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Washington, DC 20515–6115

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October 27, 2004

The Honorable William H. Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

The Honorable David M. Walker
Comptroller General
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Chairman Donaldson and Mr. Walker:

We are writing with respect to the September 27, 2004 report, Financial Market Preparedness: Improvements Made, but More Action Needed to Prepare for Wide-Scale Disasters, GAO-04-984, which was prepared by the U.S. Government Accountability Office (GAO) at our request. (See our letter dated February 12, 2003.)

The resulting GAO report evaluates the following: (1) actions that critical securities market organizations have taken to improve their ability to prevent and recover from disruptions; (2) actions that financial market and telecommunications industry participants have taken to improve telecommunications resiliency; (3) actions taken by financial regulators to ensure the resiliency of the financial markets; and (4) efforts by the Securities and Exchange Commission (SEC) to improve its program for overseeing operations risks at certain market participants, in response to recommendations contained in the February 12, 2003 GAO report, Potential Terrorist Attacks: Additional Actions Needed to Better Prepare Critical Financial Market Preparedness, GAO-03-251, which was prepared at the request of the Committee on Energy and Commerce and the Committee on Financial Services. The Committee on Energy and Commerce has jurisdiction over the telecommunications and utility infrastructures critical to the financial sector. The September 11th terrorist attacks extensively damaged the telecommunications infrastructure serving lower Manhattan, disrupting voice and data communications services throughout the area. The attacks also caused major power outages. (See 2003 GAO report, pp. 38-43, 91-97,

and 101-108.) Because of ongoing concerns about these systems' vulnerability to terrorist attacks, we asked GAO to review the progress made in addressing these issues.

In the 50-page report that we are releasing today, GAO has determined that, since GAO's last report, major improvements have been made but some serious weaknesses remain that need to be addressed promptly. GAO notes at page 36 that: "The ability of U.S. financial markets to recover and resume operating in the wake of any future attacks or disasters depends upon the extent to which these critical market participants augment their business continuity capabilities or mitigate existing weaknesses." We wholeheartedly agree. GAO's specific findings and our comments are as follows:

1. GAO reports at page 9 that: "Since our previous report, almost all of the critical organizations took steps to improve their physical and electronic security." However, as of June 2004, three of these seven critical organizations still did not have geographically diverse backup facilities capable of assuming all critical operations (pp. 11). Instead, their backup facilities were located in the same geographic area as their primary sites. Additionally, one of the three had no formal plan to ensure that sufficient numbers of trained staff would be available should staff at the primary facility be lost (pp. 12). GAO warns that "these organizations faced an increased level of risk of operational disruptions" and that "geographic concentration of these firms could leave the markets without adequate liquidity for fair and efficient trading in a potential disaster." We agree and urge these firms to explore creative solutions to this serious problem.

GAO found that all seven organizations, however, appeared to be following sound practices for ensuring the continuity and recoverability of their critical telecommunications services (pp. 12-13). We are encouraged by their progress.

2. GAO examined eight large trading firms (five broker-dealers and three banks) whose activities represent a significant portion of the total trading and clearing volume on U.S. markets. GAO found that all had taken steps to improve their recovery capabilities, but "some still faced increased risk of disruption," (pp. 14). According to GAO, four of these firms were at greater risk of a disruption to their trading operations because of the concentration of key trading staff in a single location at the same time (pp. 15). Officials at two of these firms said that, if they were to lose their trading operations staff, it would likely take several weeks to reconstitute their trading operations, even using staff from other operations. Officials at one of the firms said that replacing highly skilled trading staff with inexperienced staff could put the firm's capital at risk and that, while they might eventually reconstitute their trading operations, they would most likely exit the market for an indefinite period of time. Although officials at both firms said they recognized that they faced increased risk, they said that the costs associated with splitting or rotating these staff were viewed as too great, compared with the potential risk of disruption.

GAO notes at page 36 that: "One of the lessons learned from the September 2001 attacks was that without key broker-dealers able to trade, the markets could not reopen." While we are deeply sympathetic to the cost concerns raised by these firms, we are just as deeply concerned with the threat that they continue to pose to the resumption of fair and orderly trading in the aftermath of a disaster. We encourage them to work to mitigate this risk to the extent possible.

3. According to GAO, financial market regulators have identified vulnerabilities, participated in tests and exercises, and developed recovery goals and business continuity guidelines to reduce the degree to which potential future disasters would disrupt financial markets (pp. 24-29). For example, SEC issued a policy statement that expects exchanges and ECNs to have the capability to resume trading the next business day after a wide-scale disaster. However, because trading is a voluntary activity, and SEC cannot compel broker-dealers to participate in the markets to any degree, neither the SEC policy statement nor the business continuity rules from NASD and the New York Stock Exchange require member broker-dealers to develop capabilities to resume operations following such events (pp. 30).

GAO found that, despite the risks posed by this state of affairs, compounded by the geographical concentration of broker-dealer trading staffs, SEC has not done a systematic analysis to determine whether sufficient numbers of firms would be capable of resuming trading within regulators' current expectations after a wide-scale disruption. SEC had not completely analyzed whether firms located outside the affected area would be able and willing to conduct trading at a level necessary to ensure sufficiently fair and liquid markets if the currently most active firms were not. Officials at some of the key firms that GAO contacted indicated that they did not always have sufficient numbers of trained staff elsewhere who could assume their U.S. trading activities (pp. 31). The failure of the SEC to perform a complete analysis of market trading capabilities after a disruption and the failure of certain firms to fully address their own ability to resume trading are unacceptable.

4. GAO notes on page 17 that: "The September 2001 terrorist attacks highlighted the critical importance of resilient telecommunications services for the continued operation of the U.S. financial markets." We agree. The attacks resulted in significant damage to telecommunications facilities, lines, and equipment. And the loss of telecommunications service, as well as damage to power and transportation infrastructure, delayed the reopening of the markets.

According to GAO, since its last report, securities market participants, telecommunications carriers and industry organizations, and government agencies have worked together to improve the resiliency of telecommunications infrastructure and recoverability of telecommunications services in the event of future disruptions (pp. 17-23). For example, a new private communications network has been created to provide more reliable and resilient

communications for the broker-dealers, exchanges, and clearing organizations that participate in securities and other markets. Federal financial regulators and telecommunications organizations have worked together to identify best practices and sponsor financial market participants in federal programs that increase the priority for restoration of damaged communications circuits. Large communications carriers serving the financial district in Manhattan also have been taking steps to improve the diversity of their network infrastructures and are offering services that may improve their customers' communications resiliency. GAO warns that "maintaining telecommunications redundancy and diversity over time will remain a challenge." We agree and will continue to monitor this area.

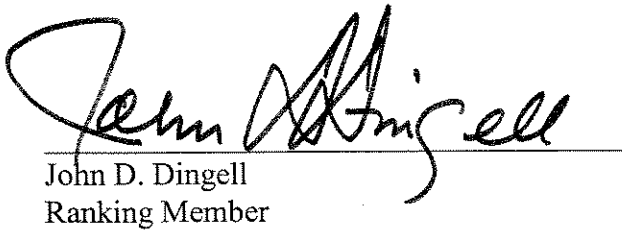
5. GAO found that, while SEC has made some improvements to the voluntary Automation Review Policy (ARP) program it uses to oversee the information security and operations continuity at exchanges, clearing organizations, and electronic communications networks [(ECNs)], it has not taken steps to address long-standing issues that hamper the effectiveness of the program and hinder SEC's oversight (pp. 31-36). These issues include insufficient resources with the appropriate expertise to increase the frequency, depth, and comprehensiveness of its examinations and the lack of a rule that mandates compliance with the ARP program's tenets and examination recommendations. The [ARP] program also suffers from limitations on its ability to oversee information security issues. This is unfortunate and unacceptable and we believe that the SEC should commit to a firm time line for addressing the remaining shortcomings. The Committee on Energy and Commerce, particularly its Subcommittee on Telecommunications and the Internet, has longstanding concerns about the ability of Government departments and agencies to adequately oversee rapid advances in information security and operations continuity.

GAO recommends that SEC fully analyze the readiness of the securities markets to recover from major disruptions and work with industry and other federal agencies, as appropriate, to determine reasonable actions that would increase the likelihood that trading in the markets could resume when appropriate. In addition, GAO recommends that SEC take steps to enhance the ARP program's effectiveness (pp. 38). We support GAO's recommendations, and note that the comment letter from SEC Chairman Donaldson generally agreed with the report and its recommendations (pp. 48-49).

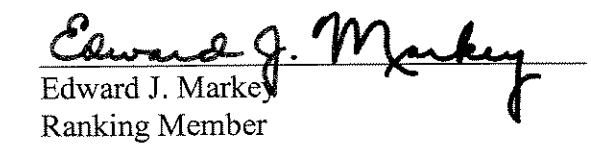
We respectfully request that GAO (1) continue to monitor progress on all open issues and (2) submit a followup report in 2005 on the status of the responses to GAO's recommendations and the need for any further actions. At the same time, we are transmitting a copy of this report

to the Chairman and Ranking Member of the Committee on Financial Services, which has jurisdiction over the financial markets, for any action they deem appropriate. Thank you for your attention to this critical issue.

Sincerely,



John D. Dingell
Ranking Member



Edward J. Markey
Ranking Member
Subcommitted on Telecommunications
and the Internet

Jan Schakowsky
Ranking Member
Subcommittee on Commerce, Trade, and
Consumer Protection

cc: The Honorable Michael G. Oxley, Chairman
Committee on Financial Services

The Honorable Barney Frank, Ranking Member
Committee on Financial Services