SEC Historical Society
Interview with John McCarthy
Conducted on July 20, 2022, by Kenneth Durr

Ken Durr:

This is an interview with John McCarthy for the SEC Historical Society's Virtual Museum and Archive on the History of Financial Regulation. Today is July 20th, 2022. I'm Kenneth Durr. John, good to talk to you today.

John McCarthy:

Thanks for having me.

Ken Durr:

Well, let's start out with some background. We were just discussing before we got on camera that you're a native Washington D.C. person, which is remarkable in and of itself. Tell me where you ended up going to college, how you got interested in the law, that sort of thing.

John McCarthy:

Sure. I grew up here in D.C. Went to Churchill High School and wanted to study engineering in college. That led me to the University of Michigan, one of the better engineering programs.

I went there and I originally went down the engineering path, but I also had a huge interest in—when I was able to take other courses, which was hard in engineering—I took an economics course that I frankly fell in love with, the professor, and I really enjoyed my experience with him. So I then changed my path a little bit to get a joint degree in engineering and econ, and that was extremely unusual for engineers to do anything unusual, especially at Michigan.

So I got an econ degree and an engineering degree and with what was increasingly my passion in economics and that whole world, I decided to get a Masters in finance from the London School of Economics. That was again, a wonderful experience in not only a great school but in the middle of London as a young kid.

Obviously, I really enjoyed that experience. Then from LSE, I went to work for a bank in London. Again, I enjoyed that, but ultimately, I think I decided I don't want to live the rest of my life in Great Britain.

Basically, I decided to go back to the States and also to pursue a professional degree. My dad always encouraged me to have a profession, the typical growing up poor type attitude, get a professional degree.

I decided to go to law school, so I went to University of Maryland. And then coming out of law school again with my econ and finance degrees from Michigan and LSE, an obvious choice was to pursue a career at a financial regulator in the SEC, being the penultimate financial regulator. Also at LSE, I gained a passion for markets and market structure and my goal was to get a job at the SEC. It was kind of all roads lead to Rome, and that was the case, and I was lucky enough to land one in the Division of Market Regulation at the time.

Ken Durr:

You did some time as a law clerk as well, right?

John McCarthy:

That's right. Good point. It was just typical for law students coming out of Maryland, they would do a clerkship in court of appeals or court of special appeals. I did that in Indianapolis with Judge Weiner.

I think anyone who's clerked realizes—probably literally to this day you spend a year going into work and 8, 9, 10 hours a day, you simply write all day. You write for a year. There's no question, that was to me, one of the most valuable and helpful experiences in my career. Unless you simply don't work, you're going to become an incredible writer. I think that I'd look back at that experience and really see how valuable it was. I would've never predicted how valuable it ultimately would be.

Ken Durr:

So it was '92 when you went to Market Reg?

John McCarthy:

That's right. Yes.

Ken Durr:

Tell me about life as a young staff attorney in market reg and the work you were doing.

John McCarthy:

Yes. Again, you're going into an environment, it's obviously all new, and you are a young whipper snapper wanting to work on interesting things, and quickly learned. I clearly got lucky because early on I was able to... I think there were exams, the odd-eighth exams and enforcement action were in the middle of their duration when I joined the Commission. I think one of the early things I got put on as just an extra body was to listen to the market maker tapes, the NASDAQ market maker tapes, and try to identify issues around collusion and persuasion and bullying around the odd-eighths issue.

Again, obviously the actual work was crazy tedious. You would listen to tapes that would be incredibly mundane for hours and hours and hours. But like anything else, when you do a job like that and you actually find something, it's incredibly rewarding.

One of my first assignments, why it was so helpful for me, is it literally gave me an experience that few people have. I was able to learn about how that NASDAQ -- which, at the end of the day, was a phone market -- how that NASDAQ over-the-counter market worked. Because you're obviously inculcated through listening to the days to days of that market, but you also then are able to apply what's going on in that market day to day with what I recently learned in academia.

At the end of the day, it was a crazy market. It was a human-based, phone-based market with ostensible rules around firm quotes and firm order execution protocols. But at the end of the day, if you had my experience, you would say that's the craziest market you could come up with. Have people call each other and harass each other. It was a great experience because I was able to learn quickly how one of the biggest markets then functioning in the US, how NASDAQ stocks were traded, and I was able to also add value to the enforcement case because I did identify some instances where there was bullying and collusion and things like that.

Ken Durr:

You're talking about being in the early end, digging up the information. How about as that went through to create the rules after the audit scandal? Were you involved in any of that in Trading and Markets?

John McCarthy:

Yes, I was involved in the sense that a lot of it... I was in the exam program, so it was kind of lent out to enforcement. I was in the exam program, but I again understood, in a hands-on way, things about the enforcement case that were kind of helpful. Questions that the policymaker would have. So I remember I was helpful in collaborating with the policymakers and understanding exactly what was found and things of that nature. Yes.

Ken Durr:

Okay. This was an unusual thing, the odd-eighths scandal that you got involved with. Talk about the usual stuff, SRO inspection and oversight, that kind of thing.

John McCarthy:

Yes, that's right. That was unusual and obviously fun. It brings back good memories. The day-to-day oversight inspection program was, when I came in, basically separated into two areas. One was basically customer-facing oversight of the SROs and the other was the trading, the SRO surveillance around trading rule violations, insider trading, surveillance and whatnot.

I was in the areas that focused on the trading oversight exams. Again, for a young kid coming out with my experience, it was a great way for me to, again, quickly learn about not just the regulatory arms of the SROs, but also how the markets worked.

For instance, when we did oversight inspections of the New York Stock Exchange, it was an opportunity for me to go from very low learning curve position up to much higher in a short period of time. The run of the mill oversight program at that time was what I call rote. You would look at the last inspection and you would plan the new inspection based upon the last inspection. They were rote, check the boxes type inspections in those early days.

Ken Durr:

Did you get involved in specialized inspections where you're going in to look for a certain thing in particular? Because I know there were different types.

John McCarthy:

I think in my early years most of the inspections were, I think they were called routine inspections. With Chairman Levitt coming in to being chairman. I think my remembrance was that there was just a mentality of being more aggressive. Rather than focus on the routine inspection, it was more like, hey, there's been issues or concerns around certain areas. So, then the inspection program started focusing in on, what I would call more targeted inspections.

Some of those were generated through newspaper articles and almost criticisms about certain aspects of the exchange programs and the regulatory programs. One that comes to mind was trade reporting. I think there was a perception that a lot of the trade reporting was a mess, especially in the third market and over the counter markets.

That's really the first time I remember doing a targeted inspection of the SROs. How well do they ensure that the trade reporting is correct and accurate? To say, again, I was young and still getting my sea legs, but it was a mess. The trade reporting, it was very easy to find major flaws and problems.

As a young attorney, I remember a friend of mine, we did an inspection of TriMark Securities, which is the third market maker that ultimately was bought by Knight Securities. But we did an inspection, and they weren't reporting millions of trades accurately. And then a friend of mine, Cam Smith, we were like, "This doesn't seem right." Obviously, it turned into a big brouhaha. But I think it was the first example of the inspection program targeting an area, trade reporting accuracy, and finding major fundamental flaws. Not only the actual conduct itself, but also in how well the SROs were managing their frontline regulatory program. In that case, it was more or less nonexistent to some extent, in the areas that we focused on.

Ken Durr:

You looked at the New York Stock Exchange, did you look at AMEX, regionals?

John McCarthy:

I think on that inspection... Oh, I'm sorry, the inspection program generally, yes. We called it the listed exchanges: New York and AMEX. A lot of them used anachronistic terminology. Then we would look at the regional exchanges and their regulatory programs. And then the other big area was of course at the time, NASD.

Ken Durr:

Were you involved in NASD oversight at all?

John McCarthy:

Yes, the trading part. Yes.

Ken Durr:

Okay. Right. You talked about Chairman Levitt, this is the period in which things are getting rolled up into OCIE.

John McCarthy:

Right.

Ken Durr:

Take me back to when you heard about it, what your perceptions were. I would think that it would've been an interesting transition. Give me a little bit of how it was for the folks at the SEC at the time.

John McCarthy:

Yes. Again, thinking back... Obviously, as a relatively young, in terms of not many years—I guess four years then. When did OCIE start?

Ken Durr:

'95.

John McCarthy:

'95. Okay. A couple of years in. I think I picked up early on that. Again, this is my recollection, whether it's skewed by all the events at the time and subsequent, but I remember that the inspection program was clearly not the priority of the director. Market Reg was a policymaking division and the inspection program, and also the exam programs, clearly were running on their own. The leadership of those programs I think were, basically, on autopilot and the focused on the directors and the assistant directors. It was rightly so on policymaking.

That was my perception. It wasn't a big deal to me personally. But when I first heard rumors about, I guess Chairman Levitt wanting to separate out the programs, it made intuitive sense to me. I said, "That makes sense. It's probably a good way to put focus on these areas." Which I personally thought were critical and important because in my initial foray into these inspections, I felt a lot of the SRO programs had major flaws.

Some of them, I would even say, were form over substance. They weren't actually mandated by which were commercial enterprises, to go root out securities law violations. They were almost just there in my judgment, because they had to be there, and the SEC self-regulatory SRO structure mandated it.

But I quickly came to the realization that, from the leadership of NASDAQ, New York Stock Exchange, and the regionals, they were not prioritizing regulation on their exchanges. Because at the end of it these were commercial enterprises. I guess my long-winded point is, I think Arthur Levitt, rightly so, felt that putting more focus on the oversight would obviously ultimately improve the regulation at the exchanges and the NASD.

Ken Durr:

A certain amount of that oversight was looking at the structures, the institutions that were set up to self-regulate. I think that one of the interesting things is how much was OCIE or Trading and Markets and then OCIE, how much were you looking at that structure, whether they could check all the boxes, and how much did you actually go in and try to figure out if they were doing something wrong?

John McCarthy:

It's a great question. I think early on, before OCIE and then once OCIE was up and running, the oversight program, at least looking at the trading surveillance side, was always just looking at and reviewing how the regulatory staff was doing. We looked at their structure, we certainly would make comments around the number of resources they were employing. We would review and make comments or findings around obviously, how well they were doing their job, the amount of resources they were employing, and whether their overall program structure made sense.

The problem with overseeing from the top-down is, obviously, all the findings that the program itself is making, you're never really sure, are they actually doing a good job? Are they actually following up on surveillance kick outs that show some indicia of trading violations, et cetera, et cetera.

When I became, I think, assistant director, I remember vividly talking to Lori about what had become the way we did things. I basically said, I don't think it really makes sense because we almost have to take what they say as factual, meaning that they are following up on, I'll say insider trading kick outs in an appropriate manner.

I felt that from an oversight point of view, it made a lot more sense to at least test what they're doing, and basically go into the front line and test what they're doing and verify whether we can find, in my example, insider trading that they couldn't. I remember Lori was incredibly encouraging to do that, but also, how come we haven't done that earlier, of course.

And I think as you look back, an oversight program is, I think it's fundamentally difficult if you don't actually get your hands dirty. What I mean by that is, figure out what the regulators have to do, what their day-to-day job is, and do it yourself to some extent, and then you'll better understand the efficacy of the program. Looking back at the time, it was just, "all right, let's start changing how we do things.

We'll start doing actual direct exams of market makers and we'll actually follow up on surveillance reports and kick outs ourselves."

But it was a dramatic and unwelcomed change from the SRO's perspective, because I think the regulatory leaders at some of the SROs almost played a middleman, and again, I hate to say this, but I felt it at the time, almost were protecting their membership from direct SEC involvement and regulation.

Again, one exchange we went in and said, "Hey, we're going to start doing direct exams of your members." There was shock. Even to the point where the head of the program said, "I don't think you can do that." When of course I was like, "These are registered broker dealers, of course we can do it."

But again, that shock to the system was healthy in a variety of ways. I think it's healthy for the inspection program because I think it invigorated a lot of people on the team. Because again, that original check the box, pure oversight way of doing inspections, ultimately wasn't as rewarding as it probably could have been. But when you're actually getting your hands dirty, learning how these regulatory programs work, learning how trading works, I think it's a lot more rewarding for the people who were on my team and then just a much, much more effective oversight program.

Ken Durr:

Because people are getting to actually inspect trading rather than inspect a program.

John McCarthy:

Inspect someone else who's inspecting trading, which is... Again, I never appreciated two things until after we implemented it: how invigorated it would be to my team. It just increased improved morale. I think it was a much more interesting place to work because you had that hands-on experience.

And then the findings we made around the deficiencies in the SROs' programs were much, much more powerful because we could support them with, again, the information that we collected during the hands-on part of the inspection. Even though it seemed incremental and at the time, it was a dramatic change in the inspection program, and ultimately, I think a significant improvement in both forcing better regulation on the SROs and then obviously, we were able to root out a lot of the problems within the industry that ultimately protected investors in a profound way in my judgment,

Ken Durr:

You've still got to do the oversight exams as well. Where did you divide it up? Was it 60-40? 75-25?

John McCarthy:

Yes. It's a good question. Say we do an inspection of the New York Stock Exchange Insider Trading Surveillance Program. We would probably cut back on the oversight, the typical oversight inspection process. We would look at fewer files, et cetera. But then we would dramatically increase resources on...

We would look for kick outs ourselves as an example. We would review reports and see whether they were properly followed up on, et cetera. I think at the end of the day, it got integrated. The inspection program and the direct, more, kind of the hands-on part of the inspection got integrated. But I think ultimately it probably was about 50-50, to answer your question directly.

Ken Durr:

Great. Well, let's move on a little bit. One of the interesting things is the function of OCIE in helping to make policy, or inform policy, and Reg ATS is coming in at this point, order handling rules are coming in. Talk a little bit about how the inspections that you were doing helped inform those efforts.

John McCarthy:

Yes, obviously the policy makers would. My recollection is the most interaction was after the rules were first implemented. The limit order display rule is a great example. That was a dramatic change in the requirements on how a specialist or how a NASDAQ market maker had to handle a customer limit order.

I think that putting the rule on the books, changing the speed limit from 95 to 55, that's easy. But I think and I'm proud of how we collaborated with the Division of Market Regulation. I think getting the industry not only to understand, "Hey, there's a new rule that you have to comply with." But ensure compliance with it in short order is what my goal was.

Collaborating with the Division of Market Regulation and having them constantly support us in our relatively aggressive ensuring implementation of these rules, was a great collaboration that I think ensured compliance in a much quicker way, And I think historically, a lot of rules would go on the books and there'd be a ridiculous amount of runway before they would actually become complied with.

Those days were over under Arthur Levitt and Rich Lindsay and Lori. I think that was a dramatic shift in the perception around how rules are implemented and how rules are expected to be complied with right away. That collaboration between OCIE in this case, Market Reg, I think proved very valuable ensuring that those orders, which are fundamental customer protection rules, were complied with right away.

Ken Durr:

This is an interesting concept, the SEC, historically the inspectors sort of prided themselves on going in and being a tough regulator if you needed to, but also just providing help saying, "Hey, here's what you need to comply with. Here's how you comply." How much of that work did you find your group doing? How much was friendly assistance?

John McCarthy:

It's interesting. The order handling rules were for instance, limit order display rule, but it also set up the ECN framework, which was a completely new regulatory framework. I was responsible for both. And the ECNs inspections—there were originally four ECNs, like Island, Instinet, Bloomberg, and Archipelago. Those inspections were to your point much more, "Hey John, how do we do this? What's the expectation here in this rule?" I think collectively those four initial ECNs wanted to...

There was no question about wanting to comply and having the spirit of compliance, but it was a completely new landscape and new players in it. Instinet was probably the only established player. I think that those inspections were often very collaborative. Again, we worked hand in glove with Market Reg to help them understand what the expectations around these rules were.

There's also a little bit of... Market Reg was, when you create something new like that you have to have an attitude, a little bit of a back and forth and collaboration, because it's not quite sure. There are unintended consequences to some of these rules.

One anecdote to show you the brave new world. We did an inspection of Island and Island was an ECN, the DNA came from the SOES bandits, that whole ecosystem. And Island was started by people that had incredible technological savvy and were incredibly talented. But they were not Wall Street. I remember

Josh Levine was... In my 30s, he had to be in his low 20s. One example of, I'll never forget during an inspection of Island like Josh Levine offered...

I was really fascinated by his Palm Pilot, this is before phones or anything. I said something like, "Oh, I really like that." So he said, "Here, you can have it." To be in an environment that's so cutting edge and bringing in players like people at Island or an Archipelago, by definition, you had to have a collaborative attitude for it to work because these were people that weren't used to regulation but ultimately wanted to change the markets. They wanted to electronify the markets.

These were some of the most talented people in the industry at the time. So it was invigorating for me and my colleagues. But again, accentuating your point, that these were collaborative type inspections as opposed to the implementation of limit order display rule were more like, "Hey, new rule. You haven't done anything to adhere to it." So very different dynamic during that period that was all up and down the spectrum.

Ken Durr:

Do any examples come to mind about that other kind, the limit order display rule for example?

John McCarthy:

Yes. Again, I'll never forget, I was on the floor of the New York Stock Exchange. Again, I'll be embarrassed to say I can't remember the exact language, but the rule basically says you are required to immediately display the limit order, but in no case more than 30 seconds. But it's displayed immediately and basically to a lay person, it better never, ever be more than 30 seconds.

Again, another example of collaboration with Market Reg, went to the floor of the stock exchange, probably went to the post of one of the most volatile and high-volume stocks. Again, I was with the head of surveillance, New York Stock Exchange surveillance, and I asked the specialist, "Hey, tell me about this new rule are you having. Are you able to immediately display limit orders? Is compliance an issue?" And he more or less said... Again, he knew I was with the SEC, I'll never forget, but he's basically said, "I'll do my best, but they're mostly going to be 30 seconds."

But then I said, of course naively, "But the rule says immediately." And they go, "Well, it says 30 seconds. You talked to..." And they pointed to the head of surveillance. But I think that moment in my career was an important one because even at that relatively young age, I knew a specialist should not be speaking to an SEC attorney with that level of cavalierness around complying with what was then a very high-profile rule in front of his head of surveillance.

It was frankly, in retrospect, an absurd insulting to the New York Stock Exchange regulatory program for him to do that. It spoke volumes about that relationship. And then for me, it was like, okay, we have a fundamental problem if they're taking me to one of their most seasoned specialists that's saying he really has a cavalier attitude toward complying with a new rule, it meant that at the time, I was thinking, we have a fundamental problem that we have to address.

I spent a lot of my career after that focused on that exchange and focused on their regulatory program, ultimately with the goal to protecting investors and improving it.

But again, it's amazing what a single conversation, it probably took less than 20 seconds, how a single conversation can have a profound impact on me, on the New York Stock Exchange regulatory program, and ultimately on the exchange itself.

Ken Durr:

Anything else we should talk about from that first period that you were with the Commission?

John McCarthy:

Yes. The order handling rules implementation was big. We focused on that. I think that's great.

Ken Durr:

You talked about how invigorating was. It was a neat job; you were learning a lot. Why the decision to go to Knight Securities?

John McCarthy:

Yes, and really the decision to go back. The person who hired me into the SEC, a guy named Mike Dorsey, he became General Counsel of Knight. Basically, he aggressively courted me and really wanted me to join Knight, which was at the time literally transforming the way customer retail orders were being executed. Knight Securities was a manifestation of the proliferation—again, don't forget the internet was relatively new—of orders being entered online.

So, Knight basically became a consortium of the online broker dealers, the knights of the round table. It was basically at the point, really a leader in this revolution of how retail orders were being executed. It was obviously for me, an exciting area to potentially work in. But to be honest, you had someone courting me, plus an exciting area, but I didn't really want to leave if I look back and am being honest.

I went up to Knight Securities. I only was there for three months, but Arthur, obviously at Lori's impetus, called me. I'm a young lawyer, I get a call from Arthur Levitt, which is of course crazy. He called me and then I said, "I'll call you back." And I went outside, and I remember Knight was in Jersey City. I remember looking at the river, Arthur Levitt saying, "Hey, you should really consider coming back." Because I had insinuated to Lori that I wasn't that happy. "You really should consider coming back. There's a lot to accomplish here." It's Arthur Levitt.

So, I came back because basically I got that phone call, in no uncertain terms. And that phone call started a lifelong relationship to this day with Arthur Levitt, who's been an important part of my life both as a colleague and as a friend. I really view him as a friend. So that phone call, even though I met him a couple of times before, that phone call was my first one-on-one interaction with him. It turned into a lifelong relationship that was incredibly important to me. You question why I left, but I'm really focused on why I went back.

Ken Durr:

Yes, well, it is a very, very brief punctuation there. It's a comma.

John McCarthy:

What's funny, sometimes when I fill out "where have you worked" I sometimes omit that or forget about it. But I think it showed two things, that my passion for the work -- obviously, the money was more, of course, at Knight -- but my passion for working at the SEC and how much I enjoyed that job, it was such an easy, just getting a little bit of an impetus from Arthur was all I needed, and I aggressively came back.

It wasn't a hard decision. Ironically, it wasn't a hard decision to come back even though... I don't know how many people come back to the SEC after three months. But it's probably a short list.

Ken Durr:

I haven't met any.

John McCarthy:

I like being on a short list of crazy people.

Ken Durr:

Well, there you go. So, you became Associate Director of Market Oversight, is that the title?

John McCarthy:

Yes, so when I came back, that was my new position. Right.

Ken Durr:

Was this a created position or had Lori and Arthur sort of talked about doing something new here?

John McCarthy:

Yes, I think that's fair. Obviously, it still had some of the oversight responsibility that always existed. But I think its focus was on trading, best execution, and oversight of the inspection programs. I'm sorry, the SRO programs in those areas. It was basically a new focus and a new carved out area.

Ken Durr:

Okay. Payment for order flow. That was one of the things you dealt with when you came back, right?

John McCarthy:

Yes.

Ken Durr:

Talk about that one, when that became a hot issue for you.

John McCarthy:

Yes, pay for order flow is one of those, literally to this day you pick up the Wall Street Journals, it's one of those issues that has more than nine lives. But I think Arthur and the Chairman's staff were particularly focused on that issue. I remember Joe Lombard who worked for Arthur was, again, particularly focused on the issue.

Again, payment for order flow. When I first focused on it in exams, I remember we did an exam of, I think it was E-Trade, and we would talk about paying for order flow and E-trade's attitude was, "Hey, we send it, whoever pays us the most money." Which we were pleasantly surprised to understand that you can get paid for order flow and create a whole revenue stream. I think that the regulatory push to ensure that hey, you can't just send your orders to someone just because they pay you the most. You're required to get best execution.

I think that it's been a long uphill battle over time. But again, when I came back and was head of market oversight, I think it was a co-commitment to the focus of the chairman. Obviously, he was uber focused on all things that affected the retail customer. So, payment for order flow was really on the top of the list. We did sweep exams, I think we called them, sweep exams in that area.

It's probably one of the prouder, prouder group of exams that I did. Because I think we found serious issues and serious flaws that were costing retail investors significant amounts of money. But we also, I think, did the work in such a way to really allow the policy makers to understand exactly what's going on and to give them the foundational facts to start addressing this from a rulemaking point of view, be it in this case at the SRO level, FINRA did rulemaking.

But again, I think that it was really one of the first times where I knew that the information we were gathering would possibly result in enforcement cases but also be the foundation for the rule policymakers, be it at the NASD or Market Reg, to improve the situation, which did happen to some extent.

Ken Durr:

You used the phrase sweep exams, which was one of the big OCIE initiatives, one of the things that first appeared there. Talk a little bit about what that meant, how you did them and why it was different.

John McCarthy:

A sweep exam, you would typically identify a practice in the industry that you thought, or you had some indication, that was somewhat widespread. Rather than doing—and clearly there were also focused exams on typically one issue.

Rather than doing those types of exams as part of your routine exam program, I think that there was a perception, I think rightly so, that if you focus in on one issue and focus in on all the players that were likely to be affected by it, it was, I think a fair way to employ examination resources. You weren't targeting randomly a handful of firms. You were targeting all the firms where were receiving significant amounts of payment for order flow. You were doing it in a targeted way and then you were also doing it in a way that would get the results much quicker. I think my first group of exams that would fall in that sweep exams was this best execution one. Yes.

Ken Durr:

Okay. Did that involve the options markets in particular?

John McCarthy:

That would've been the follow up. We would've then followed up in which we looked at the payment for order flow in the options markets as well.

Ken Durr:

Was that a particular problem in at CBOE and some of the other options markets?

John McCarthy:

Yes, it was. And then again, I think through this sweep dynamic, we were able to focus on a payment for order flow in options. Again, options were always a redheaded stepchild of both the focus on regulatory resources at the SEC. I think it was a really important group of exams in that regard. Because it was the similar conduct as in the equity side, but probably turbocharges, probably kind worse. Worse in many ways.

Ken Durr:

Okay. Well, backing up a little bit, OCIE grew pretty quickly during this period, resources were always an issue, but during this point, OCIE's getting more resources than it had for some time. Can you tell me a little bit about the training program, how you staffed up, the kinds of people that you hired, and how you brought them up.

John McCarthy:

For Lori, training was very important. I think when I joined the Commission there wasn't really a formal training program per se. In fact, I remember the extent of training as it were, we would have a monthly meeting with an SRO who would come in and there would be, I think, hot topics.

But what that was, was an opportunity for the SROs almost to lobby young staff, lobby them on the issues of the day. I remember the New York Stock Exchange was lobbying on how important the eighths were to the markets. Again, I sat through this presentation. It's like the Spanish dollar they were saying, it goes back. Lobbying me again, just way down the learning curve, didn't really understand the issue that well, but I knew it didn't feel right to give them the opportunity to lobby us. I think it was not called lobbying, obviously. Called seminars or education seminars.

But again, it didn't feel right. I'll always remember that when, fast forward to being associate director with Lori, that the importance of training, given my experience when I joined the Commission, I definitely agreed wholeheartedly with Lori how valuable and important it was. We hired I think only staff attorneys. But training and the importance of training was always a priority.

Ken Durr:

Did you ever bring in accountants, people with specialized skills like that?

John McCarthy:

Yes, we certainly had... I think there were accountants, not that I hired, but already on staff that worked in the market oversight program. We did have some, but the preponderance was attorneys.

Ken Durr:

Okay. One of the things that comes up is the moving from a cyclical approach to doing examinations to risk-based examinations. You had talked about targeting somewhat. But that's maybe not exactly the same thing as risk-based. Can you talk a little bit about the context to that, why there was this shift to risk-based examinations and how that worked?

John McCarthy:

Yes, so that's a great question. I think, again, when I joined—I think this was a common term that Lori used, but I could be wrong—but I think there was a mentality or culture, more check the box, routine check the box exams. After I became an associate director, I certainly realized that the inspection program suffered from that mentality and that was the foundation for trying to change the methodology and get what I call the hands dirty and do actual exams of either the firms or of the surveillance, do actual reviews of the surveillance reports, et cetera.

I think from my experience in the oversight program was helpful for Lori as she was moving the exam program from this check the box mentality to a more risk-based, better use of resources. Again, I call it targeted. I think targeted and risk-based are similar. But I think that the oversight program was maybe a precursor to Lori's implementation of that cultural shift within the entire program.

And then of course the exams under me, which were primarily focused on of trading reviews, based on execution, whatnot, they were all, by definition, focused on a single topic. We always scope them in a way that was very targeted for what we thought was a problematic conduct in the industry.

Ken Durr:

You're focused on trading, which is great because a lot of the focus, when you talk about OCIE people you think of broker dealers. How much did you talk to the broker dealer exam people? Was there cross fertilization at all between those two sides?

John McCarthy:

Yes, for sure. For sure. A lot of when you're staffing on sweep exams or a lot of, even, our routine best execution exams, we would take, depending on people's workload, we cross-fertilized by definition.

Part of it was, I think that my exams or the exams under my program, I think, were very sought after, because it was generally an interesting topic, trading, et cetera. A lot of people joined the Commission wanting to understand markets better. What we were looking at was the heart of how the markets function. I think definitely cross fertilization was common and it was relatively easy because people generally were more than happy to add one of my exams onto their portfolio, pretty common.

Ken Durr:

So speaking of broker dealers, it was interesting to see that you were involved with one of the early exams of Bernie Madoff. Because you're a markets person, how did you end up looking at Bernie Madoff?

John McCarthy:

Yes, again, Madoff was I think the biggest or one of the biggest third market makers, over-the-counter market makers. The third market was he traded listed stocks, New York Stock Exchange listed stocks.

For the exam of Madoff, it was again a target exam of third market makers. I think we had a theory of the case—determining whether the third market makers who had pipes of retail order flow coming in, whether they're using that information in a way that could harm the retail order flow. Using that information, but in essence, front running it if they also had a proprietary arm, or in his case a hedge fund.

I think we were basically looking at whether there was any correlation between the information they're gathering from their retail flow with their proprietary training. Madoff, obviously that was not what he was doing, front running retail order flow, but obviously he was doing a Ponzi scheme as we all know.

Ken Durr:

When was that, the examination? The front running examination?

John McCarthy:

I'm guessing 2005, '06, something in that range. Actually, probably a little early. Probably 2004.

Ken Durr:

Okay. And so obviously as we found out later, that wasn't the case. But what does that suggest about the weaknesses of the OCIE program or things that could have been fixed.

John McCarthy:

Obviously, I've thought about this for many, many hours. I think as I look back, the exam itself, the targeting in this case, that the exam itself made sense. Obviously, Madoff was one of the biggest third market makers. We were getting information that people were hypothesizing that could be done.

So the exam itself, went as I would've expected. I think that as I look back again, obviously with 20/20 hindsight, one thing that Lori and I were passionate about was supporting examiners who wanted to think outside the box, who wanted to say, "Go in a different direction." This was the anti-check the box mentality. A lot of effort and a lot of time was put in by myself and by Lori and others to change the mentality, to change the culture of the exam program and the inspection program.

I certainly feel like we were successful in that. But obviously in the Madoff exam, there was the opportunity for it—" if something seemed a little screwy, I want to go in a different direction." Obviously, we would've supported that.

The Madoff exam had the potential, had one of the examiners wanted to go off in a direction. There would've been no friction in them doing that. Obviously, had they done that, it certainly would've been possible that they would've uncovered the Ponzi scheme.

But again, to expect examiners to go in a different direction or change the scope of the exam on the fly, takes experience, it takes confidence, and ultimately, it didn't happen. Obviously, I wish it did. And it's one of those things that there's obviously a certain level of frustration. But again, I think if I was being objective, I think we did a good job in changing that culture. And there was one of the things that it had the chance to work in that context. Ultimately, it's fine that it didn't, the exam that they focused on went exactly as it should have. But it was an opportunity missed, I guess.

Ken Durr:

Right. Well, let's talk about some other notable events that you got to deal with. The investment banking, research analyst, conflict of interest scandal. Here we got Elliot Spitzer bringing this one out.

John McCarthy:

Again, I think Elliot Spitzer first found this conduct in Merrill Lynch, Blodget comes to my recollection. But ultimately, it turned into a first time in my career and maybe the first time ever, all hands-on deck, all securities regulators, attorneys general, FINRA, SEC and the states coordinating on a massive sweep to say the least, again, in a short period of time to try to identify the prevalence of what I guess Spitzer identified in the Blodget/Merrill Lynch situation.

Again, for me personally, it was frankly a lot of administrative herding cats. I think states, state regulators—some are very seasoned and sophisticated, and some aren't, and you had to deal with a dynamic that was incredibly complicated. But I think the resulting report, resulting exam findings is done in incredibly short period of time and the results were extremely high quality.

Something, I'm proud of but for me, I can't say I enjoyed it because it was literally herding cats, like it was: "There's a snowstorm in South Dakota, we can't get to the exam on time." It was that sort of dynamic in place. But it was an example, I think really give kudos to Lori where she was able to take a leadership role in the industry as a whole. And again, I was part of it, but it was a great result. But again, easier said than done. That's for sure.

Ken Durr:

You worked with the SROs, state examiners. We haven't talked much about the regional offices. You must have worked with the regional offices on this as well, right?

John McCarthy:

Yes, for sure. Regional offices were incredibly important in that exam for sure.

Ken Durr:

Yes. Did the role of the regional offices change under OCIE? Was there a new look at how you would use regional offices?

John McCarthy:

Yes, for my group, the market oversight, it was all self-contained. Certainly, when we went to do an exam of E-trade in California, we would often bring, again, example where we would collaborate with the broker dealer program. We would often bring them on those exams and help, because they would have some familiarity with firms in their region.

But from my perception, the regions were more outside my core competency. But Lori, I think, did a great job in empowering them. Again, the same thing that OCIE was for me, I think Lori did the same thing for the regions, empowering them to really have the ability to step up and act in a more autonomous way. I think from my perception, the performance of the regions improved dramatically over time with the general empowerment. Same thing that OCIE did for the exam program coming out of Market Reg.

Ken Durr:

They had a lot of responsibility for broker dealer inspection certainly. There were still a handful of regional exchanges out there though. Did the regions monitor those, or did you watch those from Washington?

John McCarthy:

The regional exchanges, the self-regulatory programs were almost exclusively monitoring their members on the trading floors. We were responsible for that. Although technically, some of them were broker dealers and technically they certainly could have fallen under the exam program. But I think that that was the area that part of the rationale for the formation of the market oversight program was to give a better SEC focus on the what's going on at the regional exchanges at that broker dealer level.

We did focus in on those, especially the options markets, which we put a lot of resources into reviewing the members in the options markets in addition to the regional exchanges.

Ken Durr:

Any notable regional exchanges that were particularly problems or challenges?

John McCarthy:

Yes. Listen, they were all a challenge and a problem because they were dying. Commercially, they just made no sense anymore. The fundamental reason why regional exchange exists in the first place was because technology at the time made it necessary to have an exchange on the San Francisco, Exchange in Chicago to allow people to buy and sell, in this case stocks, in those regions.

But quickly, even when I joined the Commission, they were anachronistic, and their business models frankly made no sense. You would certainly not start a regional exchange. I think the biggest attribute they had was they had licenses to trade. Archipelago, one of the ECNs that I talk about, they basically merged with what was a dying Pacific Exchange and bought that license.

Again, it's an interesting question, but when you have these deteriorating business models, it's not exactly a great situation for a regulator. These were self-regulatory organizations that were not doing well financially. It was always a struggle for me as an overseer to ensure that they put an adequate amount of resources into their programs, which they struggled to do.

Ken Durr:

All right. Well, that's a good one. We talked about the regional exchanges. The New York Stock Exchange is still the big show at this point. You had the front running scandal emerge and you had some role in that, OCIE did. Can you talk a little bit about how that unfolded and what OCIE was able to bring to the stock exchange as it tried to rebuild from that?

John McCarthy:

Yes. Again, we are day to day overseeing the New York Stock Exchange regulatory program. I think we got information that one of its specialists was front running customer orders. The lingo on the floor was dot arbitrage. So you had two customer orders buying and selling on the book at the same time. The New York Stock Exchange rule required the specialist to match those at a single price.

He was executing one at, say a penny difference, buying and selling at a penny difference. In my example, he was making a penny on that each trade. And those pennies added up to millions of dollars of profit. For the specialist that was a rule violation. Information came in that this one specialist was doing it to some extent. I think at that point in my career, and my colleague, Eric Swanson, that point in his career, we were at the points where we understood how trading worked on the exchange.

We understood the surveillance systems and the monitoring systems, the audit trail that they had, to a pretty sophisticated way. So we were able to quickly answer the obvious questions. How often did it happen with this one specialist? And then what we did, that OCIE did, was conduct a group of exams basically to determine how often that illegal conduct that we knew happened in the one instance happened across the floor.

At the end of the day, we quickly determined... It was very interesting, factually. I think there's thirty or forty specialists, say thirty-five maybe. Fifteen did this illegal conduct and made significant amounts of money and then the remaining specialists adhered to the rules. As I look back at what we found and the frustrations that ultimately came from the New York Stock Exchange, it was an example where some bad apples ruined it for what were compliance specialists.

To answer your question, we determined what the scope of the illegal conduct was. I think it was hundreds of millions of dollars of ill-gotten gains. We then went down the path of passing those findings on to the Division of Enforcement with the findings that the New York Stock Exchange should have done a much better job in surveilling for and preventing that dot arbitrage conduct. So there was an enforcement case against the Exchange itself.

And then there's also enforcement cases against those fifteen specialists who were the minority of specialists who were conducting the conduct. It was obviously big enforcement cases, but the inspection report that we wrote that basically outlined all this was, frankly, one of my proudest moments, in that it was a result of not so much a lot of hard work to identify the conduct at the specialist, but it's the result of getting up the learning curve over ten, twelve, thirteen years of being at the Commission and being able then to actually conduct a pretty complicated exam and group of inspections.

Ken Durr:

There's the enforcement case to deal with, but the New York Stock Exchange has also got to reinvent or fix its own surveillance supervision.

John McCarthy:

Right. They had the inspection report that became public. Inspection reports are not public, but they had the inspection report that was highly critical of their regulatory program and highly critical of how hard they looked for things.

Also, highly critical of how once they found conduct that was problematic, how they—I think that report said a slap on the wrist. There was not a very good deterrent effect. I think that inspection report was a wakeup call for the New York Stock Exchange. I think it resulted in extremely aggressive changes in their regulatory program to try to address and improve it.

Ken Durr:

Any idea how the inspection report became public?

John McCarthy:

No. It was in the, I guess, the *Wall Street Journal*. I was shocked to see my wording in the front page of the *Wall Street Journal*, but I don't know. It's a bit of a parlor game at the time and even now, how it got public. But it could be anyone from the Commission all the way to the New York Stock Exchange who had an ax to grind. If I was to guess, I would say it's probably someone at the Exchange side. But again, they said they kept it extremely tight. Not many people had the Exchange. I don't know.

Ken Durr:

Something people love to do in Washington.

John McCarthy:

Yes. It's not the first time.

Ken Durr:

Or the last. Anything else we should talk about from your associate director period?

John McCarthy:

New York Stock Exchange, that was the highlight. Yes.

Ken Durr:

Great. Well, you also did an exam of involving Knight Capital, right?

John McCarthy:

Yes. Obviously, we have the background, but I think Knight was an example of just our routine best execution program uncovering egregious... Again, in the go-go days of the dot-com bubble, the market was tearing upward.

All bets were off in terms of any sort of ensuring that customers got the best price reasonably available. It was an exam that found conduct that was way off the charts that there were commissions of a buck a share or buck 50 a share, just crazy stuff going on.

But what's interesting about that exam is, in hindsight, certainly conduct of what Knight was doing was problematic. A lot of the orders were coming from institutional investors, hedge funds, and mutual funds. I look back at that exam and one thing I regret is I didn't focus enough on the people who were sending orders were also fiduciaries for customers and they were the ones getting these crazy prices with commissions way off the chart.

I think in hindsight, best execution should include the conduct of people who are routing orders and ensuring that they're getting the right prices. That's probably an area where... I think we tried to get enforcement to bite on that, but I think that that was an area that I wish I focused on more in hindsight. Because it would be a much more effective way to ensure that customers get the right prices to put enforcement or regulatory pressure on the fiduciaries who are routing the orders to these market makers.

Ken Durr:

Yes, good point. Did this come out of routine exams or was this a matter of reading the papers and saying, "We want to look at these people in particular."

John McCarthy:

I think the Knight exam, I think it was an arbitration that someone alleged that there was problematic execution quality or something like that. I think information came that sort of way. And then we started an exam. It was what we call a "for cause" exam. We had information to suggest problems.

Ken Durr:

Okay. Well great. Then you decided to leave the Commission one more time.

John McCarthy:

Yes.

Ken Durr:

Talk about the opportunity. What took-

John McCarthy:

I joined a firm called GETCO in Chicago. Again, it's a firm that was started just a handful of years before I joined. It's about sixty, seventy people at the time in a place no one has ever heard of.

As an associate director going to a place no one ever heard of, that was strange. But what's interesting, as I look back now in my career and how lucky I was, I had a front row seat into where the markets were heading and who likely would succeed in the electronification of the markets. I knew a firm like GETCO was in a prime position to really benefit from what's an inevitable change in the market from pit to the screens.

Ken Durr:

This is an electronic market making company?

John McCarthy:

Yes. And the founders Dan and Steven were, they started in the pits one in the Merc, one in the CBOE. But they had a vision that the markets were going to change, and that the status quo was not going to last long. I think they started before anyone else to start trading electronically and there the original arbitrage pit to screen type trades that obviously eventually turned into pure electronic trading.

Yes, but by the time I was there they were trading sometimes 30 percent or 40 percent of the SPYs in the market. They were just early on the vision of what the markets were going to become, and they took full advantage of it.

Ken Durr:

What was your position at GETCO?

John McCarthy:

I was the general counsel. Again, even though I had a front row seat into this world and knew the players, the General Counsel of Island, which was the biggest electronic market at the time, he was a friend of mine, a guy named Cam Smith.

He knew one of the founders of GETCO and he said, "Hey," to Cam. "Do you know someone, good compliance, legal guy for me?" And then Cam luckily said, "John McCarthy."

Ken Durr:

So, you'd spent a whole career in looking in markets and you're outside the SEC looking in during the flash crash. Tell me a little bit about how GETCO responded to it, what your position was and what you saw the SEC doing.

John McCarthy:

Yes. Quickly as the markets changed dramatically, the financial crisis was a first crisis, that is in its name, and GETCO was a major liquidity provider in the markets during incredibly stressful and volatile times. I think that one thing I'm proud of and I really give credit to, Bob Colby at the SEC, is during that crisis, my relationship with him being able to help understand and being able to pick up the phone and say, "Bob, hey we're market makers. The short sale rule is not clear. It's anachronistic, but we're market makers in every way, shape or form. Are you comfortable if we comply with the rule in this way?"

And having the ability to get those relationships and the answers in a very stressful time was incredibly valuable. I think that it's a good... You often hear the negative aspect of the revolving door of a SEC employee going out to the private sector, but no one focuses on those relationship that they had at the Commission can prove very valuable. Not in a commercial sense, but very valuable to the markets, to investors generally.

That was a really important. I feel really good about my role at GETCO in that financial crisis because if I didn't have those relationships, then the liquidity that GETCO provided would've been more cumbersome, more full of friction and would've been potentially problematic for the markets. Because GETCO was such a big player in the markets at the time.

Ken Durr:

Was that the case during the flash crash as well?

John McCarthy:

Flash crash, similar situation. I think that on some level, different in the sense that the SEC was then trying to figure out what happened and how it happened. That's again, an example where we, GETCO, have such a good understanding of the markets and what likely happened. We are able to provide some valuable insights quickly, not only so the SEC could understand what happened on that particular day in May, but also to prevent it from happening again.

Again, we are one of several firms that I think they collaborated with to collect information. Again, very helpful. I think in this case, the Division of Market Regulation, very good at listening, hearing people's perspective, getting trading information and doing the right thing in a short period of time.

Ken Durr:

This has been a really interesting talk because, as I mentioned, when you talk about OCIE, it's usually broker dealer inspections, investment advisor inspections. I think the market side is really important. Anything else that we've missed that we should talk about from your career?

John McCarthy:

No, I think whenever I ruminate on my career, my father, what little advice I could get out of him, he would always say—he was a military guy—but he would say, "If you're getting flack, it means you're doing something right. If they're shooting at you," or whatever his militaristic metaphor was.

I feel incredibly lucky that I was at the Commission at a period in market history that, no matter what anyone says, was a pivotal time. To be in a position where I was literally at the point of the spear of that change, I realize how lucky I was and all the people I met as a result, it's just been a wonderful experience.

Ken Durr:

Well, that's a great note to wrap up on. Thank you very much.

John McCarthy:

Thank you. Thanks for your time.

Ken Durr:

Okay.