense to start it where I expected I was going to continue to be living. I wish I could provide some more or deeper meaning than that, but that is all it was. At the time I left the SEC, I decided I would go home and work from home, and started the company from there.

WT: That's eminently sensible.

SW: With regard to the substance of the startup and to the substance of what Folio does, yes, it was very much a straight line in the sense of having a great concern for smaller companies, smaller firms, and individual investors and trying to think about how you can make them advantaged, as opposed to disadvantaged, by the securities laws and allowing individuals to have better opportunities to do the things that we think that they should be able to do: deploy their capital, to obtain wealth over time, to save for retirement, to pay for a child's education, to pay for medical expenses, etc.

All the economic things we think of in this country as making this country work, such as people being able to accumulate savings and wealth so that they can retire in a proud way and with the resources needed to have a good life, and to be able to send kids to college and do the other things that we think of as part of the continuation of the generations and the economic advancement of a people who work hard. That all sort of relies on people being able to be treated fairly at work, and then to be treated fairly in terms of what they accumulate from work in terms of their investments. The corporate activities I engaged

in when I was at Covington and at the SEC, and then this company, all have that constant theme of how do we facilitate, enable and empower those kinds of benefits for everyone.

WT: Okay, well let's not get too far ahead of ourselves and skip the crucial step, which is of course the SEC. First, just how did your opportunity to be on the Commission come about?

SW: I'm not sure I'm actually the best person to answer that question. There were some people I knew from various organizations that I think thought that I would be a good candidate for the Commission. My political affiliations were, I think fairly put, weak. I did not work on the Hill or in the executive branch. I did not have a senator as a patron, or somebody in the executive branch who was going to go to the mat for my candidacy.

I think I was just very fortunate. There were a number of people who knew me or knew of me, and they were kind enough to recommend me. I know a lot of people worked hard, and a few people worked very, very hard, to try to advance my nomination, and I respect them and thank them for it tremendously and I think they really deserve all the credit for my having gotten there.

WT: On the Hill or more generally?

SW: More generally. They were not on the Hill or the executive branch. They were in the private sector, if you will, in organizations, such as investor organizations, that were,

educational and advocacy organizations, or others that just thought that I could bring a good perspective to the Commission. And I thank them very much for their faith.

WT: So who were you contacted by, initially?

SW: The initial contact from the Office of White House Personnel was a woman there who was in charge of the vetting for this position who called and said, quite candidly, she said, “I don’t know you. We’ve never met, we’ve never talked, and nobody seems to know that much about you, except a number of people keep mentioning your name and it keeps showing up from a number of different places. And when we talked to some people from the corporate community, they seemed to be quite high on you. When we talked to some people from the labor community, they seemed to be quite high on you. When we talked to some people from the investor community, they seemed to be quite high on you.”

And she said, “Quite honestly, we have never seen somebody who seems to be high on the list from labor and corporate and investor communities all at the same time.” Usually they’re negative images. People that labor wants are not the people the corporate side wants, and people that the corporate side wants are not people the labor side wants. This is the first time we’ve ever seen somebody show up on all three lists with the institutional investors at the same time.”

She continued, “We aren’t saying anything, but I’d like to meet you.” So I went down and spent an afternoon and left and figured it was a nice interview. I don’t remember

quite how long it was, probably a few weeks afterwards, I got a call back saying would you like to be an SEC commissioner? And I said, "Sure." And they said, "Well, we're thinking of going forward. Are you willing to talk to the FBI and fill out some background investigative materials, et cetera?" And I said, "Sure." And the process went from there.

WT: And the confirmation was pretty smooth?

SW: The confirmation took some time. You know, even back then, I think that they were already starting to get into some of the partisan politics. But certainly, not anything close to what there is today.

WT: This was in early 1994.

SW: Correct.

WT: So the election hadn't occurred yet, when the Republicans swept in?

SW: Correct. And what did happen is there was a little bit of a hold up in that some of the plaintiffs' lawyers were concerned that since Covington did a lot of defense work on some of the asbestos litigation and some other things, that the firm was anti-plaintiffs' lawyers. The facts of course were that I didn't do any litigation, and didn't have any involvement in anything related to the litigation side of things. I was a corporate

securities lawyer. It should not have mattered anyway, even though they thought it did.

It ended up with my actually meeting with some of the plaintiffs' lawyers and representatives, where they asked whether I was involved in certain cases. Quite honestly, I hadn't heard of most of the cases they were talking about, and so the answer was no, I really don't have any particular view on trial-lawyer issues per se and I've not been involved in them. They're not in any of the matters I've been involved in in the past. Once having clarified that, whatever hold there was on the Hill with regard to my nomination that the plaintiffs' lawyers had asked for, was lifted, and the confirmation went forward.

WT: Now, when you arrived at the Commission I guess there were probably four commissioners there, but it soon shrank down to just you and Chairman Levitt?

SW: When I first arrived, there were five of us altogether. We had a full Commission, but it was short lived. It shrank to four and then three, and then it was just two -- me and Chairman Levitt.

WT: That's kind of a unique situation. How did that kind of work itself out in practice? I know that there were some concerns about whether or not you could even legitimately act as a two-person commission, but then of course, I read a little bit, just snippets of your style versus Chairman Levitt's style, I'm wondering if you can expand on that at all.

SW: On the legal question we became very comfortable, and I believe it is now reasonably well-agreed, that as long as we had a majority of the then-sitting commissioners, which would mean by definition two out of two, because one and one obviously would not have been a majority, then we were acting with appropriate authority. As long as there was a majority, meaning in this case unanimity, voting in favor of an action, then that was an acceptable quorum and an acceptable and legally enforceable action on our part. So the legal questions, we thought, were raised, reviewed, and dismissed appropriately.

With regard to taking action, from the perspective of the one and only sitting Commissioner along with the Chair, it obviously is a wonderful opportunity as the only other vote and the only other Commissioner. You're the one whose vote is always needed to take action. By contrast, when you weigh in on actions where you're only one of five votes, there is a greater opportunity to have your view diluted by the fact that there are four others who also get to vote. You may be in the minority instead of, by definition when there are only two of you, always being in the majority.

That notwithstanding, there were not many issues that I and the Chair actually disagreed on. I think we had very similar views on many, many things. We may have had somewhat different approaches to some matters, but the goals, principals and ideals I think each of us had was pretty well shared by the other. Clearly, there were differences in emphasis, or approach or prioritization. There were some matters and issues that I thought were important while the Chair had other matters he thought were important. There was absolutely nothing wrong with that – we're not clones that would have made

the Commission much weaker. Bottom line, the differences we had made the results that much better.

On priorities, as an example, I thought it was very important to work on capital formation issues.

And so I ended up chairing the Commission's first ever Advisory Committee on Capital Formation. I'm proud and pleased that some of its core recommendations and much of the direction it suggested for evolution of the securities laws has been implemented since the last decade-and-a-half. Some of the recommendations, like full S-3 shelf registration for global issuers has developed over time to mimic what we had proposed in terms of a "company registration" concept. The current law is still more complex and tortured in some respects than what's needed if we simply implemented company registration, but in result it still arrives at almost the same place – just through a more maze-like process.

We had proposed a concept of registering companies, not securities, -- a Copernican shift from the current model -- that would eliminate some of the transaction-based complexity of the current structure and make it much more streamlined and simplified. But the current law, within at least an order of magnitude, has directionally moved ito the same place we had suggested.

Some of the regulations that have now been implemented as part of the JOBS Act were among other concepts that we had reviewed and promoted . So I feel quite proud about all that, that we've moved in the direction that that the Advisory Committee suggested,

albeit under different names, with other kinds of nomenclature and semantics, and over a timeframe that is overly long compared to what could have been done had we just moved forward in a timely manner then. But sometimes big ideas and novel approaches take time to acclimate and actually move through the process, especially when you have regulatory systems that almost by definition are primarily backwards looking and influenced heavily by incumbents as the ones with a current stake in the process. It takes a bold staff and thoughtful regulatory body leadership to be what some would -- perhaps even attempting to be disparaging in these circumstances -- call "adventurous." But I have always thought the Commission up to it.

In addition to capital formation, one of the other issues I thought important to take on at the time was the whole issue of technology. The Internet was coming into everyday life, at that time it was really the beginning of it having the transformative presence it has turned out to have. People were starting to use much more electronic means to communicate, and so many of the Commission's rules were premised on the notion of paper. There are some things where I have strong views on how rulemaking should be done—we'll get to that a little bit later—but many of the Commission's rules, because they were premised on the concept of paper and the physical delivery of things, really just didn't make any sense in an era where companies, investors, and others were starting to use electronic communications.

So I tried, and I think we succeeded quite admirably, to rethink how the whole concept of the Commission's core mission -- namely disclosure and dissemination of information --

would work in a paperless world. And we created, at that time, the still enduring electronic communications rules, which really revolutionized the ability to comply with the securities laws in a much, much more efficient mechanism using electronic means as compared to using paper means.

That also turned out to be a watershed in terms of moving some people to begin to change their thinking. They started considering what the future might hold and how technology and other innovations would require a reconsideration of the Commission's traditional rules and regulatory processes. , The new rules and the modifications to those we changed are not what I would call groundbreaking, I think they're sort of obvious on their face as to the newly embraced concepts. But getting that changed within the Commission took significant effort because people had to embrace a potentially new cultural shift in how to think and consider not just those things that happened in the past and how to have rules to address them, but about what are the things that might occur in the future and how do you make sure well-intentioned rules don't stop the things that are good that can come in the future? And how do you address some of the things that in the future may otherwise be easily foreseen as bad? So it was a different way of thinking about regulation and how to regulate, and we'll come back to that in a moment.

Another area I thought was important was to ensure we understood the economics of an issue, especially regarding matters like market structure and competition . I —remember standing at the subway with my father a long, long time ago, when I was a kid, and looking at the stock tables that were in the newspaper that he was carrying , seeing

everything in fractions, and wondering “why were stocks quoted in fractions?”

I had learned fractions in school and knew what they were, but I couldn't understand why everything else I read in the newspaper, or saw on television, was always talking in dollars and cents, but when it came to stocks, everything was talked in fractions. As an example, and for those who are younger than I am and don't know what I'm talking about: a share of stock was traded in fractions, like \$14 and an eighth. So I asked my father why are they traded in fractions and his reaction was, “you know, I have no idea”. And that was before it was easy to find an answer online, and I just chalked it up to one of those things I'd eventually know, but not then.

This sat in the back of my mind, and I never cared about it until I got to the Commission. When I asked people in my first few weeks there, “Just out of curiosity, why are stocks traded in fractions?” I found that most people had the same reaction as my father – they had no idea. And the only rationale that people could come up with is, well, it's just the way it's always been.

And quite honestly, when you think about computers and about technology and about the fact that everything is and was currently displayed in decimals -- people had spreadsheets in decimals, what you showed printed out was in decimals, and it would take effort to convert into and from fractions -- it started to become a little bit strange. People were spending real money trying to maintain things in fractions, as opposed to just converting to decimals.

It didn't seem like it made sense that the only reason that we had fractions was because, well, we've always had fractions. It seemed like there had to be an economic or some other real reason for maintaining fractions. The questions were – what was it, and is it good for investors? The investigation my office started at that time into why there were fractions led to questions about market structure, tick size, people being able to collude on keeping spreads artificially wide, on payment for order flow and on examining institutional trading venues, like Instinet at the time, that were established in part to provide pricing in between the spreads that were otherwise artificially wide, and realizing institutions were getting these narrower spread prices but individuals could not get these prices, and really starting to try to figure out what was going on.

The more I looked, the more it was obvious that having fractions was simply a means to maintain an artificially wide tick size which, from an anti-trust perspective, looks a lot like anti-competitive price fixing. Even more stunning, these artificially wide tick sizes - the fractions – were being maintained by Commission rule. The remedy was, therefore, to eliminate the SEC's insisting on the artificially wide tick size, which meant eliminating fractions and moving to decimals.

And so we began the movement towards decimalizing the markets: to move away from quoting in fractions to quoting in pennies. Final implementation took some years and did not occur until after I left the Commission, but while I was there we were able to start moving that boulder to the point where it began to crash downhill. It was inevitable

when I left that it was going to happen, but it was still a couple of years away – many who stood to lose from competitive pricing used various means, including impending Y2K initiatives, to insist that something this “dramatic” be postponed until after Y2K had played out.

So those are some of the things that I thought were important to do. And in all of those, I don’t think the Chair’s office eventually had any objections or differences of view as to the need for them over time. Consequently, the ability for us to act together allowed a large number of things to get done efficiently and well.

WT: I like how you brought that around to the question again. A number of follow up questions; I think let’s start with the last bit, of course. I was interested in your approach to the question of fractions and decimalization being a question of why this was the way it was in the first place, since the way the story is usually told is in terms of the Stanford study on the odd eighths on the NASDAQ, and then the 21(a) report. Was that something that crystallized the action in your mind, that whole investigation, or what brought it up in the first place?

SW: It certainly crystallized it. It certainly reinforced the notion that there is something odd here. That study indicated that more than only taking an artificially wide tick size because of fractions and maintaining an anti-competitive spread, those involved colluded to make it even wider by eliminating every other tick size, basically doubling the already artificially-wide spread. The question still remained as to why the Commission was

enforcing fractions in the first place. What that report showed was that it's easier to collude if you only have a few ticks, because everybody can agree on which ticks, odd or even, to use. The underlying question was why do you have that structure in the first place?

That study assumed the premise that fractions are here, and market participants were seemingly only using certain fractions thereby doubling the spread and their profit. But, I thought that missed the fundamental question of the tick size in the first place and why we do have fractions.

WT: That's very interesting. I ran into this isolated reference—and so I'm not sure if anything came of it at all—but I guess that after being in eighths they went to sixteenths, and then there was a question of whether or not there were quotes being done in odd sixteenths. That kind of meshes with what you're saying about it being in fractions and kind of lending itself to collusion in that sort of way. Do you have any insight on that, if anything came of that sixteenths question?

SW: In terms of?

WT: Was there collusion on sixteenths, as well as on eighths?

SW: I don't know the data on that, so I can't give you an informed view. But if you make it easy to collude and people can make money by colluding, I think you might expect that

over time some people will.

WT: So going back to the technology question in general, I gather you were referring mainly to electronic disclosure and that sort of thing, but of course there are the Order Handling Rules and Reg ATS. Were you centrally involved in that, as well? Was that part of that?

SW: Yes, the order handling rules were important. Part of those rules were designed to try to reach a number of these different issues. Part of my concern with the way the Commission then—and I think has from before then, and since then, regulated—is that it looks at an issue and then it attempts to have a specific rule to address that particular issue. You end up with rules that try to micromanage how certain things occur. However, the problem is that technology accelerates far faster than rules can be written, modified and updated, and as you've got smart people looking at things, and seeking to make money from them, they quickly adapt and find means around prescriptive, micro-management style rules.

Other bad things also occur. For example, you end up with an anchor to innovation, because you've got very specific rules that say this precisely is how something shall occur, and anything else is not permitted, even if it might be good in a different context. You head off good innovations that might come out of a new way of thinking about how somebody could approach a problem.

At the same time, by closing the barn door on things that have already occurred, you're

generally blinding yourself to how people who are looking for ways to still get an advantage will find a different way. Regulators don't do well with trying to issue rules after rules, a whack-a-mole approach, but ultimately that becomes what they do and it is self-defeating. First, it is very difficult, time consuming and resource intensive. It siphons off scarce personnel and mind-share from more important things. Second, the rules become so complex, and they build so much on each other, that it becomes hard for anyone to even understand what all the rules are or do. Forget about really trying to comply with them. The unintended consequences grow out of control.

It is a really bad way for a set of laws to develop and for a set of regulations to be implemented. By contrast, done right, regulatory initiatives can be incredibly effective. Look at what is probably the most famous and effective of all the SEC's rules, and probably the most useful of all the SEC's rules across a wide variety of behavior: Rule 10b-5. It is a very simple rule. It can be summarized as basically "thou shalt not lie," and it is terrific. It works in so many different places. It is so useful across so many different scenarios. It is understandable. It is something people can feel is worthwhile to enforce, and it enshrines a concept that people think is a just and a reasonable way for people to act. It doesn't cover all bad behavior in the securities markets, but it covers a lot.

That rule makes a lot of sense; nobody has micromanaged it and it has endured for the better part of a century. That's, I think, an indicator of a rule that stands the test of time; others, especially some recent ones, are almost already outmoded and outdated by the

time they were adopted. Another concern is that some of the prescriptive rules reflecting a specific micromanagement approach on very particular items and issues enshrine current thinking from current incumbents as to what they want or what they're currently doing or willing to live with. And then that – the incumbent's view -- is where you end up.

Regarding Reg ATS: part of what I wanted to do (and I wrote some articles about this), and what I was hoping would happen was that by allowing many different market venues to develop and to compete, and to offer different kinds of trading with different kinds of rules and order types, we'd see increased competition and continuing innovation and advances in markets. Unfortunately, instead of recognizing that innovation and evolution comes in fits and starts and failures and dead ends, whenever anything did not work well another rule was proposed to address it. Over time, what was intended to promote innovation and competition becomes weighted down with its own increasing set of regulatory burdens. The result is over time fewer and fewer innovations and opportunities for people to do things that could solve other problems. .

My view is simple: over time, more and more competition and innovation results in things being better, especially if public support is maintained through thoughtful, intelligent and principals-based -not prescriptive - regulation that creates guardrails to stop truly bad things. I know there are different views on that. For example, I don't know if you can find them today, but I'm sure there are people who think that if we just went back to the old Bell System, with AT&T having a monopoly on every phone in this

country with everything in one place and under one entity's control, that that would be better. I remember people talking fondly about the fact that when their phone broke, they just reached out to AT&T and somebody would come over and give them a new phone, no questions asked, no payments, nothing else as you were just leasing your phone, not owning it. Today, your phone breaks, you've got to take it in, you probably have to buy a new one. You own it, it's your problem.

So, there are some who lament that we have competition in telecom now and think the world would've been better if we had continued with the monopoly, just as we see today people lamenting the fact that we have fragmentation in the markets and think the world would be better if there was a monopoly.

I find that interesting, because in almost no walk of life, other than in this industry, do people continue to come back to the argument that we need monopolies. This industry, for whatever reason, continues to embrace the notion that there should be monopolies, and fragmentation and competition are bad. They argue that having monopolies do something is good and we should just leave the world at that.

That mindset makes a lot of sense if you don't believe in innovation, if you don't believe that there are disruptive, new kinds of ways to think about how things can get done. If you don't believe that having lower prices and people thinking about how they compete with each other is a good idea, and if you do believe that having large, enshrined incumbents is the right market structure or the right structure for the industry as whole,

you are left with the view that we should continue to have rulemaking that stops innovation. I don't subscribe to that, and I expect most people don't subscribe to that.

And so fragmentation, if it means it came about because of competition and because innovators were able to vie for market share because they had something new to offer, that's a good thing, not a bad thing. And you know, there may be consequences of some of that that somebody may not like. Just the word "fragmentation" has a negative connotation. When you take the negatives with the positives, you can try to make sure that, on balance, it continues to evolve in a way that's clearly beneficial.

To argue as many in this industry do that there could be a negative so we won't let the positives emerge is a terrible mistake. I'm not suggesting that anybody does that consciously or thinks about doing that, but I think the continuing weight of more and more micromanagement types of prescriptive rules and regulations over time results in that. No one particular rule does. Every one particular rule is always generally viewed as beneficial on its face, or at least I think most people seeking to have a rule implemented and who have the right to vote on a rule's passage think it's beneficial, but the cumulative impact of all the rules is something that nobody votes on but it's something that occurs.

WT: At the same time, the discussions of modernization in the period focused a lot on deregulation. It's after your time on the Commission, but of course, you have Gramm-Leach-Bliley and the Commodity Futures Modernization Act. What were your views on those developments?

SW: I always thought the discussion between deregulation or more regulation really very much missed the point. I don't think anybody wants to live in a world where everything is deregulated or with no regulation. Nobody wants to drive down the street and find that the green light and red light is just a choice, and if somebody decides to go through it, well, they just go through it. There'd be carnage all over the place.

I don't think anybody wants to go into a restaurant and guesses whether or not the restaurant is compliant with safe food handling rules. I think people want and need regulation that makes sense. The key though is, "does it make sense"? Is it something that is well-defined in the sense of does it have a clear goal? Is that goal something that we really do embrace, that makes sense? Is it something where the regulation itself is directed towards achieving that specific goal? Is the regulation flexible enough so that other ways of achieving that goal are permitted as opposed to prohibited?

The issue never really is less or more regulation. Rather, it's how do you get really good regulation, and how do you get it in a way that makes sense? That's a really, really hard thing to do. It's easy to write bad regulations, and it's easy to simply vote to eliminate regulations. I think it's really, really hard to write good regulations, and to understand the weight of new regulations on the foundation of existing old regulations. That's, I think, the real task that the regulators need to rise to.

WT: So in terms of those specific pieces of legislation, do you have particular opinions on

them?

SW: GLB and others are not simple pieces that have one particular provision to them. They're a combination of a number of different provisions, so you'd have to actually go provision by provision and talk about them specifically to determine whether or not you think, on balance, the legislation as a whole makes sense.

It's like Dodd-Frank. Are there provisions of Dodd-Frank that most people or many people think are not good provisions? The answer probably is yes. Would you condemn the entire legislative package because of those? I think probably most people, or many, would say no. Could you make it better? Of course.

Allowing more things to happen in the context of more and more competition is good. The problem we've seen, and you can just see it in what's happened over the last half-dozen years in this country with regard to the large banks, is that – and this is put very simply, I know it is more complex -- we ended up in a great recession based on the belief that we had a systemic risk problem, brought on by large financial institutions that were failing or being in danger of failing because of certain risky activities that they or their counterparties engaged in.

Given that premise, what happened is truly stunning. We put in an enormous amount of effort, energy and money, and ended up making the big banks even bigger. We have even further concentrated the nation's financial risk in the names of a few large financial

institutions. Think about it. We have concerns because we have these large institutions and they pose this huge risk to the economy. So let's, over the next few years after that risk became manifest, make them even larger by having them engage in more mergers and let's subsidize those mergers. Let's also place such burdens on smaller institutions that might dilute some of the concentration from the larger ones that the smaller ones won't really be able to compete. That's just a stunning outcome from the standpoint of public policy.

And then, to turn around and say, okay, so what we're now going to try to do is to regulate those huge institutions—based on what? Based on our wonderfully perceptive capabilities of foresight and to predict the problems that were occurring in the '05, '06, '07 timeframe? We're going to take our great acumen and now we're going to regulate these much, much larger institutions so that the same problems or similar kinds of problems won't exist again? Doesn't that seem like an amazing amount of hubris? .

The obvious solution is to have market mechanisms in place to encourage those institutions to become no longer too big to fail by, for example, increasing required capital ratios as an institution becomes larger and larger. We are now seeing those being implemented. Those are the kinds of things that could have been put in place initially, but instead we have legislation that attempts to micromanage the financial services sector at a level that's never been seen before, and is attempting to manage extraordinarily large institutions.

That, I think, is too arrogant a public policy and something that needs to be addressed going forward. We're just not that smart.

WT: I'd like to come back to the question of capital formation and registration. It seems to me that, looking at the history, there are a couple different issues that were being addressed at this time. I'm wondering if you could bring some clarity to my thinking. First, there's the question of state versus federal regulators in the National Securities Market Improvement Act, NSMIA, is it?

SW: Yes.

WT: And then there's the issue that you had addressed with the Advisory Committee on Capital Formation, which ultimately, well down the road, results with the development of well-known seasoned issuers. I wonder if you can tell me a little bit about how deeply the thinking on these two issues was related, if they were two prongs of a larger attempt to create a more harmonized rule environment.

SW: NSMIA itself had some terrific provisions relating to how a national securities market should evolve. There needed to be harmonization and transparency as to what laws applied in connection with nation-wide securities offerings. The blue sky laws developed at a much earlier time of geographically limited offerings needed to cede to a national marketplace for securities offerings that complied with the panoply of federal laws. Pre-emption was an idea whose time had come for these national, federally-regulated

offerings.

A decisive story that stems from companies being barred from issuing securities in a state under a Blue Sky law is the true story of Apple, which was barred from issuing its securities in Massachusetts because the Massachusetts regulator at the time felt that Apple was too highly priced and speculative to invest in. Looking back and then looking forward, it was a reasonably bad decision on the part of somebody.

That doesn't mean the concept of merit regulation was always bad, but it does mean there needed to be a deeper dive into what merit regulation was trying to accomplish once there was full and fair disclosure and nationwide attention to an offering. Additionally, in the context of heterogeneous views in the population as to what makes for a proper and fairly-priced investment, and with full investor protections surrounding the sales process,, why would it be good policy to substitute a person or a small group of people's personal view on whether or not an investment is speculative or not, with the market's view on whether something is a worthwhile investment and an issuer that might lead to great innovation.

There were questions as to whether what was going on at the state level at that time with merit regulation reviews was serving a useful purpose.

WT: I noticed on your resume that you were a member of this blue ribbon task force on federal and state relations. Did that come out of that?

SW: No, that was separate. NSMIA-related questions, with regard to pre-emption, reflected my personal view that we have a national securities market and we ought to regulate it as a national securities market. The state blue sky laws really just became a tax on capital formation and a constraint, not a benefit. The states have a significant, strong and important role to play in terms of on-the-ground enforcement of the securities laws. They have the ability to ferret out bad sales practices and frauds at the local or state level – the types of schemes that may be harder for a federal enforcement agency to find and are presumably easier for a more local or state-based enforcement agency to pursue.

The NSMIA conceptualization of the appropriate regulatory approach was and is a good one. However, I would have preferred that the definition of covered security be tied into something other than listing on a national securities exchange; it should be tied into SEC regulation or registration.

For example, tying preemption into whether a private sector organization decides to list something, or whether it's called an exchange, locks in incumbents and holds back changes permitted by newer technology. There are lots of ways for securities to be distributed at this point, to be offered, to be transacted as opposed to their always having to be on an "exchange." Yet, because of NSMIA, to obtain the benefit of state pre-emption, securities need to be listed on an exchange to obtain "covered" status. That's unfortunate.

Nevertheless, harmonizing across jurisdictions in this country and having one federal regulatory rule makes sense. The benefits are obvious especially when considering international transactions, where large multinational or other organizations, have to deal with the sovereigns of other countries, in terms of their regulatory structures. When approaching the United States, you have to navigate not only SEC rules and processes but those of fifty states as well.

State blue sky laws, at least in this context, were just against the grain of history. The European Union is moving towards a more consolidated construct of how to regulate with a more unified regulatory system. It's better to focus on what's important, and what advances investor interests, as opposed to speed-bump-types of systems where issuers simply spend a great deal of time with lawyers to satisfy state hurdles to engage in a securities offering. That system is actually just a tax, and not a very efficient one. I thought NSMIA was well-intentioned and reasonably effective, even if I had a different view on how to implement, for example, the "covered" security concept.

The blue ribbon panel on federal and state relations was focused on how to obtain the best coordination between what the SEC and state blue sky regulators most usefully do.

I was a strong supporter of NSMIA and a strong supporter of what states can do, just that they can do things that are different from what the SEC can do. My view was they ought to be complementary to each other, not overlapping.

WT: How closely or distantly related were these discussions about creating a more unified, modernized regulatory framework to what later became the Aircraft Carrier release, after you left?

SW: The Aircraft Carrier release, which commenced and was in process while I was at the Commission, was viewed by some as an alternative approach to the ideas that the Advisory Committee on Capital Formation was promoting. The idea of loading up all these rules, or rule changes, to try to modernize the securities laws was an approach—my view was there were some fundamental shifts that could more usefully resolve the problems. The name of the release itself, the Aircraft Carrier, reflects lack of any underlying conceptualizations or approach but is instead a loading up a bunch of things, reflected what most thoughtful observers thought of it. I don't think I really need to say more about it. It was not the right approach.

WT: One of the more divisive issues while you were there was the Private Securities Litigation Reform Act. I'm wondering if you can tell me about your perspective on that whole debate leading up to it.

SW: Yes, it's interesting. It stems in part from the question of what does the data show? At the time it appeared to show that the number of cases being brought and the remedies being obtained, were not advancing shareholder interests or protecting investors. Instead, they were primarily enriching the class of lawyers bringing the cases.

Moreover, there was a transfer of wealth from the corporation, a.k.a., the shareholders, to some other shareholders, but with a very large slice, a third or more, going to lawyers. In some cases it was much worse -- all the money went to the lawyers and there would be a “structural reform” or a bylaw change or something agreed to that would presumably benefit shareholders. That seemed like a remarkably inefficient way to try to both ensure people were complying with the securities laws, and to try to ensure fairness in the marketplace.

It also seemed to me that there is a governmental agency, a.k.a. the SEC, that is charged with ensuring people comply with the securities laws and ensuring fairness in the marketplace. The plaintiffs’ lawyers’ complaints were all premised on securities law violations. Why shouldn’t the SEC, as the primary regulator of the securities laws and the primary enforcer of the securities laws, instead be bringing those complaints? Why shouldn’t the SEC, as a governmental agency on behalf of the investors that are to be protected, as opposed to a private plaintiff doing it and taking very, very large swaths of any recovery on top of it, be the primary litigant? Some might put a different way: why wasn’t the SEC able and willing to do its job instead of being so willing to cede its efforts to a small group of very rich lawyers?

It seemed to me that, at its core, the system we had wasn’t very efficient, and it certainly wasn’t a very fair system. Investors in small companies where the overall dollars were much less could not find anyone to represent them. While larger issuers were simply assuming there would be shareholder lawsuits and counting paying off the plaintiff’s

lawyers as part of the cost of doing business. Moreover, the economics—going back to what we discussed earlier about asking the question about the economics—were clear. The cost of filing a complaint was absolutely immaterial compared to the potential return that a lawyer could receive if a settlement was wrested from a large company. In fact, there was a perverse incentive to file as many complaints as possible, as quickly as possible, and then settle as fast as possible for whatever is obtainable, provided only that it's a good return for the lawyer, regardless of what happens to the shareholders.

That's not a very good system of justice. It's not a very good way to suggest that the securities law enforcement and recovery framework should work.

The counter view is that the SEC has limited resources, it can't enforce the law as much as having many private actors enforcing the law, and that in some cases the SEC would look at a case and say we just don't think there's a "there" there, but a plaintiff's lawyer, being tenacious and pugnacious and much more willing to dig in, might find something.

My view on that was always, well, the SEC should get more resources. It should be a little bit more tenacious and pugnacious. It should be better at analyzing cases and really determining if there is something more there. But it shouldn't basically assume that it frequently fails, that it's not very effective, and that it's impotent to actually protect investors, and so it needs this backstop of plaintiff's lawyers to be able to do its job. I think ultimately that's very discouraging for the Commission and its mission.

I thought the SEC could simply do better. I thought the SEC could put itself in a position to actually do what it should be doing as a government enforcing regulator. And when you think about it, we have government doing that in lots of other walks of life. We generally expect government to be able to step up and do a lot of those things. But in this case, the government seems to have taken this position that it needed to cede much of its jurisdiction and authority and its potential for doing good to the private sector. And, as stated, that just seemed to me to be wrong, it seemed economically inefficient, and it seemed like it had perverse incentives.

Moreover, also as mentioned, it became apparent that plaintiffs' lawyers, for example, were not going after small companies where the presumed damages were not that great because it wasn't worth their time. And so, smaller companies were somewhat immune and larger companies, whenever there was a stock drop, would be the subject of a complaint alleging a securities law violation, even if nobody knew what the violation was, but if the stock could drop, then the reasoning went that it must be something.

Consequently, there was a strange universe of whenever there's a stock drop, there's a lawsuit - even if there was nothing there - and ultimately it would be dismissed. It became much easier for corporations to sit there and say, well, we can go through trial spending many millions of dollars and countless executive hours defending ourselves, or we can settle with insurance covering a good amount or all of the settlement. Moreover, keep in mind that the plaintiff's lawyer who won the right to pursue the case and, therefore, the bulk of what would be paid to the attorneys, was the plaintiff's lawyer who

was first to file the complaint. Consequently, the enforcement of the securities laws was turned into a game that relied almost entirely on speed to the courtroom. These laws and their enforcement are not a game. This was just a wrong way for policy to have developed.

WT: One of the interesting contexts here, in terms of the SEC's ability to assert itself, I think there was some notion that certainly the Clinton administration at the time wasn't a defender of the SEC and so there was difficulty in getting resources.

And even the fact that it had only two commissioners for so long was sort of symbolic of that general attitude. Do you think that was kind of the attitude among the people who wanted to have private litigation be a stronger tool to use in that?

SW: I did not hear that, so I don't have any informed opinion on that. I interpreted the delay in adding more commissioners to the White House's view that we must be doing a great job. But quite honestly, I've not heard that the Clinton administration didn't care about the SEC. I always was of the view that they did, and that they thought it was moving along smoothly and doing what it should be doing.

For whatever reason though, there certainly seems to be that kind of attitude over recent times, and it is a mistake. If there is to be a government agency, it should be given the resources to do its job well. If the view is that it is squandering resources and could be more efficient, then be transparent in that view and explain what it could be doing better. But allowing bad policy to develop merely because there is a desire to reduce

expenditures is not a good approach. Either cede the area to another regulator, or cede it altogether to the private sector while making it clear to those impacted that there is no government regulation in that area, but don't allow poor regulation and processes and games to develop that are actually counter-productive, that really serves no one's interests. And, if there really is a belief that an agency is woefully inefficient, explain why.

WT: It was one of those things that was batted around in the press at the time, so you can never tell, exactly.

SW: There was obviously a lot on the mind of the president. I'm sure the SEC was not the top of the agenda item at each morning briefing, but I certainly never was given the impression that the Commission was viewed as a backwater, unimportant, irrelevant, or anything else. Remember, those days – the mid to late '90s – were ones when the market was strong, the economy was growing, and the reality matched the perception that on the domestic economic front everything was going well.

WT: How engaged were you with Chairman Levitt's priority on auditor independence? I noticed an interesting line on your bio about being involved in the stock options accounting debate in particular, so I'm wondering if you can tell me a little bit about that.

SW: Auditor independence is clearly important — and we saw the implications of failing to maintain independence come to life with the Andersen/Enron case. Auditors are the

foundation for corporate financial accounting and disclosures and the backstop for ferreting out corporate financial fraud. We need auditors, we need them to do their job well, and we need them to be independent of management.

The question, again, like everything else, is do the rules make sense? For example, there was a case where an audit firm was owned by a public corporation and a subsidiary broker of an issuer owned in the broker's proprietary account a single share of stock (as it did with all listed public companies) of the audit firm's parent in order to provide certain services to its customers. The SEC staff ruled that the audit firm would not be independent of the audited company, because the audited company owned that single share of stock. That's silly on its face and can only be explained by what was said "we have a rule, and there are no exceptions no matter how small or inconsequential, because we don't want to have to get into making judgments." I'm not sure that it isn't fair for the public to ask more of its regulators than that. Perhaps the rule could have been more thoughtfully written in the first place? Don't misunderstand though, I also know there are pressures brought about a political environment where regulators are pressed to do something so they can appear to be "hard" on some matter, and making any kind of exception is just another matter that needs to be explained. But, one of the tough things I think regulators need to be able to do is make good policy and judgments and be willing to stand up for them and explain them.

And so again, if an agency develops a more thoughtful way of writing and enforcing rules, there will ultimately be better compliance and a better public policy outcome.

There will be short term pain, but a long-term return as well as a better view of the regulator and the rules.

But back to the general issue of auditor independence – it is obviously just absolutely critical and, of course, I'm very supportive of it.

With regard to your other reference about stock options and the accounting for them, that's a different area and is unrelated to the auditor independence issue. Stock option accounting was referring to the question of what's the best substantive GAAP accounting for that particular form of compensation.

Stock options, and stock based compensation generally, is interesting. When looking at the bottom line of a company and the earned income number, most investors normally think of it as money that's earned. When you think of compensation expense, most investors normally think of it as money that's paid out. And you would expect the money that's paid out to be subtracted from the money that is taken in by the company to result, at the end of the day, with a number that's impacting the money that's earned.

With stock options granted to employees, there's no question that they are compensation. That's not the issue and never was; of course they are compensation. The question was how do you account for them and what happens over time when stock values change and how do you flow those changes through the financial statements? Some believe the best way to account for that grant of a stock option as compensation is to take the position

that, once given, the value in various circumstances should be re-measured at each statement period. The result is that if the stock value has gone up ten-fold, the financial statements would now indicate that the value of the services rendered by the employee or the value the issuer has paid for them, depending on the perspective taken, is now much, much more than before. That means that as the company does better, it ends up with much, much higher compensation charges because of a decision that was made to grant stock options in a previous timeframe.

The problem with that is a difficult-to-understand financial presentation where a company that, for example, is amassing great market share, and perceived in the marketplace to be doing well so its stock price is increasing, but that has not much in the way of earnings, has an increasing charge for the cost of previously granted stock options. In fact, the company may look like it is headed into bankruptcy when the opposite is true. That's just not intuitive to most investors and will at worst be misleading. There is also the contrast with a similar company, but one that's not doing as well, and so it ends up with much higher reported earnings because its stock option compensation expense is much lower.

So I suggested to those creating accounting standards to think about this issue differently and a little out of the box. The proposal was a simple one: add the stock-based compensation as an additional item in a manner similar to how investors consider EBITDA, where depreciation, amortization, interest and taxes are shown separately and therefore a more granular and detailed presentation can be provided of income. There

would be another line item for stock-based compensation. It would be transparent.

That was anathema to a number of accountants, however. This extra disclosure separately from the compensation line was not something that fit within the traditional mindset. Consequently, we have the rule we now have. As long as investors understand it and how it works and how distortive it can be under various scenarios, and as long as there's other disclosure, so that an investor can understand, for example, the reason a company can keep showing losses because of a huge stock option compensation expense, but in fact it's not paying out money, it's part of the capital structure, then it should be fine. The company doesn't go bankrupt by having stock based compensation expense. As long as that's clear, as long as people understand it, I think it is fine either way. At the time people asked, I suggested an alternative for consideration – but there are only so many significant changes that can be implemented at any one time.

This was a bitterly fought issue on the part of some high tech companies and some on the FASB side, for an issue that just seemed like it could easily have been resolved by more transparency in a much, much easier way, where everybody could have basically come out with the right answer in terms of what they were trying to show, which is, "I'm doing a great job running my company, and I've done such a great job that there's this extra stock option compensation expense." And the owners could say, "Yes, but it is in fact compensation and it should be shown as compensation."

So you could have had a good way of showing both that would have been relatively

straightforward. But again, it is always interesting to see how hard it is for regulators and standard setters, and honestly all of us, to think about bigger changes as opposed to little tweaks. The world works on little tweaks—at least this part of the world works on little tweaks—and that’s unfortunate in at least some cases.

What we’re now seeing is technology and new thinking and processes —to use the clichéd and a way over-used term at the moment—“disrupting” various areas as people rethink some fundamental concepts. But when it comes to regulation, and when it comes to much of public policy and standards setting, because in part there is no “regulatory competition” it is difficult to rethink fundamental concepts. And instead, what you end up with are modest tweaks to existing provisions that have been in place for a long time.

WT: Another of Chairman Levitt’s early initiatives was in the area of municipal securities. I’ve talked about this with Paul Maco and with Dick Walker yesterday, in trying to build a mosaic of enforcement cases, because really, the SEC’s only jurisdiction is under the fraud provisions. Paul Maco had an interesting story about getting a 2:00 a.m. phone call from you, I think, talking about issuers’ personal responsibility and being very careful on that ground, but of course that’s just a fragment, and maybe not a good perspective on your views. So, I’m wondering if you can discuss that a little bit.

SW: Well, if I called him at 2:00 a.m., I hope he was somewhere in Europe and it just happened to be that we didn’t know what time zone he was in, because that seems unfair to do that to somebody. But in terms of the municipal securities areas, Chairman Levitt’s

efforts there, I thought, were extraordinarily laudable. It was an area with lots of different issues. The pay-for-play issue was one that, at best, appeared corrupt; at worst, it almost seemed criminal.

His effort to ferret that out, to create some rulemaking that could address it, to try to stop it from continuing to become the persistent and the normal way that people thought about municipal securities underwriting activities and local political fundraising, was really important and critical. I think that was a hallmark achievement and a terrifically important one.

WT: So I'm conscious that you have a 12:30 meeting and we're probably getting up close to the time that you have to take off. And there are a couple of areas, first is your interest in shareholder democracy, as you put it, and I'm wondering—and this is past the time when people were discussing the one-share-one-vote question as far as I know—but there was a question of shareholder proposals and all that sort of thing. I see that, again from your bio, that you were part of something called Proxy Governance, Incorporated after you left the SEC, so I'm wondering if you can discuss your interest in that subject and how that developed.

SW: Sure. Proxy Governance, Inc. was a firm I founded a number of years ago. It has since been sold off in two component pieces to others. One part went to Glass Lewis; another went to an accounting firm.

Regarding corporate governance issues: while I was at the Commission there were a series of questions that arose regarding Rule 14a-8, the Shareholder Proposal Rule. In particular, there were proposals at the time related to what was called the “ordinary business” exception to the Rule’s requirement that shareholder proposals, if they satisfy certain criteria, be included for shareholder action in the issuer’s proxy statement.

And probably the most infamous of them was one that related to a company called Cracker Barrel, which at that time was discriminating with regard to hiring certain employees where such discrimination was not then illegal but many thought was improper. A proposal was properly, regarding the other needed criteria, submitted by a shareholder regarding these practices.

The staff took the position that that proposal related to the “ordinary business” of the company in terms of its hiring practices and how it engages in applicant screening and what it does. My view was that discrimination is not ordinary business, and if a company is engaged in discrimination, that’s just not ordinary business. Excepting out that proposal, not having it included on the grounds that it was related to ordinary business, was just wrong. That was part of the original thinking that led me to look more at Rule 14a-8 and how the shareholder proposal system was working all together. And my views led to the reversal of the Commission’s Cracker Barrel position and allowed these proposals from then on to be included.

I wish I had pushed even further at the time, because this whole area has continued to

take an extraordinary amount of time and attention at the Commission. It continues to be an area where there are other solutions that could open up the opportunity for shareholders to make proposals on matters of interest to other shareholders. There would be much more, and more useful, shareholder engagement if there was the opportunity for more discussion.

But many of the SEC's rules limit shareholder discussion and centralize the shareholder discussion process that they serve, at this point, little good purpose. Instead, it is possible to relook at that rule and arrive at a different approach to allowing shareholder proposals to be includable, and made available to shareholders, both, to see and comment on, and vote on, as compared to what we have today.

WT: I'm kind of struck by an interesting parallel of both you and Chairman Breeden before your time at the Commission were interested in the question of shareholder power, and both of you afterwards—he through the creation of an activist hedge fund—evolved to try to continue to pursue this area. It's quite interesting.

Unless there's something else that you feel it's pressing that we talk about, I'd like to talk a little bit about your time after the SEC, and particularly how you decided to start this company, Folio.

SW: Folio started with a few core ideas. One was, if the technology of our time had been available in prior times, , and you rethought, for example, the ability to provide

investment management to individual investors, would you create and invent a mutual fund, or would you create or invent something else? That simple thought exercise led to the view that you wouldn't create a mutual fund. That structure is one that was created in the '30s and '40s. It was a good structure at the time, but technology, by the time you got to the end of the century, had evolved sufficiently that you could do something much more efficient and better.

The concept of folios was born; namely, the concept of having the ability for people to put together a whole basket of stocks that could reflect any kind of theme, any kind of investment style, any kind of structure, any kind of geography or sector or industry or other construct as to how you might want to put together a portfolio, and make that a customizable, personalized portfolio that somebody could cost-effectively buy.

I also wanted to do something else that reflects how a good amount of my time at the SEC was spent, obviously, talking to investor groups, investors, and others about investing and how better to invest, et cetera. There's an investor education component to being at the SEC and being a Commissioner. One of the things that struck me quite hard was, when you focus on individual investors, they did not understand the lessons learned by large institutions. Individual investors were being told that they should personalize their investments and make sure those investments fits their needs. Yet, they didn't know how to do that. They were being told to diversify, but it was hard to figure out how to diversify. They were being told to consider taxes. Individual investors really didn't have any good way to consider or manage taxes. And of course, individual investors were

being told to be cost-sensitive and think about cost.

They were also being told, of course, to be consistent in their investing. One of the things we always see, and the behavioral finance studies bear this out, was that individual investors do the bad thing of buying high, because the market is going up and they all decide to get in once the market has shown that it is moving well and increasing. Then they wait. When the market starts to have problems, begins to struggle and goes down, and their portfolio has lost value, they get very concerned, and they sell. That cycle of buying high and selling low is just not a good way to accumulate wealth.

The idea for Folio was, could you take those five fundamental investing principles -- diversification, personalization, consistent investing, tax optimization, and low cost -- and build something that would provide individual investors a platform that would allow them to practice those five principles well?

I thought you could. I thought you could compete into existence a new way for investors to invest. Part of what I learned at the Commission is that you can spend enormous time regulating out of existence bad things, but you can't really regulate into existence really novel, good things. You can make sure that nothing's in the way of doing that, but it's up to the private sector to create the innovative, new, good things. It's up to the public sector, the regulators, to stop the bad things, but get out of the way of the good things.

When I left the Commission I was no longer in a position where all I could do was stop

bad things and get out of the way of possibly good things. I wanted to see if we could really compete into existence some novel good things. I thought it was important to take these five principles, and take technology as it evolves, and see if we could create a whole new platform, a whole new structure. I wanted to focus primarily on individual investors and the people who serve them, such as investment advisors and others, so that these investors could have the benefit of investing in a smarter, better way, just as long-term investing focused, as opposed to trading focused, institutions do. And that was really the genesis of Folio.

WT: Did you have a particular sort of investor in mind? It seems that you kind of have a middle way, between the mutual fund where it's very hands-off in certain cases, such as index funds, low cost; on the other hand you have people who would invest in individual stocks by, say, an Internet broker. Is there one side or the other that you saw as your target customer, or were you really kind of trying to go for both ends of that?

SW: I was seeking to serve individual investors generally, because folios are advantaged, obviously, over mutual funds. They can be customized; you can't personalize a mutual fund. They're much more tax efficient than a mutual fund. They can be lower cost than a mutual fund. If you invest consistently, mutual funds do just as well, and on diversification mutual funds do just as well. But when it comes to the personalization, tax and generally fees, folios are better. When compared to individuals engaging in specific stock buying, clearly they're not diversified, so folios do that much better. When focused on costs, building a diversified portfolio through individual stock purchases at

any other brokerage is basically impossible for the typical individual investor, as it's just too expensive. The idea of building a diversified portfolio of individual stocks at Folio is trivial, and very low cost.

So we wanted to say to mutual fund investors and those investing in individual stocks one at a time, here's a better way. We thought we could, in essence, take the best of what mutual funds have to offer and the best of what investing in individual stocks has to offer and put that into one platform, one vehicle, one package that would allow people to receive the benefits of both.

WT: How quickly did this notion catch on to the effect that you were able to sustain the business? Was it something that customers understood right away or were attracted to?

SW: It's a good question. The reality is that for individual investors these concepts are still hard. Individual investors struggle with understanding diversification and what that really means. Trying to encourage consistent investing is still hard, et cetera.

Cost is an interesting one. For example, most individual investors don't have a clue as to how much they're actually paying for their investment in a mutual fund. There can be disclosure that states it's 132 basis points or whatever, but individual investors generally do not know what that really means to them. They don't do the math. An investor will own a \$100,000 worth of a fund and when asked what they're paying, even if told it's 100 basis points for example, they don't do the math to say, okay, that's \$1,000 or about

\$80 per month. When told that is what it is, their answer is “I thought it was much, much less”. That’s what you hear from individual investors all the time.

The bottom line, therefore, is that financial literacy and the level of education of individual investors is not as high as one might expect, and it certainly is not as high as we all would hope. A real goal and aspiration that the Commission should embrace is how do we encourage better investor education, how do we get better financial literacy in this country? It’s a real problem, and it’s something that probably ought to be taught in high school. People ought to be given a lot more financial literacy than they are. The Commission could work with others in the public and private sector – obviously this is not the Commission’s core jurisdiction – to encourage more financial literacy.

For us, the problem on the individual investor side is that we have attracted a very good customer base of smart, thoughtful, reasonably well-educated, reasonably well-off investors, who understand the benefits of what we provide and have embraced it. What we haven’t been able to do, which is a major disappointment, is reach out to the whole group of people that could be benefitted by this, but don’t even know that they could be, because they don’t know they are paying too much, or that they are not well diversified, or that their investments don’t really suit them, or that they are losing too much to taxes, etc. We need to try to figure out how to rectify that.

On the other hand, those who serve individual investors -- investment advisors and introducing broker-dealers --, understood exactly the benefits of what our platform could

provide. That part of the business has grown quite considerably. So from the standpoint of a platform for investment advisors, for other broker-dealers, and for other financial intermediaries, the platform has done very, very well.

We pioneered the whole concept of themes-based investment, of portfolio-based investing. Advisors frequently will have their own portfolios, their own models that they want to manage and our platform just works perfectly for them, so that's been the part that has really taken off the best.

We're now about fifteen years old and are thinking about how can we best get back to the retail side and reach out to that individual investor to grow that base, and hopefully, bring the wonders of diversification and cost-effectiveness and tax-optimization, and consistent investing and personalization to a wide group of individual investors.

WT: On your website you mention you have a number of patents. Are those mainly elements of the platform?

SW: We have many patents, some of which we have practiced and are clearly elements of the platform. For example, we have something that we call Tax Football, which I think is just great. It's a tool and interface for an investor to have an entire visual perspective on their tax lots and to be able to understand in a few seconds the entire set of tax implications of their account. Then with a couple clicks, the investor can achieve the exact tax result that's desired. It's really pretty stunning, and people who have looked at

it are just amazed by it. It's just great. And we have a patent on that.

We also have patents on inventions that we haven't yet practiced. We have a risk manager concept that allows someone to actually bound their portfolio, in terms of how much downside risk they're willing to take in exchange for how much upside gain they are willing to forgo. That's one I'd like to bring to market at some point. And we have a number of others that would be great innovations that we also want to bring to market; we just haven't yet. We've had no shortage of things to do and no shortage of things to build. We seem to be able to create innovations easily; we've been lucky with that.

WT: That's a very interesting business. If you have anything else you'd like to mention, please feel free to, but otherwise we're at the end of my list of questions.

SW: If I knew then what I know now, what would I have done differently? That's something that is always an interesting thing to think about because, having left the Commission, you would like to be able to tell the people at the Commission who come after you what they should know, because it's everything at least I would've liked to have known about when I was there.

And I think you end up with at least a few matters. One is to be careful what you hear from the folks that come in and talk to you, because what I found was that it was sometimes very difficult to get speech, to get voice, to get knowledge, to get information from people who were not the normal folks who lobby the Commission every day. The

benefit of the Investor Advisory Committee that I'm now on, that was established by Dodd-Frank and that advises the SEC, is really important because the intent of that Investor Advisory Committee is to give voice primarily to the individual investor perspective – a perspective that really otherwise doesn't show up at the Commission and doesn't knock on the door and doesn't get access to Commissioners' offices or others.

The big firms are there every day. The big mutual fund complexes are there every day. The large issuers, the large institutional investors and hedge funds and others in the business are there every day. There's voice there. But the individual investor just doesn't really get its voice heard. It's important to try to ferret out that information more if you're a Commissioner, and always try to keep thinking about who a rule really impacts and how it does with regard to individual investors in particular.

The other thing is to really think about the difference between a principles-based rule and a more precise, specific micromanagement-type rule. This goes back to what we were talking about a little bit earlier, but if I could go back, I would try harder to make sure that rules were much more principles-based, as opposed to trying to micromanage an area. Technology and the world just changes too fast, and so we really do a disservice when we put into stone how something should work because that's how incumbents engaged in it at that time.

To give you a specific example, there are a series of rules on prohibited transactions that state, in essence, that if you're an advisor under the Advisers Act, you shouldn't be able

to trade against your customer unless you get the specific consent of your customer on that particular transaction. Under the DOL rules with regard to ERISA, they also have a prohibited transaction rule, and without a class exemption from them you're again not allowed to engage in that trade against your customer. That means that if you have a system that allows for customer orders to interact with a house account to receive increased price improvement, compared to what they would be able to get when those orders are sent to market, then you must not provide that benefit if you are acting as an advisor or a fiduciary under ERISA.

Obviously, that is a perverse and really silly result. Investors to whom the advisor doesn't owe a fiduciary obligation get better executions than the investors to whom the advisor does owe the fiduciary obligation, because of a rule that's intended to protect the investor to whom the fiduciary obligation is owed.

It's those kinds of rules that are very specific in terms of what they say you can and cannot do, but don't think about the principles and this does a disservice to us all. If the rule had been written on a principles basis to say if you're going to interact with your own customer orders, you have to ensure that they receive a price or a benefit at least equal to what they could have gotten from a third party – and how that happens is up to you -- then you accomplish the same investor protections and allow for good things to happen.

It's just an example where a rule could have easily been written in an intelligent,

thoughtful way, to allow good things to happen, but it was written in a way that tries to just stop one bad thing that was seen at the time. In the meantime, it also stops a lot of good things. So a smarter principles-based regulation is critical for regulators to embrace, and to try to then figure out how to incorporate it in what they are doing going forward.

Those would be some of the issues. Another is a needed focus on the industry's plumbing -- one that was never been able to get attention at the Commission level, and I regret that. When these issues came up to the Commission the response was usually "Can the staff deal with this?" and they just never get Commission-level attention.

But I see now that the way the industry structures itself on these "plumbing issues" has an impact on competition and, in many cases, it materially benefits incumbents or large firms, becomes anti-competitive, and can materially concentrate systemic risk. In a world that's not so heavily regulated, you wouldn't care, because somebody would come up with disruptive ways around those things and just do it.

But in a world that's so heavily regulated, and with rules that prescribe that participants have to do the following things, and with industry structures that enforce those rules and put in place provisions that make it expensive or impossible if a participant doesn't do them, you end up getting forced into one mold. And it's the mold that gives the large firms the advantage, because they're the ones who wrote the rules. That's something I would have liked to have paid more attention to at the Commission. It's an important

issue in terms of wanting to have competition and innovation going forward. But it's one on which it is hard to get people's attention. These matters don't seem sexy and the press doesn't seem to care and they seem esoteric and complex. Unlike some other areas, these matters are not easily understood, and determining how to write or modify rules here to further the right result is difficult. You have to get into the details and the weeds, and, as a Commissioner, there are so many things on your plate that it's hard to get into that many weeds. Some attention should be paid as to how to address these issues at the level where they need some focus.

WT: Excellent, thanks. You very much live up to your reputation as being somebody with very a thoughtful, intellectual approach to questions of regulation. And I very much appreciate your time. Thank you.

(End of Interview)