



2004 Practice Guidelines for Trading in GSE European Callable Securities

Updated May 13, 2004

A. Introduction

Set forth below is a newly revised 2004 version of The Bond Market Association's ("Association") voluntary practice guidelines ("2004 Guidelines") for secondary market trading in certain GSE European-style callable securities ("GSE European Callable Securities" or "ECSs," as further defined herein). Capitalized terms shall have the meaning set forth herein and in Appendices A, B and C.

A description of the most significant new changes that have been incorporated into the 2004 Guidelines can be found in the "frequently asked questions" document that is also being republished.

The Guidelines were first issued in January of 2003 after being developed by the Association's Callable Agency Securities Task Force ("Task Force"). The Task Force was comprised of a broad array of industry professionals, including buy-side firms, issuers, dealers, inter-dealer brokers, vendors and others. The Task Force is committed to improving the overall functioning of the primary and secondary market for callable GSE securities.

The Guidelines were subsequently amended and reissued on October 10, 2003 after being approved by the Task Force and the Association's Federal Agency Securities Committee, which is comprised of representatives from the leading underwriters and dealers in GSE securities and the inter-dealer brokers that support the secondary market for GSE securities. After further deliberation and discussion by the Task Force this winter, a public exposure draft reflecting a proposed revised set of guidelines (the "2004 Exposure Draft") was released for public comment on March 10, 2004. These 2004 Guidelines reflect the changes proposed in the 2004 Exposure Draft while also incorporating some of the additional comments we received during the public comment period.

The 2004 Guidelines contain further improvements to Appendix A, B and C of the Guidelines. These appendices have been updated to reflect certain technical improvements that had been identified and to more accurately reflect current market conventions.

The Association believes that its voluntary Guidelines have helped establish a standard format for quoting prices for GSE European Callable Securities, such as those currently issued by Fannie Mae under its Callable Benchmark Notes® and Freddie Mac as syndicated callable Global Notes. The Association further believes that these Guidelines have improved the overall functioning of the secondary market for these securities by establishing standard quotation and trading conventions for GSE European Callable Securities.

A more detailed description of the Guidelines, the intended scope of their applicability and how they were originally developed is provided below. Further information about the Guidelines and how they were developed can also be found in the accompanying document entitled “Practice Guidelines for Trading in GSE European Callable Securities: Frequently Asked Questions.”

B. Definitions

1. **Base Volatility.** The term “Base Volatility” has the meaning set forth in Appendix B of these Guidelines.
2. **BMA ECS Formula.** The term “BMA ECS Formula” means the recommended mathematical formula described in Appendix A that shall be used to calculate a particular ECS’s OAS, or an OAS Associated Quotation, given a particular price, Skew Adjusted Volatility and a Designated Yield Curve.
3. **BMA Skew Adjustment Formula.** The term “BMA Skew Adjustment Formula” means the recommended process described in Appendix B that shall be used to determine the Skew Adjusted Volatility of an ECS.
4. **Designated Yield Curve.** The term “Designated Yield Curve” means a Constant Maturity Yield curve for the Issuer of the ECS that is derived by, among other things, obtaining the prevailing mid-market prices for various securities issued under one of the Issuer’s regular issuance programs (e.g. Freddie Mac Reference Notes®, Reference Bonds® and Reference Bills® and Fannie Mae’s Benchmark Notes®, Benchmark Bonds® and Benchmark Bills®) and is further defined in Appendix C.
5. **ECS.** The term “ECS” means a coupon-bearing European-style callable security issued by a GSE and having a minimum issue size of \$1 billion or more that is callable only at par and only on a single specified date that is a Coupon Payment Date and whose Notification Date is no more than ten (10) business days prior to its Call Date.

6. **ECS Buyer.** The term “ECS Buyer” means the party that has agreed to enter into a transaction to purchase one or more ECSs from an ECS Seller.
7. **ECS Seller.** The term “ECS Seller” means a party that has agreed to enter into a transaction to sell or issue one or more ECSs to an ECS Buyer.
8. **Eligible Volatility Matrix.** The term “Eligible Volatility Matrix” has the meaning set forth in Appendix B.
9. **GSE.** The term “GSE” shall mean one of the following government-sponsored enterprises: the Federal Home Loan Mortgage Corporation (“Freddie Mac”), the Federal National Mortgage Association (“Fannie Mae”), the Federal Home Loan Bank System (“FHLBanks”) including the FHLBanks Office of Finance, the Federal Farm Credit Banks (“Farm Credit”), the Federal Agricultural Mortgage Corporation (“Farmer Mac”), the Student Loan Marketing Association (“Sallie Mae”) and the Tennessee Valley Authority (“TVA”).
10. **Issuer.** The term “Issuer” shall mean the GSE that issued the ECS.
11. **Notification Date.** The term “Notification Date” means the date on which the GSE must notify the holder of record of an ECS that such security will be called on the Call Date.
12. **OAS Associated Quotation.** The term “OAS Associated Quotation” means a dollar price or OAS derived under the BMA ECS Formula for a particular ECS given the Designated Yield Curve and Skew Adjusted Volatility for that ECS.
13. **OAS Based Trading.** The term “OAS Based Trading” means providing indicative quotes or engaging an OAS Trade pursuant to these Guidelines either directly with a counterparty or via an electronic trading platform or inter-dealer broker.
14. **OAS Trade.** The term “OAS Trade” means a transaction involving the purchase or sale of an ECS pursuant to these Guidelines that is scheduled to settle regular-way (T+3 or shorter).
15. **Purchase Price.** The term “Purchase Price” has the meaning set forth in Section 1.2 of the Guidelines and is described further in Appendix A.
16. **Skew Adjusted Volatility.** The term “Skew Adjusted Volatility” has the meaning set forth in Appendix B of these Guidelines.

C. Guidelines

1. OAS to Price Conversions & Purchase Price

- 1.1. An ECS should be traded on the basis of such security's OAS to the Designated Yield Curve using the BMA ECS Formula and the appropriate Skew Adjusted Volatility.
- 1.2. For any OAS Trade, an ECS Buyer should make full payment to an ECS Seller at the price that is derived from the OAS that is agreed upon by the ECS Seller and the ECS Buyer for the ECS (the "Purchase Price").
- 1.3. These Guidelines shall not apply to the quotation, purchase or sale of an ECS if the Notification Date for such security has already occurred.
- 1.4. Any OAS to price conversion used to calculate the Purchase Price for an OAS Trade, or to display an OAS Associated Quotation for an ECS, should be calculated to the fourth digit after the decimal point and then rounded to third decimal points (e.g. 99.910). If the fourth digit to the right of the decimal point is 5 or greater, the third digit should be rounded up by 1.

2. Quotations, and the Formula for Calculating an OAS Associated Quotation

- 2.1. An OAS Associated Quotation or Purchase Price of any ECS that is quoted or traded pursuant to these Guidelines should be calculated using the BMA ECS Formula as described in detail in Appendix A of these Guidelines.

3. Quotations, and the Yield Curve for Calculating an OAS Associated Quotation Under the BMA ECS Formula

- 3.1. When using the BMA ECS Formula to calculate an OAS Associated Quotation or Purchase Price of a particular ECS pursuant to these Guidelines, the appropriate Designated Yield Curve should be used.
- 3.2. In the event a Designated Yield Curve is not generally available for a particular ECS, these Guidelines shall not apply to transactions in such securities.

4. Quotations, and the Volatility Input for Calculating an OAS Associated Quotation Under the BMA ECS Formula

- 4.1. When using the BMA ECS Formula to calculate an OAS Associated Quotation or Purchase Price of a particular ECS pursuant to these Guidelines, the Skew Adjusted Volatility for that particular security should be used.
- 4.2. Skew Adjusted Volatility should be derived from the Base Volatility using the BMA Skew Adjustment Formula outlined in Appendix B of these Guidelines.
- 4.3. If for any reason a Base Volatility is not generally available for a particular ECS, these Guidelines shall not apply to transactions in such securities.

D. Discussion

The Association originally publishing these voluntary Guidelines in January 2003 in order to foster the development of a standard market convention for quoting prices for, and trading of, GSE European Callable Securities. When the Guidelines were first published however, market participants could not actually transact under the Guidelines. The Guidelines require that certain inputs be available on a platform for a particular ECS (a Designated Yield Curve, and Base Volatility) in order for the Guidelines to be applicable. However, at the time, existing electronic trading and analytical platforms lacked a compatible yield curve feed or had yet to develop an OAS calculator that used the sort of Skew Adjusted Volatility that the Guidelines recommended.

By the time the Guidelines were amended and reissued on October 10, 2003, a number of firms had elected to develop analytical platforms and screen-based trading systems that generally support trading and/or analysis of GSE European-style callables securities in conformity with the Guidelines. The Association is obviously pleased that so many firms have elected to support trading in a manner that is consistent with these Guidelines. We view these recent developments and the reissuance of these Guidelines as important steps towards improving the overall functioning of the secondary market for these securities by facilitating electronic trading and increasing competition generally in the market for GSE European Callable Securities. The Association is convinced that these voluntary 2004 Guidelines will help to establish a standard format for quoting prices for ECSs, such as those currently issued by Fannie Mae under its Callable Benchmark Notes® and Freddie Mac as syndicated callable Global Notes. By facilitating the emergence of a single common quotation methodology, we hope to reduce the average transaction time for GSE European Callable Securities, foster a more active two-sided market, encourage

electronic trading and generally ensure greater competition in the price discovery process and the provision of related services.

The 2004 Guidelines are recommendations only and are intended for use by Association member firms in order to promote the smooth functioning of the primary and secondary market for these securities. The recommendations do not and should not restrict the flexibility of counterparties to negotiate the specific terms of any particular transaction.

As with other Association trading practice guidelines, these 2004 Guidelines are merely recommended, voluntary standards. The Association recognizes, however, that many of its guidelines are widely observed, also on a voluntary basis, by a variety of other market participants. As a result, consistent with the Association's approach to its other standard-setting initiatives, the Association has sought input from various industry participants including buy-side firms, Issuers, dealers, inter-dealer brokers and vendors.

The Association is recommending that Issuers and dealers consider following the 2004 Guidelines' formulae when initially pricing an offering of GSE European Callable Securities. Such an approach is likely not only to foster a more orderly transition from a primary offering to secondary market trading in an ECS pursuant to these 2004 Guidelines (especially in a reopening), but also improve price transparency generally for investors.

It is anticipated that these 2004 Guidelines may be used by non-members for the same reasons that motivate the Association's members: namely, the greater market efficiency that results from the broad application and common adherence to uniform standards. Dealers, inter-dealer brokers, electronic trading platforms, data vendors and other market participants interested in adopting, implementing or following these 2004 Guidelines should consult with their own attorneys regarding how to make these voluntary 2004 Guidelines legally enforceable with their counterparties or for their customers.

As with all of the Association's trading practice recommendations, the Association intends to continue to reassess from time-to-time the validity and appropriateness of the 2004 Guidelines.

E. General Applicability

Members and other interested parties should note that these 2004 Guidelines and the accompanying mathematical formulae are specifically tailored for trading in certain GSE securities with embedded European-style call options. They are only applicable to securities issued by a GSE that meet certain requirements specified in the Guidelines including that:

- (i) a Designated Yield Curve, Base Volatility and Skew Adjusted Volatility are each generally available to market participants for such securities;
- (ii) the security's issue size is \$1 billion or larger;
- (iii) the security is callable only once, at par and only on a Call Date that is a Coupon Payment Date;
- (iv) the security's Notification Date is no more than ten (10) business days prior to the Call Date; and
- (v) the Notification Date for such security has not yet occurred.

F. Appropriate Use

Members and other market participants are advised that the accompanying formulae are not necessarily suitable for usage with a security other than those covered by the 2004 Guidelines. The formulae were developed for the sole purpose of facilitating voluntary trading in GSE European Callable Securities pursuant to the 2004 Guidelines. They are proprietary to the Association, which grants you the royalty-free right to use them. Members and other interested parties should note that the mathematical formulae described in Appendix A are also not necessarily suitable for usage with yield curves other than a Designated Yield Curve.

Inquiries regarding the 2004 Guidelines should be addressed to Eric L. Foster, Vice President and Associate General Counsel at the address listed below. Inquiries may also be sent via email to: efoster@bondmarkets.com.

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