Allen & Overy LLP

MEMORANDUM OF LAW

To	The International Swaps and Derivatives Association, Inc.
From	Allen & Overy LLP
Our ref	30047-00682 NY:4071057.2
Date	September 16, 2008
Subject	**Deliverability of stripped, principal-only obligations under Credit Derivative Transactions referencing the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac")**[1]

1. INTRODUCTION

This Memorandum is rendered solely to ISDA for the benefit and use of ISDA and its board of directors. This Memorandum may not be relied upon by any other person without our prior written consent.

Following the announcement on September 7, 2008 of the decision to place Fannie Mae and Freddie Mac (each, a "**GSE**") into conservatorship, thirteen dealer firms agreed unanimously that a Credit Event had occurred with respect to each GSE, respectively, for purposes of any Credit Derivative Transaction referencing Fannie Mae or Freddie Mac. ISDA subsequently announced that it would put in place a protocol containing auction terms, in line with the procedure adopted for prior Credit Events, in order to facilitate settlement of such Credit Derivative Transactions. For purposes of the auction terms contemplated by such protocol, it is necessary to determine a list of obligations that would constitute Deliverable Obligations to be valued as part of the auction mechanism.

The market standard terms for Credit Derivative Transactions referencing the GSEs require that Deliverable Obligations under Section 2.15(a) of the definition thereof in the 2003 Definitions be obligations within the Deliverable Obligation Category "Bond or Loan".

---

[1] Terms used, but not defined, in this memorandum of law (this "**Memorandum**") shall have the meanings given to such terms in either (a) the 2003 ISDA Credit Derivatives Definitions, as published by the International Swaps and Derivatives Association, Inc. ("ISDA") (the "**2003 Definitions**") or (b) either (i) the Offering Circular dated April 1, 2008 in respect of the Universal Debt Facility of Fannie Mae (the "**Fannie Offering Circular**"), in respect of Fannie Mae or (ii) the Offering Circular dated July 22, 2008 in respect of the Global Debt Facility of Freddie Mac (the "**Freddie Offering Circular**", and together with the Fannie Offering Circular, the "**Reference Offering Circulars**"), in respect of Freddie Mac. Copies of the Reference Offering Circulars are currently freely available to the public. Fannie Mae, *Universal Debt Facility*, available at http://www.fanniemae.com/markets/debt/pdf/udf_040108.pdf (last visited September 18, 2008). See also Freddie Mac, *Global Debt Facility*, available at http://www.freddiemac.com/debt/pdf/global-circular_072208.pdf (last visited September 18, 2008).

Fannie Mae has issued Debt Securities under the Fannie Offering Circular. Freddie Mac has issued Debt Securities under the Freddie Offering Circular. Both the Fannie Offering Circular and the Freddie Offering Circular provide that certain issues of Debt Securities that are both Fed Book-Entry Debt Securities and either Fixed Rate Securities or Step Rate Securities, under the Fannie Offering Circular, or Term Debt Securities, under the Freddie Offering Circular, (each, an "**Eligible Security**") may be designated as eligible to be "separated" or "stripped" into their separate Interest Components and Principal Components.

We have been asked to consider whether a Principal Component of an Eligible Security that has been stripped in accordance with the terms of such Eligible Security (each, a "**Principal Component**") constitutes "Borrowed Money" or a "Bond" for purposes of a market standard Credit Derivative Transaction that incorporates the 2003 Definitions and specifies the relevant GSE as the Reference Entity (the "**Reference Transaction**") (the "**Question**").

2. ASSUMPTIONS AND LIMITATIONS

(a) We have assumed that the Reference Transaction is documented under a confirmation that supplements, forms a part of, and is subject to, either a 1992 ISDA Master Agreement (Multicurrency – Cross Border) or a 2002 ISDA Master Agreement (the "**Reference ISDA Master Agreement**"), that the Reference ISDA Master Agreement has not been altered in any material respect from the printed form published by ISDA, and that both the Reference ISDA Master Agreement and the Reference Transaction are governed by, and construed in accordance with, the laws of the State of New York.

(b) We have assumed that each party to the Reference Transaction has corporate power and authority to enter into the Reference ISDA Master Agreement and the Reference Transaction, that it is a sophisticated user of derivatives and that the execution and delivery of the Reference ISDA Master Agreement, including the documents and other confirming evidence exchanged between the parties confirming the Reference Transaction, have been duly authorized by all necessary actions on the part of each party.

(c) We have assumed that each Principal Component is governed by the federal laws of the United States and the laws of the State of New York. We note that the Fannie Offering Circular states that "Fed Book-Entry Securities (including rights and obligations) will be governed by, and construed in accordance with, regulations adopted by HUD or any other U.S. governmental body or agency that are applicable to the Fed Book-Entry Securities, and, to the extent that these regulations do not apply, the laws of the State of New York". Similarly, we note that the Freddie Offering Circular states that "Debt Securities will be governed by the federal laws of the United States. The laws of the State of New York will be deemed to reflect the federal laws of the United States, unless there is applicable precedent under federal law or the application of New York law would frustrate the purposes of the Freddie Mac Act or the applicable Agreement". Based on the foregoing, we have assumed that matters of contractual interpretation will be governed by the laws of the State of New York. We are not aware of any differences between the federal laws of the United States and the laws of the State of New York that would change the analysis or conclusions in this Memorandum.

(d) This Memorandum is limited to matters of the federal laws of the United States and the laws of the State of New York in effect as of the date of this Memorandum. In addition, this Memorandum does not address the effect on our analysis of any laws other than the federal laws of the United States and the laws of the State of New York.

(e) This Memorandum is limited to an analysis of the Question. This Memorandum does not address any other issues that might impact the deliverability of a Principal Component under the Reference

Transaction, and we expressly assume that no other issues would impact the analysis set out in this Memorandum. No conclusion is implied or may be inferred beyond the analysis expressly set forth in this Memorandum. This Memorandum shall not be construed as, or deemed to be, a guaranty, indemnity or insurance agreement. Without limiting the generality of any of the foregoing, the analysis set forth in this Memorandum describes how the relevant provisions of the Reference Transaction and the Principal Components should be interpreted if they were to be adequately briefed for interpretation by a court of the State of New York or a U.S. federal court sitting in the State of New York, in each case having competent jurisdiction over the parties and the subject matter in question and applying U.S. and New York law when interpreting the express terms of the Reference Transaction and the Principal Components. However, this Memorandum is not, and is not intended to be construed or relied upon as, an assurance that any court or other tribunal would interpret the Reference Transaction and the Principal Components in the way we have interpreted them or to the same effect. This Memorandum is not binding on the courts and, accordingly, there can be no assurances that a court will not ultimately hold that any of the conclusions set forth in this Memorandum are incorrect.

(f) We have assumed that the Reference Transaction and each Principal Component constitutes the valid and binding obligation of each of the relevant parties, enforceable against the relevant parties in accordance with their respective terms.

(g) We have assumed the conformity of copies to original documents and the completeness and accuracy of each Reference Offering Circular.

(h) We have assumed that all offering documents published in respect of issuances of debt securities of each GSE, other than the Reference Offering Circulars, contain provisions that, in all material respects, are substantially identical to the provisions of the Reference Offering Circulars discussed herein relating to the Debt Securities and the Principal Components thereof.

(i) We have not independently verified or investigated any factual matters or assumptions relating to the Reference Transaction or any Principal Component in connection with our preparation of this Memorandum or otherwise. Accordingly, the analysis expressed in this Memorandum does not take into account any matters not set forth herein that might have been disclosed by independent verification. Should any of the facts, circumstances or assumptions on which we have relied subsequently be determined to be incorrect or inaccurate, our conclusions may vary from those set forth below, and such variance could be material.

(j) We have assumed that any party to the Reference Transaction that purports to claim that a Principal Component constitutes "Borrowed Money" and a "Bond", each as defined in the 2003 Definitions, for purposes of the Reference Transaction has had access to, and an opportunity to review, the relevant Reference Offering Circular before entering into the Reference Transaction. Further, we assume that, in the event of a dispute as to whether a Principal Component is "Borrowed Money" and a "Bond", each as defined in the 2003 Definitions, under the Reference Transaction, nothing will emerge from emails, files, voicemail messages, recorded conversations or credible testimony that is contrary to the assumptions made in this Memorandum.

(k) We have assumed that the Fixed Rate payable in respect of the Reference Transaction was determined in part, by mutual agreement (express or implied), by reference to the then current market price for Credit Derivative Transactions that referenced the relevant GSE, which prices in turn reflected the then current market price or prices of one or more Debt Securities of the relevant GSE with a fixed interest rate, and that at the current time the market price of any such Debt Security is at, or close to, par, while any Principal Component of that Debt Security is trading at a substantial discount to par.

3. DEFINITIONS OF "BORROWED MONEY" AND "BOND" UNDER THE 2003 DEFINITIONS

A "Bond" for purposes of Section 2.19(a)(iv) of the Deliverable Obligation Category applicable to the Reference Transaction is defined in the 2003 Definitions as "any obligation of a type included in the "Borrowed Money" Obligation Category that is in the form of, or represented by, a bond, note (other than notes delivered pursuant to Loans), certificated debt security or other debt security and shall not include any other type of Borrowed Money".

It is therefore necessary to consider whether a Principal Component is (a) an "obligation of the type included in the "Borrowed Money" Obligation Category and whether a Principal Component is (b) "in the form of, or represented by, a bond, note…certificated debt security or other debt security".

3.1 "Borrowed Money"

A "Borrowed Money" obligation is defined in Section 2.19(a)(ii) of the 2003 Definitions to include "any obligation for the payment or repayment of borrowed money…".

We think there is a strong argument that a Principal Component should not fall within the definition of "Borrowed Money" in the 2003 Definitions since a Principal Component is not the whole of the borrowed money obligation. When it borrowed the money, the relevant GSE was required to repay the principal borrowed and to pay the interest in respect of its borrowing. The repayment of the Principal Component would only satisfy part of the relevant GSE's obligation. The requirement that, in order to have a borrowing, you must have both repayment of principal and payment of interest on the principal borrowed would be consistent with universal lending practices. Only a Debt Security that is an Eligible Security and a Fed Book-Entry Debt Security that is designated as eligible for stripping in the relevant supplemental offering documentation for such Debt Security may be "stripped" and such Eligible Securities pay interest . When issued, the Eligible Security was not simply an obligation for the repayment of money on the maturity, but a combined set of interest and principal payment obligations.

If a Principal Component does not fall within the definition of "Borrowed Money" contained in the 2003 Definitions, then it would not be a "Bond" for purposes of the 2003 Definitions, since the 2003 Definitions state that a "Bond" is "any obligation of the type included in the "Borrowed Money" Obligation Category…".

3.2 "bond, note…certificated debt security or other debt security"

Even if the Principal Component were to be considered "Borrowed Money", however, we believe it would not, by itself, by a "debt security" for purposes of the 2003 Definitions. .

A Principal Component is not in the form of a "bond" or "note"; as a *sui generis* product of the book-entry rules for obligations of each GSE in book-entry form on the book-entry system of the Federal Reserve Banks, it is in the form of a component. Similarly, there is no certificate created in connection with either the original issuance of an obligation of a GSE in book-entry form on the book-entry system of the Federal Reserve Banks or the stripping-out of a component thereof, thus excluding the application of the "certificated debt security" concept in the definition.

In addition, the language in the definition of "Bond" in the 2003 Definitions suggests, by virtue of the use of the phrase "or <u>other</u> debt security"[2] that the items listed ahead of that phrase in the definition, namely a "bond, note…certificated debt security", each constitute a "debt security".

---

[2] Underscoring added for emphasis.

As the 2003 Definitions do not describe how the concepts of "a bond, note…certificated debt security or other debt security" should be interpreted for purposes of the definition of "Bond" in the 2003 Definitions, we will now analyze how the term "debt security" (a) is defined under the Reference Offering Circulars, (b) is defined under certain statutes and regulations and (c) was intended to be interpreted by the parties to the Reference Transaction, to determine whether a Principal Component should be considered to be a "debt security" for purposes of the definition of "Bond" in the 2003 Definitions.

4. REFERENCE OFFERING CIRCULARS

The Reference Offering Circulars contain a substantial amount of language that we believe is relevant to the meaning of the term "debt security".

4.1 Debt Securities

The term "Debt Securities" is used throughout the Fannie Offering Circular. "Benchmark Securities" and "Other Debt Securities are described under "Description of the Debt Securities". "Benchmark Securities" are stated to be "U.S. dollar denominated issues in large principal amounts, in the form of Benchmark Bills, Benchmark Notes, Benchmark Bonds and Subordinated Benchmark Notes. Issuances may consist of new issues of Benchmark Securities or the "reopening" of an existing issue.". Under "Other Debt Securities", the Fannie Offering Circular provides that "We plan to issue other Debt Securities from time to time denominated in U.S. dollars or other currencies with maturities of one day or longer. We will issue these Debt Securities as Short-Term Notes, Notes or Bonds.".

The term "Debt Securities" is even more clearly defined in the Freddie Offering Circular as "unsecured subordinated or unsubordinated notes, bonds and other debt securities issued from time to time...Debt Securities with maturities of more than one year may be called "Notes" and those with maturities of more than ten years may be called "Bonds".". The Global Debt Facility Agreement referred to in the Freddie Offering Circular similarly defines Debt Securities as "unsecured subordinated or unsubordinated notes, bonds and other debt securities issued from time to time by Freddie Mac under the Facility". This definition would not include the Principal Component of a stripped Debt Security because the Principal Component is never itself "issued" by the relevant GSE. Rather it is a component of the Debt Security that is issued by the GSE. The concept of "Debt Securities" is further broken down in the Global Debt Facility Agreement into "Fixed Rate Debt Securities", "Fixed/Variable Rate Debt Securities", "Variable Rate Debt Securities" and "Zero Coupon Debt Securities", none of which could be construed as including the Principal Component since the Principal Component itself does not bear interest, nor are they issued at a discount to their principal amount (as required by the definition of Zero Coupon Debt Securities).

4.2 Eligibility for Stripping of Fed Book-Entry Securities

Both the Fannie Offering Circular and the Freddie Offering Circular provide that certain issues of Debt Securities that are both Fed Book-Entry Debt Securities and either Fixed Rate Securities or Step Rate Securities, under the Fannie Offering Circular, or Term Debt Securities, under the Freddie Offering Circular, are eligible to be "separated" or "stripped" into their separate Interest Components and Principal Components.

Under the Fannie Offering Circular, "Fed Book-Entry Securities" are "Debt Securities [issued] in book-entry form…through the U.S. Federal Reserve Banks"; "Fixed Rate Securities" are "Debt Securities that bear interest at a fixed rate" and "Step Rate Securities" are "Debt Securities that bear interest at specified fixed rates for specified periods".

Under the Freddie Offering Circular, "Fed Book-Entry Securities" are "Debt Securities denominated and payable in U.S. dollars that are issued in book-entry form on the book-entry system…of the U.S. Federal Reserve Banks"; "Term Debt Securities" are "Debt Securities other than Reference Bills and other Discount Notes"; "Reference Bills" are "U.S. dollar denominated Discount Notes" and "Discount Notes will have a maturity of one year or less from its Issue Date; be sold at a discount to its stated principal amount; not pay interest; and be paid only at maturity".

A review of a sample of offering documents of Freddie Mac published since 1992 and offering documents of Fannie Mae published since 1999 leads us to understand that, where such offering documents contain provisions that describe how debt securities of the relevant GSE may be separated into principal only and interest only components, the relevant portions of such provisions are, in all material respects, substantially identical to the corresponding provisions of the Reference Offering Circulars.

4.3 Components

Each Reference Offering Circular clearly states that the result of "stripping" a Debt Security is that the relevant Debt Security is separated into two Components, one of which is a Principal Component. A Component is not, by itself, defined as a separate Debt Security in either of the Reference Offering Circulars, but rather each Reference Offering Circular is written so that, as the term suggests, a Component is merely a constituent part of a Debt Security.

A Debt Security that is both an Eligible Security and a Fed Book-Entry Security may be stripped after it is issued upon the request of the holder thereof. The request is made of the Federal Reserve Bank of New York and does not require the consent of the relevant GSE. Although a Component may be transferred on the Fed Book-Entry System separately from the Debt Security from which it has been stripped and although, within the Fed Book-Entry System, a Component will receive a different CUSIP number and, in respect of a Component of a Debt Security of Freddie Mac, a different ISIN number from the CUSIP number and, if applicable, ISIN number of the original issuance of the relevant Debt Security, each Reference Offering Circular does not describe the process of "stripping" as a new issuance. The Fannie Offering Circular in fact describes the process as the relevant Debt Security being "separated into its Components". We do not believe that the fact that a Component may receive a separate CUSIP and/or ISIN number should be regarded as evidence that such Component should, by itself, be treated as a separate Debt Security.[3]

At the request of a holder of both a Principal Component and all applicable unmatured Interest Components of a stripped Debt Security, the Federal Reserve Bank of New York will "restore" or "reconstitute" such Principal Component and such Interest Components of a stripped Debt Security "in fully constituted form".

We have concluded therefore that, under the definitions and other disclosures in each Reference Offering Circular, a Principal Component would not constitute a "Debt Security" as that term is used in each Reference Offering Circular.

---

[3] CUSIP Global Services, *CUSIP Service Bureau*, available at https://www.cusip.com/static/html/webpage/pdf/CUSIPIntro_%207.26.2007.pdf (last visited September 15, 2008) (According to information published by the CUSIP Service Bureau (operated for the American Banker's Association by Standard & Poor's), "[g]eneral interest is the primary consideration in determining what financial instruments are covered by the CUSIP identification system…". (Standard & Poor's CUSIP Service Bureau – Introduction – What Financial Instruments are covered by the CUSIP Numbering System?). CUSIP numbers are therefore clearly available to instruments other than "securities". Some GSE Securities have ISIN numbers. ISIN numbers are international securities identification numbers allocated pursuant to International Standard ISO 6166 of the International Organization for Standardization. Section 3.1 of ISO 6166 defines an ISIN as a "code which uniquely identifies a specific security or other financial instrument". Therefore, the fact that a financial instrument has a separate ISIN does not necessarily make it a separate debt security. Indeed, Annex B (Competence of numbering agencies) to ISO 6166 specifically provides a category for "stripped coupons and principal", separate from the categories that deal with "bonds and debt instruments" and states that the numbering convention rules that apply to bonds will also apply to "official stripping (the stripping is made under the responsibility of the issuer)".).

5. STATUTES AND REGULATIONS

Although it is reasonably easy to characterize the Principal Component as evidence of a debt, it is more difficult to understand whether, for purposes of the 2003 Definitions, it is a "debt security" itself or a sub-part of another "debt security." We review several relevant statutory or regulatory definitions below that may be relevant to our inquiry.

5.1 Securities Laws

There is no single statutory or regulatory definition of a security under New York law or U.S. federal law. The United States Securities Act of 1933, as amended (the "**Securities Act**") defines the term "security" broadly. 15 U.S.C.A. § 77b(a)(1) (2008). The United States Securities Exchange Act of 1934, as amended (together with the Securities Act, the "**Securities Laws**") offers a parallel definition. 15 U.S.C.A. § 78c(a)(10) (2008). The wide scope of the Securities Laws' definitions of the term "security" is consistent with the broad consumer and market protection purposes of the Securities Laws; indeed, the definitions are so broad that they ultimately beg the question of where their borders lie. Although a Principal Component is probably within these Securities Laws' definitions, it is by no means clear that these definitions are appropriate to the context of the 2003 Definitions.

5.2 Uniform Commercial Code

The Secretary of Housing and Urban Development has issued regulations applicable to maintenance of "GSE Securities" (the "**HUD Regs**").[4] The HUD Regs are intended to dovetail with Article 8 of the Uniform Commercial Code, to the extent the governing documentation would apply the law of a jurisdiction having such a statute.[5] Article 8 of the Uniform Commercial Code as in effect in the State of New York on the date of this Memorandum (the "**NY UCC**") governs matters relating to "Investment Securities".[6] Accordingly, we look next to Article 8 of the NY UCC and then to the HUD Regs themselves as we attempt to establish if a Principal Component should, by itself, be viewed as a "debt security".

The NY UCC definition of "security" also does not seem appropriate to govern the use of that term in the context of the 2003 Definitions. Like the Securities Laws definitions discussed above, the NY UCC definition is so broad that it enables an "opt-in" by parties wishing to make use of Article 8 mechanics with respect to instruments not conforming to the definition.[7] It seems apparent that parties contracting in connection with credit derivatives would not be relying on a definition intended for such a fluid environment.[8]

---

4 *See* 24 C.F.R. Part 81 (2008).

5 *See* 24 C.F.R. § 81.92(d) 1 (2008).

6 *See* N.Y. U.C.C. § 8-101 et seq. (2008).

7 *See* N.Y. U.C.C. § 8-102(a)(15)(iii)(B) (2008).

8 Alternatively, as described below, to the extent the NY UCC definition is specific, that very specificity would seem to be too narrow to accommodate a Principal Component. The NY UCC defines, under Section 8-102(a)(15), a "security" as:

"*an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer:*

(i) *which is represented by a security certificate in bearer or registered form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer;*

(ii) *which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and*

(iii) *which:*

(A) *is, or is of a type, dealt in or traded on securities exchanges or securities markets; or*

(B) *is a medium for investment and by its terms expressly provides that it is a security governed by this Article*."

A Principal Component would constitute an obligation of the relevant GSE for the reasons already discussed. Transfers of a Principal Component would also be registered on books maintained for that purpose on behalf of the relevant GSE, i.e. the book-entry system operated by the Federal Reserve Bank of New York. In addition, a Principal Component may be dealt in, or traded on, securities exchanges or securities markets. However, we question whether a Principal Component would satisfy the requirement in part (ii) of the definition of "security" under the NY UCC as a Principal Component would not itself seem to be "a class or series of…obligations". Instead it is a component or piece of an obligation which meets that description.

5.3 HUD Regs

The HUD Regs deal specifically with rights and obligations with respect to securities of the GSEs and the operation of the Federal Reserve Banks' book-entry systems for issuing, recording, transferring and maintaining those securities. Although the HUD Regs contain a broad, somewhat circular, "common meaning" definition of the term "security", the defined terms that are used with respect to obligations of the GSEs are "GSE Security" and "Book-entry GSE Security".

The HUD Regs define a "GSE Security" as:

> "*any security or obligation of Fannie Mae or Freddie Mac issued under its respective Charter Act in the form of a Definitive GSE Security or a Book-entry GSE Security.*" [9]

The HUD Regs define a "Book-entry GSE Security" as:

> "*a GSE Security issued or maintained in the Book-entry System. Book-entry GSE Security also means the separate interest and principal components of a Book-entry GSE Security if such security has been designated by the GSE as eligible for division into such components and the components are maintained separately on the books of one or more Federal Reserve Banks.*"[10]

A Principal Component would clearly fall within the definition of a Book-entry GSE Security. However, a Principal Component would not by itself constitute a GSE Security as it was not "issued in the form of a…Book-entry GSE Security", rather it would be the Debt Security that had been stripped that was issued in the form of a Book-entry GSE Security. This position is further supported by the use of the word "also" in the second sentence of the definition of Book-entry GSE Security, which implies that the Principal Component would itself not fall within the first sentence of the definition, i.e. that it would not be a GSE Security issued or maintained in the book-entry system. Since a Principal Component is maintained in the book-entry system, the conclusion should be that it should not be a GSE Security.[11]

In our view, this distinction is important as it gives regulatory recognition to the difference between a security as a whole obligation issued by a GSE and a security arising solely by operation of the book-entry system when a holder requests that the whole obligation be stripped into its Principal Component and Interest Components in accordance with the terms of such obligation.

Our analysis is not intended to call into question how a Principal Component is classified or treated for purposes of the Federal Reserve Banks' book-entry systems, including the classification thereof by the Federal Reserve Bank of New York as a Book-entry GSE Security.

6. CONTRACT INTERPRETATION

A fundamental notion of contract interpretation under New York law is that written agreements, such as a confirmation documenting the Reference Transaction, are construed in accordance with parties' intent.[12] The

---

[9] 24 C.F.R. § 81.2(b) (2008).

[10] *Id.*

[11] The Release of the Office of the Secretary of the Department of Housing and Urban Development accompanying the promulgation of the final version of the HUD Regs makes clear that the term "Book-entry GSE Security" was intended to assure the functionality of the Federal Reserve Bank of New York's book-entry system with respect to Principal Components and Interest Components, but not to alter their characteristics as components of GSE Securities and not GSE Securities themselves. 62 Fed. Reg. 28975 (May 29, 1997).

[12] *See, e.g., Greenfield v. Phillies Records, Inc.*, 98 N.Y.2d 562, 569 (2002); *Belle Harbor Wash. Hotel, Inc. v. Jefferson Omega Corp.*, 795 N.Y.S.2d 597, 612 (2005).

strongest evidence of what parties to a written agreement intend is the enumerated terms of their writing; thus, for a written agreement that is complete, clear and unambiguous on its face, the intent of the parties must be found within the four corners of such written agreement, and the ordinary and usual meaning of the chosen words will be used to establish the parties' intent, giving a practical interpretation to the language employed and the parties' reasonable expectations.[13] Here, however, there are several possible sources to look to for the meaning of "debt security".

When interpreting the language of a contract, a New York court begins with the assumption that the parties have used the language in a way that reasonable persons ordinarily do and in such a way as to avoid harsh, absurd or nonsensical results.[14] Consequently, a New York court will examine the entire terms of the Reference Transaction and will consider the relation of the parties and the circumstances under which the Reference Transaction was executed, and, as such, particular words are considered, not as if isolated from the context, but in the light of the obligation as a whole, and the intention of the parties as manifested thereby; thus, form should not prevail over substance and a sensible meaning of words should be sought.[15]

6.1 Clear Meaning of the Terms is in Dispute

In certain instances, the clear meaning of terms of a contract may be in dispute and may require interpretation in order to fully understand and fairly interpret the true intentions of the parties. In such instances, New York courts will typically take the view that reasonable parties ought to choose the interpretation that is more in line with the spirit of the provisions of the contract, and therefore a contract should be given a fair and reasonable interpretation based upon its language, in light of the purposes sought to be attained by parties.[16]

6.2 Judicial Interpretation Relies Upon a Standard of Reasonableness

It is well settled that construction of a contract that produces unreasonable results should be avoided if possible and that a more reasonable construction should be sought.[17] New York courts have noted that in interpreting commercial documents, a cardinal principle is to ascertain the intent of parties and an over-technical approach should not be taken.[18] In instances where there exists two or more potential meanings of a disputed term, as is the current case in determining whether a Principal Component, by itself, is a "debt security", a construction should be adopted which is rational, commercially reasonable and does not reach an absurd result.[19]

If the contract is on a widely-used standard form, the use of a test of reasonable interpretation has the advantage of promoting uniform interpretation, without regard to the chance circumstances of the parties.

6.3 Judicial Interpretation Looks to All Circumstances

Judges in New York will assert that contract interpretation is a matter of common sense[20] and that the 'plain and ordinary meaning' doctrine is at the heart of contract construction.[21] In its search for that meaning, a court is free

---

13 *AFBT-II, LLC v. Country Vill. on Mooney Pond, Inc.*, 759 N.Y.S.2d 149, 150-51 (2003).

14 *North German Lloyd v. Guar. Trust Co.*, 244 U.S. 12 (1917) ("Business contracts must be construed with business sense, as they naturally would be understood by intelligent men of affairs."); *Farrel Lines, Inc. v. City of New York*, 30 N.Y.2d 76, 83 (1972). *See also Nelson v. Schellpfeffer*, 656 N.W.2d 740, 743-44 (S.D. 2003) ((stating that an absurd result is one that the "parties, presumed to be rational persons pursuing rational ends, are very unlikely to have agreed upon") (citing THE AMERICAN HERITAGE DICTIONARY, 4th ed. (2000))).

15 *Fourth Branch Assoc. Mechanicville v. Niagara Mohawk Power Corp.*, 754 N.Y.S.2d 783, 786 (2003) (citing *William C. Atwater & Co. v. Panama R.R. Co.*, 246 N.Y. 519, 524 (1927)).

16 *Smith v. Brown & Jones*, 633 N.Y.S.2d 436, 442 (1995).

17 *Nassau Chapter, Civil Serv. Emp. Ass'n, Inc. v. Nassau County*, 430 N.Y.S.2d 98, 100 (1980).

18 *Deering Milliken, Inc. v. Georgette Juniors, Inc.*, 235 N.Y.S.2d 72, 73 (1962).

19 *Ronnen v. Ajax Elec. Motor Corp.*, 88 N.Y.2d 582, 589 (1996).

20 *See, e.g., Heller v. Pope*, 250 N.Y. 132, 524 (1928) ("Form should not prevail over substance and a sensible meaning of words should be sought.").

to look at all the relevant circumstances surrounding the transaction because the essence of proper contract interpretation is to enforce a contract in accordance with the true expectations of the parties in light of the circumstances existing at the time of the formation of the contract.[22]

Parties do not always use words in accordance with their dictionary definitions. Often the meaning attached to a word by the parties must be gleaned from its context, including all the circumstances of the relevant transaction.[23] Sometimes the nature of either the parties or the subject matter shows that the contract was made with reference to a specialized vocabulary of technical terms or other words of art. Sometimes it can be demonstrated that the parties contracted with respect to a usage in their trade or even with respect to a restricted private convention or understanding. Therefore, in interpreting a contract, the document must be read as a whole to determine the parties' purpose and intent, giving a practical interpretation to the language employed so that the parties' reasonable expectations are realized.[24]

7. CONCLUSION

New York law, and U.S. federal law to the extent relevant, thus points towards a sensible, practical, fair and commercially reasonable result in light of the intentions of the parties in determining whether a Principal Component is a "Bond" for purposes of the Reference Transaction. In the absence of contrary evidence, we think that the best available evidence of the reasonable intention of the parties is (a) the method used to determine the Fixed Rate payable under the Reference Transaction and (b) the market understandings and expectations created by the clear distinctions made repeatedly in the Reference Offering Circulars between Debt Securities, on the one hand, and Principal Components and Interest Components, on the other hand. We further think that it would be inappropriate and overly technical to look solely to the Securities Laws, the NY UCC or the HUD Regs to resolve the issue before us.

As a result, and subject to the assumptions and limitations stated above, we are of the view (a) that there is a strong argument that a Principal Component should not be found to be "Borrowed Money" under the 2003 Definitions, (b) that a Principal Component should not be found to be a "Bond" under the 2003 Definitions and therefore (c) that a Principal Component should not be a Deliverable Obligation for purposes of the Reference Transaction.

---

[21] *See, e.g.*, *Greenfield v. Phillies Records, Inc.*, 98 N.Y.2d 562, 572 (2002).

[22] *Reiss v. Fin. Perform. Corp.*, 715 N.Y.S.2d 29, 34 (2000).

[23] *William C. Atwater & Co. v. Panama R.R. Co.*, 246 N.Y. 519, 524 (1927).

[24] *Queens Best, LLC v. Brazal S. Holdings, LLC*, 826 N.Y.S.2d 684, 697 (2006) (quoting *Snug Harbor Sq. Venture v. Never Home Laundry*, 252 A.D.2d 520, 521(N.Y. App. Div. 2d 1998)).