NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
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GNMA STUDY SENT TO CONGRESS

The Commission and the Federal Reserve Board have transmitted to Members of Congress a joint study of the government-related securities markets, including a draft of legislation which would implement recommendations of the study.

The study was undertaken in January 1980 by the staffs of the Commission, the Federal Reserve Board and the Department of the Treasury, in response to an inquiry from Senator Harrison A. Williams, Jr. While the study and its recommendations have been endorsed by the Commission and the Federal Reserve Board, the Administration has not taken a position with regard to it.

Printed copies of the nearly 300-page study are expected to be available next month from the Commission's Office of Consumer Affairs and Information Services, and from the Federal Reserve Board. In the interim, it is available for inspection by the general public at the Commission's Public Reference Room, 1100 L Street N.W., and copies may be obtained in person or by mail through the Public Reference Section at a cost of 10-cents per page. Members of the press may inspect a copy of the report at the Commission's Office of Public Affairs, 500 North Capitol Street, or at the Federal Reserve Board.

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 5, 1980

The Honorable William Proxmire
United States Senate
Washington, D.C. 20510

The Honorable Harley O. Staggers
United States House of Representatives
Washington, D.C. 20515

Dear Sirs:

The Securities and Exchange Commission (the "SEC") and the Board of Governors of the Federal Reserve System ("Federal Reserve Board") have today transmitted under separate cover the Report of the Joint Treasury-SEC-Federal Reserve Board Study of the Government-Related Securities Markets (the "Report") and draft legislation entitled "The Government-Related Securities Act of 1980." I would like to take this opportunity, on behalf of the SEC, to provide some background into the Joint Study and to summarize its findings.

The Joint Study was undertaken, as you may know, in response to an inquiry from Senator Williams about the need for regulation of dealers in government-related securities. In January 1980, staff members of the three agencies began a comprehensive review of the government-related securities markets and analyzed the existing regulatory structure in light of the abuses that had occurred in those markets. On the basis of their findings, the Joint Study participants unanimously recommended specific legislation that would establish a new regulatory structure, that would be applicable to forward trading in securities guaranteed by the Government National Mortgage Association ("GNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC"), and that could, as necessary, be extended to other government-related securities.

This Report and draft legislation were completed in July 1980, reflecting the unanimous views of staff members from each agency detailed to the Joint Study. At that time, both the SEC and the Federal Reserve Board by formal vote endorsed the results of the Study and the legislative proposal. While the Study has also been endorsed by the responsible senior officials at the Treasury Department and recommended favorably by them to the Office of Management and Budget ("OMB"), we understand that the Department is unable to express a formal position on the legislation without approval by the OMB. Although the Report and draft legislation were referred to the OMB in August, that Office has yet to reach a final decision.

In drafting the Report, the Joint Study participants gathered and analyzed data on the government-related securities markets, including markets for Treasury securities, government-sponsored agency securities and government-guaranteed securities. The Report concludes that regulation appears necessary at this time only in the case of forward trading in GNMA and FHLMC mortgage-backed securities. However, the legislative proposal would permit, under stringent procedures including unanimity among the Federal Reserve Board, the SEC, and the Department of the Treasury, an extension of regulation to the cash market in these securities or to the markets in other government-guaranteed securities.

A primary purpose of regulation in the government-guaranteed securities markets would be the reduction of abuses arising from the absence of uniform margin requirements for forward trading. Although recent public and private efforts have somewhat reduced the potential for abuse, it still remains possible to assume large, highly leveraged positions in GNMA or FHLMC securities with long delayed delivery dates without the deposit of margin either initially or at any point thereafter to meet adverse market moves. This practice has contributed to a high degree of speculative activity, and, thus, to losses incurred by dealers and investors in these securities.

Based on the experience of the SEC and the Federal Reserve Board with implementing margin requirements for stocks, the Report recommends the adoption of minimum measures necessary to implement margin requirements for forward trading in GNMA and FHLMC mortgaged-backed securities. Effective margin regulation requires the registration of professionals effecting forward transactions, the adoption of recordkeeping provisions and a program of surveillance and inspections. Furthermore, to the extent that margin requirements involve the deposit of customer funds and securities with brokers and dealers, margin regulation must be accompanied by financial responsibility standards for non-bank government-related securities professionals in order to safeguard those funds and securities.

In addition to the problems associated with the absence of margin requirements, the Study participants identified a number of other seriously abusive practices which are described in Chapter IV of the Study Report. The findings of that chapter detail problems arising from the making of unsuitable recommendations, the employment of high pressure sales methods, the unauthorized execution of trades, and the misuse of customer funds and securities. Measured responses to these unfair practices would include suitability standards for recommendations, supervision requirements in order to reduce sales practices abuses, and standards for the safeguarding of customer funds and securities from unauthorized use. Many of these measures simply reflect good business practices and have, in fact, been advocated by the leaders of the industry.

To minimize federal intrusion into these markets the legislative proposal would provide supervised rulemaking authority to a self-regulatory organization called the Federal Mortgage-Backed Securities Rulemaking Board (the "Board"). The self-regulatory Board, modeled along the lines of the Municipal Securities Rulemaking Board created under the Securities Acts Amendments of 1975, would be composed of representatives of bank and non-bank securities dealers and public representatives. The expertise and understanding of the markets possessed by industry members, who would comprise a majority of the Board, should assure that any regulatory measures adopted will provide appropriately limited responses to specific problems in the markets for government-regulated securities. The Board would exercise its rulemaking authority subject to the oversight of a Council composed of the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, and Chairman of the SEC, or their designees. The Council would have the power to approve, disapprove, or alter the rules of the Board, and to adopt its own rules in certain areas. Before making its own rules, the Council would be required to consult with all interested agencies (e.g., GNMA and FHLMC).

In constructing a proposed regulatory framework for the government-guaranteed securities markets, the Joint Study participants carefully considered the potential costs and benefits of regulation. Because the current absence of regulation makes it difficult to develop precise figures, the Report draws upon the self-regulatory model for the municipal securities markets, on which the proposed legislation is largely patterned. Based upon the experience in the municipal securities markets since 1975, we believe that the costs of extending federally-supervised self-regulation to the government-guaranteed securities markets will be relatively modest. At the same time, direct benefits of deterring abuses in these markets should be substantial. Furthermore, the Report points out that legislation in this area will greatly increase public confidence in these markets and enhance investor protection, benefits which cannot readily be measured but which are nonetheless of great importance.

To help ensure that benefits will continue to exceed cost in the implemention of this regulatory scheme, the draft legislation contains explicit competitive standards to govern rulemaking by either the Board or the Council. A rule could be adopted by either only where it is demonstrated that regulatory purposes outweigh any competitive burden.

The SEC believes that this draft legislation, if enacted, would reduce substantially the incidence of abuses and restore public confidence in the government-guaranteed mortgage-backed securities markets. We are confident that the Joint Study's recommendations, reached after considerable review and analysis, are sound and closely tailored to

achieve regulation necessary to deal with proven abuses, without imposing any undue burdens on the markets for these securities.

Sincerely,

Harold M. Williams

Harold M. Williams
Chairman