

Securities and Exchange Commission Historical Society
Interview with Martin E. Lybecker
Conducted on May 3, 2016 by William Thomas

WT: This is an interview for the SEC Historical Society's virtual museum and archive of the history of financial regulation. I am William Thomas. I'm talking with Martin E. Lybecker, the date is May 3, 2016, and we are in Washington, D.C. So, thanks very much for agreeing to speak with us today. We usually start with a bit of personal background. I see that you were born in Nebraska. Did you grow up there as well?

ML: No, my father was in the Army Air Force and that is where he was stationed near the end of World War II. I'm a baby boomer. That's just where I was born. Both my mother and my father grew up in eastern Washington State.

WT: And then I saw you did your undergraduate work there in at the University of Washington.

ML: Yes, my parents moved to the State of Washington State and finally settled in Seattle. So most of my childhood was spent in Seattle; I graduated from high school, college, and law school in Seattle.

WT: So you studied accounting and history at University of Washington?

ML: Yes.

WT: And then, as you said, you attended law school there as well. What got you into law?

ML: I'm not one of those people who wanted to be Perry Mason, but I liked the idea of a professional job, and accounting is one way to do that, and the law was the other. At the University of Washington, all undergraduates were allowed to study in the law school library, and it was by far the nicest place to study in the entire university. I got used to being there and hearing people talk. It was on the Quad, too. It was one of the oldest buildings on campus, it just felt very comfortable.

WT: Then did you have any aspirations, what you wanted to do? I see that you then went on to do further legal education at the University of Pennsylvania.

ML: I knew that I wanted to be a business lawyer. In the fall of the year that I would have graduated from law school, Boeing lost the SST, there were no fish in Alaska, and Weyerhaeuser couldn't sell timber to the Japanese, as the local story went. So there were literally no jobs in Seattle. When you graduated from the University of Washington Law School, the local catchment area Seattle and the greater Pacific Northwest, and there just weren't any jobs.

So my tax professor talked me in to going to NYU for a year, and I got an LL.M. in Taxation. My business planning professor and securities law professor talked me into going to Penn for a second LL.M., which I got studying under Robert Mundheim, who

was then one of the senior reigning securities professors in the country. Professor Mundheim helped me get hired by the SEC at the end of my one-year Fellowship at Penn. As my father liked to say, I enjoyed nine years of higher education before I figured out what I wanted to do when I grew up.

WT: So were you steering in any particular direction through your LL.M.s, or were you being steered?

ML: I liked being a securities lawyer and I liked being a business lawyer. Between the accounting, tax, and securities law work at Penn, I had a great background for it. It seemed that the public interest aspect of working at the SEC certainly wouldn't hurt and would be a good thing for one's career. Also, 1972 and 1973 were very exciting times to think about being at the SEC. Life was changing dramatically, and it's always to be at a place when things happening.

WT: So you got a job, then, straightaway in the Office of the Chief Counsel in the Division of Investment Management?

ML: Yes.

WT: Tell me how that came about and what that job was all about.

ML: Professor Mundheim introduced me to the senior people in the Division. I was hired to be in Alan Rosenblat's office. The way work was divided then in the Division, that Office got all the rules, the no-action letters, and the legislation. So other than working on exemptive applications, that Office had a big hand in everything fun that the Division was doing.

WT: So did you have any particular responsibilities with respect to your position versus what other people in the Office would do?

ML: I remember that Alan Rosenblat had three or four people in his Office and we shared the work. I did work with Alan to create the Division's library. Prior to that time, there wasn't anything that was a formal collection spot. We hired a person from one of the record-keeping branches at the SEC and turned her into our librarian, and captured everything that was going on in the division so that one copy of everything ended up being in the library. So a younger lawyer could go find precedent more readily.

At the same time, as you know, Louis Loss was at the beginning end of doing his ALI Securities Code and he had decided that he didn't want to try and take on any of the 1940 Act questions. Perhaps he thought they were too hard or it would be too disruptive or controversial. Anyway, there were a lot of things in the 1940 Act that the Division wanted to get fixed, and the ALI Code would have been a perfect vehicle for doing that. After we had prepared all of our comments for the ALI Code, Alan gave me permission to write a comprehensive law review article which was subsequently published in the

University of Pennsylvania Law Review in 1976, where for 100 pages we tried to address every single question, every single problem that needed fixing in in the 1940 Act in some way or another, whether it was just an anomaly from history, whether it was a lack of foresight on the part of the drafters of the 1940 Act, or whether it was a provision that had been misapplied by a court, or whatever.

With the Division's library right next to me, I spent half a day, every day, for a long time just going through historical files. I read the original files on the rule making on Rule 17d-1, all the Section 17 Rules. At one point, I read every single Advisers Act release. What a wonderful opportunity to just relive history all over again. In those days, there was a thing called a "ribbon copy" where you could see where the typewriter had actually smashed in the paper through the carbon page, and so you could see author's initials and everything. It was very interesting.

WT: That's very nice. Were there any particular areas that you focused on in that review of the 1940 Act?

ML: There were things that were on the Division's list of things to fix. For example, the District Court decision in *Fifth Avenue Coach Lines* had decided that some kinds of CDs were cash and therefore not securities. That legal position would have left the application of Section 17 to Roy Cohn's alleged mistreatment of the condemnation proceeds received by Fifth Avenue Coach Lines outside the ambit of the 1940 Act. So we wanted to fix things like that, take the opposite legal position, and try and get it fixed in the ALI Code.

WT: Was there any interaction with Louis Loss and that project?

ML: At the time, Professor Loss had something of a personal conflict in that he was legal counsel to the American Council of Life Insurance on securities and insurance questions, which would include issues relating to variable annuities and variable life, so he assigned Professor Victor Brudney to us, a charming person, but also much more sympathetic to the Division's concerns,. We spent a lot of time interacting with Professor Brudney. It was fun.

WT: So, of course, the ALI Securities Code Project ultimately did not go through. What was kind of the history of your own work with that? Were there prospects that there would be reforms on the basis of it?

ML: Yes, looking over your shoulder at my bookshelves you can see the two bound volumes of the ALI Code right there, and every tentative draft, and I still consult them regularly. I couldn't say every day, but it's at least once every couple of weeks, because what was captured in the ALI Code and the commentary was every anomaly in and all of the policy arguments behind every section of the Federal securities laws. So if you're trying to figure out why beneficial ownership means one thing in Section 13 of the Securities Exchange Act but it means another thing in Section 2(a)(9) of the 1940 Act, using the ALI Code probe what Professor Loss thought about such a disparity. He points out in the commentary a lot of the nobody-can-figure-it-out anomalies. While the powers that be in

the American Law Institute got it adopted and published, the securities bar was not eager to have it passed by Congress. Probably very disappointingly to Professor Loss personally, who only lived for another four or five years, it was never even introduced as a bill in the U.S. House of Representatives or the U.S. Senate. However, it is still a valuable reference source and sits on a lot of people's bookshelves.

WT: So I know it wasn't too long before you also ended up doing some academic work as well.

ML: I left the SEC in June of 1975 and became a full-time law teacher, fully expecting to be that for the rest of my life. While I was at the University of Washington, I'd been a part-time accounting teacher in the School of Business while being a full-time law student, which is sort of interesting, having an appointment in another department and being a student in another department, but that's what I did. So the idea of being a teacher was very comfortable for me. However, the economic situation in Seattle, in terms of thinking about going home, hadn't really changed much by 1975. Law firms that hadn't been hiring in 1969-1970, still weren't hiring. So academia seemed like a better place. I looked all around the country, and ended up going to State University of New York at Buffalo, and was on the law faculty there for two years, and then taught one year full-time at the Duke Law School. At the same time that I was teaching at Duke, I had a co-appointment at UNC Law School down the road in Chapel Hill.

WT: Had you wanted to do that all along, or had this project that you were working on at the SEC kind of pushed you in that direction, all the research involved?

ML: Teaching was interesting and challenging. I'm very comfortable in a classroom in a teaching mode. My natural instincts are to be a teacher. Certainly from a sports standpoint, my natural instincts are to be a coach, as my father was. So having gone through the SEC as sort of a quasi-academic experience, I was very happy to be a law teacher thinking about the same kinds of ideas.

WT: Let's talk a little bit about the investment management area at that time. The first thing, of course, you have the 1940 Act, and you have the Advisers Act, and I know that the Advisers Act, there wasn't as much activity in that area. So maybe we should just deal with that first, and talk about what the status of it was at the time.

ML: The Advisers Act really was the stepchild from the Division's standpoint. From the beginning, Congress had just intended it to be a survey in that requiring registration was one way of making sure the SEC knew exactly how many people there were acting as investment adviser. At that time, there really weren't many substantive rules under Section 206. When the SEC won the so-called min-account case against Citibank in 1971, the SEC took the position that if a person sold an interest in what purported to be a separate account, but in fact each investor was being treated exactly the same way every other investors was being treated then there was no individualized service being provided, and the offering of that service was treated as a security.

If that was the law, then it seemed that very blue chip investment advisers were at risk if, in managing separate accounts in a similar manner that it could be alleged they were offering securities in an illegally unregistered investment company. It seemed wrong for that to be the correct conclusion if the apparent confluence of similar holdings in different separate accounts for different Section 401 plans because each of those employees had similar demographics amongst their employees. That spawned the mini-account project that I worked on, along with others, and that was probably the principal effort that was made to flesh out the Advisers Act from 1972 to 1975.

WT: They ultimately came up with an Office of Investment Adviser Regulation in 1978.

What was that?

ML: Administratively, it was in the same group that Syd Mendelsohn headed that had been responsible for exemptive applications. So it was, from my personal and geographic perspective, it was on the other side of the Division. I didn't have anything to do with it in the Chief Counsel's Office. Syd also had responsibilities for inspections and examinations. Since Syd had examination responsibilities for advisers, it was a way for him to also affect the law.

WT: Maybe we could talk generally about the exemptive authority and the role that it played in the Division's activities. It's a broad question, I know.

ML: It's by far the most interesting thing about the Division. And it's very misunderstood, but not in a bad way. So, if you worked in Corp Fin or you worked in Market Reg and somebody asked you a question like, like whether something is a security, the only way the SEC staff in those Divisions could respond was with a no-action letter, and then you had to interpret the statute. By contrast, because Section 6(c) exists and Section 17(b) and the other sections in the 1940 Act empower the SEC to issue exemptive orders, the process of issuing an exemptive order allows the SEC staff to take into account through prophylactic conditions restrictions to exempt an applicant from a restriction in the statute that's unduly harsh or doesn't make any sense in the context of that applicant's proposed activities. I don't want to suggest that the Division just "makes up" conditions or restrictions, but the Division can get to different prophylactic regulatory structure that the statute would otherwise have applied. The absence of exemptive authority in the other Federal securities laws necessarily affected the way all of the other Divisions did their work. Speaking as someone who worked in the Chief Counsel's Office, if we decided to say "no" to someone that we're not going to interpret the word that way, there was always a safety valve in the form of exemptive applications so good ideas did not have to die, whereas Corp Fin and Market Reg often had that problem.

Instead, the Division could say "that's a bad question for a no-action letter, why don't you file an exemptive application?" If the applicant was willing to agree to certain conditions or restrictions, we could recommend that the exemptive order be issued. An exemptive order is actually better than a no-action letter from an administrative law perspective, because if the applicant got an exemptive order, it was basically the Good

Housekeeping Seal of Approval from the SEC, and it was valid as against any third party. Unless the SEC process was procedurally defective, then someone contesting an exemptive order in a U.S. Court of Appeals would have to prove that issuance of the exemptive order was arbitrary and capricious. The presence of the exemptive order process often proved to be a much better way of handling questions, and from the Division's standpoint, that issuing no-action letters, and it let the Division experiment with a situation through the process of issuing a series of exemptive orders.

In the mid-80s, first Vanguard and then T. Rowe Price filed applications with the SEC asking for an exemptive from the fund of funds provision in order to offer an IRA fund that would invest in their other proprietary mutual funds. Each of the applicants negotiated with the Division, and they came up with different ways of addressing the problems that had caused the prohibition on fund of funds based on abuses that had occurred in the 1960s involving Bernie Cornfeld. That didn't mean the prohibitions in Section 12(d) were wrong, but it meant that if the application was willing to do other things, it was possible from an investor protection standpoint to say that those applications were consistent with the public interest and the protection of investors. Those two firms got orders. It was controversial, the vote at the Commission level was three to two, but they went allowed to go forward and the SEC could observe what happened through inspections or otherwise.

Four or five years later both applicants came back and amended the orders, and the whole concept of fund of funds got to blossom because the Division did not have to apply the

statute rigidly notwithstanding the merits of the investment proposal being made. On the one hand, anybody with a “forever” stamp can file an exemptive application and make the Division’s life miserable by asking the Division to address something that it has no interest in addressing. On the other hand, with that same “forever” stamp, a fund group can file an exemptive application seeking an exemption from a provision that would make their product illegal if the Division had insisted, for example, to apply Section 12(d) or Section 17 literally. With some modifications, the Division can make an application work and the applicant can accomplish what they wanted to do, and the Division has done nothing to damage investor protection. No other Division ever had that capacity until very recently.

So when prior to this interview I gave you that long list of things that happened over the course of the 1970s, the 1980s, the 1990s, and 2000s, almost every single one of those is, I would say, an imaginative, creative, and thoughtful use of exemptive authority by the Division to let applicants engage in an activity that would otherwise be illegal. For example, the statutory concept that an investment company must mark its assets to market is a very fundamental investor protection at the core of the 1940 Act. There’s no regulator anywhere, bank regulator, insurance regulator, or securities regulator who doesn’t want their regulated persons to mark to market; if the regulated person marked to market at the end of business yesterday, then in the morning the regulator can know exactly how much cash that person has and y how much capital it has. Why would a regulator ever want to give up that kind of core investor protection?

Rule 22c-1 requires every mutual fund mark to market every single day. The idea of a money market fund that doesn't mark to market is perverse, in that that's the exact opposite of what the statute would require a money market fund to do. It took a couple of years of an administrative hearing, and ultimately the adoption of Rule 2a-7, but the concept was that a product that has a stable net asset value per share is a product that would be helpful to consumers, and would be helpful to trust departments and institutional investors. And because it was a product that probably ought to exist, the Division did not have to just say no because Rule 22c-1 requires mutual funds to mark to market.

At the beginning of the existence of money market funds, that's what the investment advisers were doing. They were marking to market, but they used the arithmetic concept of "penny rounding" so that the mark to market variations stayed within a very narrow range so that the net asset value per share ("NAV") didn't fluctuate over or under a dollar. In the case of institutions like Merrill Lynch, they used stock splits and stock dividends to help keep the NAV at a dollar. Do you understand what I'm saying? They were marking to market in compliance with Rule 22c-1, but it was causing the fund sponsors great dislocations in order to do it. And all we had to do was say yes to the idea of not marking-to-market.

WT: Say yes to the idea of not marking-to-market.

ML: Yes, agreeing to let sponsors of money market funds to use the amortized cost method of account to achieve a stable net asset value per share, while basically requiring the money market fund industry to mark to market beside the stable net asset value. That meant that the money market fund sponsor had to monitor use of the amortized cost method of accounting against the day-to-day mark-to-market price to make sure that the stable net asset value per share was fair to investors. But that's also one of those situations where the five commissioners had very strong views about wanting to mark to market. While the SEC staff was less opposed to the idea, the Commission set the Federated application down for a hearing, then procedurally the Division was required to oppose the application during the administrative hearing.

Having the Division formally oppose the application when it is set down for a hearing does mean that the ALJ and the Commission get a fully-developed record to review. Any time there are two advocates fighting on both sides, the result is a better record. But it's also an odd place to be creating a record, because you're not doing it in front of your bosses, the Commissioners, and you're not doing it in front of your colleagues. You're doing it in front of an administrative law judge who has no particular commitment to the mutual fund industry, to the administration of statute, to money market funds as a product, or to anything in particular. An ALJ is an independent decision-maker, but it's very hard for him to take policy considerations into account like the Division does and the Commissioners do.

WT: So when you say that the exemptive authority is misunderstood but not in a bad way, what exactly do you mean by that?

ML: I think most people who are either 1933 Act or 1934 Act specialists always find the 1940 Act mysterious because a lot of the jurisprudence is sort of subterranean. It's not in a rule, and it may not be in a no-action letter, but it may well be in an exemptive order. If you're trying to practice law from Spokane, Washington, and you don't know that, then that lawyer is worse off in representing his client than a person in New York or Washington, D.C, might be. It's not because the East Coast lawyer is any smarter, he just knows that a lot of the "yes" answers aren't in rules. They're in exemptive applications.

One of the things we tried to do when I returned to the SEC in 1978 was codify a lot of that jurisprudence so that it would come out of the dark and be part of a rule. Such a process would also mean that, if were to propose a rule allowing cross transactions between two affiliated accounts under Rule 17a-7, then both the lawyers and the accountants would pay help surveil compliance with that, and we could task the board of directors to surveil compliance with it. In a sense, the Division could outsource some element of its compliance program to the professionals in the industry.

WT: My understanding—I was speaking to Joel Goldberg a couple of weeks ago—is that if you're an investment company, generally, it's preferable to try and get a no-action letter rather than to go for an exemption, just on a procedural level. Is that your perception?

ML: It all depends at the point in time. If the client you're dealing with is flexible, then there's less process around a no-action letter and it can be easier to get the Division to issue a no-action letter. You can negotiate directly over the phone; there doesn't have to be an in-person meeting. It has also true that the exemptive applications can be creatures of precedent to the point where it is very hard to change what the last person was able to get.

So the joke has always been that if the last person who filed an application was a redheaded, left-handed stepchild, then the next person better be a redheaded, left-handed stepchild to get the same exemptive relief. It may turn out that being redheaded, left-handed, and a stepchild do correctly describe the last applicant both those fact weren't critical to getting the exemptive order and the factors are more important. But your task as an advocate it to persuade the junior lawyer to whom the application was assigned that those really weren't the critical factors, that it's these other things that were in fact the important investor protections. For obvious reasons, the Division staff handling exemptive applications has traditionally been more tied to precedent in the way they apply the law.

WT: Just at kind of an order-of-magnitude level, what would the volume of exemption applications be at the SEC during the '70s?

ML: During the '70s, I would guess that we probably handled 200, 250 applications a year. The no-action letters would have been less than 100.

WT: That's good. That helps put things in perspective. So, there had been the 1970 Amendments to the '40 Act a little bit before you arrived, and I know that there were still activities related to that in that early to mid-70s time frame. Could you talk about some of the things that you'd have been dealing with, with respect to that?

ML: There were still things left over. Alan Rosenblat was very involved in the negotiations in '69 and '70, as had been Allan Mostoff and Lew Mendelson, and so they had a list of things that they wanted to clean up. Some of the things were harder to do, and some of the things that were added in 1970 had lost some of their purpose. So, the classic one was Section 17(j). At the time, in 1969, it wasn't clear that there would be a cause of action under Rule 10b-5 for a mutual fund to sue someone who was an employee who had purchased and sold the security being held by the mutual fund because the mutual fund wasn't a purchaser or a seller. They just happened to hold something that the human being traded.

It wasn't clear that there was standing for the mutual fund under Rule 10b-5, so the solution was to add an anti-fraud provision to Section 17(j), and the SEC was authorized to adopt a rule regarding personal securities transactions. But Section 17(j) was not a high priority. When I rejoined the Commission in 1978, Chairman Harold Williams said the rule implementing Section 17(j) had been just pending long enough, so one summer for two months it was my job to collect up everything, re-propose it, get it published, get it adopted, and get it done.

WT: I know that there were a few other things. I apologize because of having talked to Joel a couple weeks ago, so everything I ask is reflected through the things that he said.

ML: That's fine. At the time, he was the Associate Director for the other side of the division, so either his group was working on solving the problem or my group was working on it, so I'm not surprised that he shares a lot of the same memories and experiences.

WT: So there will be things that you probably wouldn't have as much insight on that he would and vice versa. So, one thing that he had mentioned is that by the time that he had arrived, contractual plans had been pretty much destroyed by the amendments, or that they were already on their way out and that that was hastened.

ML: He would have been conscious of that because his group would have been processing the registration statements. Since the '40 Act was amended in '70, that wasn't something that had to pass our desks daily. Joel was also the one who was responsible for re-proposing Rule 22d-1. My group wouldn't have had anything to do with sales loads. No one in the Division had any direct involvement with Section 36(b), the provision that prohibits excessive fees. We were all very conscious of the *Rosenfeld* case, and then later the litigation that popped up in 1980 and 1982 regarding excessive fees and money market funds, but other than watching those developments carefully, there really wasn't much of anything for us to do.

WT: So were there other things that were going on? I know there were very broad changes in the mutual fund industry at this time. Maybe we should discuss those in terms of how they would have impacted what was going on in the division, your part of the division.

ML: '78 to '81, that's the timeframe you want to talk about?

WT: No, the earlier time that you were there. Maybe those hadn't quite worked their way through yet.

ML: The biggest thing from our perspective was the '75 Amendments to the Exchange Act. The Division was responsible for writing Section 13(f) under the Exchange Act. I was the one whose pen had to write that, and I helped with the Division of Market Regulation draft Section 28(e) in the Exchange Act. But it was mostly reform to the '34 Act, and what was being called the big bang because that legislation was going to deregulate fixed minimum commissions on the New York Stock Exchange. There wasn't much of the amendments to the Exchange Act that that had any effect on the Division. When the '75 Amendments were finally enacted, the Division proposed and adopted Rule 17e-1 in the '78-'79 era, but all that did was make it permissible for mutual funds to pay affiliated broker-dealers something other than a fixed minimum commission as long as they kept records about it.

WT: What was the situation with respects to the relationship between mutual funds and banks and insurance companies at that particular time? Just situate us there historically.

ML: When the Comptroller in 1961 decided that it was lawful, notwithstanding the Glass-Steagall Act, for banks to be involved in offering and managing commingled managing agency accounts, the then-SEC Chairman Cary, a former Columbia law professor, told the Comptroller of the Currency that, as one government agency speaking to another, the Comptroller of the Currency could say whatever he wanted about the banking laws but compliance with the banking laws didn't make the interests in the commingled managing agency accounts not a security. When you look at the history of it, for three or four years there were hearings on Capitol Hill on whether interests in commingled managed agency accounts were a security, and whether they had to register as an investment company. Throughout the '70s, '80s, and '90s, Citibank generally did not want to fight with the SEC and usually opted to doing whatever it took to actually get in the business, whereas other banks often wanted to litigate to make the legal point and win or lose on their legal theory. So Citibank actually registered an investment company. It required some exemptive relief, and the SEC issued the necessary exemptive order.

WT: Is that Citibank?

ML: Yes, Citibank commingled managing agency account fund. At the same time, the Comptroller of the Currency had to give Citibank exemptive relief from Reg 9, 12 C.F.R. Section-9 that regulates bank fiduciary activities so that the Citibank fund could be managed by independent directors. The NASD then sued the SEC over the exemptive order that the Commission has issued to Citibank and the ICI sued the Comptroller of the

Currency over their legal analysis of the Glass-Steagall Act. All of this got mixed into the 1970 amendments of the '40 Act, because the Congress was reluctant to be in the middle of that fight. Congress didn't want to sort out whether the securities industry had a monopoly on offering mutual funds or whether the banking industry could join.

The '70 Amendments to the '40 Act had a number of provisions that would have permitted banks to offer mutual funds, the same parallel provisions in the Bank Holding Company Act. The Bank Holding Company Act Amendments of 1970 were going through Congress at exactly the same time. So there were three separate tracks, *ICI v. Camp* in the courts, mutual fund reform going through the Senate Banking Committee, and banking reform going through the Senate Banking Committee. The Senate Banking Committee was considering those two different pieces of legislation at the same time.

So the Senate Banking Committee convened to the classic smoke-filled room, literally, and when the mark-up votes were completed, the Senate Banking Committee had decided that they would strip out of the Investment Company Act all the permissive provisions that would have allowed banks to be in the mutual fund business, and let whatever the Supreme Court decided in *ICI v. Camp* be the law. When *ICI v. Camp* was decided in spring of '71, the Supreme Court decided that it was illegal for a bank to underwrite shares of a comingled managed agency account. They were interpreting the provisions in the Glass-Steagall Act that prohibited a bank from being an underwriter. The Supreme Court's decision in *ICI v. Camp* basically stopped banks from engaging in those kinds of banking activities for the next fifteen years.

On the other hand, the Federal Reserve had the authority under its Regulation Y, after it was amended in the bank holding company amendments, to permit banks do engage in any activity that was closely related to banking. So the Federal Reserve proposed in 1971 to allow a bank holding company, or an affiliate, to give investment advice to a closed-end fund. That litigation was decided in 1981, but in the meantime, there was a lot of discussion between the banks and the SEC on whether certain activities were legal for a bank to engage in.

At the same time in *New York Stock Exchange v. Bloom*, the Comptroller of the Currency decided it would be proper for a bank to accept orders from its accounts and place them with a real broker-dealer on a prescribed basis. So, in your personal checking account, they would take money out, kind of like a payroll deduction plan, and the bank would instruct the broker-dealer to buy securities with the money. Not surprisingly, the mutual fund industry wasn't very happy about that either, nor was the brokerage industry.

If you think of the Glass-Steagall Act as prohibiting a bank from being an underwriter, and prohibits an underwriter from being a deposit taker, then the early '70s and early '80s were all about what the securities laws and banking laws meant when they were all passed in the 1930s, by exactly the same committee, in exactly the same period of time, usually with exactly more or less the same words. Not surprisingly, when the Supreme Court decided the commercial paper cases in the 1980s, they took the view that if commercial paper was a security for purposes of the securities laws, it had to be a

security for purposes of the banking laws because they were decided at the same time, and therefore, underwriting commercial paper was illegal. That was the *Bankers Trust* case.

The SEC was involved because the banking industry was trying to interpret what we kept thinking of as “our” words in ways that would be permissive under the Glass-Steagall Act or Bank Holding Companies Act from an activities’ standpoint by interpreting the words in the securities laws a way that would allow the activity to be permissive even though it had implications for us. The SEC was actively involved, in ‘78 through ‘81, in talking to the Federal Reserve Board and the Comptroller of the Currency about bank securities activities. The SEC didn’t participate formally in any of the cases, but we participated informally in conversations with the Federal Reserve Board and Comptroller of the Currency on all the banking cases.

WT: Is that something that you got involved with personally in ‘78, or was it before that?

ML: No, it was largely before that. From ‘72 to ‘75 I was involved personally, because of the time that I had spent at Penn thinking about the banking laws, and after 1978 it was me personally again. From ‘75 to ‘77 it was Jack Murphy, who was then working for Harvey Pitt on the Bank Securities Study.

WT: Should we go into how you came back to the SEC in ‘78, or is there something that we should deal with before then?

ML: I wasn't really expecting to come back, and I was surprised. Ralph Ferrara called. I was teaching at Duke Law School, and as it turned out, Allan Mostoff had left the SEC, Anne Jones had left the SEC, Syd Mendelsohn was now an associate director, and SEC Chairman Williams was trying to decide what to do. Basically, the senior management of the Division, each for their own personal reasons, had moved on. Chairman Williams felt that he didn't understand enough about the Division and he wanted to talk to somebody, so Ralph arranged for me to fly from Durham, NC, to the SEC, then still at 500 North Capitol. My memory is I did it three or four times. Maybe I did it more, maybe I did it less.

WT: What was Ralph Ferrara's position?

ML: He was executive assistant to the chairman. So we basically sat in Harold Williams's office for two hours or three hours of an evening several times over the course of maybe a month, and gave him ideas on what I would do if I were him to make the Investment Management Division work better. It had suffered from some criticism from the industry that it was stifling innovation and requiring the mutual fund industry to make disclosure that wasn't fair. You can probably imagine the normal complaints that the mutual fund industry might make about their principal regulator. And then I put it out of my mind. Out of the blue, Ralph Ferrara called me. It must have been April—maybe it was early May, because I was already planning for the next semester. As you know, in academia you're always planning at least a half a semester ahead if not more. Ralph Ferrara said

that Chairman Williams agreed with my ideas and wanted to appoint me to a senior position in the Division.

I was stunned, because I did not realize I ever filed a job application, nor did I think that one was available. So I left the SEC in 1975 and came back in 1978 as an SES-1. The effect was to elevate me over a number of people who had previously been my supervisors and I ended up being their supervisor. I think at the time I was the youngest person to ever be appointed an associate director, and I don't think anybody else younger has ever been given that job.

WT: How old were you at the time?

ML: Thirty-two, seven years out of law school.

WT: So tell me, what was your focus then? Joel was saying that he had a series of responsibilities, and that you then were the other associate director and you had the other set of responsibilities.

ML: I had the Investment Company Act Study, I had exemptive applications, I had insurance products, and I had the inspection program. The Investment Company Act Study was formed to review everything comprehensively see what could be changed or improved or abandoned, whatever the right answer was. Among other things, one of the goals was to go take a hard look at every single type of exemptive application that was done

repeatedly. The goal was to adopt a rule that would basically supplant the need for mutual funds to have to apply and for the Division to do one-on-one counseling with each individual applicant.

I think, over a period of about two and a half years, we adopted more than twenty-five rules. It meant that we were at the Commission table almost once every two or three weeks with either a proposed rule or a rule to be adopted. The theme was to try and get rid of as many applications as we could. In the conflict of interest area in Section 17, the theme was to try and find a way to make the rule dependent upon review by the independent directors, so that we could basically make the directors, the accountants, and the lawyers be the first point of contact instead of us and help carry some of the compliance burden.

When you have responsibility for so much of the Division's work, it also means that you can cause things to be handled one way versus another. One aspect was figuring out what to do to motivate people. If you're trying to find a way to make their jobs interesting, then one of alternative was to have people who had just been involved in exemptive applications go on field trips by join the inspection people. For example, travel to Indianapolis and visit a very large investment adviser, which would give a person involved in exemptive application a very real world experience, have them come back and have to write up the exam report, and then if there was something that was wrong, they got to follow up on the enforcement case. That kind of experience made being involved in exemptive applications much more real than just getting a piece of

paper from Sullivan & Cromwell and having Sullivan & Cromwell tell you what the real world looked like. It seemed like a great way to give a young lawyer who was two or three years out of law school to gain some personal experience in the industry.

In addition to money market funds, which from that perspective, was an exemptive application, we also were deeply involved in developments in the banking and insurance industries as they tried to fit into the securities laws. I always thought of that period from '78 to '81 as being just an incredibly remarkable time, because the banking and insurance people had to come and explain what their products were to the Division. A single premium deferred annuities was the product of the time, we were worried that it was the offering of a unregistered security, and the Division ended up writing a release, 1933 Act Release 6051, that was basically the law on insurance products as a security for another ten years.

WT: What did the release state?

ML: It restated the principles upon which an insurance policy would be deemed to be a security. I tried to have the SEC state policy upon which the questions would be evaluated, so that we could, again, make the private sector be as responsible for as much of the decision making as they could. So, instead of deciding whether a separate account is the offering of a security, we turned it to the opposite.

We published a release, that became proposed Rule 3a-4, that takes the position that if the level of individualization in giving investment advice to an individual investor is sufficient, then the investment advice is a personalized service even if most of the investors end up owning the same kinds of securities. Individualized investment advice means that I've looked at your financial circumstances, I've thought a lot about you, I've tried to figure out what kind of taxes you've paid, how many children you have, what your investment goals are. At the end of the day, I may decide to recommend the same securities to your, and I may decide to recommend similar securities for another investors, but the investment recommendation is based on evaluation and each person's own circumstances..

I didn't think we could ever say what a security was in the context of evaluating the legal status of a separate account. It would be too hard for Corp Fin and Enforcement because there would be too many situations where they'd want to take a different position in the context of those particular circumstances. But we could always say that the offering of individual services wasn't the offering of a security. Part of the goal was just to bring as much certainty to the area as we could. For the lawyers in the industry, uncertainty is bad because it also means your client may or may not be taking risks that they have fully understood and intended to take.

WT: So in light of that goal, did the industry view that as a successful set of rules?

ML: Some yes and some no. The releases that were issued were long, they were academic, they were footnoted, and they were thorough, and that did get comments from the industry about the Division taking legal positions in the long, careful, footnoted releases. Our goal was to write footnotes that expressed Division positions that might not have ever otherwise have seen the light of day, which was I thought a healthy thing because then everybody would know about it. That lawyer in Spokane could read a release and find out for himself the Division's positions on various questions.

Some of the rule proposals like Rule 3a-4 weren't popular because the ICI was concerned that anybody with a computer who was smart enough could provide something that would look like individualized service, but in fact it would just be an illegally unregistered investment company. I think the industry was generally very happy with the array of conflict rules that we adopted, all of which are still on the books and many of which have never been changed.

WT: So, we're talking about money market funds earlier within the context of the exemptive authority. Is there more that we want to say about this? I know this has been a particular specialty of yours, so I don't know. We talked about the different kinds of pricing of the fund.

ML: It was a good experience and a bad experience, and I think we, the Division as a group of lawyers, learned from it. At the same time the money market fund applications were being handled, the Division was processing the Vanguard exemptive application. The

Vanguard plaintiff asked for the administrative hearing to be in Philadelphia, and we ended up having to have Arthur Brown go live in Philadelphia I think for three or four months in order to prosecute it. So we realized we had a flaw in the Commission's procedural rules that allowed the protestant to decide where the hearing was going to be held. In the case of money market funds, from '75 to '76, the Commission had been very, at best, lukewarm about the use of the amortized cost method of accounting being used by money market funds. Perhaps, more fairly, they were opposed. The various Commissioners simply didn't want to let anybody not mark to market on a daily basis.

Federated Investors filed an exemptive application seeking permission to use the amortized method of accounting, asked for a hearing, got an appearance before the Commission, and then procedurally, under the rules, the only thing the Commission could do procedurally is to comment on the exemptive application or set it down for a hearing. So the Commission set it down for a hearing, and that, of course, caused the industry—essentially for everybody to want to mimic Federated. If Federated was going to get an order that would allow them to use the amortized method of accounting, then everybody else wanted such an exemptive order, too.

All of a sudden we had this open-end hearing where everybody and his brother could join, and under the Commission's rules, everybody and his brother got procedural rights. Every time a new applicant would seek to join hearing, it was if we had to start the whole thing all over again. So we had to find some way to cease adding additional applicants to the hearing so we could deal with it substantively with whoever was standing in front of

using the context of a hearing in front of an administrative law judge. I still believe it's very hard to engage in policy discussions in front of an administrative law judge. You can certainly develop facts and challenge the credibility of witnesses, but arguing policy is hard because it's not part of the normal job description for an administrative law judge. Ultimately, where we got was a negotiated settlement of the hearing with the various applicants. It was agreed that applicants and the Division would agree to agree about a set of conditions, which are basically the core of what is now Rule 2a-7.

Then, because there was a hearing, I had to ask all the applicants to give me the authority to appear before the Commission without them present, i.e., have an ex parte contact with the Commission at a non-public meeting, because I was a party to the hearing but I was going to go talk to the ultimate judges in the appellate court, if you will, without anybody else being present. The Commission did approve the negotiated agreement, and we issued exemptive orders to the twenty-two or applicants that were in the hearing, and then I think it's like '82 or '83 when Rule 2a-7 finally gets proposed and adopted so that the Division could cease processing individual exemptive applications.

WT: What was the source of the Commission's discomfort in this situation?

ML: I think they were uncomfortable exempting an investment company from marking to market. The amortized cost method of accounting causes the NAV to be stable while in the real world the actual value of the portfolio is going up and down. One of the prophylactic conditions that was agreed to would be that that range had to be monitored

by marking-to-market on a “shadow” basis. If something happened, if the actual mark-to-market NAV went too high or it went too low, then things had to happen in the sense that the board of the money market fund had to be alerted, they had to make decisions, etc.. The Commissioners seemed to be afraid that the sponsors of the money market fund would abandon the stable NAV in a crisis, undo the mark-to-market, and leave the investors holding the bag for lost principal.

Think of a trust account that we’ve set up for your children. Some of your children are the income beneficiaries, but you still have the hopes of having more children so they would be the remainderman. If you lose a penny of principal in order to get another dollar of income for the income beneficiaries, you’ve hurt the remainderman to the benefit of the income beneficiaries, and it was hard to see why that would ever be good investor protection.

As it’s turned out, as you know, the sponsors have done exactly the opposite. Every single time where the money market funds have held a security that gets in trouble or distressed in whatever way has to be written down, it’s either got a credit quality problem or a credit quality timing problem, the sponsors have stood up and made the money market fund whole. The number of exceptions—you can count them literally on one hand, and the most obvious one was in September 2008 with the Reserve Fund.

WT: So that was one aspect of kind the aftermath of 2a-7 that I wanted to ask about. Now, it’s also a fairly complicated rule, too, in terms of the prescriptions involved for the

requirements on money market funds in terms of what they can and cannot invest in and so forth.

ML: It's highly prescriptive. The original version had restrictions, but it was more principles-oriented. One of the things with rules that are highly prescriptive is that it encourages people to engage in activities that are right up to the edge of the rule, rather than say, "I know that's wrong and I shouldn't do it." Once you start down a prescriptive road in drafting a rule, you just have to keep prescribing until you've prescribed every ounce of risk out of it. The other thing about money market funds is that, originally, it was generally understood that if a money market fund broke a dollar, that's just what happened and the industry would just have to live with it. Reputational risk, however, seems to have motivated sponsors of money market funds to behave in the opposite way in fact.

You're a historian. As a securities lawyer I would say to you, if you own shares of a money market fund, what you actually own is an equity security in a corporation or a trust, and it owns ultra-short-term debt, that's what a money market fund is. A banking lawyer might say to you that a money market fund is an unlicensed lender with a lousy appetite for risk, and they would be describing exactly the same thing.

Appropriately, the SEC is always focused on, not surprisingly, is the investor protection angle of money market funds. Whereas, from a banking perspective, money market funds have supported upwards of 50 percent of all the short-term financing in the United

States, which is stunning, and has almost entirely replaced short-term lending by banks. That's because the banking agencies focus on what the money market funds buy as distinct from whether they have fully described the risk of owning shares in a money market fund. And, of course, the point of sale is where the SEC is always intensely focused.

WT: I know there was some concern as time went on that in these instances where money market funds are getting bailed out, that that would also tend to push them toward being a bit more risky as well. Is that so?

ML: When the sponsor of a money market fund has had to bail it out, there can be an interesting effect in the subsequent board meetings when the sponsor's investment management agreement is being considered. The investment adviser might say, okay, I've now bailed out this money market fund four times. The next time my investment management agreement comes up for review, I expect you all to remember that because there's only so many times I can afford to bail out the money market fund. Sometimes making a money market fund whole is not quite as painful if it's not a credit problem. Let's say the money market fund owns a security with an interest rate reset and the interest rate readjustment has lagged behind the market so there's no question that the debt instrument is going to get paid but it is currently trading below par. It could be a Federal Home Loan Bank bond, for example, so there is no question about the issuer's ability to pay but the security has an interest rate reset formula that makes it out of the market.

Ultimately, it will get paid. So the only difference between its mark-to-market value now and its final maturity value is the time value of money in terms of interest being paid so there's no principal risk. That's very different from something that gets downgraded from A1, P-1 to A2, P-2 to A3, P-3. It is true that in the earliest days of money market funds, some money market funds tended to buy A2 and P-2 and A3, P-3 paper in order to enhance the yield for competitive reasons. That is true, and it did involve taking an incremental risk on the repayment of principal at final maturity.

WT: So did you have anything to do then with the study on disclosure?

ML: Not me. That was Joel.

WT: Joel told me quite a bit about the background to 12b-1 and the rationale underlying it. Did you have anything to do with that either?

ML: Well, it was actually money market funds that were the problem. A broker-dealer like Merrill Lynch could sell your IBM shares, and it would take two or three days for the money to clear and become Fed Funds. During that delay, Merrill Lynch would keep the float, and they could use the float to pay their broker-dealers to provide shareholder services to you about your money market fund shares, even though they weren't getting a brokerage commission or a sales load.

One of the things that we kept hearing was that some people were doing was making payments for distribution that clearly had to have come out of the advisory fee, but weren't necessarily being paid by the investment adviser where we could track it down during an examination of the investment adviser or the money market fund. Often it was a parent or an affiliate. The theology about Section 12(b), and later Rule 12b-1, is the investment adviser shouldn't be paying for distribution out of the advisory fee, and the facts are pretty clear that's exactly what was happening. Joel probably said the same thing, but we had a Commission that wasn't very happy about being asked to adopt Rule 12b-1. The argument we made, Joel, Syd, Dick Grant, and I, was that it would be better to have a Rule 12b-1 that would require the investment adviser to put all the facts and payments on the table where we could see them and have the directors surveil them, than it was to have payments where we couldn't see them, we couldn't surveil them, and it was affecting distribution.

The only part of Rule 12b-1 that I can lay personal claim to—Joel and Dick Grant did most of the work—was to figure out the tautology for the no-load, direct distribution investment advisers, which is that if what the investment adviser is being paid is a legitimate profit within the meaning of Section 36(b), then whatever the investment adviser pays for distribution is permissible, because the investment adviser could have paid higher salaries, could have rented space in a bigger building, could have done all sorts of things. It's the investment adviser's choice, rather than keep the money, that it invests its legitimate profits back in to the business by paying for distribution in lieu of adopting a Rule 12b-1 Plan.

The problem, of course, was that money market funds that were being sold with no or small sales loads were being handled very differently than, say, a T. Rowe Price or a Dreyfus whose mutual funds were offered on a no load basis. Those no-load advisers had no revenue source from which to pay people to continue to give investment advice other than the investment advisory fees. We had the intellectual problem of explaining why a no-load investment adviser could pay for distribution out of their own resources, but it would be illegal for somebody without a 12b-1 plan to pay for distribution. So, I'm the creator of that long paragraph that explains the tautology.

WT: Another thing that I understand you were involved with was the business development companies, the provisions for them, the Small Business Securities Act Amendment of 1980, if I have that right.

ML: A number of venture capital people, and some specific SBICs, were unhappy with the way they were being treated by the '40 Act, and they did not think they could exemptive orders that would address their issues to their satisfaction. So, they captured the attention of Senator Tower, the senior Senator from Texas, and he put a hold on the SEC's appropriation. If I remember correctly, it would have been the first time ever that the Commission would have had an appropriation for more than one year. It was going to be a two-year appropriation. Of course, anytime a Senator puts a hold on the SEC's appropriation, the whole agency is looking right at you to solve his problem so he will lift the hold.

I got instructions from Harold Williams, and Commissioner Steve Friedman was designated to be my mentor. Steve and I went over to the Senate and started negotiating with representatives of the National Association of SBICs, and a lawyer representing the National Venture Capital Association. That lasted from April through September, and during that six months, my job was to do my regular job half of every day, and half of every day was to work on legislation that would be acceptable to that group of people, because until we got something that was acceptable to everybody, the Senator from Texas was prepared not to remove the hold on our appropriation.

It meant, in a very hot summer, walking from 500 North Capitol all the way over to the Senate and back. It also meant getting home at eight or nine o'clock every night, which wasn't much fun. I had a new baby. But at the end of the day, what we came up with, the so-called BDC rules, are a package of provisions that, leaving aside the fact that they're attached to the Investment Company Act, would have been the prophylactic restrictions and conditions that we would have arrived at had someone been willing to file an exemptive application, and had we had to give them an order. That was the metric I used to determine whether the specific issues that they had were fair, or whether they were unusual.

The reason they have a different scheme is because it was argued to us that they have a different business. Whether it's Fidelity or Dreyfus or Vanguard, they rarely have anything to do with management of a portfolio company. Whereas with a venture capital

fund, one of the things they do is help some guy who's created the new drug to cure cancer, wears a white coat, kills mice, does experiments, but has no idea about marketing or finance. If the venture capital fund provides the seed capital for his venture, then he needs help to get his idea to somewhere where he actually has a viable operating company. The venture capitalists swore up and down that's what they did, so we exempted them. Among the things that they were exempted from were all the concentration and diversification requirements in the '40 Act, as distinct from the Internal Revenue Code, so that they could basically concentrate in just venture capital-type investments.

But the price was that the legislation had to be about who puts money in America. So the thing that made it work politically was that the BDC had to buy stock in a start-up company. They couldn't buy stock of that start-up in a secondary market. They couldn't buy stock in a public company. So they could buy stock or debt, we didn't care how the BDC financed its portfolio companies, but the idea was the start-up company was technically or practically incapable of financing itself through the normal markets or the normal credit sources, and the BDCs were going to be the alternative.

WT: Was this something that had at all been on the SEC's radar prior to this?

ML: From the standpoint of being criticized by the small business community and the venture capital community that the Division wasn't being helpful to them, yes. In fairness, they hadn't presented a story that could be heard that was different from the story that mutual

funds were telling, and it was hard to see why they needed exemptive relief that was any different, because the investor protection concerns were the same. So, in order to give them some help on the conflicts of interest, we let the board deal with conflicts of interest where the conflict was remote, but where the conflict was direct the BDCs still have to come to the SEC the same way any mutual fund would have to. Rule 12b-1 was the first time a rule required that an investment company have at least 50 percent independent directors. BDCs, by law in the '40 Act, must have at least 50 percent independent directors.

WT: Unless there are particular legal issues that you think that we should talk about from this period, I was wondering if I could ask some just general questions about the people around you, Syd Mendelsohn in particular, but if we should stay on a legal side of things...

ML: I was looking at what was left. That's fine.

WT: All right. I understand that Mendelsohn had been there for quite a long time.

ML: Did Joel tell you that he started out in the mailroom as a messenger?

WT: No, I don't think he did. Maybe he did, I'd have to check the interviews.

ML: They were good personal friends, but that's where he started out. So we're talking about a guy who went to law school at night, and I can't remember whether he went to GW or Georgetown. He was at the SEC during World War II, so part of the time was in Philadelphia, and he was at the SEC before it was at 500 North Capitol Street, so he'd been there, literally, forever. He commuted from Silver Spring with three other people who were very much like him, from the old school. And because of the way he grew up, Syd had very good judgment about what was right and wrong, and the arguments that you could accept and arguments you couldn't accept from the industry.

He'd done enforcement cases with Dave Butowsky, and had been involved in the cases against Roy Cohn and Fifth Avenue Coach Line, so he had an enforcement mentality. I think anybody who knew him knows that he was a completely loveable person, but in terms of social graces, or ability to write, or ability to communicate—like using President Obama as the standard, which is very unfair—that wasn't him. So we all enjoyed sort of treating him as Uncle Syd. I don't think anybody ever called him that, but he got more than his fair share of practical jokes played on him, because he was the perfect foil.

My personal favorite was every now and then we'd all go over to the Grand Hyatt that's right across the street by Georgetown Law School, and Syd was always a very modest buyer of things at lunch. The Grand Hyatt was a little above what he figured was an appropriate expense for lunch. So we'd always try and get his wallet out on the table so we could make change, because it was only fair to pay the waitress in money, not in multiple credit cards. If we could do it, we'd try to get a twenty out of his wallet and

make sure that no more than five got back. He never bought anything that was more than five or six dollars, so we were clearly bilking him. If you just moved the money around fast enough with everybody cooperating, we could effectively get twenty dollars out of him for a lunch that was maybe only five. At one point, he started bringing along Gene Gohlke and making him bring along his pocket calculator, because he knew we were screwing him but he couldn't quite figure out how we'd managed to do that.

He was also famous for hooking up his trailer to the back of his—I can't remember what kind of car he had, but dragging it all the way from Florida for a six-week vacation. When you're the age I was at, the idea that you would take six weeks off was just extraordinary. But he and Stan Judd had both worked there so long that they were entitled to six weeks. In the government, if you go away for six weeks, normally, nobody else does your work while you're away. It's there waiting for you when you come back. So we would always try and have a little surprise for him when he'd come back.

A couple of times I pretended to be Ralph Ferrara or the Chairman and wrote him a hoax memo, and then we'd leave it on his desk, and then tell his secretary that she wasn't allowed to call anybody. His hands were so big it was hard for him to use the dial on phones, so he would usually just yell at his secretary to tell her to call somebody. He would read, and you could see his eyes go across the page just like an old typewriter would when he was reading letter for letter, word for word across the page. Then you could see the color come up in his face. We'd always make sure we were in the room when he was reading the hoax memos so that he wouldn't actually do something.

But my favorite—when he was away, one time I made up a memo where I was pretending I was Harold Williams, and I changed the inspection program so that somebody from Inspections always lived in the largest broker-dealers and mutual funds. Since that's where the largest problems were, it made sense to have somebody on site. I changed the name of the division and put a semi-colon in the middle of it, which gave it a silly name. Just things that no one ever would have done, and they were all sort of ridiculous, sort of in the nature of April Fool pranks. It was always fun that way to tease him. He was an extraordinarily nice man, and he had just very good judgment.

WT: Bringing up the area of Inspection and Enforcement, maybe you could tell me a little bit about the activities of the division in that time. I understand there wasn't a whole lot of enforcement activity. Could you just give me kind of a perspective on what it was like at that time?

ML: We had some '40 Act cases. Some provisions of the '40 Act prohibits the mutual fund from doing a principal transaction with an affiliated person. So if the affiliated person has caused the mutual fund to violate something only the mutual fund can violate, you basically have to prove the case against the bad guy. The mutual fund is the victim, even though it's the thing that's actually, from a statutory standpoint, has done the violation. It made a lot of those cases very unattractive. If you just think of it from a headline standpoint, it was very hard to convince the Enforcement people that that was where you wanted them to spend their time.

When inspections were part of the division—and from a zero-based budgeting standpoint we had to be responsible for the compensation paid to inspection people in every single regional office—we got a lot of cooperation from the regional offices. When we first were concerned about money market funds and what they were buying, Syd would insist that all the various inspection groups, New York, LA, Chicago, all of them go look at the money market funds in their districts and we can get like an instant survey. It was like having, literally, boots on the ground. So from that standpoint, it was wonderful.

Syd had been involved for years in doing educational programs. So part of it was outreach to the regional offices, part of it was education to the regional offices, part of it was also helping, being an agent or an advocate for the regional office when the inspection would come back as an enforcement case. There were a number of situations when we used the inspection system to get to something that would have been very hard to persuade the Commission to do on the merits if we'd just gone upstairs and said this is the regulatory proposal. People know the story, so it's not unfair to tell it.

The San Francisco office had a mutual fund that had basically sold its Treasuries and bet on Treasury futures. The Treasury futures were outside the investment adviser's investment objective, so he was out of bounds by any standards. Virtually all the futures went bad on the same day so the mutual fund lost—this is from memory --forty percent of the net assets in the fund on one day. It was spectacular, and it was a fraud, but it wouldn't have advanced the jurisprudential ball at all to call it a securities fraud. Because

the investment adviser had a defective prospectus, we weren't going to teach anybody anything new if we handled this situation as a fraud case.

What we did was slow down the enforcement case. The regulatory problem was that he'd bought something that was a future without setting aside money to have to pay for it, in effect creating a senior security in the nature of debt. We used that as the basis for writing Release No. 10666, the derivatives release, and because it involved an enforcement case, we could talk to the Commission about the release and the enforcement case at the same closed meeting. We could show them a real-life situation where an investment adviser had done exactly what shouldn't have happened, had the release been in place, and we were able to get the Commission to publish the release.

Then we also thought about what we wanted the release to be. We couldn't sue the California investment adviser for violating a release; what we had to do was announce principles. If we announce the principles, then if you were a lawyer in the industry you'd say, "Oh, the SEC is very concerned about mutual funds and derivatives and we have to have these set-aside accounts. We have to mark to market, we have to do this, we have to do that." By issuing the release, we could encourage pro-active behavior on your part. Two months later, the Commission announced the enforcement case, and now you would call your clients and say, remember when I told you two months ago, they're really concerned about derivatives, well look what they did to this guy.

I always thought it was really helpful, from a number of perspectives, to have the regulatory people work hand-in-glove with the inspection people, because then you could use them like your foot soldiers, but you could also use the cases that they would find to make larger principles and teach the Commission about the problems that needed to be dealt with, too.

The last bullet you've got here is that the Carter years were a deregulatory time, and that's true, and so if you marched upstairs to the Commission table and said we want to make this a harsher regulatory environment, it was a hard world in which to make that happen. But with Harold Williams, in particular, if you told him what the problem was, and you gave him a way to think about, say six months in advance, then by and large we were able to prevail at the Commission table. To me, that's just the best way government works. You find a problem, you figure out a way to package it so that you can get a yes, and then the package gets published, and people in the real world do what you want.

WT: Did the resources that you have for inspection have anything to do with the work you were doing with the study in '78 and the desire to put more on the lawyers and the accountants?

ML: Yes, they were tied. We had some of the people working on the Investment Company Act Study group do inspections. I've forgotten which office it was, I think it was Chicago—we were able to get somebody from one of the regional offices involved in one of the Investment Company Act Study projects. I just can't remember which person,

what project, but we deliberately tried to spread the wealth around so that everybody could have a different kind of intellectual mix of things they were doing.

At the semi-annual meetings we had with the inspection people, usually one or another of the regional offices would be the host. So if it was New York, maybe we'd end up in the Adirondacks, and everybody would go there. If it was Atlanta, we'd be somewhere in the Atlanta suburbs. Then we'd use those experiences to teach, so that the regional offices felt like they had somebody in at headquarters in Washington, D.C., who was helping them. They also knew exactly what we were thinking, what we were doing, so in their own jobs they could anticipate there would be an interest, that the home office would be very interested in knowing if there were problems in the money market funds, for example. They understood that if they were to identify a problem, raise your hand. I thought it was, again, the best way government works, where everybody had the same mission, same goal, and we were working hand-in-glove together.

WT: So were they pretty hard-pressed then, at that time, just in terms of the number of them versus the number of people who they had to oversee?

ML: We had zero-based budgeting. I've forgotten whether the inspection cycle for investment advisers was once every five years, or once every eight years, or once every ten years, but it was abysmal. The inspection cycle for mutual funds was much better. One of the things that we tried to do was use the adviser inspection cycle to create Advisers Act enforcement cases that would be decided as Advisers Act fraud. Stanley Sporkin didn't

care, as long as you just said the fraud words, he didn't care whether you charged Rule 10b-5 or you charged a violation of Section 206(1) or (2) under the Advisers Act, and we used that to start creating good enforcement jurisprudence that was Advisers Act-specific.

It made a huge difference to us to be able to be able to cite Section 206 and the fiduciary duties there that were specific to investment advisers that the inspection people could enforce. It's the same thing you've been seeing in newspapers for the last couple of years, the same things that the inspection people have been alleging with respect to the private equity advisers, is the law that we began developing back then.

WT: So, you mentioned the kind of general deregulatory atmosphere under Carter. Now, of course, that changes under Reagan to become stronger, and he appoints John Shad as the Chairman. Did you stay for a little while when John Shad came? I know that was in '81 that you left.

ML: I left in May, early June of '81, and I don't think I overlapped with Chairman Shad for more than three or four months.

WT: Joel was saying that he was interested in getting rid of the '40 Act and all that.

ML: At the philosophical level, when an agency has a permanent staff or a permanent bureaucracy, one of the things that happens is when somebody new comes in at the top, a political appointee says "I want to do this or I want to do that," almost always it's

something that the permanent staff thought about or has dealt with before. And so they can say, no, no, no, if you do that, these bad things will happen, or, we did that in 1945 and this bad thing happened. Chairman Shad didn't seem to be deterred by that sort of institutional memory.

I don't know if you know anything about Rule 415 and shelf registration, but the idea was that an issuer or underwriter would not do the kind of due diligence that everybody had done since 1933. Chairman Shad, in 1980, he just couldn't understand why a debt security had to go through that kind of process. So he was the one who proposed shelf registration where the issuer can file a registration statement, and on a moment's notice declare it effective and sell it on the market that day. So Chairman Shad's willingness to override institutional memory caused the SEC to be much more responsive to the market.

I've always thought that if the Commission that had had that question was the one that I worked for from '78 to '80, they would never have done it because those were traditional securities lawyers who absolutely knew what due diligence was. They would have thought that shelf registration was ridiculous, but Chairman Shad was from a different era and a businessman, so he was trying to find a way to make things happen, better, quicker, cheaper. From a Wall Street industry perspective, that made him a very different Chairman.

WT: Is there anything that you'd like to cover that we haven't discussed, because then I think I'd like to transition into your post-SEC career.

ML: I'd say '78 to '81 was an extraordinary experience, because things were changing everywhere. For the first time, the mutual fund industry had, in that sense, a brand new product with money market funds. There were brand new insurance products with single premium deferred annuities. We had a brand new player in the market, meaning the banks. And we had pressure from the venture capital guys on the other end of the Investment Company Act. There's probably somebody else who served at the SEC in some other period of time who can claim that their period was more intense, more interesting, more challenging than mine, and I know that it's sort of silly always to say that life was better way back then. And I'm not sure life was better, but life was challenging.

WT: So you did then leave in '81?

ML: Yes.

WT: Did you have any notion of staying for more than a few years, or why did you leave?

ML: I didn't go back in 1978 with any particular time frame in mind. I would have been perfectly happy staying at the SEC for the rest of my professional life. However, I thought I had achieved everything I wanted, and I wasn't sure that I would be as comfortable with the administration that John Shad and his Commission as I had been with the Harold Williams Commission. In particular, Steve Friedman had been a very

good friend to the division and very helpful—a very clever, smart guy, had been at the Treasury, he’s very knowledgeable, a former Wall Street lawyer. I just didn’t think I was going to be in quite the same group.

WT: I probably should have asked about your experience with other Commissioners as well. Is there anything more to say on that, or have we just covered it?

ML: I think we all knew which Commissioner was a Republican and which Commissioner was a Democrat, and we knew the story on how they got appointed, most of them, because they weren’t big secrets. But I don’t ever remember thinking we need to cast this project in these tones in order to capture that Republican Commissioner’s vote. They worked together then very collegially. If they weren’t, it certainly wasn’t visible to the rest of us.

Even if they came, like Roberta Karmel, with a particular point of view, if you were telling her something that was essentially right and in the consumer’s best interest, she would be as quick to get behind it as anybody else. I can’t remember a single thing we got turned down on that we wanted that was the result of a Commissioner’s politics. The Division did get instructions from them that were inconsistent with what the industry wanted, which meant that we found ourselves fighting for something that we didn’t, as a group, necessarily believe in. But that’s the boss’s right, and if you think he’s wrong, you’ve got to go persuade him.

WT: So then you went to private practice, I think, for the first time in your life after you left the Commission.

ML: I looked for law school jobs, and I didn't find anything I liked. At the time, I had a brand new baby and I kept thinking about growing up where you could throw a baseball to your kid in your own backyard. We liked the house we were living in in Chevy Chase, and liked living here in Washington, D.C., so after not liking the academic choices I had, I looked for law firms. And you're right. I started out as a partner in a Philadelphia law firm in their Washington office. I'm probably the only person you're going to interview who was never an associate in a law firm. I started out as a partner, which is wonderful. I never had to live through what associates think is agony.

WT: So how was that transition for you? Was it a fairly simple one moving from IM into, I presume most of your work was in that same area of a private practice?

ML: It was representing banks trying to get into the mutual fund business. It was representing different kinds of mutual funds. I think you would be disappointed if, when you leave the SEC, there's a group of people who are ready to hire you. Because it means you haven't been terribly objective and thoughtful and careful about the way you did your job when you were with the SEC, and I always tried to be just as scrupulously fair and precise as I possibly could be, and I got lucky. In my personal practice, I've always had work come looking for me rather than having to go looking for work. So I was busy, literally, from

day one. I showed up for work at 9:00, and I got a call at 10:00 from a large client with a great project. So I was busy from the beginning.

WT: So, tell me about the evolution of this relationship between the banking sector and the mutual fund sector moving through. Before, we brought the story up to that 1981 period, some of the Supreme Court cases that were decided around that time. Of course, it continues to be an erosion of the barrier between those areas right up until the Gramm-Leach-Bliley Act, or maybe it was pretty much gone by that time.

ML: Exactly. The way life worked out for me, I represented banks in trying to help them and teach them how to be in the brokerage business, and how to be in the mutual fund business. It helped to be able to speak banking to do that, because then you could speak their own language to them and explain what they were doing in their trust department and how it matched up to what they would doing in a mutual fund.

In 1983, I think is the year, I also got asked to represent the insurance industry. So for the next fifteen years, I sued either the Federal Reserve Board, the Comptroller of the Currency, or the FDIC on behalf of the insurance industry whenever those banking agency let banks engage in some activity that would let them be involved in the sale or manufacturing of insurance. It's very unusual to get to represent an entire industry on a question. What it means is that everybody in that industry is looking at every word you write, and they've all got something to say about it. So you have to really be careful with

what you're doing. It also means that you are rolling the dice for a whole lot of people and a whole lot of lives, and a whole lot of fortunes.

So, for the fifteen years that we represented the insurance industry. If you look over your left shoulder, you can see the feather that is what you get when you go to the Supreme Court, and I got to be second chair in the so-called second *VALIC* case. It is quite a privilege when you can represent an entire industry. Later I represented the American Bankers Association. From time to time, I've represented the Investment Company Institute, and I've represented other kinds of trade associations and similar groups. Representing trade associations is a trick in itself, because you are talking about an entity that has a life, but it also has members, and the members also have interests, and the interests aren't always the same because the members compete with each other.

WT: From a legal standpoint, what are some of the highlights of the whole history of this area? Are there particular cases that you would view as particularly significant?

ML: When you teach this, of course, you can teach it through the legal issue as it evolved over time, which is not the way life actually happens. When you're living through the experience, you have to adjust to the legislation, cases, or things that happen in this year, and in the next year, then the next year, and the next year, because it's all chronology. If you can teach it, you can focus narrowly on each activity. So when I taught the Gramm-Leach-Bliley class at Duke and now at Georgetown, the students would read the four cases that allowed banks to get into the investment advisory business. That's the first

class for two hours. The second class is read the four cases that allowed banks to become broker-dealers. That's the next segment. Then the last one is underwriting. Then, because there's the same sequencing in insurance, it basically takes three more segments, two-hour classes, so you're half a semester teaching how banks got involved in the mutual fund industry, and how banks got involved in the insurance industry. Almost 40 years of important economic life crammed into six teaching segments!

Then you can flip the mirror and look at the other side. If banks were trying to cherry-pick somebody else's industry, they should want to be an investment adviser, a broker-dealer, or an insurance agent, because those are basically riskless in the larger sense of the word, and they are steady streams of income if you're successful in selling products.

On the other side of the fence, you're Merrill Lynch, you look at banks and you say, what have they got that I want? You say, wow, how do you go about getting deposits? I'd sure love to be in that business. Nobody ever wants to be in the commercial lending business. But of course, the consumer lending business, with 18 to 26 percent usury limits is also a really attractive thing.

The other side was the creation of non-bank banks and all the non-bank bank businesses, and the unitary savings and loan holding companies, and all of the situations that these days it is fashionable to call the "shadow banking" system. But it's basically just another financial institution doing an activity that would be part of the definition of bank if you looked in the banking statutes. Of course to work in this area required that you be

conversant in the industry that wanted to know about the other industry, and you had to be conversant in the industry they wanted to know about. So being able to be both a bank securities lawyer for banks and a bank securities lawyer for mutual funds was great fun.

WT: Given everything that had happened before Gramm-Leach-Bliley, was there anything in particular that Gramm-Leach-Bliley changed in this environment?

ML: The principal restriction that had grated on banks was the so-called Section 20 affiliates. They were broker-dealers that were affiliated with bank holding companies, but the Federal Reserve Board limited the amount of underwriting the securities affiliates could engage in so that the banks weren't in violation of Section 20. The limits were necessarily arbitrary, and not all the regional banks were large enough to create a securities affiliate. The very biggest of the banks, let's say the five or six biggest, could move over to the securities affiliate a big part of their commercial banking business, they could move over their Treasury business, and they could move over what would be called "good" underwriting in order to engage in what was called "naughty" underwriting. The smaller the bank, there was less of the treasury business to transfer, therefore, the less of the naughty underwriting that the smaller bank's securities affiliated could do. So it was basically a big bank versus small bank divide without the Glass-Steagall Act meaning to be that way.

The big pressure was, of course, Citibank acquiring an insurance company and wanting to be able to own the insurance company. The way they did it was to have the insurance

company acquire Citibank. So the insurance company was a brand new, newly registered bank holding company. Citibank was the acquisition target. That meant that the insurance company only had to get permission from the insurance commissioner of the state of Connecticut for approval of its acquisition of Citibank. Citibank had to get approval from the Federal Reserve Board, and it now had a brand new bank holding company sitting on the top of the corporate structure.

The existing permissions of the Bank Holding Company Act grandfathered all of the non-banking activities in which the insurance company was engaged for three years, and that statutory grandfather would allow the insurance company to divest the non-banking activities slowly. That transactions happened in 1998, so there was huge pressure to not let three years of grandfather run and watch the two companies have to come apart. The Hill was pressed very hard to adopt the financial holding company provisions in the Bank Holding Company Act that allowed that transaction to exist. It was legal anyway, and “grandfather” allowed the combined company to exist until the legislation could be enacted.

Then, of course, you saw a number of transactions right after that where Schwab bought U.S. Trust, for example, where the business model of the 2000s was, “I like what I’m doing but I need what this other activity, too, but that other activity is a banking business where, if I buy that company then I have to become a banking holding company. I don’t want to be that.” When both Morgan Stanley and Goldman Sachs registered as bank holding companies, and the Dodd-Frank Act created the new category of SIFIs to

describe Morgan Stanley, Goldman Sachs, GE Capital, and AIG, it was recognition of the fact that each of those companies were engaged in activities that would have otherwise required them to be bank holding companies.

WT: While you were at the SEC, there was a growth in retirement funds, IRAs in particular, but that becomes much greater after you leave in the '80s and '90s and of course later. What were some of the key issues that would have come up with that development?

ML: During the '78 to '81 period, or after that?

WT: After that. Well, if you have anything in particular to say about that period.

ML: In 1940, when the '40 Act was adopted, there were no collective investment funds for pension plans. Common trust didn't even exist for banks until 1933. There was an exemption in the '40 Act for a specific pension plan and a related trust, but not for a commingled investment fund for pension plans. There was a lot of discussion in the 1960s about what ought to be the rule for pension plans. It was argued that, if it is going to be permissible for banks to have collective investment funds for pension plans that aren't required to register as investment companies, then it needs to be permissible for insurance companies to commingle pension assets in separate accounts, too.

And so in 1970, Congress amended Section 3(c)11 so that it worked reasonably well, but it took until the '80s for the other statutes, the '34 Act, or the '33 Act, to get the parallel

exemptions for common trust funds and collective investment funds so that all of the statutes matched up. I'm pretty sure it's NSMIA that conforms the '33 Act, '34 Act, and the '40 Act so that they all have exactly the same definitions. Prior to that time, literally for fifty years, everybody had worked with inconsistent definitions, knowing full well that the SEC was not going to do raise objections if if you just did what the Investment Company Act permitted.

The big surprise, of course, was IRAs and then 401(k)s. The legal theory for excluding pension plans from the securities laws was that the person who was making decisions for the pension plan was a corporate treasurer, and he was a sophisticated investor on behalf of a sophisticated company. Employees just got defined income payments when they retired. The employees weren't involved in the money management aspects of the pension plan. When Congress added IRAs and 401(k)s to the Internal Revenue Code, human beings were now choosing investments for their own pension plans and the investor protection that would have been there, with the sophisticated treasurer, just didn't exist, and the '40 Act never caught up to that.

WT: So what were the consequences of that, then? I won't ask you to comment on the whole industry, but maybe just on the legal aspects of dealing with this area.

ML: Well, the 1992 study spends an entire chapter trying to sort out the rationality of the different ways in which IRAs are different from 401(k)s, are different from guaranteed payments plans, from defined benefit plans, from defined contribution plans. How each

of those plans is treated depends on what part of the law applies to it. A large amount of the money has moved from a situation where there was a corporate treasurer responsible for it and a defined benefit being paid.

It's easiest if you just think of a teamster. He's going to get defined payment of \$500 a month under his pension plan. It's the institutional investor's job to make sure the money is there to pay it. The pension environment went from that to a defined contribution plan for somebody at a law firm who said, I want to put in fifteen percent of what I make and I'm going to invest it and let's see how it all comes out. The first guy really has a pension. Somebody like me really has no pension; my "pension" is totally dependent on how good my investment acumen turns out to be. No one's going to give me a dollar when I retire. Whatever I've saved is all I've got. So it's my defined contribution plan that has made the difference for me, and nobody's invested the money but me.

The magic of people dreaming up different kinds of investment models got way ahead of Congress. It is often easier for the mutual fund industry to compete in the retirement market, because all the mutual fund industry has to do is put more disclosure in the mutual fund prospectus. If it's a security, then it's not a banking product, and then the banks have to do something very different—same thing with the insurance companies.

WT: In the money market area, of course, Dodd-Frank is probably the most significant legal event in this, but I don't want to constrain your comments to that. What have been the developments there that you would like to highlight?

ML: If this was a corporate finance class, you would be talking about the equation $Y = a + b$, and “b” would be volatility, and “a” would be diversification. If there is perfect diversification, then “a” is zero and if the investments perfectly match the volatility in the market, then “b” or beta is 1 and the formula would create a graph that would have a diagonal line right from the bottom left axis to the top right corner. You’re not taking more risk or less risk.

That model is what we had in mind in 1980 when we were trying to figure out how to regulate money market funds, and we tried to get the “alpha” to be zero by making sure that money market funds could only buy A1, A2 commercial paper. We tried to make sure there was no alpha risk in money market funds. We tried to take care of beta by making sure that the money market funds couldn’t own a security that was longer than 360 days. The average weighted portfolio security had to be 120 days. As always will be true, the competition in market caused money market funds to find ways to buy debt instruments that would be technically in compliance with the rule, but would allow investment advisers to take more risk, and therefore get more yield.

The other way of thinking about this is that the very first tax-exempt money-market funds bought the last 90 days, 120 days, or whatever on what had been a five- or ten-year municipal bond. That was crazy, but they had to buy something that was that short in order to satisfy the amortized cost method of accounting rules. The market reacted to that by creating demand notes that basically were a brand new thing for the municipal bond

marketplace, solely as a result of the portfolio construction needs of tax-exempt money-market funds. I live in Montgomery County, Maryland, and assume the treasurer of Montgomery County decides that the county needs fifty more school busses, and that the county needs at least five years to pay those off. So the county could issue a five-year bond at five-year interest rates. As a taxpayer in Montgomery County, that's a general obligation bond, I have to pay it off. The buyer of that bond gets the tax-exempt income.

What if the county could issue a five-year bond, but it had interest rates that reset every thirty days or every ninety days, and the municipal bond had a put that allowed the owner to put the bond back as the buyer every ninety days if I wanted to. What that means is that the county is able to borrow money for five years at the interest rates for a thirty- to ninety-day bond that has the legal ability to matures every ninety days.

This represents a wealth transfer from wealthy people to every municipality and every taxpayer. What the municipal bond owner has done is eschew a higher interest that they could have earned to get the stable NAV from the money market fund. The lesser interest they will receive in the form of dividends from the tax-exempt money market fund is worth it to them in the trade-off for daily liquidity. That's just an extraordinary change in the market that tax-exempt money market funds caused.

With money market reform, one group that was complaining, if they lost their ability to raise money through tax-exempt money market funds, were municipalities, because they depend upon tax-exempt money market funds to buy their instruments to basically sell

them to people like you and me who want tax-exempt income. Securities lawyers tend to focus on what the SEC looks at, while the market tends to focus on money market funds as a source of financing. In this case, the market was the treasurer in Montgomery County who was trying to buy five busses and this is how he's going to do it. It's extraordinary that what we look at as the sale of interests in an investment vehicle has huge implications in the market. That's really just remarkable.

WT: As part of the study in '78 of the '40 Act, you're putting more on the independent director, and that's something that increases through time. And ultimately the SEC, particularly under Arthur Levitt, becomes very interested in increasing the responsibilities of the independent directors. What can you comment on as far as that and the SEC's rules in the mid-2000s on making it so the chair has to be an independent director in order to receive an exemption? Is that correct?

ML: Yes. Mutual funds by law have to have independent directors, and by law at least 40 percent of them have to be independent. Mutual funds are different from any other kind of entity that you've ever known about. They're not the same as foundations, they're not the same as universities, they're not the same as for-profit companies, because everyone who works for a mutual fund is actually employed by an entity that's not the mutual fund. The only people who get Form 1099s from the mutual fund are the independent directors. Everybody else works for somebody else, so all the relationships are there by contract.

In a regular company, IBM, Microsoft, Google, whatever, there's a board of directors on top, and there's a clear distinction between a being director and being management. From the beginning, Congress got it, that there's always a conflict between the investment adviser and the mutual fund over the terms of the investment management agreement. If you did it in law and economics terms, you'd say that the adviser wants to provide the worst investment performance possible for the greatest amount of money possible; from the perspective of a director, you'd say that the mutual fund wants to pay the least amount of money possible for the best performance possible. Well, nobody really wants both of those extremes, and so that's why you end up with some bargaining that's in the middle, but their positions are literally adverse.

In the '78-'81 era, we were trying to focus on the things where there was a real conflict. What directors can bring to the party is an ability to evaluate a conflict of interest. If they are ill at ease at trying to figure out what standard they should apply, then it's easy for the SEC to say, "well, the standard for that kind of conflict is fairness, or the standard for that kind of conflict is no overreaching on the part of any person concerned." The SEC can set standards like that that make it easy for directors to make decisions subject to the business judgment rule. If they make a mistake, but it's just a business decision.

We tried to stay away from involving independent directors in things that were more properly the responsibility of management. Release 10666 that imposes segregation

requirements on assets in order to invest in derivatives doesn't impose any specific responsibilities for independent directors in it. It's all an operational management responsibility, not a directorial responsibility. I'm not saying they don't have oversight, but they don't have anything to decide other than general oversight. I thought that was a very clear distinction, and a very rational one, given the mutual fund model. Whatever caused Chairman Levitt and Chairman Donaldson to decide they needed more corporate governance, I don't know. Clearly, that's the era of mutual fund scandals. It's right after Canary Capital, the market-timing scandals, and all the enforcement cases that were brought between 2000 and 2005.

WT: Although Levitt was emphasizing this even before that.

ML: You can count the number of cases the SEC has ever brought against mutual fund directors on one hand, and they all involve personal overreaching, or personal egregious behavior. They don't just involve bad business judgement. So it was a little hard to understand quite where Chairman Donaldson was going with the corporate governance rules. I thought that the evidence that the SEC had the statutory authority to increase the requirement from the statutory 40 percent to 75 percent was thin, because Congress had thought about the idea of having more than 40 percent independent directors and had expressly rejected it.

I wasn't upset when the D.C. Circuit said that the corporate governance rules were a bad decision. I didn't think it was well documented, even if they had the statutory authority.

A number of the rules that the SEC adopted in the 2000s I thought were equally flawed, in that the SEC seemed to be working backwards. They seemed to have decided what the result was going to be, and then try to create cost-benefit or other analysis that would support it. Currently, the liquidity release, the derivatives release, and the pricing release give independent directors an enormous amount of responsibility.

If you were my client as an independent director, I think I could look you in the eyes and say I have no idea how you're supposed to satisfy that new responsibility. And what, exactly, do you know about the markets that makes you personally capable of making that pricing or liquidity decision? If you say, "I don't, but I hope you will," as a lawyer I'm in the same place you are.

Matt Fink has written several articles about this recently, and he's right. We did send the Commission down the path of putting more things in the lap of the independent director. But they all had a conflict of interest element in it that was different than just supervising management decisions. To me, even with a mutual fund conflict structure, the external investment adviser structure, there ought to be something that's management's job and management's alone that's only the subject of oversight and not direct decision making by the independent directors.

WT: In terms of the decision to contest the rule on the basis of cost-benefit analysis—and of course this has been used in other areas as well—is that something that was particularly

justified in this case, or do you think that it was just part of a general, novel strategy that has been used against the SEC and has just happened to come against this particular rule?

ML: Don't forget that there's a lot of people who can't win fights on the Hill for whatever reason. One way you can win a fight that you can't win on the merits is to switching it from the Hill, where there is no such thing as due process, to an administrative agency, but then tilt the scales on what is due process by making the cost/benefit analysis really, really hard to do. The securities laws are almost unique in that the mission that's given to the agency, of course, is to protect investors and get full disclosure, but it's also to make sure that we have better markets. Some of the decisions the Commission has to make, it's may be very hard to explain why the rule to be adopted will make the markets better.

It's also really hard to explain the cost/benefit analysis when Congress has told the SEC, "You must adopt this rule." If Congress has told the SEC that, "You must amend the '34 Act to require every issuer to explain whether or not they have anything to do with conflict minerals," Congress might as well ask the SEC to require issuers to explain if that company's got anything personally to do with climate change, or global warming, or human slavery, or any other issue you could think of. Those are all interesting and challenging situations. They may be morally, ethically, or politically interesting questions, but from a securities lawyer purist perspective, what Congress has done has hijacked the disclosure process to cause companies to have to make disclosures about things that have very little to do with the materiality of running their business.

The disclosure process may not be the most effective way to police that behavior. It's probably just the most embarrassing. If disclosure is a requirement, then when a company fails to meet the requirement, whether or not it has anything to do with the business, whether it would have been material fact but for Congress meddling in it, the securities enforcement process becomes trivialized.

Let's take the fixed index annuity insurance case just as an example. The Chairman decided, right at the end of his tenure, that he was going to do something for seniors that was going to be memorable, so it was going to be stop this kind of fixed index annuity contract from being sold to seniors, and one way to do that was declare that it's a security. The consequence of that is, instead of having the insurance laws apply, the securities laws apply including all the fraud provisions, but it also means that the insurer has to file a prospectus with the SEC, and you the customer now are going to have to look at a list of fixed index annuity prospectus that's one foot thick, setting forth all of the assets held in the insurance company's general account that supports the promise in the fixed index annuity contract. I dare you to tell me that that's a meaningful disclosure to you, and having stared at that list of investments that is over a foot of paper, you'll have any idea what you're doing.

The way it got argued was, of course, that a prospectus would be better than no prospectus. Well, I suppose that's true. I don't know how you disprove it, but it's very hard to say that empirically because nobody tested whether it would be true. The SEC staff didn't have some sort of focus group say, if you got a prospectus would you be

happier? There was no empirical proof. They just assumed the truth of it. So not surprisingly, the D.C. Circuit said that was not a cost analysis that they would defer to.

At this point, partly through their own processes and partly as a result of the cost/benefit analysis requirement, the SEC staff has gotten to a place where the D.C. Circuit is a very hostile environment for them. If you've lost your case on the Hill, you didn't win, and you argued it before the agency and you didn't win, then when you sue, you can try to win on cost-benefit. In many respects, it is sort of a travesty, in that it's given the person who lost all the substantive arguments just one more place to go. Inside the agency, it's pretty clear that it's made it extremely hard to propose a rule to deal with a problem for fear that the SEC will get sued and lose the issue.

WT: This is a completely separate question. Is it possible to say anything about the evolution of compliance within the mutual fund industry? Traditionally, it's considered to be an extremely clean industry. Then you have the late trading and market timing scandals. What happens in between within these companies? Were they unable to keep up with their own growth? Were the compliance procedures not the same as they would be in other entities? It's a general question, I suppose.

ML: And I don't have an empirical answer. I have an impression. My impression is that from the mid-90s until the market break in April of 2000, most of the mutual funds invested heavily in tech stocks. When the tech stocks and the dot-coms broke in April of 2000 and that market fell off by 40 or 50 percent, a lot of the mutual funds got hit. It cost them net

assets. Of course, it drove down the NAV from the standpoint of the investor. But losing assets also means that you lose revenue.

Imagine what it would be like in a law firm if one minute after April of 2000 you wake up and you say, okay, well, we've now lost forty percent of the gross revenue. What exactly are we going to do next? Well, in a rational business you'd fire 40 percent of the people, because you could no longer feed them.

If you stuck a pin through all the firms that were involved in the market timing scandal, I think you'd find that one common factor was usually that the investment adviser that got hurt during the market timing scandals had had a high emphasis on technology in their fund stocks, and so they lost a lot of money. I don't think the compliance environment changed, I think the economic environment changed, and some people were willing to turn a blind eye to the economic reality of what they were asking their distribution guys to do.

Certainly it's true that, since 2002, if you don't think compliance people aren't taking their jobs seriously, then you haven't talked to one lately. In the last two years at least, the number of cases that have been brought by the SEC against compliance people personally has gone up. It's probably fair to say that the allegations in most cases are tough, in that the person did something bad. The compliance person probably should have caught it. He may or may not have been complicit in it. There's an impression that the SEC is out to get the compliance guys. One way of evaluating that is that the market

salaries that compliance guys can command has almost doubled in the last five years, because you have to pay somebody quite a bit to be willing to take that amount of personal risk.

On the other hand, even the most casual player in the mutual fund industry has probably doubled, tripled, or quadrupled their compliance budget, and certainly the number of people involved, and with the board of directors constantly asking about compliance. If you were my client and you went to the regular quarterly board meeting of a mutual fund, more than half the time of the board meeting would be spent on some aspect of regulation or compliance. Not the business of being a mutual fund, but compliance. If you add cyber risk to that, it just is one more thing that makes people fret, and there's very little they can do about it. The director's not personally going to be able to unplug something from the wall that will stop cybercrime from happening.

WT: So, we haven't talked about hedge funds, which have not traditionally been in quite the same regulatory area as mutual funds, but there's been movement in the past fifteen, twenty years to come to terms with that industry to at least a certain extent. I don't know what I can ask you from a general perspective about this, but perhaps you just have impressions or highlights that you might wish to discuss about the significance of that area.

ML: Advisers to hedge funds and private equity weren't registered under the Advisers Act before Dodd-Frank. The distributor wasn't registered under the Exchange Act. They

weren't investment companies, because they could rely on Section 3(c)(1) or 3(c)(7). And they rarely issued securities in a manner that would be described as a public offering. The only law that applied to the adviser to a hedge fund or private equity fund was the anti-fraud provisions of Rule 10b-5. Fairly or unfairly, it seemed very clear by 2008 that Congress was going to demonize hedge funds and hold them responsible for the Great Recession, and were going to make them register along with private equity funds because Congress was going to repeal Section 203(b)(3) of the Advisers Act. That would cause a wide swath of investment advisers to be caught in the registration net.

In the language of political Washington, D.C., those who were relying on Section 203(b)(3) who not advisers to hedge funds were just "unintended consequences." The Congressional goal seemed to be to require hedge fund advisers to register, not anybody else. Not surprisingly, the advisers to venture capital funds complained, because if the venture capital fund really is engaged in venture capital, it is buying companies that are start-ups. It's very hard to see how there's anything systemic about what the venture capital advisers do.

Family offices were also due to be caught. We represented the trade association that fought for an exemption for family offices. Advisers to venture capital funds and family offices were only two types of previously-unregistered investment advisers that were exempted by Dodd-Frank. One outcome from that hedge fund advisers and private equity advisers that has raised a new fund in 2005, when the SEC would come in and

look at the hedge fund adviser or private equity adviser 2012, 2013, or 2014, they were looking at the documents and disclosures that had been prepared in 2005, or '6 or, '7.

If you thought at that time that the anti-fraud rules were the only part of the Federal securities laws that the hedge fund adviser or private equity adviser was subject to, you might have made decisions, for example, in describing conflicts of interest, exactly how the investment adviser is going to get paid, oversight fees that the investment adviser might be charging portfolio companies, investment banking fees, were decisions that should be made in light of the materiality standard in the anti-fraud provisions. A lot of the apparent "crime wave" that a casual read of the newspaper might think has been happening in the last two or three years in private equity funds and hedge funds is the SEC inspection and enforcement staff criticizing decisions that were made when the hedge fund adviser or private equity adviser was subject to different laws in 2005, 2006, and 2007. If you thought about hedge funds from an academic economic standpoint, a market that works in terms of good price discovery involves a willing buyer and a willing seller. From that perspective, a hedge fund adviser serves an important function because, through his shorting activities, he's helping with price discovery.

WT: Okay, well I don't have any more questions, but if you want to sum up, or if there's anything we haven't covered, by all means do so.

ML: Thank you for the privilege of being interviewed, and I am grateful to be able to contribute to the oral histories of the SEC Historical Society. I am a long-time donor and

a long-time supporter of the SEC Historical Society, and a personal friend of Carla Rosati. I think that the whole experiment with oral histories is an inspired one. I've also been a personal contributor of documents to the virtual library. The SEC Historical Society is a very good thing.

WT: Well, thanks very much for your participation, and adding to the oral history collections. I've certainly enjoyed working for the Historical Society and doing these interviews myself, so it's a real pleasure.

ML: Thank you.

[End of interview]