

Commercial Paper Programs

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What is Commercial Paper?

- Commercial paper is a term that tends to be used to refer to corporate short-term debt securities. Maturities are typically less than 12 months.
- Classically, commercial paper meant debt securities issued under Section 3(a)(3) of the Securities Act.
- There has also developed a market in short-term corporate debt issued under Section 4(a)(2) of the Securities Act.
- There are differences between the two types of commercial paper in terms of investor base, use of proceeds and securities law requirements for issuance.

Historical Roots

- The legislative history of the Securities Act provides an explanation of the genesis of Section 3(a)(3).
- Commercial paper was issued by merchants and manufacturers for short-term financing of operations and was sold primarily to banks through commercial paper dealers.
- There was a concern that if short-term paper that arises out of or finances current transactions and rarely bought by private investors were required to be registered, it would radically interfere with commercial banking transactions.
- The original Federal Reserve Act included commercial paper as an instrument rediscountable by Federal Reserve banks.
- In 1933, the Federal Reserve requested an exemption for commercial paper and provided the language that became Section 3(a)(3).

Section 3(a)(3) Requirements

- Section 3(a)(3) provides an exemption from the registration requirements of the Securities Act for:
 - Any note, draft, bill of exchange, or banker’s acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited;
- In 1961, the SEC stated in Rel. 33-4412:
 - The legislative history of the Securities Act makes clear that Section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well-recognized types of current operational business requirements and of a type discountable by Federal Reserve banks.
 - [T]he staff of the Commission has interpreted Section 3(a)(3) to exclude as not satisfying the nine-month maturity standard, obligations payable on demand or having provisions for automatic “roll-over.”

Section 3(a)(3) Requirements *(cont'd)*

- The SEC imposed six separate characteristics as necessary for qualifying for Section 3(a)(3):
 1. Negotiable
 2. Prime quality
 3. Eligible for discount at Federal Reserve banks
 4. Not ordinarily purchased by the general public
 5. Used to facilitate “current transactions”
 6. Maturity of nine months or less with no automatic roll-over

“Current Transactions”

- Through a long series of no-action letters, the staff has defined current transaction for a variety of businesses.
- Traditionally, it was necessary to trace the use of proceeds to identifiable current transactions.
- Today, following a 1986 staff response, it is only necessary to demonstrate that current transactions on the balance sheet exceed the amount of commercial paper outstanding at any time.
- Inventories and accounts receivable have long been accepted as current transactions. Also operating expenses, such as salaries, short-term lending, federal, state and local taxes, and various types of bank loans with maturities not exceeding five years, have been accepted.
- However, acquisition financing is **NOT** considered a current transaction.

Section 3(a)(3) as Public Offering

- Section 3(a)(3) provides an exemption from the requirement in Section 5 of the Securities Act to register any offer or sale of securities with the SEC.
- 3(a)(3) commercial paper is not a privately placed security
 - This is important, for example, in connection with 1940 Act exemptions under Sections 3(c)(1) and 3(c)(7), which may not be used if the issuer is making a public offering.
- To meet the “not ordinarily purchased by the general public” standard, commercial paper is normally issued in minimum denominations of \$100,000, although occasionally you will see \$25,000 minimum denominations.
- 3(a)(3) commercial paper is usually rated “A-1” to satisfy the prime quality standard.

Continuous Issuance

- Commercial paper is issued in continuously offered programs.
- Typical maturities are in the range of 7 to 21 days
 - See FRB H.15 releases and the Commercial Paper releases for maturity distributions and other statistics.
 - *Volume statistics are available at:* <http://www.federalreserve.gov/releases/CP/volumestats.htm>
- Proceeds of commercial paper are often used to pay off maturing commercial paper.
- In the days before shelf registration, it would have been impossible to issue this frequently if registration were required.
- And even today, the registration costs would be prohibitive considering the high frequency of issuance.

Book-entry Considerations

- Since 1990, virtually all commercial paper is issued in book-entry form through DTC or other clearing entities.
- The issuing and paying agent (or depository bank) holds a master note for the benefit of DTC and records on its records daily issuance and redemptions of commercial paper.
- There is generally no involvement of counsel in daily issuances.
- Companies issue commercial paper by direct calls to a dealer's commercial paper desk.
- Upon agreement on terms, dealers will buy the entire daily issuance and resell to investors.

Private Commercial Paper

- Nowadays, commercial paper may also be issued under Section 4(a)(2) as a private placement of securities.
- Historically, the 3(a)(3) market was larger and deeper than the 4(a)(2) market because privately placed securities are restricted securities.
- Today, the two markets provide about the same liquidity.
- The advantage of Section 4(a)(2) is that the section does not have any maturity limitations, so longer dated paper can be issued, and proceeds do not have to be used for current transactions.
- Most privately placed commercial paper is issued in Rule 144A programs, although some programs still issue to institutional accredited investors.

4(a)(2) Requirements

- Historically, private placements were conducted under old Section 4(2) with resales to a limited number of investors under the so-called Section 4(1 $\frac{1}{2}$) exemption. This sharply limited the size of the market.
- Today, between Regulation D and Rule 144A, the private placement market is approaching the public securities market in size.
- Until the recent enactment of the JOBS Act, the prohibition on general solicitations in Rule 502(c) applied to commercial paper issued under Section 4(a)(2).
 - Occasionally, issuers would trip over this limitation and have to stay out of the market for 30 to 60 days.

JOB Act Changes to 4(a)(2) Offers

- Title II of the Jumpstart Our Business Startups (JOBS) Act of 2012 directed the SEC to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 of Regulation D and under Rule 144A.
- Under the SEC rulemaking, new paragraph (c) was added to Rule 506 to permit general solicitations under certain circumstances.
- Incidentally, this rulemaking now permits general solicitation in an offering even though the issuer is relying on Section 3(c)(1) or 3(c)(7) of the 1940 Act, which prohibits a public offering.
- Thus, a Rule 144A program no longer risks being out of the market for 30 to 60 days as a result of an inadvertent publicity problem.

JOB Act Changes to 4(a)(2) Offers *(cont'd)*

- However, in order to use general solicitation under Rule 506(c), the issuer and offering participants must not be “bad actors.”
 - An offering is disqualified from relying on Rule 506(c) if a “covered person” has a relevant criminal conviction, regulatory or court order or other disqualifying event.
 - “**Covered persons**” include: (1) the issuer, including its predecessors and affiliated issuers; (2) directors, general partners, and managing members of the issuer; (3) executive officers of the issuer, and other officers of the issuers that participate in the offering; (4) 20% beneficial owners of the issuer, calculated on the basis of total voting power; (5) promoters connected to the issuer; (6) for pooled investment fund issuers, the fund’s investment manager and its principals; **and** (7) persons compensated for soliciting investors, including their directors, general partners and managing members.
- Certifications as to bad actor status are time consuming to obtain and this is not practical for commercial paper which can be issued daily.
- As a result, issuers and dealers do not use general solicitation and instead rely just on Section 4(a)(2) rather than Rule 506(c)

Amended “accredited investor”

- In August (Rel. 33-10824), the SEC adopted amendments to the definition of “accredited investor” and the definition of “QIB”
 - Added any entity not listed in (a)(1), (2), (3), (7), or (8) with at least \$5M of investments
 - That addition clarifies that municipalities and other government entities qualify
 - Also added “family office” and “family client”
- QIB definition amended to add any institutional accredited investor not listed in 144A(a)(1)(i)(A) through (I) or (a)(1)(ii) through (vi)
 - And it may be formed for the purpose of acquiring the securities offered

Use of Proceeds of 4(a)(2) Paper

- One of the advantages of 4(a)(2) commercial paper is that there is no requirement to use the proceeds for current transactions.
- 4(a)(2) commercial paper programs are often used to finance acquisitions until term financing can be arranged.
- Proceeds can be used for any legitimate purpose consistent with the board resolutions for the program.

Disadvantages of 4(a)(2) Paper

- 4(a)(2) commercial paper is still a “restricted security.”
- Some investors have limits on the amount that they can invest in restricted securities.
- This might have some impact in the secondary market, but generally the secondary market is a dealer market, i.e., most sales in the secondary market are back to dealers who may hold or may resell the paper to other customers.

Conversion of 3(a)(3) to 4(a)(2)

- It is not uncommon for issuers to convert 3(a)(3) commercial paper programs to 4(a)(2) programs.
- Historically, there were transition issues in moving from a public offering program to a privately placed program to avoid integration of the private program with the public program while losing the 3(a)(3) exemption.
- This was addressed by covenants to use the proceeds for current transactions, but to make sales only to QIBs, for a six month period.
- With the changes brought about by the JOBS Act, this overlap should no longer be necessary to deal with the general solicitation issues created by the 3(a)(3) programs.

Side-by-side Programs

- Some issuers still operate side-by-side 3(a)(3) and 4(a)(2) programs.
- Historically, there had to be careful segregation of proceeds and use of proceeds, and perhaps different maturities to deal with the integration issue.
- Today, after the JOBS Act, the integration concern from general solicitation is removed but also perhaps there is no longer a reason to operate two programs.

Financial Institution Issuance

- Financial institutions account for about 60% of commercial paper issuance.
- 2/3 of that is from foreign financial institutions
- Domestic banks rely on Section 3(a)(2) for their exemption from the registration requirements
 - If OCC registered then must comply of Part 16 of the OCC's rules
- Branches and agencies of foreign banks also rely on Section 3(a)(2)
 - 1986 SEC Release 33-6661 is an interpretive release
 - If OCC registered then must also comply with Part 16 of OCC rules
- Foreign banks may issue directly under either Section 3(a)(3) or Section 4(a)(2)
 - Some banks have a U.S. branch program and a home office program

Asset-Backed Commercial Paper

- Starting in the 1980s, asset-backed commercial paper (ABCP) programs become common.
- Under accounting rules at the time, the sponsor of the program could operate the program off-balance sheet, so no capital was required to be held against the assets.
- Numerous ABCP programs foundered during the financial crisis and today they are much less common; ABCP volumes have declined from a high of about \$1.2 trillion to less than \$300 billion today.
- Revised accounting rules and other regulatory developments have made it increasingly difficult to maintain these programs off-balance sheet, so much of the reason for their separate existence is gone.
- They are still used, however, for trade receivables financing and other short-term, maturity-matched lending situations.

1940 Act Considerations

- With ABCP, because the issuer is an SPV and not an operating company, it is necessary to consider what exemption from the 1940 Act may be available.
- Many ABCP programs previously relied on Sections 3(c)(1) or 3(c)(7) for an exemption.
- For bank sponsors, the Volcker Rule will now require a careful examination of other possible exemptions under the 1940 Act or exemptions under the Volcker Rule from the definition of “covered fund.”
- Section 3(c)(5) of the 1940 Act or Rule 3a-7 under the 1940 Act are possibilities and also compliance with the definition of “qualifying asset-backed commercial paper conduit” under the Volcker Rule.
- If swaps are used in the program, attention must also be paid to the Commodity Exchange Act and initial and variation margin requirements.

Disclosure Considerations

- Disclosure practices for commercial paper developed from the historical antecedent of Section 3(a)(3), where commercial paper was used for commercial banking transactions.
- Section 3(a)(3) itself does not impose any disclosure requirements.
- Disclosure documents for commercial paper have traditionally been very brief, providing little more than identification of the issuer. Accordingly the offering documents may be little more than a term sheet.
- 4(a)(2) commercial paper adopted the same disclosure approach.
- As a consequence, 10b-5 letters from counsel are not utilized in the commercial paper market.

Issuing Documents

- Issuing Agreement
 - Issuing and Paying Agency Agreement
 - Depositary Agreement
- Agreement with distributing dealer
 - Commercial Paper Dealer Agreement
 - Private Placement Agreement
- Disclosure Document
 - Offering Circular
 - Private Placement Memorandum
- Liquidity Agreement

Practical Considerations

- Maturity limits on 4(a)(2) commercial paper:
 - Seldom sold with maturities longer than 390 days, a limit determined by money market fund considerations, as money market funds have traditionally been very active purchasers of commercial paper;
 - MTN and senior note programs are usually established for issuance of maturities of one year or more;
 - Generally, investment banks have separate desks for commercial paper and MTN and senior note programs;
 - MTN and senior note programs have more traditional prospectus disclosure; at longer maturities, the rationale for brief disclosure documents is not supported.

Securities Law Liability

- No liability under Section 11 of the Securities Act for issuers with respect to 3(a)(3) or 4(a)(2) programs.
- After *Gustafson v. Alloyd*, there is no liability under Section 12(a)(2) of the Securities Act for privately placed commercial paper.
- Section 17 of the Securities Act will support SEC actions, but not investor actions.
- Sections 12(a)(2) and 17 of the Securities Act apply to 3(a)(2) commercial paper, notwithstanding the exemption from registration provided by Section 3(a)(3).

Securities Law Liability *(cont'd)*

- For investors, Rule 10b-5 under the Securities Exchange Act provides principal remedy against both dealers and issuers.
 - Consider the exclusion from the definition of a “security” in Section 3(a)(10) of the Securities Exchange Act for “any note which has a maturity at the time of issuance of not exceeding nine months,” which appears to exclude 3(a)(3) commercial paper. However, notes which fail the ‘prime quality’ standard have been held to fall outside this exclusion.
- After the SEC’s enforcement proceeding settlement against Goldman Sachs in the 1974 arising out of the Penn Central bankruptcy and commercial paper default, many dealers have assumed that they will be unable to avoid liability for any defaulted commercial paper.
- The SEC stated that Goldman had failed to conduct a reasonable investigation of Penn Central and had implicitly represented to its customers that the issuer was creditworthy.

Due Diligence Defense

- Classic due diligence inquiry not possible due to issuance mechanics
- No 10b-5 opinions are given
- No accountant's comfort letters are received
- There is no questioning of management prior to each issuance
- Thus, there can be no "reasonable investigation"
- Some dealers established credit departments to monitor their issuers continuously
- Generally, dealers act defensively and rating downgrades or headline events can lead to dealers and investors refusing to roll over an issuer's commercial paper, forcing the issuer to rely on bank lines of credit

Issuance Volumes

Source (as of January 27, 2021): www.federalreserve.gov/releases/cp

Period	Total	Nonfinancial			Financial			Asset-backed	Other
		Total	Domestic	Foreign	Total	Domestic	Foreign		
Monthly-end levels									
2020-Aug.	997.0	209.9	142.2	67.7	544.2	185.3	358.9	242.9	.0
Sept.	956.9	183.4	122.2	61.2	532.8	165.3	367.5	240.7	.0
Oct.	966.1	198.4	133.1	65.4	528.2	173.8	354.5	239.4	.0
Nov.	982.7	189.9	127.0	62.9	549.5	185.8	362.2	243.2	.1
Dec.	986.9	180.9	132.1	48.8	549.6	165.1	381.6	256.3	.1
Weekly (Wednesday) levels									
Dec. 23	1,032.4	188.3	134.2	54.1	588.6	198.9	386.9	255.4	.1
Dec. 30	1,010.8	183.7	133.4	50.3	570.0	186.2	381.0	257.1	.1
Jan. 6	1,039.3	187.8	132.8	55.0	594.1	192.3	398.6	257.3	.1
Jan. 13	1,062.7	192.4	136.1	56.2	613.8	201.9	408.7	256.4	.1
Jan. 20	1,067.6	198.8	139.9	58.9	613.6	205.8	404.1	255.1	.1

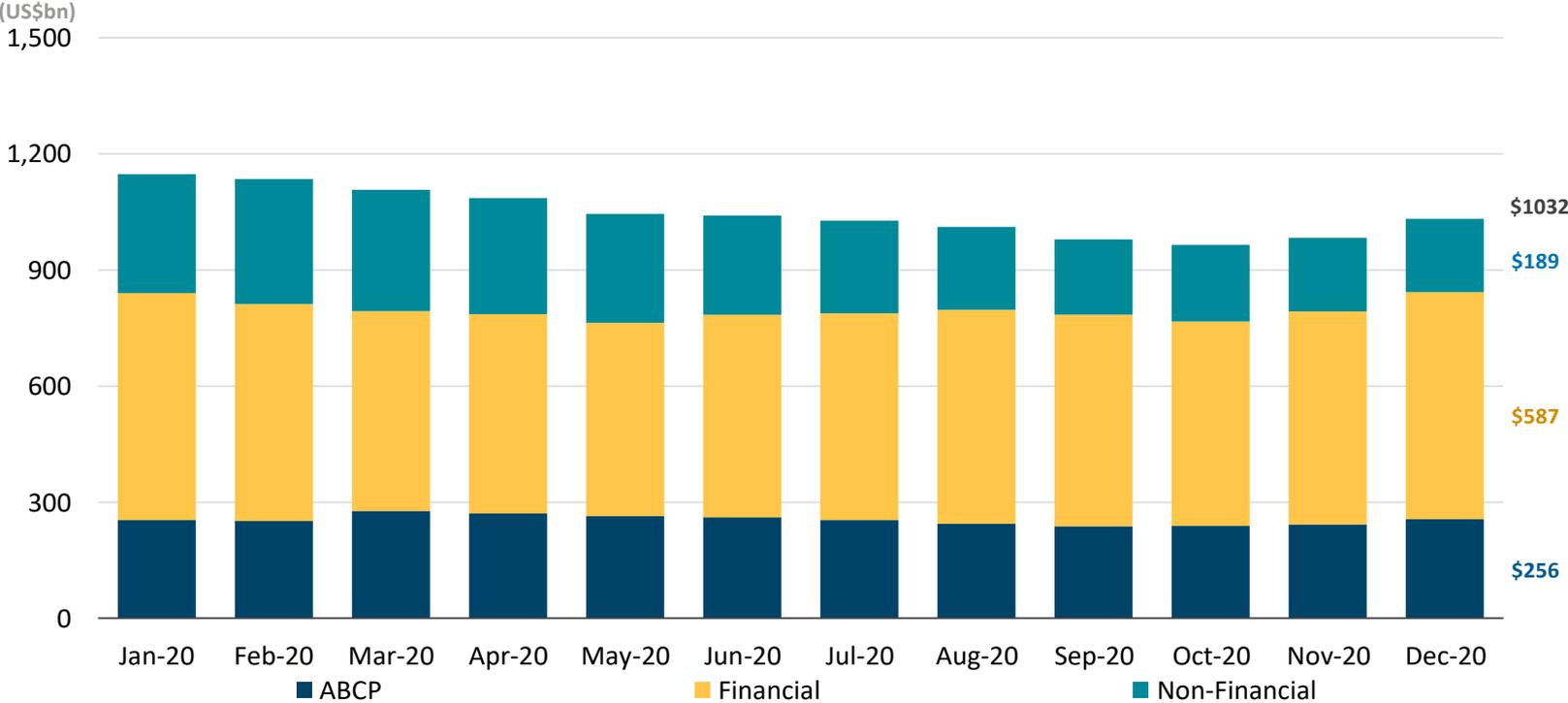


US and Euro Commercial Paper Market

February 1, 2021

US Commercial Paper Market

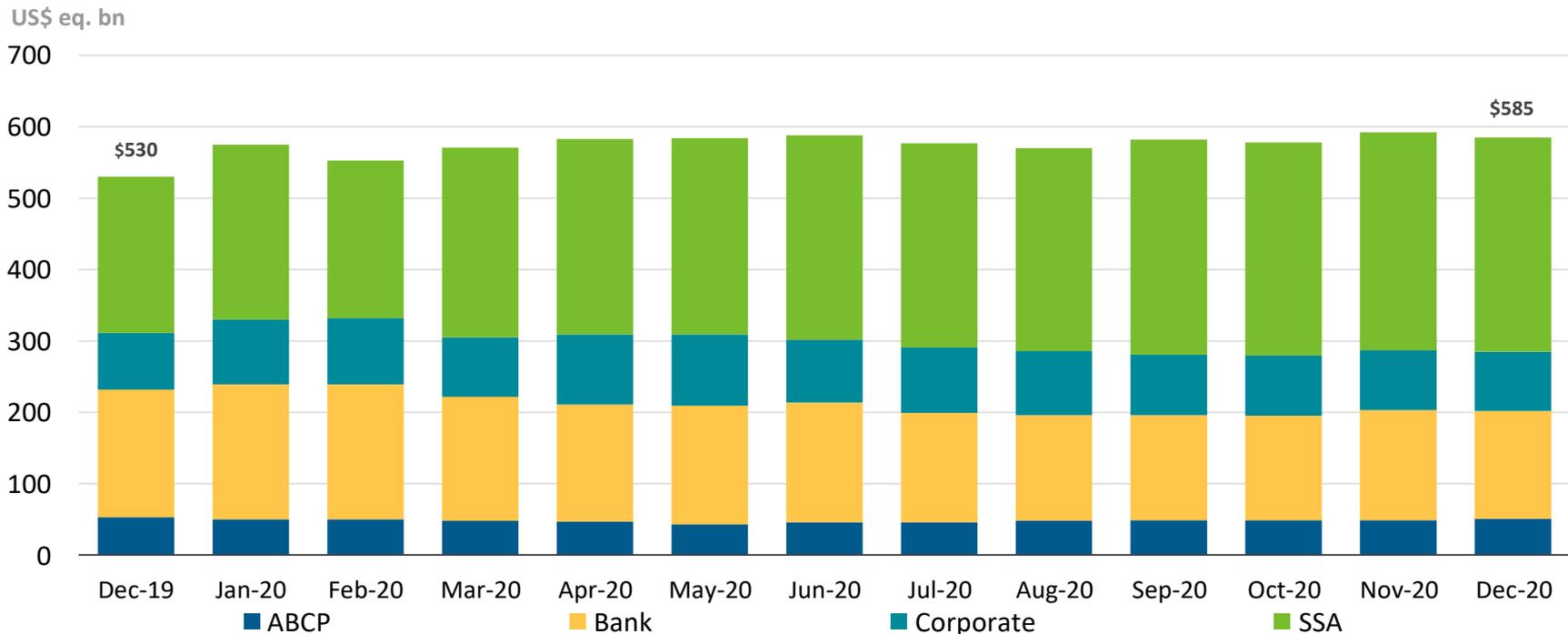
USCP Monthly Outstandings (by Type)



Source: Federal Reserve

Euro Commercial Paper Market

ECP Outstandings by Sector



Source: CMD

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