

THE FUTURE OUTLOOK FOR
SECURITIES PROCESSING REGULATION

SPEECH BY RICHARD G. KETCHUM
DIRECTOR
DIVISION OF MARKET REGULATION
SECURITIES AND EXCHANGE COMMISSION

BEFORE THE OPERATIONS CONFERENCE
SECURITIES INDUSTRY ASSOCIATION
MAY 29, 1985

I WANT TO THANK YOU FOR THE OPPORTUNITY TO TALK WITH YOU.

I'D LIKE TO SPEAK TO YOU TODAY ABOUT RECENT DEVELOPMENTS IN SECURITIES PROCESSING REGULATION. AS MANY OF YOU KNOW, THE PAST FIVE YEARS HAVE BEEN A VERY ACTIVE AND PRODUCTIVE TIME FOR BOTH THE SECURITIES PROCESSING INDUSTRY AND THE COMMISSION. THESE YEARS HAVE BEEN MARKED BY A SPIRIT OF CLOSE COOPERATION AND COORDINATION BETWEEN THE COMMISSION AND THE INDUSTRY.

THE LAST FIVE YEARS HAVE SEEN A STEADY EFFORT TO INCLUDE ALL RELEVANT PARTIES AND SECURITIES IN THE NATIONAL CLEARANCE SETTLEMENT SYSTEM. THROUGH YOUR WILLINGNESS TO WORK FOR CHANGE, THE PROCESSING AREA HAS BEEN AMONG THE INNOVATIVE SECTORS OF THE SECURITIES INDUSTRY. FOR EXAMPLE, WITH THE HELP OF ADOPTION OF NYSE RULE 387, THE NATIONAL INSTITUTIONAL DELIVERY SYSTEM HAS INCLUDED THE MAJOR INSTITUTIONAL PLAYERS NECESSARY TO GREATLY INCREASE THE EFFICIENCY OF SECURITIES CLEARANCE AND SETTLEMENT. SIMILARILY, THROUGH THE DEVELOPMENT OF DTC'S VOLUNTARY OFFERINGS PROGRAM AND THE ADOPTION OF RULE 17Ad-14, TENDER OFFERS NO LONGER AUGER THE PROCESSING NIGHTMARES THEY ONCE DID.

IN ADDITION, MUNICIPAL SECURITIES PROCESSING HAS COME A LONG WAY IN THE LAST TWO YEARS. TODAY, THE MUNICIPAL SECURITIES INDUSTRY FOR THE MOST PART EXPERIENCES SYNCHRONIZED CUSTOMER-SIDE/ STREET-SIDE SETTLEMENT. THIS IS A DIRECT RESULT OF COORDINATED MSRB, COMMISSION, CLEARING CORPORATION AND SECURITIES DEPOSITORY EFFORTS. FURTHER ENHANCEMENTS ARE ON THE HORIZON. IN PARTICULAR, WE ARE LOOKING FORWARD TO THE SOON-TO-BE-IMPLEMENTED EXPANSION OF

NSCC'S MUNICIPAL SECURITIES PROCESSING SYSTEM TO WHEN-ISSUED MUNICIPAL SECURITIES ISSUES.

MOREOVER, THE INDUSTRY HAS BEEN EXPLORING NEW EXCITING TECHNOLOGIES, LIKE LIGHT SIGNATURES, THAT CREATE MACHINE-READABLE CERTIFICATES AND OFFER REAL PROTECTION AGAINST COUNTERFEITING AND THEFT OF SECURITIES CERTIFICATES. THOSE TECHNOLOGIES, IN OUR VIEW, COULD GREATLY INCREASE THE INTEGRITY OF SECURITIES CERTIFICATES, ESPECIALLY IF THE TECHNOLOGY IS LINKED TO SECURITIES INFORMATION CENTER, THE COMMISSION'S FACILITIES MANAGER FOR THE LOST AND STOLEN SECURITIES PROGRAM. INDEED, THOSE TECHNOLOGIES OFFER THE SECURITIES INDUSTRY TANTALIZING POSSIBILITIES THAT COULD REDUCE THE PROCESSING INEFFICIENCIES INHERENT IN PHYSICAL CERTIFICATES. THEY DESERVE SERIOUS EXAMINATION OVER THE COMING YEAR.

THE MAJOR STRIDES MADE IN THE LAST FEW YEARS ARE TO THE INDUSTRY'S CREDIT. WE AT THE COMMISSION HAVE ATTEMPTED TO REMAIN OPEN TO NEW INITIATIVES AND, WHERE APPROPRIATE, ADOPTED OR APPROVED RULES NECESSARY TO BUILD USAGE OF INNOVATIVE SYSTEMS WHICH HAVE REDUCED PROCESSING COSTS FOR ALL. WE HAVE ALSO ATTEMPTED TO ENCOURAGE THIS INNOVATIVE SPIRIT THROUGH HOSTING THE APRIL 1984 SECURITIES PROCESSING ROUNDTABLE.

AT THE ROUNDTABLE MANY OF YOU HELPED IDENTIFY WAYS TO INCREASE EFFICIENCY AND SAFETY IN EXISTING NATIONAL CLEARANCE AND SETTLEMENT SYSTEM SERVICES.

IN RESPONSE TO ROUNDTABLE DISCUSSIONS, STAFF FROM THE COMMISSION, CLEARING AGENCIES AND MARKET SRO'S FORMED A MONITORING COORDINATION GROUP, WHICH HAS TAKEN SEVERAL STEPS TO IMPROVE COMMUNICATION WHEN A FIRM FACES FINANCIAL PROBLEMS. ALSO, A TRANSFER AGENT PRACTICES UNIFICATION GROUP WAS CREATED TO DEAL WITH INDEPENDENT REGISTRAR REQUIREMENTS AND NON-UNIFORM TRANSFER AGENT STANDARDS, FORMS AND PRACTICES. FINALLY, THE SIGNATURE MEDALLION PROGRAM DEVELOPMENT GROUP HAS MET SEVERAL TIMES AND IS CLOSE TO A FINAL RECOMMENDATION ON WAYS TO STREAMLINE THE SIGNATURE GUARANTEE PROCESS.

WHILE WE HAVE MADE EXCELLENT PROGRESS, MUCH WORK STILL REMAINS. FOR EXAMPLE, WE AT THE COMMISSION ARE CONCERNED ABOUT THE SLOW PROGRESS BEING MADE RESPECTING NSCC'S PLANNED CENTRALIZED, AUTOMATED SECURITIES LOAN ACCOUNTING AND MARKETING SYSTEM. THROUGH THE SECURITIES LENDING TASK FORCE, NSCC HAS MAINTAINED A DIALOGUE SINCE THE ROUNDTABLE WITH THE SECURITIES LENDER COMMUNITY AND OTHER INTERESTED SECURITIES INDUSTRY GROUPS REGARDING THE CREATION OF SUCH A SYSTEM. YET NSCC INFORMS US THAT THE PROPOSAL HAS RECEIVED A LUKEWARM RECEPTION. WE UNDERSTAND THAT SOME PLAYERS ARE HESITANT BECAUSE THEY HAVE THEIR OWN EFFECTIVE STOCK LOAN ACCOUNTING AND MARKETING PROGRAMS AND, UNDER THE PROPOSAL, FEAR PROGRAM DUPLICATION. HOWEVER, WE BELIEVE THAT A WELL-CONCEIVED, INDUSTRY-WIDE, UNIFORM STOCK LOAN ACCOUNTING AND MARKING SYSTEM WILL REDUCE SUBSTANTIALLY THE INDUSTRY'S RISKS FROM STOCK LOAN ACTIVITY. WHILE THE DIFFICULTY OF INSURING FULL INSTITUTIONAL PARTICIPATION IN THE SYSTEM MAY IMPOSE

COSTS ON SOME FIRMS, IT SEEMS TO ME THAT THE POTENTIAL ADVANTAGES OF A CENTRALIZED SYSTEM OUTWEIGH THOSE COSTS. WE HAVE ALREADY SEEN SOME OF THE CONTROL PROBLEMS FIRMS HAVE ENCOUNTERED IN RUNNING THEIR ISOLATED STOCK LOAN PROGRAMS - LET'S NOT WAIT FOR THE TYPE OF DISASTERS THAT HAVE OCCURRED IN THE GOVERNMENT SECURITIES REPURCHASE AREA BEFORE WE MOVE TO A SAFER SYSTEM.

IN ADDITION, I WOULD LIKE TO TURN FOR A MOMENT TO AUTOMATING THE CUSTOMER ACCOUNT TRANSFER PROCESS. IF THE SECURITIES INDUSTRY HAS AN ACHILLES HEEL THIS IS IT. THE COMMISSION HAS RECEIVED FAR AND AWAY MORE COMPLAINTS REGARDING ACCOUNT TRANSFER THAN ANY OTHER AREA. UNCONSCIONABLE DELAYS IN ACCOUNT TRANSFER REDUCE PUBLIC INVESTOR CONFIDENCE IN THE SECURITIES MARKETS AND ENCOURAGE CUSTOMERS TO HAVE SECURITIES TRANSFERRED INTO THEIR OWN NAME. THE SITUATION TODAY REDUCES THE EFFICIENCIES OF STREET-NAME OWNERSHIP AND FRUSTRATES FURTHER CERTIFICATE IMMOBILIZATION. TO SPEED UP AND MAKE MORE EFFICIENT THE BROKER-TO-BROKER CUSTOMER ACCOUNT TRANSFER PROCESS, NSCC AND THE NYSE HAS BEEN DEVELOPING AN AUTOMATED SYSTEM THAT WOULD TRANSFER BY BOOK-ENTRY A CUSTOMER'S ENTIRE STREET-NAME POSITION BETWEEN BROKERS, INCLUDING FULLY-PAID AND MARGIN STOCKS, MARGIN COLLATERAL, IRA'S AND KEOUGH'S. NSCC'S SYSTEM IS SCHEDULED FOR A JULY START-UP. I ENCOURAGE YOUR SUPPORT OF THIS PROPOSAL.

OTHER PROBLEM AREAS WILL BE DEMANDING YOUR ATTENTION DURING THE NEXT YEAR. FOR EXAMPLE, YOU WILL NEED TO MAKE COORDINATED EFFORTS TO ADDRESS:

- THE DEVELOPMENT OF STANDARD INTERFACES BETWEEN ALL DEPOSITORIES;
- THE FAILURE OF MUNICIPAL PUT BOND TENDER AGENTS TO USE DEPOSITORIES' VOLUNTARY OFFERINGS PROGRAMS TO PROCESS PUT TENDERS BY BOOK-ENTRY;
- NON-STANDARD DISCLOSURES TO MUNICIPAL BOND HOLDERS REGARDING PUT ELECTION PERIODS;
- THE MOVE TO A SAME-DAY FUNDS SETTLEMENT CAPABILITY AT SECURITIES DEPOSITORIES; AND
- THE DEVELOPMENT AND EXPANSION OF TRANSFER AGENT CUSTODIAN PROGRAMS NATIONWIDE.

I KNOW THAT YOU WILL SOLVE THESE AND OTHER PROBLEM AREAS IN THE SAME COOPERATIVE, IMAGINATIVE AND RESPONSIBLE WAY THAT YOU HAVE MET PAST CHALLENGES.

BECAUSE SO MUCH IMPORTANT WORK REMAINS TO BE DONE, THE COMMISSION HELD THE SECURITIES IMMOBILIZATION WORKSHOPS IN WASHINGTON IN FEBRUARY AND MARCH OF THIS YEAR. A NUMBER OF YOU PARTICIPATED IN THESE WORKSHOPS, AND FISC WAS INSTRUMENTAL IN HELPING US ORGANIZE THEM. WE APPRECIATE YOUR EFFORTS IN PUTTING THESE SESSIONS TOGETHER.

WE ARE IN THE PROCESS OF PREPARING A REPORT ON THE WORKSHOPS AND PLAN TO HAVE IT AVAILABLE FOR DISTRIBUTION VERY SOON. I'D LIKE TO PREVIEW FOR YOU WHAT WE THINK ARE THE MAJOR CONCLUSIONS AND ACTION ITEMS FROM THE WORKSHOPS.

THE WORKSHOPS FOCUSED PRIMARILY ON THREE OBJECTIVES:

1. WAYS TO INCREASE THE IMMOBILIZATION OF SECURITIES CERTIFICATES IN DEPOSITORIES.
2. PROMOTING FULL IMMOBILIZATION THROUGH THE USE OF GLOBAL CERTIFICATES. (A GLOBAL CERTIFICATE IS ONE CERTIFICATE CUT FOR AN ENTIRE ISSUE, REGISTERED IN THE NAME OF A DEPOSITORY AT ISSUANCE, DEPOSITED AND PERMANENTLY IMMOBILIZED IN A DEPOSITORY. NO ADDITIONAL CERTIFICATES ARE THEN ISSUED AND OWNERSHIP INTERESTS ARE RECORDED BY BOOK-ENTRY NOTATIONS.)
3. EVALUATION AND ISSUER CONSIDERATION OF CERTIFICATELESS BOOK-ENTRY SYSTEMS.

PARTIAL IMMOBILIZATION

THE CONSENSUS OF THE WORKSHOP PARTICIPANTS WAS THAT THE NATIONAL CLEARANCE AND SETTLEMENT SYSTEM FACILITIES HAVE BEEN WORKING EFFECTIVELY IN IMMOBILIZING THE MAJORITY OF CORPORATE SECURITIES. THE SUCCESSFUL PERFORMANCE OF THESE SYSTEMS IS DEMONSTRATED BY THE VOLUME OF CORPORATE SECURITIES NOW IN THE DEPOSITORY ENVIRONMENT. CURRENTLY, 50% OF NYSE EQUITY AND 65% OF NYSE ISSUER DEBT ARE IN SECURITIES DEPOSITORIES.

IN MY VIEW, ACCELERATING THE ON-GOING IMMOBILIZATION OF CORPORATE EQUITY AND DEBT SECURITIES - PARTICULARLY OF INSTITUTIONAL PORTFOLIOS - CONTINUES TO BE THE MOST IMPORTANT TASK FACING THE INDUSTRY TODAY. FURTHER PROGRESS IN THIS AREA WILL BE CRITICAL TO YOUR ABILITY TO HANDLE SUSTAINED HIGH VOLUME TRADING ON A ROUTINE BASIS. THE TASK AT HAND INVOLVES THE EXTENSION AND REFINEMENT OF EXISTING FACILITIES, AND AS SUCH, IS PART OF THE EVOLUTIONARY PROCESS BEGUN MORE THAN TEN YEARS AGO. SEVERAL MEANS TO ACCOMPLISH THIS ACCELERATION WERE EMPHASIZED AT THE WORKSHOPS:

1. EXPAND THE USE OF CLEARING AGENCY FACILITIES FOR THE CONFIRMATION, AFFIRMATION, AND BOOK-ENTRY SETTLEMENT OF INSTITUTIONAL TRADES THROUGH FULL OF COMPLIANCE WITH NYSE RULE 387. CURRENTLY, INSTITUTIONS ARE AFFIRMING ONLY 84% OF THE CONFIRMED TRADES, AND ONLY 91% OF THOSE TRADES ARE SETTLING WITHIN THE REQUIRED TIME FRAMES. SRO MONITORING PROGRAMS, FIRM COMMITMENT TO 387, AND SPECIAL ASSISTANCE SEMINARS WOULD HELP BOOST COMPLIANCE.

BEYOND THAT, IT MAKES SENSE FOR BOTH THE COMMISSION AND THE SROs TO CONSIDER THE COSTS AND BENEFITS OF RULE REVISIONS TO ELIMINATE THE CURRENT EXEMPTIONS FOR NON-DEPOSITORY PARTICIPANT AGENT TRADES.

2. THE INDUSTRY MUST PRESS FOR AMENDMENTS TO THE REMAINING STATE STATUTORY RESTRICTIONS ON INSURANCE COMPANY USE OF SECURITIES DEPOSITORIES. ONLY ONE-THIRD OF THE \$325 BILLION ELIGIBLE INSURANCE

COMPANY ASSET BASE IS NOW IMMOBILIZED IN DEPOSITORIES; ONLY 20% OF INSURANCE COMPANIES THAT PARTICIPATE IN THE SECURITIES MARKETS HAVE ASSETS ON DEPOSIT IN DEPOSITORIES.

FIFTEEN STATES CONTINUE TO PROHIBIT DEPOSITORY USE BY INSURANCE COMPANIES BY REQUIRING THAT ALL ASSETS BE HELD WITHIN THE STATE. ALSO, NEARLY ALL STATES REQUIRE THAT INSURANCE COMPANIES DOING BUSINESS IN THE STATE KEEP A CERTAIN AMOUNT OF ASSETS ON DEPOSIT IN THE STATE - SOME REQUIRE THAT THE ASSETS BE HELD IN THE INSURANCE COMMISSIONER'S VAULT.

STATE INSURANCE REGULATORS' OPPOSITION TO DEPOSITORY USE HAS DIMINISHED OVER THE LAST TEN YEARS. THIS HAS OCCURRED, IN PART, THROUGH THE PAST EFFORTS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS ("NAIC") TO SEEK TO CHANGE STATE LAWS AND TO INFORM STATE INSURANCE COMMISSIONERS ABOUT THE SAFETIES AND BENEFITS OF THE DEPOSITORY SYSTEM. WE BELIEVE IT IS TIME TO REVITALIZE THE NAIC TASK FORCE AND COMPLETE THE TASK IT BEGAN TEN YEARS AGO -- TO BRING THE BULK OF ELIGIBLE INSURANCE COMPANY ASSETS INTO THE DEPOSITORY SYSTEM. THE SIA'S SUPPORT FOR THIS EFFORT WOULD BE VERY HELPFUL.

3. ON THE RETAIL SIDE, WORKSHOP PARTICIPANTS ACKNOWLEDGED THAT WORK TOWARD ACHIEVING GREATER IMMOBILIZATION ALSO REMAINS TO BE DONE. THERE IS NEED FOR AN EDUCATIONAL CAMPAIGN AIMED AT THE INDIVIDUAL INVESTOR ABOUT THE BENEFITS OF STREET-NAME OWNERSHIP AND THE LITTLE-PUBLICIZED COSTS AND RISKS OF INVESTOR CERTIFICATE CUSTODY.

THESE STEPS TO INCREASE PARTIAL IMMOBILIZATION WOULD PROVIDE SIGNIFICANT BENEFITS.

- ISSUER TRANSFER AGENT COSTS COULD BE REDUCED BY A THIRD IF WE MOVED FROM 50% TO 85% IMMOBILIZATION IN A DEPOSITORY.
- THE BROKER COSTS OF SETTLING A RETAIL TRADE THROUGH BOOK-ENTRY ON A STREET-NAME ACCOUNT IS ONE-TENTH THAT OF SETTLING A TRADE THAT INVOLVES PROCESSING A CERTIFICATE.
- BANK NET CHARGES FOR CERTIFICATED TRADE PROCESSING CAN BE TWICE AS MUCH AS BOOK-ENTRY SETTLEMENT CHARGES.

ACCORDINGLY, IN MY VIEW, FASTER PROGRESS TOWARD FULLER IMMOBILIZATION IS THE MOST IMPORTANT AGENDA ITEM FOR 1985.

GLOBAL CERTIFICATES

MOST OF YOU ARE AWARE OF THE SUCCESS OF FOUR RECENT MUNICIPAL BOND OFFERINGS - DELAWARE, MASSACHUSETTS, UTAH AND CONNECTICUT - ISSUED IN ESSENTIALLY CERTIFICATELESS FORM THROUGH THE USE OF GLOBAL CERTIFICATES PERMANENTLY IMMOBILIZED AT DTC. AND, JUST THE OTHER DAY, OHIO ISSUED \$110 MILLION IN SPECIAL OBLIGATION BONDS IN "BOOK-ENTRY" FORM.

THE MARKET'S FAVORABLE RECEPTION HAS BEEN DEMONSTRATED BY DELAWARE'S PLACING ITS \$50 MILLION GLOBAL ISSUE AT AN INTEREST RATE 10 BASIS POINTS LOWER THAN A HIGHLY-RATED OFFERING ISSUED THE PREVIOUS DAY. MORE TO THE POINT, A GLOBAL ISSUER PAYS VIRTUALLY NOTHING FOR ISSUANCE AND TRANSFER. ONLY ONE CERTIFICATE IS PRINTED AND ISSUED; ALL TRANSFER FUNCTIONS THROUGHOUT THE ISSUE'S LIFE ARE PERFORMED BY THE DEPOSITORY AS AGENT FOR ITS PARTICIPANTS. MOREOVER, THE ELIMINATION OF CERTIFICATE HANDLING REDUCES DRAMATICALLY SECONDARY MARKET PARTICIPANT PROCESSING COSTS.

WORKSHOP PARTICIPANTS RAISED TWO PRIMARY CONCERNS WITH EXPANDING THE USE OF GLOBALS. FIRST, THEY EXPRESSED THE VIEW THAT IT WOULD BE INAPPROPRIATE TO MANDATE THE CONVERSION OF PHYSICAL SECURITIES POSITIONS HELD BY MILLIONS OF PUBLIC INVESTORS THROUGHOUT THE UNITED STATES. SECOND, ISSUERS WERE CONCERNED THAT 100% STREET-NAME ISSUES WOULD EXACERBATE THE DIFFICULTIES OF COMMUNICATING WITH THEIR SHAREHOLDERS. I AGREE THAT THESE ARE SERIOUS IMPEDIMENTS TO THE USE OF GLOBAL CERTIFICATES FOR EQUITY SECURITIES. I CAN'T IDENTIFY, HOWEVER, ANY REAL IMPEDIMENTS TO THE USE OF GLOBALS FOR DEBT SECURITIES. WE PLAN TO DO WHAT WE CAN TO PROMOTE SUCH ISSUES FOR BOTH CORPORATE AND MUNICIPAL BONDS, AND WE HOPE TO HAVE YOUR SUPPORT. WE INTEND TO MEET WITH GROUPS OF ISSUERS AND THEIR INVESTMENT BANKERS TO URGE THAT THEY CONSIDER USING THE GLOBAL CERTIFICATE MECHANISM FOR THEIR NEXT DEBT OFFERING.

BOOK-ENTRY

THE WORKSHOPS ALSO EXAMINED THE POTENTIAL USES OF PURE BOOK-ENTRY SYSTEMS. PURE BOOK-ENTRY SYSTEMS OPERATED BY ISSUERS OR THEIR TRANSFER AGENTS PRESENT POTENTIAL OPERATIONAL PROBLEMS AND RAISE A NUMBER OF LEGAL SNARLS. ON THE OPERATIONAL SIDE, IF SUCH A SYSTEM DOES NOT MAKE ACCOMMODATION FOR CENTRALIZED SETTLEMENT PROCESSING - EITHER THROUGH A DEPOSITORY OR THROUGH AN NSCC SERVICE LIKE THE ONE BEING DEVELOPED FOR MUTUAL FUNDS - BROKER AND TRANSFER PROCESSING COULD FACE DELAYS AND CONFUSION.

ON THE LEGAL SIDE, ONLY 14 STATES HAVE ADOPTED THE 1977 AMENDMENTS TO THE UNIFORM COMMERCIAL CODE THAT RECOGNIZE UNCERTIFICATED SECURITIES. THIS PATCHWORK OF STATE LAWS INJECTS SIGNIFICANT UNCERTAINTY INTO MULTISTATE SECURITIES TRANSACTIONS INVOLVING UNCERTIFICATED SECURITIES. ALSO, 1977 CODE PROVISIONS, WHICH REMAIN UNTESTED, CREATE SPECIAL DUTIES FOR ISSUERS AND MARKET PARTICIPANTS.

DESPITE THESE OBSTACLES, IN MY VIEW BOOK-ENTRY ISSUANCE SHOULD CONTINUE TO BE EXPLORED AS AN EFFICIENT LONG-RANGE MODEL FOR SOME TYPES OF SECURITIES.

MORTGAGE-BACKED SECURITIES

THE WORKSHOPS ALSO ADDRESSED THE RISKS INHERENT IN THE CURRENT MORTGAGE-BACKED SECURITIES SETTLEMENT PROCESS - PARTICULARLY THE SETTLEMENT OF GNMA'S. GNMA'S REMAIN THE LARGEST PART OF THE BURGEONING MORTGAGE-BACKED SECURITIES MARKET; THEY ARE TOTALLY CERTIFICATED AND SETTLEMENT OCCURS OUTSIDE OF ANY NC&SS FACILITY. WORKSHOP PARTICIPANTS UNANIMOUSLY CHARACTERIZED THIS AS A "PAPERWORK CRISIS" WAITING TO HAPPEN.

THE PAPER-INTENSIVE AND DECENTRALIZED SECURITIES PROCESSING IN THIS MARKET IS REMINISCENT OF THE EQUITIES MARKETS TWENTY YEARS AGO. BUT THE RISKS OF AN OPERATIONAL BREAKDOWN IN THE GNMA MARKET ARE GREATLY MAGNIFIED BY ITS PARTICULAR CHARACTERISTICS: GNMA SETTLEMENT TAKES PLACE ONCE A MONTH WITHIN STRICT TIME CONSTRAINTS; SETTLEMENT IS IN SAME-DAY FUNDS; AND MOST TRADES ARE \$1 MILLION

OR MORE IN SIZE. ONE FAILURE TO DELIVER CAN GENERATE A DOMINO-LIKE SERIES OF FAILS WITH FINANCING BURDENS FOR FIRMS THAT FAR EXCEED THAT OF THE USUAL FAILED EQUITY TRANSACTION.

RECENTLY, THE INDUSTRY NARROWLY AVERTED A MAJOR CRISIS CAUSED BY THE FALLOUT FROM THE ESM AND BBS FAILURES. S&Ls TRYING TO LOCATE COLLATERAL, PRESUMABLY HELD IN SAFEKEEPING BY THESE TWO FIRMS, PLACED STOP ORDERS ON \$110 MILLION IN GNMA CERTIFICATES. ALTHOUGH AFFECTING ONLY A SMALL PIECE OF THE \$350 BILLION MORTGAGE-BACKED SECURITIES MARKET, THESE STOP ORDERS CAUSED SIGNIFICANT DISRUPTION AS DEALERS DISCOVERED AT SETTLEMENT THEY WERE HOLDING NON-TRANSFERABLE, VALUELESS CERTIFICATES.

FOR SOME TIME THE INDUSTRY HAS RECOGNIZED THE NEED TO DEVELOP A DEPOSITORY OR BOOK-ENTRY SOLUTION TO THE GNMA SETTLEMENT PROBLEMS. FIRMS HAVE BEEN ON THE FENCE DECIDING WHETHER TO PARTICIPATE IN THE MIDWEST'S MBS-CC PILOT OR WAIT FOR GNMA TO TAP THE FED AS ITS FISCAL AGENT AND REQUIRE CONVERSION TO BOOK-ENTRY.

AS THE LATEST CRISIS ILLUSTRATES, ACTION CANNOT BE FURTHER DELAYED. WE STRONGLY URGE YOU TO TAKE IMMEDIATE STEPS TO JOIN THE PILOT PROGRAM. WE WILL SUPPORT THAT PROCESS IN WHATEVER WAYS WE CAN.

IN SUMMARY, WHAT WE HAVE SEEN DURING THE LAST FIVE YEARS IS THE BEST SORT OF RELATIONSHIP BETWEEN GOVERNMENT AND THE SECURITIES PROCESSING INDUSTRY - STRONG INDUSTRY INNOVATION COUPLED WITH THE ENCOURAGEMENT AND CAREFUL AUDIT OF THE REGULATORS. I LOOK FORWARD TO THAT SAME KIND OF LEADERSHIP AND INNOVATION FROM YOU IN FACING THE CHALLENGES OF THE SECOND HALF OF THIS DECADE.