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## The New Normal: Changes in Self Regulation and the Securities Industry in the Wake of the 9/11 Tragedy

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## LECTURE

### THE A.A. SOMMER, JR.' ANNUAL LECTURE ON CORPORATE SECURITIES & FINANCIAL LAW\*\*

#### THE NEW NORMAL: CHANGES IN SELF- REGULATION AND THE SECURITIES INDUSTRY IN THE WAKE OF THE 9/11 TRAGEDY

*Mary L. Schapiro\*\*\**

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\* We all mourn the passing of A.A. Sommer, Jr. in January 2002.

\*\* Mary L. Schapiro delivered this address at Fordham University School of Law on November 13, 2001. The Editors of the Fordham Journal of Corporate & Financial Law have left the text unedited.

\*\*\* Mary L. Schapiro is President of NASD Regulation, Inc. ("NASDR") and a member of the Board of NASD, Inc. She assumed this position in February 1996. NASDR was created as an independent National Association Securities Dealers, Inc. ("NASD") subsidiary, which is responsible for regulating 5,500 member brokerage firms, 670,000 individual registered representatives and oversight of The Nasdaq Stock Market.

Before assuming her present duties, Ms. Schapiro was the Chairman of the Commodity Futures Trading Commission ("CFTC"). She was appointed by President Clinton in 1994. The CFTC is the federal agency responsible for regulation of the U.S. futures markets, including financial, agricultural and energy markets. As Chairman, Ms. Schapiro participated in the President's Working Group on Financial Markets with the Secretary of the Treasury, the Chairman of the Federal Reserve Board and the SEC.

Prior to assuming the Chairmanship, Ms. Schapiro served as a Commissioner of the Securities and Exchange Commission. She was appointed to that position by President Reagan in 1988 and reappointed by President Bush in 1989 for a five-year term. She was named Acting Chairman of the SEC in 1993 by President Clinton. While at the SEC, Ms. Schapiro was named Chairman of the SEC Task Force on Administrative Process, with responsibility for comprehensive review and revision of the agency's rules for administrative

Thank you so much. Al Sommer, Dean Feerick, John Peloso; Dean Sharon Smith; members of the Fordham Law School community; alumni, honored guests and the many friends I see here tonight; good evening.

It is a special thrill for me to deliver this second annual A. A. Sommer lecture. For anyone who has followed his wonderful careers, Al Sommer is a legend and an inspiration. From his years of selfless public service to his brilliant work at Morgan Lewis to his words and deeds in World War II, Al's life is a lesson in how much can be achieved by combining a powerful mind with a peerless heart.

Al and Starr have been wonderful friends to me over the years—from helping me through my first terrifying months as the youngest SEC commissioner, to Al's service on the NASD Board when I arrived there nearly six years ago to his continuing wise counsel today. During much of our industry's most stunning growth, Al has been a voice—at the SEC, in the private sector, at the Public Oversight Board and at the NASD—for doing the right

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proceedings and implementation of the agency's new enforcement powers. The report of the Task Force, "Fair and Efficient Administrative Proceedings," was released in February 1993.

Ms. Schapiro has acted as a liaison to the U.S. Working Group of the Group of Thirty on securities clearance and settlement matters. She was also an active member of the Technical Committee and the Developing Markets Committee of the International Organization of Securities Commissions ("IOSCO"). Through IOSCO and independently, she has worked extensively with developing markets, particularly in Latin America and Asia, on capital markets regulatory structure.

Before being appointed to the SEC, Ms. Schapiro was General Counsel and Senior Vice President for the Futures Industry Association ("FIA"), an organization of brokerage firms, domestic and international futures exchanges, banks, law and accounting firms, and market users. She joined the FIA in 1984. A 1977 graduate of Franklin and Marshall College (Lancaster, Pennsylvania), Ms. Schapiro earned a Juris Doctor degree (with honors) from George Washington University in 1980. She is a member of the District of Columbia Bar and the American Bar Association. She is a member of the Board of Trustees and Vice Chairman of the Audit Committee of Franklin and Marshall College, Lancaster, Pennsylvania. She is a member of the Board of Directors of Cinergy Corp. and Kraft Foods. Ms. Schapiro was named the Financial Women's Association Public Sector Woman of the Year in May 2000.

thing in the right way. Al, I am honored to honor you tonight.

I am also delighted to share in such a propitious moment for the Fordham Law School. Dean Feerick, after two truly distinguished decades of leadership, you will be leaving this institution stronger than ever. And just one sign of that is the establishment of the new corporate law center which will cement Fordham's reputation as a forum for scholarship and practical insight in the city whose financial markets remain the best developed and most admired in the history of the world.

You know, I spent a long time thinking about what I should discuss with you tonight. And before the tragedy of September 11, there was no shortage of interesting issues on the horizon—such as regulatory convergence in financial services; or market structure; or technology; or globalization. But frankly, none of them seemed sufficiently relevant and “of this moment” in an industry and a city so profoundly affected by the terrifying events of the past two months.

So what I would like to talk about is our future as an industry in the wake of September 11, from the perspective of the NASD as a self-regulatory organization with major responsibilities for protecting investors and preserving the integrity of our markets.

This will be a policy discussion, not a requiem. But I cannot simply launch into it without acknowledging the almost incomprehensible grief we all feel for the loss of so many colleagues and heroes. The cold words “human capital” cannot begin to capture all the ways in which our friends and associates will *never* be replaced.

And so much that we once took for granted has changed. The safety of our workplaces and the security of our children. The trepidation of boarding an airplane or taking an elevator up high in a skyscraper. Even the previously heedless task of opening the mail.

With so much having changed, it is tempting to think that things will *never* return to normal. But while that feeling may help to ward off any return to complacency, in the larger sense, I firmly disagree. Because our industry *can* claim normalcy. It is just that there will be a “new normal,” as I call it—and it will have to differ markedly from what preceded the tragedy.

I am not enough of a sage to be certain whether this new normal will be better or worse than the old. Certainly in a number of ways it will be less convenient and more costly, at least in the short run. But insofar as it will make us wiser about our markets and less insular with respect to America's place in the world, I have to believe—as an act of willed optimism—that in the long run we will come through this crucible tempered and stronger.

No one disputes what a blow the attacks were to our industry and our broader economy. It is too soon to have reliable numbers, but the Securities Industry Association, among others, has done a study showing that in our industry alone, the impact of the attacks can be measured in many billions of dollars.<sup>1</sup> And of course, September 11 compounded what was already a worsening economic and employment situation.

But one truth cuts boldly against this darkening grain. Considering all that has happened since September 11, our securities markets have performed incredibly well. Indeed—given the orderly trading even in the very first days after the markets reopened—it has been nothing short of a systemic triumph.

Partly this confirms the wisdom of the investments in infrastructure and capacity that the industry made over the preceding decade. And partly it indicates that our system did well in absorbing the lessons of the “Black Monday” crash of October 1987.

But in the broadest sense, it is an amazing tribute to the confidence of investors worldwide in the fundamental soundness of our markets. And that, I would argue, is a function of the unwritten contract between our markets and investors that the markets would operate fairly even in the uncharted aftermath of September 11.

The U.S. markets have long attracted capital in times of *foreign* conflicts, coups or chaos. But there had been no event to test whether this kind of flight to quality and security would be reversed if it were Wall Street, and not some foreign capital, that came to resemble a war zone.

Well, the global jury is in. And the money has stayed here, in

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1. See <http://www.sia.com/press/html/pr-year-end.html>.

*our* markets. Through the attacks; through the anthrax; through the news of rising unemployment; through it all. The world's investors have voted with their wallets and they are saying that the U.S. equities markets remain among the very finest havens they can find.

One of the key factors in our markets' success and resiliency throughout this period has been the strength of our regulatory system. Of course, this is no cause for complacency. The long-term future of our markets and our industry is bright only to the extent we can honor that unwritten contract to keep investors' interests paramount. And in meeting this imperative, self-regulation must continue to play an indispensable role.

Self-regulation brings to bear a keen practical understanding of the industry. It taps resources and perspectives that are not as readily available to governments. It fosters investor protection as well as member involvement. At its best, it is a nimble, responsive test-bed for regulatory innovation. And it promotes high standards that go well beyond simply obeying the law.

That is why self-regulation is so well suited to help usher in the new normal in the securities industry. Because no one has a stronger incentive than our member firms to ensure that their disaster recovery and business continuity plans—to take just one big example—are fully adequate to ensure that they can survive and do business under adverse circumstances. And no one can bring greater resources or expertise to bear than our industry, acting collectively, to see that such plans are not only formulated, but followed.

I do not want to imply that the new normal is simply a matter of doing more to terror proof our markets and our industry. We must do far more than prepare for a repeat of attacks such as those of 9/11. Our efforts must encompass hardening our markets against cyber-terror, disruptions of our mail and telecommunications infrastructure, and natural disasters as well as man-made ones.

But the new normal calls for changes far broader even than these. It will also entail a comprehensive and interconnected set of measures, some requiring increased cooperation across markets and across borders; others involving new regulatory flexibility; and

many others drawing upon large doses of technological creativity.

Let me give you a specific sense of what I mean, starting with what has been the NASD's bread and butter as a self-regulatory organization in the two months since the attacks.

In dealing with an utterly unforeseen disaster, the appropriate degree of regulatory flexibility can be a hard thing to define in advance. With apologies to the late Justice Potter Stewart, sometimes you just know it when you see it.<sup>2</sup>

On the 11<sup>th</sup> and days following, we fielded dozens of calls from firms needing relief from regulatory requirements, specific to their own circumstances. We evaluated their requests in real time, and provided tailored relief where consistent with investor protection and market integrity.

One step the NASD took after the attacks was to expedite our review of corporate financing filings. We extended test windows and continuing education requirements. We granted blanket extensions on regulatory requests for information, and expanded them further, as appropriate, for hard-hit firms. And we made it clear that industry professionals called into active military duty can continue to receive transaction-based compensation—and that while on special status, all their NASD dues and assessments will be waived.

None of this means we abandoned our rulebook, or the goals of investor protection and market integrity that it serves. What it does mean is that we have exercised a good deal of commonsense discretion as to how best to pursue these goals in the wake of the tragedy. Under the appropriate circumstances, I would do so again without hesitation.

Such regulatory relief may seem like largely a humanitarian matter. But as you can well imagine, it has very practical, dollars-and-cents consequences. A prime example involves the need of some firms to rapidly reconstitute their offices, business and employment arrangements in the aftermath of 9/11.

Last year, the NASD put in place new rules and procedures designed to permit certain business expansions without obtaining regulatory pre-review and approval. Then, when the tragedy

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2. *Jacobellis v. Ohio*, 378 U.S. 184 (1964).

struck, we devoted extra effort and human resources to processing the most urgent membership applications on an expedited basis.

Now, going forward, we are developing operating procedures that will harness both of these improvements. Our new contingency plan will enable us to screen and process applications on an urgent basis when our member firms need to merge, consolidate or acquire branch offices; change clearing firms; or make other changes to maintain business continuity with little advance warning.

The benefits of such regulatory nimbleness are difficult to quantify in advance. But we can already see that our new procedures will shrink the time it takes to process urgent applications from weeks to days. And in an industry where time is money, the ability to make such changes at the speed of business—not at the speed of regulation—makes great economic sense.

This also demonstrates why, in the new normal, regulatory flexibility cannot be a one-time accommodation, but must become a permanent part of the landscape. Our industry faces both increasing demands in dealing with the terrorist threat, and increasing cost pressures in dealing with today's economy. So if we as self-regulators are going to sustain the strength of our unwritten contract with investors, we must find more lasting and systematic ways to maximize the industry's regulatory benefits while minimizing its regulatory costs.

Fortunately, the NASD has been marching down this road for some time now. Over the last couple of years, NASD Regulation began the process of modernizing our rulebook with a major retooling of several of our rules. This year, we have broadened that effort. The goal of our Rule Modernization initiative is to ensure that the benefits of our rules justify their burdens.

To help us in this effort, we have enlisted the assistance of a distinguished Economic Advisory Board with a wealth of experience in economics, finance, consumer protection and cost-benefit analysis. Working closely with senior NASDR management, these experts are helping us review our existing rules; improve and modernize any we find wanting; and design a template for enacting more streamlined and modern rules in the future.



The first tranche of rules we are working through includes, for example, rationalizing across regulatory regimes the definition of an "institutional investor." Clearly, given the state of the industry today, we are powerfully motivated to move this entire process along with a real sense of urgency.

Rule modernization may lead to *less prescriptive* regulation in some areas. Hopefully it will lead to *better-tailored* regulation given the changes in market structure, technology and investor base in our industry. But there is one aspect of the new normal that will surely entail *more* regulation. The securities industry will have to take on much greater responsibilities to detect and deter money laundering and other suspicious activities.

Until now, such duties applied mostly to banks. Under the Bank Secrecy Act of 1970,<sup>3</sup> securities firms were encouraged, but not obligated, to file suspicious activity reports. By and large, that status quo was accepted.

But September 11 changed everything. Money laundering legislation in the U.S. Senate gained great impetus; and objections to it in the House were swept away. Late last month, President Bush signed into law an anti-terrorism bill, called the Patriot Act,<sup>4</sup> which contains comprehensive new money laundering legislation.

The new law grants the Treasury Secretary broad discretion in its implementation. The NASD has offered the Treasury Department whatever assistance we can provide in the drafting of these implementing regulations. And we are prepared to do whatever is necessary to help our partners throughout the government and the private sector to ensure that the new money laundering legislation achieves its worthy goals.

Three things about the new law bear special emphasis for tonight's purposes. The first is its breadth. The law applies to all U.S. financial institutions that maintain even a single account for a

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3. Pub. L. No. 91-508, 84 Stat. 1114-1124 (1970) 12 U.S.C. §§ 1829(b), 1951-1959, 31 U.S.C. §§ 5311-5330 (2000).

4. The Patriot Act is the short title for the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001. The Act was passed as Pub. L. No. 107-5 115 Stat. 272. *See also* <http://www.whitehouse.gov/new/releases/2001/10/1001/026-5/html>.

customer outside the United States. By requiring broker/dealers to file suspicious activity reports, it makes mandatory what was previously voluntary. And it also requires every affected broker/dealer to establish a soup-to-nuts compliance program, from internal policies, controls and employee training through independent audits.

Second, the new money laundering law will require our industry to think and talk about traditional “know your customer” concepts in a new way. The NASD and the New York Stock Exchange have used different terms, but meant essentially the same thing, when we have spoken of either “suitability” or “know your customer” obligations. In both instances, the duties have to do with protecting the interests of investors and securities firms.

But the new money laundering law—and this is my third point—is not primarily about protecting firms *or* particular investors. It is about protecting society at large from money laundering and other illicit uses of our financial system.

Simply put, our industry once had the luxury of not worrying unduly about whether certain customers were not right—so long as they were right for the investments we were recommending them. Both of America’s elected branches of government have just spoken very plainly that our country can no longer afford that luxury.

As you might suspect, commensurate with such major changes, the NASD’s examinations of firms for money laundering will also change considerably. This past spring, we began working with the SEC and NYSE to develop a joint money-laundering examination module, and we have been conducting such examinations for several months now. Once Treasury has promulgated its new regulations, we will obviously take them into account in determining how we should adapt our procedures to best examine for compliance.

It is already quite clear that in light of 9/11 and the new law, the securities industry is going to have to devote unprecedented focus and attention to illicit uses of our markets generally, and money laundering specifically.

I do *not* want to leave you with the impression, however, that the new normal is only about new demands on industry (and on

regulators for that matter), with no new resources to meet them. Let me turn now to one very valuable growth fund for such resources, which I mentioned earlier. It has to do with greater cooperation and information sharing across markets, across national borders, and across traditional lines of jurisdiction and turf.

To extend the metaphor for just a moment, we saw this fund achieve spectacular early returns in response to 9/11. The fiercest of competitors cooperated like the closest of friends. This happened on everything from sharing trading floors to sharing strategies on trading halts to coordinating on the united reopening of the markets.

I am not dreaming that once 9/11 has had a chance to recede from memory a bit, the securities industry will be forever transformed from one seen as dog-eat-dog into one in which the lions routinely lie down with the lambs. But I *am* suggesting that our industry could do far worse than to build on the spirit of civility and cooperation that bloomed in the wake of the tragedy.

This is much more than an emotional point. Just as the attacks have spurred a realization that U.S. law enforcement authorities must cooperate far better with one another and their counterparts around the world, so must a concomitant realization spread among regulators and firms throughout the global financial services industry.

All of us have more to do in the new normal, from terror-proofing our markets to helping halt money laundering in its tracks. The only way we can do it, under the tightening cost pressures that are already being felt throughout the industry, is if we all leverage our resources more effectively — with less concern for whose turf or initiative may be at issue, and more concern for what will get the job done.

Looking forward, that statement applies to the NASD, the other self-regulatory organizations, the SEC, the states and the industry. It applies to sharing suspicions about questionable trading activity or traders. It means we should reach out to our counterparts in the banking industry and among the banking regulators who have a great deal of experience dealing with money laundering issues. And we should help our government put a full

court press on the many countries that have been ducking their obligations in this area for far too long.

Here too, my point can be simply summarized. The financial markets are rightly known as a forum for all-out competition. But that competition should be played out in the field of stocks and bonds, profit and loss. When it comes to meeting the new dangers, obligations and challenges of the new normal, we will *all* do better working not with our elbows out, but our arms linked.

I spoke earlier of the increased terror proofing and disaster hardening our industry will have to undergo. This need is as important as it is obvious. Let me address a couple of specific aspects, starting with disaster recovery.

It will not surprise you to learn that in the wake of tragedy, the NASD was interested to learn whether our member firms had plans in place to deal with such issues as data back-up and recovery, financial and operational assessments, alternative communications, regulatory reporting, investor access, business continuity and the like.

So we took a small survey to find out. And what we learned is that all of the firms we surveyed *did* have disaster recovery or business continuity plans in place.

Now we are taking the next step: conducting a greatly expanded second survey that will be far more statistically meaningful—a true reflection of industry readiness in the face of potential catastrophe. In an area as critical as this, our duty as self-regulators demands that we be armed with facts, not conjecture.

By taking this step, we are not primarily looking to judge the value of any individual firm's plan, but rather, to assess the overall readiness of the industry to continue operating and protecting investor interests during an emergency. A clearer understanding of what the industry is doing in this area could form the basis for a set of best practices whose widespread acceptance would bring added strength to the markets and confidence to investors.

Of course, the NASD's own readiness for disruptive events is being beefed up as a result of the tragedy. For example, we are pulling together an emergency operations manual to capture for future readiness the key procedures we had to formulate in real time in the hours and days after 9/11. And we have begun to build

situation rooms where our senior managers in Washington can be linked with counterparts elsewhere in responding rapidly to an event.

Speaking of linkages, there is a broader need in our interdependent industry to maintain the best possible emergency contact networks, including among the NASD and our 5,600 member firms. If our industry is to maintain our unwritten contract with investors, we must never fail to provide them access to their brokers and their accounts—without uncertainty and without delay.

So, while something like the maintenance of absolutely current and complete emergency contact information may seem ministerial, in fact it is vital. And not only as a matter of terror-proofing, but of improved cooperation, market resiliency, and investor confidence as well.

There is an even more obvious need, in an emergency, to ensure the survival of firms' books and records. This brings us to the cross-cutting issue of technology—the last subject I would like to discuss with you tonight before taking your questions.

The immediate aftermath of 9/11 has already provided some impressive examples of technological creativity in action. Brokerage firms were able to patch together back-up data in innovative ways. Clearing firms used the time while the market was closed to reduce system risk. Stock exchanges cobbled together temporary trading floors in a matter of days.

For our part, the NASD was able to begin posting critical information on our Web Site within hours, regarding everything from regulatory relief to investor advice to a clearinghouse that allowed firms needing office space to find firms that could make space available.

Many of these are examples of unprecedented cooperation. But they have all been crucially enabled by new uses of technology as well. I would like to put a couple of ideas on the table, involving NASD technology, that I believe could help expand these trends and make them a more permanent part of the new normal.

Several of you have heard me talk about the great potential of a system we have been developing for some time now, called INSITE. By using a sophisticated analytical engine, data mining

and pattern recognition, INSITE will allow us to base our brokerage firm examinations on compliance risk, not on the calendar. The upshot is quite practical. Better focus on where the real risks exist. More timely alerts to potential red flags. Less compliance burden for the overwhelming majority of member firms who run a tight ship.

And consider this added benefit, which today looms larger than ever. If technology such as INSITE can enable us to examine our member firms with less need for our physical presence, it can not only decrease regulatory burdens, but *increase* regulatory certainty—by ensuring that we can get our job done *regardless* of any weak links in the transportation system, including air travel.

Similar data mining and pattern detection capabilities are found in our market surveillance technology, called the Advanced Detection System, or ADS. Over time, such tools should enable us to target our surveillance to look for signs of money laundering, or even to provide advance warning of potential terrorist trading activity or other attempted market manipulation.

Finally, there is Web CRD—the Central Registration Depository that is the largest such system, bar none, on the Internet. September 11 underscored the vulnerability of our industry's paper books and records; and many firms have realized, if they had not understood already, how expensive and cumbersome it is to duplicate all essential books and records.

That is why it makes so much sense for the CRD to serve as the “gold source” for the books and records of our member firms, thereby transferring a substantial burden from them to us. So we are working with the SEC, other self-regulatory organizations, the states and the industry to see if certain NASD records systems—which are fully backed up and have disaster recovery facilities—can serve as firms' official books and records. This will reduce overall industry costs by centralizing a necessary function. Even more important, it will reduce reliance on vulnerable paper records, without reducing regulatory oversight for us or operational capability for our firms.

Before I stop for your questions, let me take up one potential objection I can imagine coming from Cheyenne, Wyoming or Topeka, Kansas or any other smaller city that might seem very far

removed from the possibility of being a direct target of terror. Brokers in such cities might feel, at first blush, that after 9/11 they are being asked to bear costs and inconveniences that actually have very little to do with them.

While I might understand that feeling, it does not stand up to closer inspection.

First, as evident from my discussion of CRD, Rule Modernization and several other subjects indicates, many of the things I have talked about today will in the long run *save* the industry money by increasing efficiencies and reducing burdens.

Second, giving yourself some margin for error by expecting the unexpected is a habit that almost always, sooner or later, pays off. One key example is Y2K—derided by some as an expensive non-event, but explicitly credited by several of the respondents to our survey with providing the impetus for business continuity plans that they found invaluable after September 11.

And finally, it should be clear by now that disasters are an equal opportunity threat that know no borders, and that terrorism also has been democratized. Every brokerage firm, however small or remote, depends on infrastructure systems that can fail, and receives mail that has passed through a big-city post office.

Now, I am *not* talking about curling up into some kind of survivalist's defensive crouch. But it should be clearer than ever that in the new normal—as in the old—no one is immune from the possibility of unforeseen business disruptions. It is just that now we can imagine the unimaginable. So we should take seriously the many lessons we have learned from the tragedy. And take heart from all the reasonable steps we can take to apply them.

You know, we have all discovered a great deal about our world and our country in the last nine weeks.

We have had to confront within our own borders what an oxymoron the term “holy war” is.

We have learned that a single zealot—infected by hate—is the most potent biological weapon of all.

And we have been reminded yet again that it is when times are toughest that Americans are at their best.

That is a lesson the greatest generation of Al Sommer knew in its bones and etched in stone with its sacrifice.

And it is one we will reflect on and reaffirm often in the months and years to come.

Our industry and our nation will face our challenges with purpose, without panic, but also without complacency.

If we are faithful to the spirit of service that is found at this law school—and which imbues the entire life and career of Al Sommer—then we will act with every bit of wisdom and courage that we need. And thus reclaim, with every step forward, what has rightly been called the quiet miracle of a normal life.

Thank you very much.



*Notes & Observations*