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Commercial Paper: An Exempted Security Under Section 3 (a) (3) of the Securities Act of 1933

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**COMMERCIAL PAPER: AN EXEMPTED
SECURITY UNDER SECTION 3(a)(3)
OF THE SECURITIES ACT
OF 1933**

J. William Hicks*

INTRODUCTION

Corporations and other business entities have a need from time to time to borrow substantial sums of money for short-term use. Interim financing of this type can, of course, be sought in conventional loans from banks and other lending institutions, but an attractive remedy may exist in commercial paper, which usually takes the form of short-term unsecured promissory notes.¹ Commercial paper is relatively inexpensive² and easy to use and, as a money market instrument, has traditionally been viewed by investors as almost entirely without risk.³ Furthermore, unlike other

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¹ Some of the information on the commercial paper market set forth in this Article is based on interviews conducted between October 1975 and June 1976 with representatives of major institutions participating in the market, including several commercial paper dealers located in New York City, several direct issuers of commercial paper, the Securities and Exchange Commission (Washington, D.C.) and several major New York City law firms.

Since most of those interviewed could have reasonably expected that certain candid comments would not be attributed to them, information received from these interviews is cited to this footnote generally. [Hereinafter cited as Interviews]

² Commercial paper has generally been less expensive to finance than bank borrowings. See, e.g., SEC no-action letter (First R.R. & Banking Co. of Ga.), issued May 29, 1975, [1975] CCH FED. SEC. MICROFILM, roll 6, frame 06497, 06501. See generally N. BAXTER, *THE COMMERCIAL PAPER MARKET* (2d ed. 1966); Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1972) [hereinafter cited as *Commercial Paper Market*].

³ According to an SEC staff report, investors' confidence in commercial paper has been almost unshakable:

The most noteworthy factor in the commercial paper market (at least until the Transportation Co. bankruptcy) was the common belief held by purchasers, to a degree not even found among those who invest in the bluest of blue chip securities, that commercial paper was designed to be entirely riskproof. Because safety of principal so far and away transcended rate considerations, a very large number of purchasers of commercial paper did not shop for rates at all. Most looked upon commercial paper as the equal of U.S. Treasury notes or bank certificates of deposit (CD's) in terms of safety.

STAFF REPORT OF THE SECURITIES AND EXCHANGE COMM'N TO THE SPECIAL

investment devices, commercial paper escapes many of the rigors of the federal securities laws. The Securities Act of 1933 (1933 Act)⁴ requires that all securities sold in interstate commerce⁵ be registered⁶ with the Securities and Exchange Commission (SEC) unless the security or transaction is exempted. Commercial paper constitutes a "security"⁷ under the 1933 Act but is exempted by section 3(a)(3) from this registration requirement⁸ if it is a note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which

SUBCOMMITTEE ON INVESTIGATIONS: THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY 272 (1972) [hereinafter cited as SEC STAFF REPORT], summarized in [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,931.

⁴ 15 U.S.C. §§ 77a *et seq.* (1970).

⁵ Section 2(7) of the 1933 Act defines "interstate commerce" as "trade or commerce in securities or any transportation or communication relating thereto among the several States." *Id.* § 77b(7).

⁶ *Id.* § 77(e). For an overview of the registration process, see generally 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 7.02 (1975).

⁷ Section 2(1) of the 1933 Act defines a "security" as follows:

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1970).

Although the Supreme Court has indicated that the definition of a "security" under the 1933 Act is, for most purposes, interchangeable with the definition contained in the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.* (1970) (1934 Act), *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967), a significant difference exists in the case of commercial paper. Under the 1933 Act, commercial paper can qualify as an exempt security, under section 3(a)(3). 15 U.S.C. § 77c(a)(3) (1970). But short-term notes, *i.e.*, commercial paper, are excluded from the definition of a "security" in section 3(a)(10) of the 1934 Act. 15 U.S.C. § 78c(a)(10) (1970). *But see Sanders v. John Nuveen & Co., Inc.*, 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972) (promissory notes with a maturity not exceeding nine months that are offered to the public as "investment contracts" and not as commercial paper fall within the definition of a "security" for purposes of the 1934 Act); *accord*, *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir. 1973); *United States v. Rachal*, 473 F.2d 1338 (5th Cir. 1973). The Investment Advisors Act of 1940 also applies to commercial paper. 15 U.S.C. § 80b-2(a)(18) (1970).

⁸ The exemption provided by section 3(a)(3) applies only to the registration requirements of section 5 of the 1933 Act, 15 U.S.C. § 77e (1970). The civil liability and antifraud provisions of the 1933 Act, sections 12 and 17, 15 U.S.C. §§ 77l, q (1970) respectively, remain applicable if the issuer utilizes the requisite jurisdictional means. *See* note 5 & accompanying text *supra*.

The antifraud provision of the 1934 Act, 15 U.S.C. § 78j (1970), and rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1976), are also available to the SEC or private litigants if they can establish a violation in connection with the purchase or sale of commercial paper that is deemed an "investment contract." Unlike section 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1970), which defines commercial paper as a security, section 3(a)(10) of the 1934 Act states that the

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 limited⁹

An examination of the commercial paper exemption under section 3(a)(3) is appropriate at this time for several reasons. The commercial paper market has expanded in volume and importance during the past forty-three years.¹⁰ Investor confidence in commercial paper has lessened,¹¹ a change attributable at least in part to the financial disaster of Penn Central Transportation Company, which had eighty-two million dollars of commercial paper outstanding when it filed its bankruptcy reorganization petition in

term "security" means

any note . . . [or] investment contract . . . but shall not include currency or any note, draft, bill of exchange, or banker's acceptance, 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.

15 U.S.C. § 78c(a)(10) (1970).

In order to recover under the antifraud provisions of the 1934 Act, the plaintiff must first establish that the short-term notes were not of the type intended by Congress to be excluded from the coverage of the 1934 Act but were instead investment securities or investment contracts and therefore within the purview of the statute. For cases in which short-term notes have been deemed to be "securities" under the 1934 Act, see *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir. 1973); *United States v. Rachal*, 473 F.2d 1338 (5th Cir. 1973); *Sanders v. John Nuveen & Co., Inc.*, 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

Although an important topic, the question of civil liability in the sale of commercial paper will not be discussed in this Article. See generally *Commercial Paper Market*, *supra* note 2, at 396-400.

⁹ 15 U.S.C. § 77c(a)(3) (1970).

¹⁰ It is estimated that in 1933 the commercial paper market averaged only \$139 million in commercial paper outstanding. N. BAXTER, *supra* note 2, at 17. The market grew slowly, reaching \$4.5 billion by 1960. On December 31, 1965, the amount had grown to \$9 billion outstanding, with the rapid growth still to come: December 31, 1967, \$16 billion outstanding; December 31, 1969, \$31.6 billion outstanding; and June 30, 1970, \$39.9 billion outstanding. SEC STAFF REPORT, *supra* note 3, at 273. It is estimated that in 1976 the commercial paper market will average \$50 billion outstanding. Interviews, note 1 *supra*. This recent growth of the commercial paper market has been explained as

directly related to the monetary squeeze in which U.S. industry found itself at the end of the 1960's. In December 1968, the Federal Reserve Bank imposed a ceiling on CD interest rates. The banks, expectedly, strenuously objected to regulation Q, as it is known, which had the effect of diverting funds from the banking system and into commercial paper and other money market instruments, but the banks themselves were contributing to the increase in commercial paper outstanding. Bank holding companies began to issue commercial paper, and the banks put hundreds of disappointed loan customers in the direction of commercial paper as a cure to corporate liquidity problems.

SEC STAFF REPORT, *supra* note 3, at 273. The SEC staff has shown concern that the "rapid growth of the market for commercial paper has involved its increased use as a substitute for long-term financing." *Id.*

¹¹ See, e.g., Hussey, *Loss of Confidence*, BARRON'S, July 15, 1974, at 5; Loomis, *The Lesson of the Credit Crisis*, FORTUNE, May 1971, at 141.

1970.¹² In light of these changes, what was considered an appropriate security for exemption in 1933 may now be inappropriate. Criticism of current commercial paper regulation has prompted Congress¹³ and the SEC¹⁴ to reevaluate the 3(a)(3) exemption and its administrative interpretations. Moreover, the SEC has recently stated that it is committed to coordinating and integrating a continuous disclosure system with the various exemptive provisions provided by the federal securities laws.¹⁵ Section 3(a)(3)

¹² See generally SEC STAFF REPORT, *supra* note 3, at 271. In the Penn Central disaster, investor confidence was maintained by quick action on the part of the Federal Reserve Board.

In the 30-day period following the Transportation Co. bankruptcy, the runoff in commercial paper is estimated to have reached \$3 billion. Only quick action by the Federal Reserve, which had been alerted to the approaching bankruptcy a day or two before, appears to have saved the day. On June 19, 1970, in anticipation of trouble, the Federal Reserve had agreed to let commercial banks borrow freely at its discount window. And on June 23, it voted to change its regulation Q, which limits what banks can pay for deposits, thus allowing them to buy money freely. And the banks borrowed heavily from the Federal Reserve in the weeks that followed—\$1.7 billion in just 1 week in mid-July. More than \$2 billion in bank money went to aid corporations in paying off maturing commercial paper. This rescue operation not only took some companies out of trouble, it also restored lender confidence in the commercial paper market. What could have blown into a major liquidity crisis vanished almost before it began.

Id. at 272.

¹³ On December 8, 1971, in the wake of the financial collapse of the Penn Central Company, Congressman Harley O. Staggers introduced H.R. 12128, a bill "to extend the protection provided by the Federal securities laws to persons investing in securities of carriers regulated by the Interstate Commerce Commission" 117 CONG. REC. 45613 (1971). Although the proposed legislation was aimed at the rescission of section 3(a)(6) of the 1933 Act, 15 U.S.C. § 77c(a)(6) (1970), which exempted securities issued by persons regulated by the ICC, its sponsor was concerned with other aspects of the federal securities laws, including section 3(a)(3). The SEC testified before the Special Subcommittee on Investigations for the Committee on Interstate and Foreign Commerce and later submitted to the subcommittee its detailed report on the collapse of the Penn Central. See SEC STAFF REPORT, note 3 *supra*. The Commission's efforts to have section 3(a)(3) amended were unsuccessful, although Congress did eventually narrow the exemption under section 3(a)(6) in section 308 of the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31.

¹⁴ The Commission examined section 3(a)(3), 15 U.S.C. § 77c(a)(3) (1970), in connection with its staff report on the financial collapse of the Penn Central. SEC STAFF REPORT, *supra* note 3, at viii-ix. The Chairman of the Commission suggested that Congress amend section 3(a)(3) "in order to provide more definite standards." *Id.* at viii.

¹⁵ In November 1967, the SEC authorized a small group from the Commission's staff to "examine the operation of the disclosure provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and Commission rules and regulations thereunder." SEC Securities Act Release No. 4885 (Nov. 29, 1967), [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 83,011. The study group, headed by Commissioner Francis M. Wheat, reported its recommendations in March 1969. SECURITIES AND EXCHANGE COMM'N, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS: THE WHEAT REPORT (1969) [hereinafter cited as WHEAT REPORT]. One of the major recommendations of the *Wheat Report* called for a shift

appears to be an exception to this commitment since it permits commercial paper to be sold without the disclosure protection of the 1933 Act to investors who may know little or nothing about the issuer¹⁶ and who lack effective controls over the use of the proceeds¹⁷ or any of the borrower's other business decisions.¹⁸ Finally, section 3(a)(3) has been largely ignored in legal journals,¹⁹ a fact that can be explained by the shortage of useful legislative history²⁰

in emphasis by the Commission from disclosure in the new issue market to continuing disclosures which benefit the trading markets in securities. *Id.* at 11. With appropriate new rules and regulations, the SEC could, it was hoped, "enhance the degree of coordination between the disclosures required by the '33 and '34 Acts . . ." *Id.* at 8. After an abortive attempt to adopt a series of rules recommended by the *Wheat Report*, the Commission in January 1972 adopted rule 144, the first of four "140 series" rules. Rule 144, 17 C.F.R. § 230.144 (1976). The Commission envisioned rule 144 as an important part of its efforts to achieve what the SEC considered the objectives of the federal securities statutes, "a continuous disclosure system designed to protect investors and to assure the maintenance of fair and honest securities markets . . ." SEC Securities Act Release No. 5223 (Jan. 11, 1972), [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,487, at 81,051. In adopting each of the other three rules in the 140 series, the Commission has repeated its conception of the Congressional purposes behind the federal securities laws and has described each new rule as a further effort in the Commission's goal "to coordinate and integrate the disclosure system with the exemptive provisions provided by the laws." *See* the Commission's promulgation of rule 145, SEC Securities Act Release No. 5316 (Oct. 6, 1972), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,015; rule 147, SEC Securities Act Release No. 5450 (Jan. 7, 1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,617, at 83,649; and rule 146, SEC Securities Act Release No. 5487 (Apr. 23, 1974), 1 CCH FED. SEC. L. REP. ¶ 2710. *See generally* 3 H. BLOOMENTHAL, *supra* note 6, at 4-1 to -190.

¹⁶ Investors lack information about the issuer

[b]ecause of the short-term nature of commercial paper and the way in which investments in commercial paper are made—there is a continuous turnover and a customer usually must choose from whatever commercial paper the dealer has available at the time which will meet the customer's maturity requirements—the usual purchaser does very little investigation or analysis of the investment merits of commercial paper. He is not in a position to acquire information directly and must rely on what he can get from the dealer selling the paper, rating services and the public media.

SEC STAFF REPORT, *supra* note 3, at 276.

¹⁷ For a discussion of the limitations on the use of commercial paper proceeds under section 3(a)(3), see text accompanying notes 107-225 *infra*.

¹⁸ For example, it is almost impossible for purchasers of commercial paper to secure restrictive covenants limiting the issuer's freedom to raise additional debt. SEC STAFF REPORT, *supra* note 3, at 272.

¹⁹ *See Commercial Paper Market*, *supra* note 2, at 380-96, for an excellent analysis of the impact of federal securities laws on the commercial paper market and the significance of section 3(a)(3). That student comment is the only in-depth study that addresses commercial paper under the securities acts. *See generally* 3 H. BLOOMENTHAL, *supra* note 6, at § 2.03[1]-[2]; 1 L. LOSS, *SECURITIES REGULATION* 566-68 (2d ed. 1961); 4 *id.* 2590-91 (Supp. 1969). *See also* Schweitzer, *Commercial Paper and the Securities Act of 1933: A Role for Registration*, 63 GEO. L.J. 1245 (1975).

²⁰ *See generally* H.R. REP. NO. 85, 73d Cong., 1st Sess. 15 (1933). The legislative history of section 3(a)(3) is discussed at text accompanying notes 226-41 *infra*.

and judicial interpretation²¹ of the exemption and, until recently, the scarcity of administrative guidelines²² for its use. Since December 1, 1970, the SEC has made available to the public²³ the correspondence between SEC staff members and persons seeking official opinions regarding the effect of federal securities law on contemplated transactions. The staff may either render legal interpretations of statutory provisions or administrative regulations without reference to particular facts²⁴ or, alternatively, state that no enforcement action will be recommended to the Commission if the transaction is consummated in the manner contemplated.²⁵ Sec-

²¹ Section 3(a)(3), 15 U.S.C. § 77c(a)(3) (1970), has received limited judicial attention in the following cases: SEC v. Continental Commodities Corp., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,724 (5th Cir. 1974); United States v. Rachal, 473 F.2d 1338 (5th Cir. 1973); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); Franklin Savs. Bank v. Levy, 406 F. Supp. 40 (S.D.N.Y. 1975); SEC v. M.A. Lundy Assocs., 362 F. Supp. 226 (D.R.I. 1973); United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969); SEC v. Perera Co., Inc., 47 F.R.D. 535 (S.D.N.Y. 1969); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705 (D. Minn. 1968).

²² The SEC to date has issued the following releases on section 3(a)(3): SEC Securities Act Release No. 401 (June 18, 1935), 1 CCH FED. SEC. L. REP. ¶ 2041 (1975); SEC Securities Act Release No. 4412 (Sept. 20, 1961), 1 CCH FED. SEC. L. REP. ¶ 2045 (1975); SEC Securities Act Release No. 5453 (Feb. 1, 1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,634.

²³ Prior to December 1970, SEC interpretative letters, no-action letters and the inquiries upon which they were based were not generally available to the public. On September 20, 1968, the Commission requested comments on whether its policy of nondisclosure should be changed. SEC Securities Act Release No. 4924 (Sept. 20, 1968), [1967-1968 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,606, at 83,295. The overwhelming majority of responses favored some form of public disclosure of the matters treated in no-action and interpretative letters, and the Commission responded with a formal proposal, SEC Securities Act Release No. 5073 (July 14, 1970), [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,838, which was adopted in SEC Securities Act Release No. 5098 (Oct. 29, 1970), [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,921.

²⁴ Interpretative letters provide a useful method for the Commission staff members to assist persons in complying with a new administrative ruling and in certain cases such letters replace no-action letters as the forum for staff expression. For example, when the Commission adopted its nonexclusive rule 147, 17 C.F.R. § 230.147 (1975), as a clarification of the intrastate exemption under section 3(a)(11) of the 1933 Act, it announced that the staff would issue no-action letters in regard to transactions in reliance on section 3(a)(11) outside the rule "only on an infrequent basis and in the most compelling circumstances." SEC Securities Act Release No. 5450, *supra* note 15, at 83,654. The Commission assured the public, however, that the staff would issue interpretative letters to assist persons complying with the rule.

²⁵ Staff responses to requests for no-action treatment regularly include the caveat that they only express a position on enforcement action and do "not purport to express any legal conclusion on the questions presented." SEC no-action letter (Pacesetter Fin. Corp.), issued Jan. 23, 1974, [1974] CCH FED. SEC. MICROFILM, roll 2, frame 01618, at 01619.

A no-action letter may, in fact, be an interpretation of the statute; most often, however, it is something entirely different. It may be a . . . decision in a particular case, after considering the priorities and problems

tion 3(a)(3) has been the subject of many "no-action" letter requests and staff responses during the past six years.²⁶

This Article will examine section 3(a)(3) under both traditional interpretations and the "informal policy"²⁷ articulated by the SEC staff in interpretative and no-action letters. Part I reviews the current SEC interpretation of the exemption requirements, including some issues that have not yet been resolved. Part II assesses this treatment of the exemption in terms of the overall purpose of the 1933 Act. Suggestions will be offered in Part II for the reform of the SEC interpretation of section 3(a)(3) to better comport with congressional goals.

I. REVIEW OF SEC AND STAFF INTERPRETATION OF SECTION 3(a)(3)

Section 3(a)(3) exempts certain commercial paper and bank-

before the agency, the manpower available [and] the effects on the public . . . , whether it is necessary to crank up a proceeding if someone should proceed in the manner suggested.

Release No. 4924, *supra* note 23, at 83,294 n.3, citing Panel Discussion, *Public Information Act and Interpretative and Advisory Rulings*, 20 ADMIN. L. REV. 1, 24 (1967).

A no-action position by the staff is binding on the Commission but does not serve as a bar to a private litigant who wishes to challenge the legality of a transaction consummated in reliance upon the administrative position. *See* SEC Securities Act Release No. 4552 (Nov. 6, 1962), 1 CCH FED. SEC. L. REP. ¶ 2770 (1975), where the SEC warned the public that

persons receiving advice from the staff of the Commission that no action will be recommended if they proceed without registration in reliance upon the [section 4(2), 15 U.S.C. § 77d(2) (1970)] exemption should do so only with full realization that the test so applied may not be proof against claims by purchasers of the security that registration should have been effected.

Id. at 2922.

²⁶ According to the microfilm record of no-action letters, the following number of requests for staff response relating to section 3(a)(3) have been answered since 1971:

<u>Year</u>	<u>Number of Letters</u>
1971	25
1972	45
1973	88
1974	63
1975	27
1976	26 (as of July 1976)

²⁷ There is some dispute over the proper weight to be given to no-action letters. According to Professor Kenneth Culp Davis, "some of the most important law of the SEC is embodied in this big batch of no-action letters. This is law. The interpretations are law." The SEC's response is that "while the Commission does not agree that this much significance should be attached to views expressed by the staff, it may nevertheless be true that practitioners might find these letters helpful" Release No. 4924, *supra* note 23, at 83,294. For a critical analysis of the Commission's informal method of modifying substantive law through the publication of no-action responses, see Lowenfels, *SEC No-Action Letters: Conflicts with Existing Statutes, Cases, and Commission Releases*, 59 VA. L. REV. 303 (1973).

er's acceptances²⁸ from the registration and prospectus requirements of the 1933 Act. Persons claiming the exemption must establish that they have met all of the conditions stated in the exemptive provision itself and, in addition, those imposed by the SEC staff.²⁹ Determining the full extent of these staff-imposed conditions is somewhat difficult, but it appears that the availability of the commercial paper exemption depends upon the nature of the (a) security, (b) issuer, (c) purchaser, (d) manner of sale, and (e) use of proceeds. Each of these factors will be examined separately.

A. *The Security*

Commercial paper in the form of promissory notes is sold in denominations ranging from \$5,000 to \$1,000,000,³⁰ depending upon the size of the offering and the type of purchaser.³¹ The notes are either discount notes without interest or nondiscount notes with interest,³² and are payable on a fixed date.³³ Maturities can vary from 3 to 270 days but the bulk of commercial paper

²⁸ Section 3(a)(3) refers specifically to a "note, draft, bill of exchange, or banker's acceptance." For a discussion of the Commission's interpretation of these terms in the exemption, see notes 38-42 & accompanying text *infra*.

²⁹ Persons claiming an exemption under section 3(a)(3) are not required to inform the SEC of their decision to invoke the exemption. The burden of proving compliance with all of the requirements of the exemption arises only if the issuer is challenged by the Commission or by disgruntled investors for selling unregistered securities.

³⁰ Most commercial paper sold by dealers has a minimum denomination of \$100,000. Interviews, note 1 *supra*. Issuers who sell their notes directly are more likely to sell their short-term notes in denominations of \$50,000, but may sell them in denominations as small as \$5,000. *Id.* The largest denominations, those in excess of \$5 million, are usually sold directly by the issuer. McGillicuddy, *The Commercial Paper Market?*, J. COM. BANK LENDING, April 1972, at 2, 3. For a discussion of the methods of selling commercial paper, see text accompanying notes 90-106 *infra*.

³¹ Specifying the size of commercial paper notes may be a function of the commercial paper dealer if the issuer does not place its securities directly.

Some dealers prefer to market notes of small denomination. These generally handle paper of moderate-size issuers who may prefer to spread out the maturity dates of their notes, and appeal to relatively small investors who want to diversify their paper portfolios. Other dealers try to avoid handling small notes because the marketing effort is much the same as for large notes, and the commission is calculated on the dollar value of the transaction.

N. BAXTER, *supra* note 2, at 29.

³² Section 3(a)(3) is available for either type of note. See, e.g., SEC action letter (DAC Corp.), issued June 17, 1974, [1974] CCH FED. SEC. MICROFILM, roll 7, frame 09302.

³³ At maturity the notes are normally redeemable at the issuer's bank. The investor's bank is likely to effect collection for him through the paying bank and eventually credit his account with the proceeds. McGillicuddy, *supra* note 30, at 3.

falls due within 90 days.³⁴ The debt instrument usually does not indicate the source of repayment funds³⁵ or provide for a security interest,³⁶ which leaves the investor as a general creditor unsure of how the debt will be repaid.

Section 3(a)(3) identifies the type of commercial paper eligible for an exemption as "any note, draft, bill of exchange, or banker's acceptance."³⁷ The exemptive provision states that such

³⁴ *Id.* at 4; Interviews, note 1 *supra*. According to one source, money market experts estimate that commercial paper typically matures 15 to 30 days after issuance. Foldessy, *Sour Notes? Money-Market Critics Say Commercial Paper is Less than Risk-Free*, Wall St. J., May 16, 1974, at 1, col. 6.

³⁵ Such funds can be generated by the issuer in the normal course of business, obtained through long-term financing, or produced by another offering of short-term commercial paper. For a discussion of the problem of successive short-term securities offerings under section 3(a)(3) serving as long-term financing, see text accompanying notes 283-87 *infra*.

³⁶ It is possible, of course, to sell secured promissory notes on a short-term basis. For example, a collateral trust note is a note secured by receivables that are assigned to a trustee. Nothing in the staff's interpretations of section 3(a)(3) restricts the exemption to unsecured obligations. Exempt commercial paper may be backed by letters of credit issued by commercial banks, *e.g.*, SEC no-action letter (Commonwealth Nat'l Realty Trust), issued May 9, 1974, [1974] CCH FED. SEC. MICROFILM, roll 6, frame 07830, or be guaranteed by an affiliate, *e.g.*, SEC no-action letter (NCR Corp.), issued June 10, 1975, [1975] CCH FED. SEC. MICROFILM, roll 7, frame 08544.

³⁷ Each of these terms had a generally accepted meaning prior to 1933; the terms appear to have been taken directly from the language in section 13 of the Federal Reserve Act, 12 U.S.C. § 343 (1970), and the Federal Reserve Board's Regulation A, 12 C.F.R. § 201 (1976), which allowed a Federal Reserve Bank to discount for any of its member banks "any note, draft, or bill of exchange." See, *e.g.*, *Regulation A, Regulations of the Federal Reserve Board, Series of 1920*, in 6 FED. RES. BULL. 1179 (1920). For a description of Regulation A, see note 46 *infra*.

Regulation A, as of 1920, contained definitions of each of those terms that later appeared in section 3(a)(3). The definitional parts of Regulation A were eventually removed by amendment. According to Regulation A, Series of 1920, *supra*, a note was defined in the terms of a promissory note, that is, "an unconditional promise in writing, signed by the maker, to pay, in the United States, at a fixed or determinable future time, a sum certain in dollars to order or to bearer." *Id.* at 1180. A draft or bill of exchange was defined as

an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay in the United States at a fixed or determinable future time a sum certain in dollars to the order of a specified person

Id. A banker's acceptance within the meaning of Regulation A was defined as a draft or bill of exchange, whether payable in the United States or abroad and whether payable in dollars or some other money, of which the acceptor is a bank or trust company, or a firm, person, company, or corporation engaged generally in the business of granting bankers' acceptance credits.

Id.

Open market paper today consists primarily of short-term promissory notes and bankers' acceptances. All of the section 3(a)(3) no-action requests to the Commission relate to the use of short-term notes, the money market instrument

a security must possess a maturity at the time of issuance of not more than nine months, exclusive of days of grace. The maturity of any renewal also must be limited to nine months. In Securities Act Release No. 4412,³⁸ the Commission interpreted the nine month standard of section 3(a)(3) to exclude any obligation "payable on demand"³⁹ or "having provisions for automatic 'roll over.'"⁴⁰ In the process of reaching that interpretation, the SEC used the legislative history of the exemption to support a three-part test to further identify the type of security which may properly fall within the terms of section 3(a)(3). According to the SEC, Congress intended section 3(a)(3) to apply

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 eligible for discounting by Federal Reserve banks.⁴¹

As a result, the exemption is restricted by interpretation to negotiable commercial paper that is (1) prime quality, (2) not ordinarily purchased by the general public, and (3) eligible for discounting⁴²

usually associated with the phrase "commercial paper." Bankers' acceptances are credit instruments designed to finance shipment or storage of merchandise by both domestic and foreign manufacturers. In effect, they are drafts that have been accepted (guaranteed) by a bank or trust company for payment on a specific date in the future, usually from one to six months. The acceptance results in the substitution of the credit of the bank for that of the drawer. Such short-term, guaranteed notes may be marketed several times before maturity by the few securities dealers who maintain secondary markets for them. See generally J. BOGEN, FINANCIAL HANDBOOK (1968).

³⁸ Release No. 4412, note 22 *supra*.

³⁹ The Commission's position on demand notes, as expressed in its 1961 Release No. 4412, *supra* note 22, was consistent at that time with an informal ruling by the Federal Reserve Board that a demand note or bill was not eligible for rediscount because it was not by its terms payable within the 90 days prescribed by section 13 of the Federal Reserve Act. 3 FED. RES. BULL. 378 (1917), cited in 1 L. Loss, *supra* note 19, at 568 n.32. In 1966, the Federal Reserve Board reconsidered its 1917 ruling and decided that since "demand paper is due and payable on the date of its issue, it satisfies the maturity requirements of the" Federal Reserve Act. 31 Fed. Reg. 5443 (1966); 12 C.F.R. § 201.107d (1976). There is no indication that the Commission has reversed its position on demand notes.

⁴⁰ Release No. 4412, *supra* note 22, at 2570. Commercial paper that is reissued upon maturity is said to be "rolled over." Although exempt commercial paper may not contain a provision for automatic "roll-over," certain issuers regularly reissue their notes to the same or different investors. See McGillicuddy, *supra* note 30, at 12; see also notes 283-87 *infra*.

⁴¹ Release No. 4412, *supra* note 22, at 2569-70.

⁴² Discounting is the method by which a noninterest-bearing note is valued prior to maturity. See generally J. BOGEN, *supra* note 37, at 27-12. One of the functions of the Federal Reserve Banks is to extend temporary credit to member banks, thereby assisting the member banks in coping with sudden withdrawals of deposits or seasonal requirements that cannot be replenished from the banks' own resources. A member bank of the Federal Reserve System

by Federal Reserve Banks. In addition, section 3(a)(3) expressly limits the exemption to commercial paper arising out of or the proceeds of which are used for "current transactions."⁴³

Neither the Commission nor the staff has defined exactly what they consider "prime quality" commercial paper.⁴⁴ In practice, however, this absence of administrative guidelines is immaterial since it appears that the SEC has incorporated the prime quality

may borrow from a Federal Reserve Bank in one of two ways. It can rediscount short-term commercial, industrial, agricultural or other business paper that it has previously discounted for its customers. Under this method, the borrowings are referred to as discounts. Alternatively, it can issue its own promissory notes secured by paper eligible for discounting, government securities or other acceptable collateral. Borrowing of this type is referred to as advances. *Id.* at 2-15.

⁴³ Some confusion exists concerning the origin and number of requirements for section 3(a)(3). If one adds the three-part test advanced by the Commission in Release No. 4412, note 22 *supra*, to the explicit "current transactions" requirement in section 3(a)(3), the availability of the exemption appears to depend upon satisfaction of four separate tests. Certain interpretations of Release No. 4412 suggest a four-part test for section 3(a)(3) that appears to flow completely from an administrative construction of the exemption. *See, e.g., Commercial Paper Market, supra* note 2, at 383; *Sanders v. John Nuveen & Co., Inc.*, 463 F.2d 1075, 1079 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972). According to such an interpretation, an issuer must demonstrate compliance with not only the three requirements identified in the text as administratively imposed criteria, but also with the requirement that the paper be "issued to facilitate well recognized types of current operational business requirements." Release No. 4412, *supra* note 22, at 2570. If this so-called fourth requirement is to be viewed as separate from the "current transactions" requirement stated explicitly in section 3(a)(3), it adds nothing to the Commission's interpretation of the exemption that is not already part of the other three elements. The requirement as to eligibility for discounting by Federal Reserve Banks, requirement (3) in the text, includes by implication all of the requirements of Federal Reserve Board Regulation A, note 46 *infra*. Regulation A contains a requirement that the commercial paper arise out of current operating expenses of commercial, agricultural or industrial business or that the proceeds from the paper be used for such expenses. The Commission notes this fact in Release No. 4412, note 22 *supra*.

⁴⁴ The SEC has never suggested that the "prime quality" criterion is related to the highest rating available to an issuer or its commercial paper by a rating service. *See* SEC no-action letter (Albertson's, Inc.), issued July 19, 1976, [1976] CCH FED. SEC. MICROFILM, roll 8, frame 10152, where the staff granted the no-action request of an issuer whose commercial paper had received a rating of A-2 from Standard & Poor's. *See also* note 54 *infra*. When the staff has a reason to use the phrase "prime quality" in describing the type of security that will qualify under section 3(a)(3), it merely repeats the definition used in Release No. 4412, note 22 *supra*, without meaning to suggest the "prime" rating used by rating agencies. *See, e.g.,* SEC no-action letter (Neil Stephens Assocs., Inc.), issued Dec. 10, 1974, [1974] CCH FED. SEC. MICROFILM, roll 1, frame 00190, where an issuer planned to sell "non-negotiable certificates of indebtedness" with a maturity date not exceeding 250 days and in \$1,000 denominations with a \$5,000 minimum purchase requirement. The staff denied the request for an exemption under section 3(a)(3). Referring to Release No. 4412, note 22 *supra*, and its requirement of prime quality negotiable commercial paper, the staff explained that "prime quality" meant "paper issued to facilitate well recognized types of current operational business requirements." SEC no-action letter (Neil Stephens Assocs., Inc.), *supra* at 00190. For a discussion of the prime quality criterion as it relates to issuers, see text accompanying notes 55-66 *infra*.

criterion into requirement (3).⁴⁵ Thus, a note or other security is considered prime quality if it is eligible under Federal Reserve Board Regulation A⁴⁶ for discount with Federal Reserve Banks. Since the Federal Reserve Board has established eligibility requirements which are detailed in Regulation A, it is relatively easy to determine whether a particular security will satisfy criteria (1) and (3) under Release No. 4412.

Even if commercial paper fails to satisfy the eligibility requirements under Regulation A, it may still qualify under section 3(a)(3) if it is "of a type" so eligible for discounting.⁴⁷ This argument was advanced by Texaco International Finance Corporation (TIFCO), a wholly-owned subsidiary of Texaco, Inc.,⁴⁸ in connection with its plan to sell notes, guaranteed by Texaco, outside the United States to only foreign investors. Although the Commission has traditionally taken the position that the registration requirements of the 1933 Act are primarily intended to protect American investors and has not required domestic corporations to register securities for sale abroad, it does insist on registration if the securities involved in a foreign offering may be expected to flow into the hands of American investors.⁴⁹ TIFCO foresaw that domestic corporations might cause their foreign subsidiaries to

⁴⁵ This conclusion is based on staff interpretations of section 3(a)(3) which appear to rely heavily upon representations by issuers' counsel that the proposed commercial paper satisfies the eligibility requirements for discounting imposed by the Federal Reserve Board. See, e.g., SEC no-action letter (Southeast Bancorp., Inc.), issued Apr. 15, 1971, [1971] CCH FED. SEC. MICROFILM, roll 1, frame 00833. See also Brief for Plaintiff, SEC v. Perera Co., 47 F.R.D. 535 (S.D.N.Y. 1969), on file at the UCLA Law Review [hereinafter cited as SEC Brief], discussed in note 98 *infra*, where the Commission asserted that "the notes eligible for discount with the Federal Reserve represented the type of 'quality commercial paper' which the proponents of the exemption referred to in explaining why registration of such paper would not be necessary." *Id.* at 41.

⁴⁶ 12 C.F.R. § 201 (1976). Regulation A provides in relevant part that a Federal Reserve Bank may discount for a member bank a negotiable note, draft, or bill of exchange bearing the endorsement of a member bank, *id.* § 201.4; that has a maturity not exceeding ninety days (except agricultural paper which may carry a maturity of up to nine months), *id.* § 201.4(a); that has been issued or drawn, or the proceeds of which are to be used in producing, purchasing, carrying, or marketing goods or in meeting current operating expenses of a commercial, agricultural or industrial business, *id.*; and that is to be used neither for permanent or fixed investment such as land, buildings or machinery, *id.* § 201.4(a)(2), nor for speculative transactions or transactions in securities (except direct obligations of the United States government), *id.* § 201.4(a).

⁴⁷ A Federal Reserve Bank, if it chooses, may make advances on commercial paper regardless of whether the notes conform to the eligibility requirements set forth in the regulations regarding automatic discountability of such notes. 12 C.F.R. 201.2(c) (1971). This fact was the basis for a successful no-action request in SEC no-action letter (Citizens Mortgage Inv. Trust), issued July 25, 1972, [1972] CCH FED. SEC. MICROFILM, roll 8, frame 13237, at 13241.

⁴⁸ SEC no-action letter (Texaco Int'l Fin. Corp.), issued July 1, 1971, [1971] CCH FED. SEC. MICROFILM, roll 5, frame 10240.

⁴⁹ The Commission's position on the registration of foreign offerings by

purchase the paper for them from the foreign underwriters and dealers. Instead of risking a violation of the registration provisions of the 1933 Act, TIFCO decided to qualify its notes under section 3(a)(3). Because of the issuer's prohibition on sales to United States residents or nationals, the paper was not eligible for discounting by a Federal Reserve Bank, but the staff concurred in counsel's opinion that section 3(a)(3) applied if TIFCO's paper was "of a type" eligible for discounting.⁵⁰

The Commission's requirement that section 3(a)(3) securities be of a type "not ordinarily purchased by the general public" has dual significance. It directly limits eligible commercial paper to a certain type of paper and indirectly restricts both the manner in which an issuer may offer its exempt securities and the type of purchaser to whom the paper may actually be sold. As a direct limitation on the type of paper eligible for the exemption, the requirement is interpreted as a restriction on the denomination of an issuer's notes. The staff evidently feels that notes of large denomination are not ordinarily purchased by the general public, and therefore qualify for the exemption. Conversely, small denominations are seen as inconsistent with the limited scope of section 3(a)(3).⁵¹

domestic issues is set forth in SEC Securities Act Release No. 4708 (July 9, 1964), 1 CCH FED. SEC. L. REP. ¶ 1361-63 (1975). Essentially, the Commission's interpretation of the 1933 Act dispenses with the need for registering the securities of domestic issuers which are distributed abroad "under circumstances reasonably designed to preclude distribution or redistribution of the securities within, or to nationals of, the United States." *Id.* at 2124.

⁵⁰ SEC no-action letter (Texaco Int'l Fin. Corp.), *supra* note 48, at 10240.

⁵¹ *See, e.g.*, SEC no-action letter (Michigan Ave. Financial Gp., Inc.), issued Feb. 3, 1975, [1975] CCH FED. SEC. MICROFILM, roll 3, frame 02569 (exemption denied for notes to be sold in denominations of not less than \$5,000); SEC no-action letter (Texas Am. Bancshares Inc.), issued Aug. 1, 1974, [1974] CCH FED. SEC. MICROFILM, roll 9, frame 12239 (exemption denied to commercial paper to be sold in denominations of \$10,000); SEC no-action letter (Cent. Serv. Corp.), issued June 15, 1973, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,460 (exemption denied for notes sold in denominations of \$10,000, due, in part, to "the relatively low minimum offering price," *id.* at 83,290). *See also* SEC no-action letter (First Union Real Estate Equity & Mortgage Invs.), issued May 2, 1972, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,837, where the staff denied a section 3(a)(3) exemption to the issuer "in view of the minimum denomination in which the commercial paper was to be issued [\$75,000]." *Id.* at 81,833. *But see* SEC no-action letter (Merrill, Lynch, Pierce, Fenner & Smith, Inc.), issued Aug. 1, 1972, [1972] CCH FED. SEC. MICROFILM, roll 9, frame 14817, where the brokerage firm, acting as a dealer, requested staff approval for the sale of commercial paper in minimum denominations of \$25,000. Merrill, Lynch believed that it could better serve issuers by selling their paper in denominations lower than the customary \$100,000, and added that it would continue to sell "only to institutions and wealthy individuals who in its judgment are in a position to assume the risks inherent in this type of investment." *Id.* at 14818-19. The staff's response was that "[t]he availability of the exemption would not be in question if commercial paper were issued in denominations of \$25,000." *Id.* at 14817.

The exemption on its face is limited to "any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions." A literal reading of this limitation on the exemption suggests that the "current transaction" requirement can be satisfied in one of two ways. If, for example, an issuer decides to sell unregistered short-term notes because of transactions currently demanding financial relief, one might argue that whether the proceeds are later applied to current transactions is irrelevant since the commercial paper arises out of a current transaction. The issuer under this interpretation would be free to utilize the proceeds from its notes in any manner desired so long as the transaction that prompted it to sell its notes qualified as current within the meaning of section 3(a)(3). Such a literal interpretation of the exemption finds no support in the legislative history, the Commission's releases, or in the staff's no-action letters. Instead, the administrative construction requires as a condition of exemption that the proceeds from unregistered notes "have been or are to be used in current transactions."⁵²

B. *The Issuer*

Although almost any highly regarded business entity that wishes to sell its commercial paper can find an interested purchaser, less respected businesses may not be as successful. In view of the substantial investment that is necessarily involved in the purchase of commercial paper⁵³ and the impracticability of an independent evaluation of the issuer, prospective investors, including dealers, tend to rely most heavily upon the rating assigned to an issuer's commercial paper by one of the agencies that perform the rating function.⁵⁴ An issuer that does not secure such a rating for

⁵² See, e.g., Release No. 401, *supra* note 22, at 2569, where the Commission identifies the *use of proceeds* as a separate requirement of the exemption. The SEC interpretation of the restriction on the use of proceeds is discussed in detail at notes 107-225 & accompanying text *infra*.

⁵³ For a discussion of the denominations of most commercial paper, see text accompanying note 30 *supra*.

⁵⁴ Most commercial credit rating is done by one of two agencies. The National Credit Office (NCO) of Dun & Bradstreet is the oldest rating agency in existence today and it now relies on Moody's Investors Service, Inc. to handle its rating function. Moody's grades commercial paper Prime 1, Prime 2 and Prime 3. Standard & Poor's is the other rating service available to a prospective issuer of commercial paper. It assigns A-1, A-2 and A-3 grades to eligible paper instruments. A third agency, Fitch Investors Services, entered the paper-rating field in 1971, using designations of F-1, F-2 and F-3. In theory, all three rating services have lower ratings but an issuer of commercial paper would not accept them. As of July 15, 1974, Moody's had rated 606 commercial paper issuers, Standard & Poor's had rated 356 and Fitch had rated 63. Hussey, *supra* note 11, at 5.

For a service fee, a rating agency will investigate a prospective issuer of com-

its short-term notes or receives an unsatisfactory rating will have difficulty selling its commercial paper.

Section 3(a)(3) does not *by its terms* limit the exemption to an issuer that has attained certain minimal financial achievements or has received an acceptable evaluation from a rating agency. As a result, the exemption has been safely invoked by a wide range of issuers, only some of which have received the highest rating for their commercial paper, including sales and personal finance companies,⁵⁵ industrial companies,⁵⁶ util-

mercial paper and prepare a confidential release for those actual and potential investors who subscribe to the agency's reports. The release includes information about the company's principal banks, amount of credit available, financial data, management profile, line of business and subsidiaries. N. BAXTER, *supra* note 2, at 36.

A representative of one rating agency has indicated that it is difficult to list all the standards used in evaluating the quality of commercial paper notes, due to the diverse industries on which a large agency reports. He did, however, offer the following factors as some of the major ingredients in a rating decision:

- (a) Compare each issuer's various ratios against industry averages;
- (b) Judge progress at least over the previous ten years;
- (c) Evaluate the company and its markets and the market's potential;
- (d) Make an appraisal of principal officers and their business experience;
- (e) Analyze the company's potential in future years;
- (f) Review bank support and periodically contact a sampling of the company's line banks, as deemed necessary.

Letter from Louis C. Ward, manager, commercial paper division of NCO, to Steven Clarke of Goldman, Sachs & Co., Jan. 29, 1966, *cited in* SEC STAFF REPORT, *supra* note 3, at 297.

⁵⁵ See, e.g., SEC no-action letter (Inland Steel Fin. Co.), issued Feb. 22, 1973, [1973] CCH FED. SEC. MICROFILM, roll 3, frame 04075. Finance companies, which were minor factors in the commercial paper market in the 1920's, are now the largest component on the basis of volume. See 62 FED. RES. BULL. A25 (Mar. 1976). The greatest growth in commercial paper as a source of funds for finance companies occurred after 1966 when many companies sought relief from the tight money period in the commercial paper market as a way to hedge against the possibility of a curtailment in bank credit lines. *Survey of Finance Companies, 1975, id.* at 197, 200. As of June 30, 1975, 67 finance companies, each reporting receivables of at least \$100 million, accounted for 97 percent of the finance company paper outstanding. The bulk of these short-term notes—91 percent in mid-1975—was sold directly by the issuer to the lender, usually at a savings over bank credit. *Id.* For an historical view of the growth of finance company paper, see N. BAXTER, *supra* note 2, at 15-25.

⁵⁶ See, e.g., SEC no-action letter (Northrop Corp.), issued April 16, 1971, [1971] CCH FED. SEC. MICROFILM, roll 1, frame 00838. In most cases, the commercial paper needs of a finance company are entirely different from those of an industrial company.

By the nature of their business of borrowing and lending money, finance companies usually have paper outstanding at all times and roll-over their notes at maturity. In this sense, commercial paper is a "permanent" source of finance. Industrial issuers, on the other hand, generally use the commercial-paper market to meet seasonal-borrowing needs. A canner, for example, purchases fruits and vegetables during a few months of the year, at harvest time. His sales, however, occur rather uniformly throughout the year. This pattern of receipts and expenditures means that, unless the firm maintains very high working capital, it will be a

ities,⁵⁷ affiliates and subsidiaries of commercial banks⁵⁸ and Real Estate Investment Trusts (REIT's).⁵⁹

One should not conclude, however, that the quality of the issuer is irrelevant in deciding the availability of a section 3(a)(3) exemption. The Commission has limited the exemptive provision to "prime quality" paper,⁶⁰ a limitation that indirectly affects the issuer. Certainly, a business entity that is unseasoned or teetering on the brink of insolvency may find it difficult to support an assertion that its notes are of prime quality. This was the problem that faced Real-Tex Enterprises, Inc.⁶¹ when it requested a no-action letter from the SEC staff for Real-Tex's proposed offering of notes. The staff refused to issue a no-action letter under section 3(a)(3). This refusal was based in part on the fact that "the Company [was] recently formed and consequently [did] not have an established history of operations."⁶² The same prime quality obstacle confronted the defendant in *Sanders v. John Nuveen & Co., Inc.*⁶³ when it claimed an exemption under section 3(a)(3) for notes it had issued when its assets were 12.5 million dollars and its liabili-

net borrower in those months when and just after payments are made, and may be a net investor at other times of the year. Commercial paper is used as an ideal supplement to bank loans for these seasonal needs. In fact, the existence of such seasonal demands for funds is a common denominator among virtually all industrial issuers. Only those industrial firms whose seasonal borrowing needs are predictable enough for them to sacrifice the added flexibility of bank loans, and are large enough to make the savings over bank loans worthwhile, find it practical to resort to the open market.

N. BAXTER, *supra* note 2, at 32-33.

⁵⁷ See, e.g., SEC no-action letter (Michigan Consol. Gas Co.), issued Oct. 16, 1973, [1973] CCH FED. SEC. MICROFILM, roll 11, frame 19094.

⁵⁸ See, e.g., SEC no-action letter (Mercantile Bankshares Corp.), issued Jan. 8, 1974, [1974] CCH FED. SEC. MICROFILM, roll 2, frame 01579. For a discussion of the factors that led banks and bank holding companies into the commercial paper market, see McGillicuddy, *supra* note 30, at 6-7; see also note 16 *supra*.

⁵⁹ See, e.g., SEC no-action letter (Commonwealth Nat'l Realty Trust), note 36 *supra*. See generally Gumpert & Starr, *Too Much Too Soon: How REIT's Gave Backers Big Gains and Losses*, Wall St. J., Mar. 14, 1975, at 1, col. 6; Meyer, *Falling Out: Real Estate Trusts Feud with Advisors over Their Obligations*, *id.*, Mar. 13, 1975, at 1, col. 6.

⁶⁰ See note 41 & accompanying text *supra*.

⁶¹ SEC no-action letter (Real-Tex Enterprises, Inc.), issued Apr. 13, 1972, [1972] CCH FED. SEC. MICROFILM, roll 5, frame 07332.

⁶² *Id.* at 07333-34. See also *United States v. Hill*, 298 F. Supp. 122 (D. Conn. 1969), where the court, in rejecting an issuer's claim to the commercial paper exemption, stated:

The 3(a)(3) exemption was not intended, and does not extend, to cover financing by an insolvent company in its speculative attempt to launch an enterprise. This is precisely the kind of financing for which Congress considered it necessary that a company complete the registration requirements of [the] act.

Id. at 1227.

⁶³ 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

ties were more than 36 million dollars. In rejecting the claimed exemption, the Seventh Circuit Court of Appeals stated that "because of the company's insolvency, it seems highly unlikely that the paper purchased by the plaintiff and members of his class is . . . prime quality."⁶⁴

Since the nature of the issuer may be the determinative factor under section 3(a)(3), an ineligible prospective issuer of commercial paper might try to enhance its status by adding to the transaction an eligible co-maker, guarantor or accommodation endorser and thereby qualify for the exemption. Although the staff has not yet given an opinion on whether this type of addition would result in prime quality commercial paper, the staff has indicated that where an issuer who fits the section 3(a)(3) requirements wishes to upgrade the value of its notes by adding an issuer of equal status as co-maker or accommodation endorser, the commercial paper jointly issued is eligible for the exemption.⁶⁵ Arguably, therefore, despite the fact that two separate issuers may be involved, section 3(a)(3) should exempt the notes if an eligible issuer is primarily liable or is required to assume the primary obligation. The prime quality criterion under section 3(a)(3), as it relates to the issuer, could be interpreted simply as a means of guaranteeing investors a direct route to the party whose financial position would, by itself, satisfy the Commission's standards.⁶⁶

⁶⁴ *Id.* at 1079.

⁶⁵ *See, e.g.*, SEC no-action letter (Mutual Life Ins. Co. and Mony Mortgage Investors), issued March 11, 1975, [1975] CCH FED. SEC. MICROFILM, roll 4, frame 04066, where a REIT planned to sell its commercial paper with its investment adviser serving as a co-maker or accommodation endorser. The trust decided that commercial paper as to which both it and its investment adviser were liable "would be salable at material interest savings when compared to commercial paper on which only the Trust is liable, even though the Trust's current commercial paper [was] rated Prime-1 by Moody's." *Id.* at 04070. *See also* SEC no-action letter (Equitable Life Mortgage & Realty Investors), issued March 3, 1975, [1975] CCH FED. SEC. MICROFILM, roll 4, frame 04059, where a trust intended to issue \$100 million of commercial paper with its investment adviser, the Equitable Life Assurance Society of the United States (Equitable), as co-maker or accommodation endorser. As planned, both entities were to jointly issue the securities. The trust was to sign the notes as maker and Equitable would sign as co-maker, or become obligated on the notes by signing them as endorser, waiving any requirement of presentment or notice of dishonor. Regardless of which form the arrangement took, the trust and Equitable were to agree that the trust would pay the obligations on the commercial paper and if Equitable were required for whatever reason to assume the primary obligation, Equitable was to look to the trust for reimbursement. The SEC staff agreed with the counsel for the trust that section 3(a)(3) exempted either type of commercial paper. *Id.*

⁶⁶ If the ineligible issuer arranged for an eligible issuer to become obligated on notes by signing them as endorser, a direct route to the eligible issuer would require the endorser to waive any requirement of presentment or notice of dishonor.

Multinational corporations present an interpretative problem under section 3

The SEC also has not yet taken a position on the more controversial problem of the eligibility of commercial paper where a financially weak issuer attempts to compensate for its deficiencies by backing its commercial paper with a line of credit extended by a bank.⁶⁷ In effect this arrangement substitutes the bank's credit rating for that of the issuer.⁶⁸ If the bank meets the prime quality criterion under section 3(a)(3), the issuer is offering investors protection similar to that present in transactions involving a co-maker or guarantor. But unlike the obligation of a co-maker or guarantor, which is absolute, the bank's duty to extend credit to an

(a)(3) where the issuer of commercial paper is a foreign subsidiary of an American parent corporation that guarantees the notes and some of the commercial paper is to be sold in this country. The staff does not view the presence of a foreign issuer in a commercial paper transaction as a disqualification under section 3(a)(3), at least where an American company is involved as a guarantor. See, e.g., SEC no-action letter (NCR Corp.), note 36 *supra*. See also SEC no-action letter (Mitsui & Co. (Canada), Ltd., Mitsui & Co. (U.S.A.), Inc.), issued Aug. 6, 1974, [1974] CCH FED. SEC. MICROFILM, roll 9, frame 12245, where the staff agreed that section 3(a)(3) applied to the commercial paper of a foreign subsidiary of a foreign parent corporation where the paper was guaranteed by an American subsidiary of the same parent corporation.

⁶⁷ The Comptroller of the Currency, the Federal Reserve Board and the FDIC have all expressed concern over use of bank lines of credit. Such arrangements have been criticized as involving the assumption of contingent liabilities by banks without adequate control or disclosure on their balance sheets of the existence or proportion of these obligations. Furthermore, it is argued that widespread use of the financing technique could threaten the ability of the Federal Reserve Board to manage the nation's supply of money.

It has become almost commonplace for someone—usually a commercial-paper dealer—to form a “dummy” corporation whose single purpose is to buy and hold equipment for lease to a big corporate client. The dummy corporation sells bank-backed commercial paper to finance the purchase of the equipment—which may range from office furniture to nuclear fuel cores—and then leases it to the corporate client.

The dummy corporation's sole source of income is often its lease rentals. “The great danger inherent in such a scheme” warns Robert C. Holland a Federal Reserve Board governor “is that in a period of tight monetary policy one such dummy issuer of commercial paper wouldn't be able to meet its maturities. A chain reaction might ensue, leading to the inability of a sizeable number of the paper issuers to ‘roll-over’ or refinance the IOUs coming due by the sale of new ones.

That could trigger calls for banks to make good their credit commitments at a time when banks too would be over-extended. At that point, [the] Federal Reserve System could be impelled to supply reserve funds itself to the banking system to counter the threat of a partial collapse of the commercial paper market.

Something like that happened in 1970 when the Penn Central Transportation Co. ran out of cash and defaulted on its commercial paper. To offset the sudden rupture of confidence in the market and meet corporate needs for cash the Fed had to pump billions of dollars into the banking system over a period of weeks. This increased the nation's money supply a good deal more than policy makers otherwise thought desirable.

Foldessy, *supra* note 34, at 1, col. 6. See also Hussey, *supra* note 11, at 14.

⁶⁸ The practice of issuing bank-backed commercial paper is attractive to “a small regional or foreign enterprise not known well enough to be accepted by paper buyers or . . . a privately-owned enterprise that prefers to keep its finances confidential.” Hussey, *supra* note 11, at 14.

issuer may be conditional. A line of credit is usually extended by a bank on the condition that no material adverse change in the financial condition of the potential borrower occur between the date of issuance and the date of actual borrowing. If the issuer's creditworthiness disappears between the time its commercial paper is sold and the time it matures, bank support could vanish.⁶⁹

C. Purchasers

Most purchasers of commercial paper are institutions⁷⁰ which range from highly sophisticated investment-oriented entities to unsophisticated institutions such as small town banks, small manufacturing companies, and many college trust funds.⁷¹ A small percentage of commercial paper, in terms of dollar amount, is purchased by individuals.⁷² All purchasers, institutions and individuals, have the common objective of investing funds for a short period of time with the smallest possible risk and the maximum

⁶⁹ See McGillicuddy, *supra* note 30, at 11-12. See also M. MAYER, *THE BANKERS* (1974). Mayer suggests that many commercial paper issuers maintain a close relationship with banks in order to make their short-term notes acceptable to investors:

Commercial paper dealers and buyers require each seller to maintain at his bank or banks a "line of credit" sufficient to pay off the commercial paper when it comes due. This is usually a commitment to lend, not entirely unlike the commitment made to a builder, except that the builder is expected to use his and the issuer of commercial paper is not—if he comes to the day of reckoning on the paper without the money to pay it off, he "rolls over" his indebtedness: that is, he sells new paper.

Id. at 263.

⁷⁰ SEC STAFF REPORT, *supra* note 3, at 275; N. BAXTER, *supra* note 2, at 39-41.

⁷¹ SEC STAFF REPORT, *supra* note 3, at 276. As of 1966, it was estimated that nonfinance companies supplied most of the funds to the commercial paper market but commercial banks, which were the chief investors before World War II, remained an important factor. N. BAXTER, *supra* note 2, at 39. It appears that the major investors in commercial paper in 1976 are corporations, trust departments of banks, insurance companies, mutual funds and state and municipal governments. Interviews, note 1 *supra*. As the *SEC Staff Report* suggests, not all institutional purchasers of commercial papers are located in the financial centers of the country.

Small country banks are significant investors in paper, especially those located in areas where loan demand (perhaps largely from farmers) is of a seasonal nature. When demand for direct loans slackens, these institutions buy paper to build up their loan portfolios. Their purchases of open-market paper generally consist of notes of small denominations (\$10,000 to \$50,000), and their preference leans toward the dealer market. Here, with one contact, they can purchase several notes, each within their legal lending limit, representing firms from a wide variety of industries.

N. BAXTER, *supra* note 2, at 39.

⁷² SEC STAFF REPORT, *supra* note 3, at 275. Individuals who purchase commercial paper frequently acquire their investment through a local bank that purchases the paper in its own name without disclosing the identity of the principals. Interviews, note 1 *supra*.

return.⁷³ Because there is no secondary market for commercial paper, purchasers must expect to retain their investments until maturity.⁷⁴

Under the Commission's interpretation of section 3(a)(3), the sale of commercial paper to certain types of purchasers may make the paper ineligible for the exemption. The SEC restricts the exemption to negotiable commercial paper of a type "not ordinarily purchased by the general public."⁷⁵ What appears to be a requirement aimed solely at the nature of the instrument to be sold may turn out in practice to govern the type of purchaser as well. In a no-action inquiry for Michigan Avenue Financial Group, Inc.,⁷⁶ counsel for the issuer challenged this restrictive view of section 3(a)(3). Michigan Avenue had issued what it described as financial notes in denominations of not less than \$5,000, bearing interest at varying rates and expiring 270 days after issuance. The notes had been advertised in newspapers of general circulation as well as on the physical premises of the issuer and had been purchased by the general public.⁷⁷ Proceeds from the notes had been disbursed to a banking subsidiary where they were commingled with the bank's general funds. Counsel for Michigan Avenue contended that the notes satisfied all of the criteria for a section 3(a)(3) exemption,

⁷³ SEC STAFF REPORT, *supra* note 3, at 275.

⁷⁴ On occasion, an issuer that sells its commercial paper directly to investors may enter into a "gentlemen's agreement" to repurchase their notes from investors who are faced with a "valid emergency." Such a buyback arrangement would be offered "not to encourage rate speculation, but rather to provide commercial paper with additional liquidity in the event of unforeseen needs." N. BAXTER, *supra* note 2, at 110.

A similar situation exists in the case of commercial paper that is sold by dealers:

Until recently, none of the dealers had a standing policy of repurchasing commercial paper prior to its maturity. Currently, a few dealers will under certain conditions repurchase the commercial paper of issuers which they handle. But a repurchase facility usually is not a condition of the original sale and is completely discretionary with the dealer. Infrequently, dealers will repurchase to preserve a good customer's relationship, although not as a condition of the original sale.

SEC STAFF REPORT, *supra* note 3, at 275-76. For a discussion of the desirability of a secondary market for commercial paper, see generally N. BAXTER, *supra* note 2, at 109-18. According to Baxter, who interviewed representatives from banks and corporate investors, direct placers and commercial paper dealers are generally opposed to the development of such a market. *Id.* at 112. Furthermore, his evidence indicates little demand for a secondary market. *Id.* at 115.

⁷⁵ Release No. 4412, *supra* note 22, at 2569-70. See text accompanying note 50 *supra*.

⁷⁶ SEC no-action letter (Michigan Ave. Financial Gp., Inc.), note 51 *supra*.

⁷⁷ The issuer's advertisements came to the attention of the SEC's Chicago Regional Office which requested that Michigan Avenue cease selling or advertising the financial notes. The issuer complied with that request and was in the process of liquidating the notes as they matured when it wrote to the SEC requesting a statement that no administrative action would be taken. *Id.* at 02571.

including the requirement that they be "of a type not ordinarily purchased by the general public." Counsel pointed out that

even though, in this particular case, the general public was purchasing the commercial paper, historically this *type* of commercial paper is not ordinarily purchased by the general public. There is no prohibition against any commercial paper being purchased by the general public and not be [*sic*] subject to registration. The requirement merely goes to the nature of the instrument and not to who in fact purchased the particular instrument.⁷⁸

The staff denied the no-action request, based on the facts as presented in the letter of inquiry, "particularly the relatively low minimum offering price, the advertising of and *sale* to the general public, and certain possible uses of the proceeds from the offering of the notes."⁷⁹ The staff added that "neither the absence of general advertising nor a change in the denomination of the notes alone or together would change this position."⁸⁰

Limiting section 3(a)(3) to particular types of purchasers, as the staff appears to have done,⁸¹ raises at least three questions for an issuer contemplating the sale of unregistered short-term notes: (1) May it sell its commercial paper to any non-institutional investors; (2) does it have a duty to assess the sophistication of each prospective purchaser; and (3) if such a duty exists, will its assessment of sophistication be judged by the same standards associated with the non-public offering exemption under section 4(2) of the 1933 Act.⁸²

⁷⁸ *Id.* at 02572.

⁷⁹ *Id.* at 02569 (emphasis added).

⁸⁰ *Id.* at 02570.

⁸¹ SEC no-action letter (Rowe Corp.), issued Oct. 21, 1974, [1974] CCH FED. SEC. MICROFILM, roll 11, frame 14950, where the staff denied a section 3(a)(3) exemption to an issuer that planned an offering to its employees and subsidiaries of 90-day \$100 notes, with interest not to exceed 9 percent per year. According to the staff, the proposed offering to employees would have involved "a part of the general public" which the staff viewed as inconsistent with the legislative history of section 3(a)(3). *Id.* at 14951. See also SEC no-action letter (Delaware Valley Realty & Mortgage Investors), issued Apr. 23, 1971, [1971] CCH FED. SEC. MICROFILM, roll 3, frame 06371, where the staff denied section 3(a)(3) to a REIT that planned to offer its short-term notes to 4,000 shareholders of the two parent corporations. Counsel recognized the position taken by the Commission in Release No. 4412, note 22 *supra*, as to offerings to the general public. "In our view, however, the offer and sale to existing stockholders of the Trust's parents differs materially from an offer and sale to the general public." SEC no-action letter (Delaware Valley Realty & Mortgage Investors), *supra* at 06374. The staff was unable to concur in counsel's judgment because of "the unsophisticated character of the offerees." *Id.* at 06372.

⁸² Section 4(2) of the 1933 Act provides an exemption from the registration requirements of section 5, 15 U.S.C. § 77e (1970), for "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(2) (1970). This phrase is not defined in the 1933 Act. As a result, the task of interpreting the exemption has been left to the courts and the Commission. In *SEC v. Ralston*

Although the staff prohibits issuers from selling unregistered commercial paper to the general public, it has not limited section 3(a)(3) to institutional purchasers. The section 3(a)(3) exemption has been allowed where commercial paper was sold to a limited number of individual experienced investors.⁸³ For example, Union Trust Bancorp⁸⁴ planned to sell unregistered commercial paper in minimum denominations of \$25,000 to certain wealthy, sophisticated individuals along with the usual institutional investors. These additional purchasers were to include bank customers of Union Trust as well as other individuals known to be interested in such investments. Counsel for the issuer assured the staff that

[i]n all cases, the commercial paper purchasers will possess such knowledge and experience in financial and business matters that they are capable of evaluating the merits of investing in commercial paper. . . .⁸⁵

The staff agreed that section 3(a)(3) was available under those circumstances.⁸⁶

The staff response to the inquiry by Union Trust Bancorp suggests that the issuer must determine whether an *individual* is sufficiently sophisticated, which in the context of section 3(a)(3) appears to include both wealth and experience as an investor in the securities market.⁸⁷ In this respect, the sophisticated purchaser of exempt commercial paper bears a resemblance to the sophisticated investor in a private placement who possesses the requisite knowledge and experience to evaluate the merits and risks of the pro-

Purina Co., 346 U.S. 119 (1953), the Supreme Court established the criteria to be considered in determining the availability of section 4(2). Basically, the issuer's concern must focus on whether the offerees need the protection of the 1933 Act, evidenced by whether they have "access" to the same kind of information that would appear in a registration statement and whether they are able to fend for themselves. *Id.* at 127. Recently the Commission adopted rule 146 to establish more objective standards for interpreting and applying the exemption under section 4(2). 17 C.F.R. § 230.146 (1976).

⁸³ See, e.g., SEC no-action letter (DAC Corp.), note 32 *supra*.

⁸⁴ SEC no-action letter (Union Trust Bancorp), issued Mar. 25, 1975, [1975] CCH FED. SEC. MICROFILM, roll 4, frame 04077.

⁸⁵ *Id.* at 04080. Counsel's characterization of prospective purchasers is apparently based on the test of sophistication embodied in rule 146(d) under the 1933 Act. 17 C.F.R. § 230.146(d) (1976). See note 15 *supra*.

⁸⁶ SEC no-action letter (Union Trust Bancorp), note 84 *supra*.

⁸⁷ See, e.g., SEC no-action letter (DAC Corp.), *supra* note 32, at 09302, where the investors included "a few individuals who normally purchase commercial paper," *id.*; SEC no-action letter (Blyth Eastman Dillon & Co., Inc.), issued Apr. 21, 1975, [1975] CCH FED. SEC. MICROFILM, roll 5, frame 05222, where the staff allowed the issuer to utilize section 3(a)(3) for sales of commercial paper to medium and small-sized institutions, and individuals "of substantial means" all of whom are "sophisticated investors accustomed to substantial securities transactions." *Id.*

posed investment and is capable of bearing the economic risk of the investment. In practice, however, the limitations imposed on offerees and purchasers by administrative interpretations of section 4(2) are far more demanding than those suggested by the staff in connection with section 3(a)(3).⁸⁸

Staff interpretations of the exemption do not suggest, however, that issuers or those acting for them are under an affirmative duty to investigate the business and financial experience of *institutional* purchasers.⁸⁹ Yet sales to small unsophisticated corporations, pension funds, or investment trusts without assurances of financial expertise would seem to be inconsistent with the Commission's view of section 3(a)(3) concerning individual purchasers and might cause an issuer to lose its exemption.

D. *Manner of Sale*

Commercial paper may be sold directly to the investor by the issuer (direct paper) or indirectly through a commercial paper dealer (dealer paper). Either type of paper may qualify under section 3(a)(3).⁹⁰

Direct paper provides several advantages to the issuer. An issuer which places its short-term notes directly can establish a more personal relationship with investors and is in a position to tailor the terms of a transaction to their exact needs.⁹¹ The issuer also avoids paying a dealer's commission on such sales.⁹² Notwithstanding these advantages, most issuers⁹³ sell their commercial

⁸⁸ In the opinion of the SEC, the term "sophistication" as applied to offerees and purchasers in a nonpublic offering under section 4(2), 15 U.S.C. § 77d(2) (1970), is not to be equated with wealth or business experience.

It is the Commission's view that "sophistication" is not a substitute for access to the same type of information that registration would provide, and that a person's financial resources or sophistication are not, without more, sufficient to establish the availability of the exemption.

SEC Securities Act Release No. 5487, *supra* note 15, at 2907-3.

⁸⁹ *But see* SEC no-action letter (Blyth Eastman Dillon & Co., Inc.), note 87 *supra*.

⁹⁰ *See, e.g.*, SEC no-action letter (Larwin Mortgage Investors), issued Apr. 10, 1974, [1974] CCH FED. SEC. MICROFILM, roll 5, frame 06636 (direct paper); SEC no-action letter (Gulf Mortgage & Realty Invs.), issued Aug. 1, 1972, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,008 (dealer paper).

⁹¹ SEC STAFF REPORT, *supra* note 3, at 275. The direct issuer will sometimes repurchase the paper prior to maturity if the purchaser so requests, adjusting the interest rate paid to the holding period actually elapsed. *Id.*; Hussey, *supra* note 11, at 5. *See* note 74 *supra*.

⁹² The dealer fee is usually one-eighth to one-quarter of one percent. SEC STAFF REPORT, *supra* note 3, at 276.

⁹³ According to one source, as of 1974 only about 30 finance companies and 50 or 60 other companies were selling paper directly. Hussey, *supra* note 11, at 5. Dealer paper in 1974 was divided among approximately 650 issuers. *Id.*

paper through one of the major dealers,⁹⁴ since few persons have the dealer's knowledge of the market or the sales force of his organization.⁹⁵ The dealer may either purchase the paper from the issuer as principal or merely serve as a sales vehicle.⁹⁶

The Commission's requirement that the commercial paper be of a type not ordinarily purchased by the general public has been interpreted by the staff as a restriction on the manner of sale.⁹⁷

⁹⁴ The nine major commercial paper dealers are Goldman, Sachs; A. G. Becker & Co.; Lehman Commercial Paper, Inc.; Salomon Brothers; First Boston Corp.; Merrill, Lynch, Pierce, Fenner & Smith, Inc.; Eastman Dillon, Union Securities; Loeb Rhodes; and Paine, Webber, Jackson & Curtis. *Id.*

The relationship between a business entity and a dealer is usually an outgrowth of one of the aspects of an investment banking relationship that a dealer has with an issuer. Once an issuer decides it wants to issue commercial paper through a dealer,

the dealer will want to determine whether the issuer is credit-worthy, i.e., able to repay the additional debt. The dealer will usually have a credit department or a credit analyst who is charged with the responsibility for making this determination. With some dealers the recommendation of the credit department or analyst can be overridden by a partner or by the head of the commercial paper department. With others, the recommendation is final.

The dealer, having decided that the issuer is creditworthy, will usually then confer with the issuer to determine how much paper to issue based upon how much the issuer wishes to borrow and how much the dealer estimates can be marketed.

Next, the dealer and the issuer enter into an oral agreement whereby the dealer is to be the exclusive dealer to market a specific amount of commercial paper for a specific time. Normally, the dealer will buy from the issuer as principal and reoffer it to the public at a markup of from one-eighth to one-quarter of 1 percent. The dealer agrees to assist in the technical tasks involved. The issuer agrees to provide certain information at certain intervals and access to information of the nature provided to banks for line credit.

SEC STAFF REPORT, *supra* note 3, at 274-75 (footnotes omitted).

⁹⁵ Sellers of direct paper tend to be the larger and more established businesses that possess the ability to reach purchasers for their securities. One commentator suggests that a company must have a continuous need for several hundred million dollars in order to place paper directly. He further explains that [i]n order to achieve this volume, an efficient sales organization is called for. The company must not only be in the market continuously but they must also sell paper even when they don't need it in order to satisfy some of the bigger and better customers. As a consequence, most of the direct issuers are active on both sides of the market; that is, from time to time they are investing funds at the same time that they are selling paper.

McGillicuddy, *supra* note 30, at 3; see also N. BAXTER, *supra* note 2, at 37.

Finance companies, bankholding companies, and a few large industrial companies constitute the bulk of direct paper issuers. Hussey, *supra* note 11, at 5. Although direct placers represent a minority of the commercial paper issuers, as a group they account for about two-thirds of dollar volume outstanding. *Id.* This is explained by the fact that finance companies and certain bankholding companies have continuous borrowing needs as opposed to the seasonal needs of other companies that can be satisfied with less frequent entries into the commercial paper market. N. BAXTER, *supra* note 2, at 37.

⁹⁶ SEC STAFF REPORT, *supra* note 3, at 274-75.

⁹⁷ Most commercial paper is sold to investors through personal contacts by representatives of the issuer or the dealer and not by general advertising. In the

General advertising is prohibited as inconsistent with the purposes of section 3(a)(3).⁹⁸ More limited advertising may also be disal-

case of direct paper, the majority of which is issued by finance companies, sales are made without the assistance of large sales forces. Since most direct paper issuers are constantly in the market with their short-term obligations, they are well known by prospective investors. Quotations on commercial paper rates are regularly communicated by representatives of the issuers to the money market centers in the different parts of the country for dissemination to prospective purchasers. The financial pages of many newspapers also carry the current money rates on commercial paper available directly from issuers or from dealers. Customers contact either the issuer or a local bank which executes the transaction for them. If the investor is the bank's trust department, the purchase may be made under a Master Note Agreement. By such an arrangement, the bank trust department is able to pool funds from many separate accounts and invest them in a single master note. Typically the trust department is required to maintain a minimum amount in the issuer's commercial paper, such as \$10 million, with the expectation that during the life of the agreement the exact amount of the investment will fluctuate depending upon the availability of funds.

Commercial paper dealers, on the other hand, rely upon a sales staff to identify investors. A dealer's sales department might even be divided into geographic areas of responsibility. Upon notice from the firm's trading department that an issuer's commercial paper is available for sale, sales personnel begin telephoning the various institutions that have previously been identified as potential purchasers. Interviews, note 1 *supra*.

On occasion, an issuer or dealer may be tempted to generate wider acceptability for its paper by advertising. While such a sales plan may appear proper under a literal interpretation of section 3(a)(3), it is inconsistent with the Commission and staff interpretations. See note 98 & accompanying text *infra*.

In a request for a no-action letter for Centran Bancshares, where general advertising was used, counsel informed the staff:

We do not believe the method of sale of commercial paper should affect availability of the exemption under Section 3(a)(3) inasmuch as that section deals with the nature of the security being sold rather than the type of transaction in which it is sold.

SEC no-action letter (Centran Bancshares Corp.), issued June 5, 1973, [1973] CCH FED. SEC. MICROFILM, roll 7, frame 12308. The staff denied the exemption for the issuer, stating in response to counsel's argument:

We cannot agree with either the reasoning employed or the conclusion reached. As the legislative history of the section makes clear, it was intended to apply to high quality paper "of a kind not generally sold to the public."

Id. at 12309. For a discussion of the staff's interpretation of this requirement as a limitation on the type of purchaser, see text accompanying notes 70-89 *supra*.

⁹⁸ See, e.g., SEC no-action letter (Michigan Ave. Financial Gp., Inc.), *supra* note 51, at 02569. See also SEC no-action letter (American Auto. Ins. Brokers, Inc.), issued May 24, 1974, [1974] CCH FED. SEC. MICROFILM, roll 6, frame 07836. In a no-action request, American Automobile described a plan to sell short-term notes in \$25,000 denominations through advertising in Chicago daily newspapers. The staff rejected that request "particularly in view of the proposed advertising which would necessarily involve an offering to the general public." *Id.*

The staff's position on general advertising was also made clear by its efforts to obtain a permanent injunction against Perera Company. The defendant Perera was a New York corporation which had been continuously engaged in the foreign exchange business for over 40 years and was the oldest and largest foreign exchange dealer in the United States. SEC Brief, *supra* note 45, at 2. Perera sold its promissory notes in denominations of \$1,000 or less to members of the general public without complying with the registration requirements of the 1933 Act. The

lowed. In one situation, a prospective commercial paper issuer, American Automobile Insurance Brokers, Inc., planned to advertise its notes in insurance trade publications primarily circulated among insurance companies and their brokers and agents.⁹⁹ The staff denied the requested no-action treatment because the advertising as planned might have involved an offering to the general public.¹⁰⁰

The safest approach for an issuer with little experience in the commercial paper market might be to structure the offering as though it were a private placement under section 4(2) of the 1933

SEC's complaint charged that Perera solicited the purchase of its securities with a four-page printed pamphlet entitled "How to Earn More on Your Money," copies of which were available on the counters of its various business offices. The Commission contended that Perera's activities were unsupervised by any regulatory body including banking authorities. *Id.* at 5. In response, Perera claimed an exemption under section 3(a)(3). It maintained that, without exception, all of its notes satisfied the requirements for that exemption. "Perera has never defaulted on any note issued by it and we do not understand the Commission to urge the contrary." Defendant's Brief for Summary Judgment at 3, *SEC v. Perera Co.*, 47 F.R.D. 535 (S.D.N.Y. 1969), on file at the UCLA Law Review. Perera denied the Commission's claim that it was unsupervised by a regulatory body, stating that it was a member of the New York Commodity Exchange and the New York Produce Exchange and was licensed by the Banking Department of the state of New York as a transmitter of money. *Id.* at 4.

The litigation between the parties resulted in a settlement approved by the district court. BNA SEC. REG. & L. REP. No. 65, at A-5 (Aug. 26, 1970). Under the compromise, which did not include any admission by either party as to the validity of the allegations or the defenses, Perera agreed to avoid using any pamphlets, brochures, or other written forms of solicitation or advertisement, except for an order form which could be sent to present or former holders of the short-term notes, with the notation that the notes were not being offered or sold pursuant to a registration statement. *Id.* A copy of Perera's most recent financial statement was required to accompany the order form. The compromise allowed Perera to continue using its brochure listing its many services, provided that any references in the brochure to Perera's promissory notes would be limited to the statement: "Under certain circumstances Perera sells its promissory notes with a maximum maturity of 270 days." *Id.* Perera agreed that it would not offer or sell any short-term notes in denominations of less than \$2,500 and that the proceeds from such sales would be used primarily for the purpose of financing the purchase of foreign exchange inventory and the repayment of short-term notes on their maturity. *Id.* For a discussion of the Commission's interpretation of section 3(a)(3), as articulated during the Perera litigation, see note 253 *infra*.

The Commission does not consider the Perera settlement as a precedent with regard to section 3(a)(3). See, e.g., SEC no-action letter (Real-Text Enterprises, Inc.), note 61 *supra*. The staff in Real-Text emphasized that

[e]ach request for exemption or claim of exempt status based upon Section 3(a)(3) must stand on its own merits and the Division [Corporation Finance] considers the totality of the circumstances in each particular situation in determining the availability of the exemption.

Id. at frame 07333.

⁹⁹ SEC no-action letter (American Auto. Ins. Brokers, Inc.), issued June 19, 1974, [1974] CCH FED. SEC. MICROFILM, roll 7, frame 09324.

¹⁰⁰ *Id.*

Act.¹⁰¹ Springs Mills, Inc., successfully used this approach in 1972.¹⁰² Springs planned to issue promissory notes from time to time in minimum amounts of \$200,000 with the aggregate amount of all notes outstanding at any one time not anticipated to exceed \$5 million. Under a proposed short-term borrowing agreement between Springs and a local bank, the bank was to assemble a list of eligible investors not to exceed 100 in number, for whom the bank would act as agent in purchasing Springs' short-term notes. It was contemplated that the bank would limit the investment opportunity to fewer than 25 persons.¹⁰³ In responding to a request for no action, the staff approved the proposed sale of commercial paper under section 3(a)(3).¹⁰⁴

It should be noted that even if an issuer structures the sale of commercial paper as a nonpublic offering, purchasers of the short-term notes are not guaranteed the disclosure protections of section 4(2).¹⁰⁵ Section 3(a)(3) does not require issuers to provide any specific disclosures to investors as a condition for exemption, although an issuer that claims the exemption must comply with the disclosure requirements of the antifraud provisions of the securities laws.¹⁰⁶

E. Use of Proceeds

Interim financing through the sale of commercial paper can satisfy many needs of the issuer or one or more of its subsidiaries,¹⁰⁷ but not every desired use of proceeds from the sale of

¹⁰¹ See note 82 *supra*.

¹⁰² SEC no-action letter (Springs Mills, Inc.), issued Dec. 6, 1972, [1973] CCH FED. SEC. MICROFILM, roll 1, frame 00207.

¹⁰³ *Id.* at 00212.

¹⁰⁴ *Id.* at 00207.

¹⁰⁵ See note 82 *supra*. For a description of the type of disclosure that issuers must make available to offerees and purchasers under section 4(2), 15 U.S.C. § 77d(2) (1970), see *SEC v. Continental Tobacco Co. of S.C., Inc.*, 463 F.2d 137 (5th Cir. 1972); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971). The Commission, in rule 146, has interpreted section 4(2) to require the issuer to make available to certain offerees and actually furnish to others the same kind of information that registration would disclose. Rule 146(e), 17 C.F.R. § 230.146(e) (1976). Furthermore, rule 146 requires an issuer to be available during the course of the transaction and prior to the sale to answer questions from prospective investors. Rule 146(e)(2), 17 C.F.R. § 230.146(e)(2) (1976).

¹⁰⁶ See note 8 *supra*.

¹⁰⁷ The issuer is not required by section 3(a)(3) to use the proceeds from its unregistered commercial paper for its own purposes. Such funds can be advanced to a subsidiary. See, e.g., SEC no-action letter (Merrill Lynch & Co., Inc.), issued Aug. 19, 1974, [1974] CCH FED. SEC. MICROFILM, roll 9, frame 12265 (proceeds to be advanced to a subsidiary to finance an inventory of government securities); SEC no-action letter (Wells Fargo & Co.), issued Dec. 28, 1973, [1974] CCH FED. SEC. MICROFILM, roll 1, frame 00215 (proceeds to be advanced to Wells Fargo Mortgage Co. for pre-construction loans).

commercial paper will allow the issuer to qualify its notes under section 3(a)(3). The exemption is limited to "[a]ny note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions . . ."¹⁰⁸ Since this limitation has been interpreted as a requirement that the issuer use the proceeds for current transactions, regardless of whether the note arose out of current transactions,¹⁰⁹ the use of proceeds has become an important factor in determining eligibility for the exemption.

The Commission has expressed its opinion on what constitute current transactions in two separate releases. The question was first addressed in Securities Act Release No. 401, where the Commission discussed the availability of section 3(a)(3) for notes of the type normally issued by finance companies.¹¹⁰ The Commission warned that a decision on what is a current transaction must be made in light of the particular facts and business practices surrounding individual cases. It concluded that generally the exemption would apply to such notes if they satisfied all conditions required by section 3(a)(3), including the requirement that

[t]he proceeds of the notes for which exemption is claimed are used for current transactions, which may properly include either (a) the making of loans upon or the purchasing of such notes, instalment contracts, or other evidences of indebtedness in the usual course of business, or (b) the payment of outstanding notes exempt under section 3(a)(3).¹¹¹

In Release No. 4412 the SEC expanded the definition of current transactions by referring to the assets financed by eligible commercial paper as "easily convertible into cash and . . . comparable to liquid inventories of an industrial or mercantile company."¹¹² The Commission cautioned that the current transactions standard would not be satisfied where the proceeds were to be used for the following specific transactions: the purchase or construction of a plant; the purchase of durable machinery or equipment; the funding of commercial real estate development or financing; the purchase of real estate mortgages or other securities; the financing of mobile homes or home improvements; or the purchase or establishment of a business enterprise.¹¹³

¹⁰⁸ 15 U.S.C. § 77c(a)(3) (1970).

¹⁰⁹ See text accompanying note 52 *supra*.

¹¹⁰ Release No. 401, *supra* note 22, at 2569.

¹¹¹ *Id.*

¹¹² Release No. 4412, *supra* note 22, at 2571.

¹¹³ *Id.* at 2570. The liquidity aspect of the definition was emphasized in an answer to a no-action inquiry by Ban Corp. The SEC staff stated that the purpose of the current transactions requirement is to limit the exemption to "issuers of short-term obligations who will invest the proceeds in current assets, such as working capital to finance inventory and account [*sic*] receivable which

Despite the Commission's efforts to define current transactions as it applies in section 3(a)(3), the requirement continues to raise two major issues for those wishing to claim the exemption: which transactions are specifically deemed to be current; what proof must the issuer offer that it intends to use and in fact uses all the net proceeds from the sale of unregistered commercial paper in current transactions.

1. Current Transactions

Most of the no-action letter inquiries that relate to section 3(a)(3) focus on the term "current transactions." Over the years the SEC staff has been presented with descriptions of certain recurring transactions which issuers intend to fund with the proceeds of commercial paper. Although at times the staff has taken inconsistent stances on the eligibility of certain transactions¹¹⁴ and recently has refused to express an opinion on the availability of section 3(a)(3) for certain business plans,¹¹⁵ on a majority of the recurring uses the staff has developed a firm position which, for the most part, represents a liberal construction of the current transactions requirement.¹¹⁶

a. Specific Transactions.

(1) Commercial Financing. Proceeds of commercial paper sold under section 3(a)(3) may be used for commercial accounts receivable loans or inventory financing loans.¹¹⁷ These loans are generally made pursuant to revolving credit agreements¹¹⁸ extended

are inherently self-liquidating." SEC no-action letter (Ban Corp.), issued Sept. 13, 1972, [1972] CCH FED. SEC. MICROFILM, roll 10, frame 16063.

¹¹⁴ See, e.g., text accompanying notes 123-24, 126-35 *infra*.

¹¹⁵ See text accompanying notes 124, 203, 205-14 *infra*.

¹¹⁶ The Commission has acknowledged that it has given a broad meaning to the current transactions test. See SEC STAFF REPORT, *supra* note 3, at VIII (statement by William J. Casey, then Chairman of the SEC). In reaching its permissive attitude towards section 3(a)(3), the staff has been heavily influenced by the Federal Reserve Board's expansive interpretation of section 13 of the Federal Reserve Act as reflected in the Board of Governor's Regulation A, 12 C.F.R. § 201 (1976). See text accompanying notes 263-68 *infra*.

¹¹⁷ See, e.g., SEC no-action letter (CBT Corp.), issued June 6, 1974, [1974] CCH FED. SEC. MICROFILM, roll 7, frame 09269.

¹¹⁸ Under a revolving credit agreement, the balance owed fluctuates depending on the finance charge, the amount of credit extended and the payments made. Such an open-end credit arrangement is the basis for the revolving charge accounts used by many merchants who permit their customers to purchase merchandise on credit. This form of financing is distinguishable from a closed-end credit agreement—for example, the purchase of an automobile—where the amount owed is fixed in advance and is repaid in installments. See, e.g., SEC no-action letter (Detroitbank Corp.), issued June 4, 1974, [1974] CCH FED. SEC. MICROFILM, roll 7, frame 09247. Loans made pursuant to revolving

to manufacturing firms, dealers or merchants, and are secured by the borrower's accounts receivable, equipment or inventory.¹¹⁹ With the loan proceeds the borrower is in a position to maintain its business while awaiting payment on its accounts receivable¹²⁰ or, in the case of inventory financing loans, to purchase inventories for its business¹²¹ or carry present inventories until they are sold.¹²² Upon receipt of payment from its customers, the borrower is then in a position to liquidate the accounts receivable loan or inventory financing loan.

In deciding whether commercial financing is current under section 3(a)(3) the staff has not, until recently, looked behind accounts receivable¹²³ to examine the nature of the goods or services responsible for the sales. In the case of inventory financing loans, on occasion the staff has examined the nature of the inventory to be acquired or carried.¹²⁴ It appears that the staff will now

credit agreements are generally called "revolving credits" and are made against an available line of credit having a fixed maturity—two to three years—after the date of issuance. At maturity the outstanding balance of principal plus interest on the loan is satisfied either by direct payment by the borrower of the revolving credit or by converting the outstanding balance of the loan into a term loan. *Id.* at 09252-53.

¹¹⁹ See, e.g., SEC no-action letter (First Nat'l State Bancorp.), issued Feb. 26, 1974, [1974] CCH FED. SEC. MICROFILM, roll 3, frame 03382, at 03391; SEC no-action letter (Chase Manhattan Corp.), issued Aug. 26, 1974, [1974] CCH FED. SEC. MICROFILM, roll 9, frame 12285.

¹²⁰ See, e.g., SEC no-action letter (Florida Power & Light Co.), issued July 12, 1974, [1974] CCH FED. SEC. MICROFILM, roll 8, frame 10867, where the issuer, a utility, intended to use part of the proceeds to carry accounts receivable during the lag time between meter reading and collections.

¹²¹ See, e.g., SEC no-action letter (Tektronix, Inc.), issued Nov. 7, 1974, [1974] CCH FED. SEC. MICROFILM, roll 12, frame 16157, where the proceeds were to be used partially to purchase component parts, raw materials and supplies for the issuer's business.

¹²² Counsel for issuers intending to use proceeds from exempt short-term notes for commercial financing frequently refer to Regulation A of the Federal Reserve Board as authority for eligibility of such notes under the Federal Reserve Act and for exempt status under section 3(a)(3) of the 1933 Act. See notes 46, 116 *supra*. Section 201.4 of the Regulation makes a note eligible for discount if it has been issued or drawn or the proceeds of which are to be used "in producing, purchasing, carrying, or marketing goods in the process of production, manufacture, or distribution. . . ." 12 C.F.R. § 201.4(a)(1) (1976).

¹²³ See, e.g., SEC no-action letter (Interstate Corp.), issued May 22, 1972, [1972] CCH FED. SEC. MICROFILM, roll 6, frame 09552, *discussed in note 124 infra*.

¹²⁴ See, e.g., SEC no-action letter (Interstate Corp.), *supra* note 123, at 09553, where the staff disallowed the use of commercial paper proceeds for the carrying of a retail inventory of trucks and trailers. However, the staff allowed Interstate to use proceeds from commercial paper to finance accounts receivable arising from the sale of trucks and trailers by its subsidiaries. The staff allowed another subsidiary, operating as a finance company, to carry purchasers' installment obligations which had a maximum maturity of 36 months and were secured by the truck or trailer underlying the transaction. The staff also allowed the issuer to use such proceeds to carry a parts inventory. See also SEC

scrutinize both types of commercial loans. If the loans suggest a permanent investment, either because of the character of the assets involved or the duration of the financing arrangement, the exemption will not apply.¹²⁵

(2) Consumer Credit Loans. The SEC staff allows the section 3(a)(3) exemption for commercial paper where the proceeds are used for consumer credit loans of a type eligible for discount by a Federal Reserve bank.¹²⁶ Such loans may be se-

no-action letter (B.C. Ziegler & Co.), issued Aug. 16, 1971, [1971] CCH FED. SEC. MICROFILM, roll 6, frame 12609, where the exemption was denied to an issuer planning to use proceeds for the purchase of X-ray machines and other durable equipment for leasing to hospitals.

Where an issuer intends to use proceeds from commercial paper to finance the purchase of assets that have an appearance of permanence, the issuer might try to structure the financing arrangements to provide the quantum of liquidity that the staff requires under section 3(a)(3). It was apparently this realization that motivated Citizens & Southern Holding Co. (Holding Co.) to seek staff approval for the use of proceeds from commercial paper to finance the purchase of inventory by mobile home dealers. SEC no-action letter (Citizens & S. Holding Co.), issued Jan. 24, 1974, [1974] CCH FED. SEC. MICROFILM, roll 2, frame 01601. Although the staff refused to take a position on the contemplated action, Holding Co. claimed that under its method of doing business, the purchase of mobile homes by dealers was an integral element in the distribution of mobile homes and did not involve a permanent investment in those assets. *Id.* at 01603. Under the proposed inventory financing, Citizens & Southern Servicing Co., an affiliate of Holding Co., planned to utilize the standard security agreement and collateral note for retail inventory which Holding Co. and its subsidiaries regularly used in connection with financing many types of retail inventory including automobiles, appliances and motorcycles. *Id.* For the position taken by the Federal Reserve Board on the eligibility for discount of commercial paper traceable to mobile home sales, see note 135 *infra*.

¹²⁵ See, e.g., SEC no-action letter (Northwest Acceptance Corp.), issued Jan. 29, 1976, [1976] CCH FED. SEC. MICROFILM, roll 3, frame 03069, where the issuer was engaged in the business of financing sales of income-producing capital equipment primarily for use in the construction, forest products and trucking industries. On October 31, 1975, 81 percent of the issuer's finance receivables were represented by retail installment contracts acquired from dealers and by equipment loans made to persons who were purchasing equipment or refinancing equipment debts. *Id.* at 03072. The issuer sought a section 3(a)(3) exemption for its short-term notes. The proceeds were to be used for additional retail contract loans and equipment loans that would mature between three and one-half and five years. The staff denied the request "in view of the relatively large proportion of the finance receivables and the relatively long duration of the loan [*sic*] to be covered and substantial doubt whether or not current transactions are proposed to be financed." *Id.* at 03070. Upon reconsideration, the staff allowed the exemption for such retail contract loans and equipment loans but gave no explanation for the reversal of its earlier decision. SEC no-action letter (Northwest Acceptance Corp.), issued Apr. 28, 1976, [1976] CCH FED. SEC. MICROFILM, roll 5, frame 06246. In an earlier no-action request from a corporation seeking to utilize section 3(a)(3) to raise funds for equipment financing loans, the staff refused to express an opinion since such use of proceeds was "currently under study." SEC no-action letter (Mercantile Nat'l Corp.), issued Jan. 12, 1976, [1976] CCH FED. SEC. MICROFILM, roll 2, frame 01313, 01314.

¹²⁶ See, e.g., SEC no-action letter (First Bank Sys., Inc.), issued Sept. 9, 1974, [1974] CCH FED. SEC. MICROFILM, roll 10, frame 13437. Regulation Z

cured¹²⁷ or unsecured,¹²⁸ payable on demand,¹²⁹ issued with stated maturities¹³⁰ or issued under open-end agreements.¹³¹ The purposes for which these loans are made are those generally associated with consumer lending, including discharge and consolidation of obligations of the borrower to finance companies, appliance stores, automobile dealers, and creditors under conditional sales contracts.¹³² Proceeds from such loans may also be used to finance purchases made by holders of credit cards.¹³³ At one time the staff was concerned with the character of the assets to be purchased by the consumers through the use of such loans. The staff denied no-action treatment where, for example, the loans were made to assist consumer purchase of mobile homes or home improvements.¹³⁴ It now appears that the staff has reversed itself and

of the Federal Reserve Board defines consumer credit as "credit offered or extended to a natural person, in which the money, property, or service which is the subject of the transaction is primarily for personal, family, household, or agricultural purposes." 12 C.F.R. § 226.2(p) (1976). Loans for consumer credit meeting this definition qualify for discount by a Federal Reserve bank. *Id.* § 201.104.

¹²⁷ See, e.g., SEC no-action letter (Fidelity Am. Bankshares, Inc.), issued June 17, 1974, [1974] CCH FED. SEC. MICROFILM, roll 7, frame 09309 (issuer described the bulk of its consumer loans as being secured by automobiles, household goods and other personal property, *id.* at 09313); SEC no-action letter (DAC Corp.), note 32 *supra* (issuer made consumer finance loans secured by liens on improved real estate with maturities not exceeding 61 months).

¹²⁸ See, e.g., SEC no-action letter (Security Pac. Corp.), issued June 3, 1974, [1974] CCH FED. SEC. MICROFILM, roll 7, frame 09238.

¹²⁹ See, e.g., SEC no-action letter (CBT Corp.), note 117 *supra*.

¹³⁰ *Id.* Some of the issuer's loans had stated maturities of one year or less. *Id.* at 09280.

¹³¹ See, e.g., SEC no-action letter (Rhodes, Inc.), issued June 17, 1974, [1974] CCH FED. SEC. MICROFILM, roll 7, frame 09318 (issuer intended to use part of the proceeds from unregistered commercial paper to carry accounts receivable from consumer credit sales of home furnishings under open-end agreements); SEC no-action letter (First Bank Sys., Inc.), *supra* note 126, at 13439-40. The term "open-end credit" is defined by the Federal Reserve Board as

consumer credit extended on an account pursuant to a plan under which (1) the creditor may permit the customer to make purchases or obtain loans, from time to time, directly from the creditor or indirectly by use of a credit card, check, or other device, as the plan may provide; (2) the customer has the privilege of paying the balance in full or in installments; and (3) a finance charge may be computed by the creditor from time to time on an outstanding unpaid balance. . . . The term does not include negotiated advances under an open end real estate mortgage or a letter of credit.

12 C.F.R. § 226.2(x) (1976).

¹³² See, e.g., SEC no-action letter (DAC Corp.), note 32 *supra*.

¹³³ See, e.g., SEC no-action letter (Security Pac. Corp.), note 128 *supra*.

¹³⁴ See, e.g., SEC no-action letter (Detroitbank Corp.), note 118 *supra*, where the staff informed counsel for the issuer that it did not agree with their opinion that loans for home improvements and mobile homes, included under the general heading of consumer credit loans, met the current transactions test of section 3(a)(3). *Id.* at 09248. The staff referred to Release No. 4412, note 22 *supra*, as authority for its position. SEC no-action letter (Detroitbank Corp.), *supra* note 118, at 09248.

intends to permit issuers of unregistered commercial paper to use the proceeds for any type of consumer loan.¹⁸⁵

(3) Mortgage Warehousing Loans. These loans are made to mortgage bankers and others who need funds to carry temporarily an inventory of long-term mortgage loans pending the packaging of such loans in a sufficient number and amount for sale to permanent mortgage investors.¹⁸⁶ The loans are ordinarily secured by pledges of the mortgage notes being "warehoused" by the mortgage bankers.

The SEC staff views the temporary warehousing of real estate mortgage loans as a current transaction under section 3(a)(3).¹⁸⁷

¹⁸⁵ See, e.g., SEC no-action letter (First Md. Bancorp.), issued July 18, 1974, [1974] CCH FED. SEC. MICROFILM, roll 8, frame 10882 (staff concurred in counsel's opinion that the issuer's contemplated use of proceeds satisfied the current transactions requirement; the issuer included within its plans loans on mobile homes with maturities ranging up to ten years, *id.* at 10887); SEC no-action letter (Horizon Bancorp.), issued Aug. 22, 1975, [1975] CCH FED. SEC. MICROFILM, roll 9, frame 11698 (issuer's consumer loans with maturities not exceeding five years would have allowed borrowers to finance home improvements, *id.*) discussed at note 203 *infra*. But see SEC no-action letter (BancOklahoma Corp.), issued Jan. 29, 1976, [1976] CCH FED. SEC. MICROFILM, roll 3, frame 03060, where the staff granted no-action status to an issuer planning to claim a section 3(a)(3) exemption. The staff refused, however, to permit part of the proceeds to be used for consumer loans which would have maturities ranging from one to four years in most instances, but would range up to seven years with respect to boat loans and ten years with respect to mobile home loans. Although the reason for the staff's position on the consumer loans is not clear, it appears that the intended duration of the loans was deemed unacceptable under section 3(a)(3).

The staff's reversal of its earlier interpretation of current transactions for consumer loans can be traced to the Federal Reserve Board's decision in 1972 to construe "actual commercial transactions" in section 13 of the Federal Reserve Act, 12 U.S.C. § 343 (1970), to include consumer loans. 58 FED. RES. BULL. 279 (1972). According to the Board, "borrowing for the purpose of purchasing goods is borrowing for a commercial purpose, whether the borrower intends to use the goods himself or to resell them." *Id.* More specifically, the Board's interpretation was intended to include "notes given for the purchase of mobile homes that are acquired by a finance company from a dealer-seller of such homes." *Id.*

¹⁸⁶ The mortgage company (mortgage banker) functions as a middleman rather than an investor. It originates loans to those persons who construct or acquire properties. The mortgage company then sells the loans (while usually retaining the servicing of the mortgages) to banks and insurance companies in the secondary mortgage market or to the Federal National Mortgage Association (Fannie Mae). A mortgage company is often formed

by a real estate firm, an insurance agency, or a commercial bank, and depends heavily at first on short-term credit to finance the purchase of mortgages for resale on speculation or, more normally, on the strength of a prior commitment from a secondary purchaser. In time, the more prosperous companies are able to originate some mortgages for their own account. The major revenue sources for a mortgage company are its earnings from placement fees and servicing charges, from allied real estate and fire insurance brokerages, and from real estate investment trusts formed by the company itself.

G. LEFCOE, LAND DEVELOPMENT LAW 573 (2d ed. 1974).

¹⁸⁷ See, e.g., SEC no-action letter (Mercantile Bankshares Corp.), note 58

As a result, issuers of unregistered short-term notes are free to use the proceeds to finance this type of interim loan.¹³⁸ The staff does not require as a condition for exemption that the issuer have commitments for the purchase of the long-term mortgage loans by permanent lenders prior to making its loans to mortgage bankers.¹³⁹ The issuer must, however, limit the borrower's warehousing period to one year if the issuer's loans are to qualify as current.¹⁴⁰ In the staff's opinion, if a mortgage banker does not turn over its inventory of mortgage loans at least once a year, a mortgage warehousing loan takes on the character of a permanent investment and is, therefore, no longer a current transaction for purposes of section 3(a)(3).¹⁴¹

supra; SEC no-action letter (Marine Corp.), issued Jan. 21, 1974, [1974] CCH FED. SEC. MICROFILM, roll 2, frame 01605. The inventories of mortgage loans are distinguishable from the durable assets accumulated under inventory loans, note 124 *supra*, because an established market for mortgage loans is prepared to accept them at an appropriate discount.

¹³⁸ The staff's position is consistent with that of the Federal Reserve Board. In 1970 the Board interpreted section 13 of the Federal Reserve Act, 12 U.S.C. § 343 (1970), to make mortgage company notes eligible for discount. 12 C.F.R. § 201.109 (1976). In that interpretation the Board noted that Congress in 1913 sought to exclude investment securities from discount eligibility because speculation was a major congressional concern. The Board decided that "speculation is not a material element in mortgage banking operations." *Id.* § 201.109(d). The Board was also aware that Regulation A denies eligibility to certain notes if the proceeds are used "for permanent or fixed investments of any kind, such as land, buildings or machinery, or for any other fixed capital purpose." It concluded, however, that

the proceeds of a mortgage company's commercial paper are not used by it for any permanent or fixed capital purpose, but only to carry temporarily an inventory of mortgage loans pending their "packaging" for sale to permanent investors that are usually recurrent customers.

Id. § 201.109(e). Therefore, "notes having not more than 90 days to run which are issued to finance the temporary holding of mortgage loans are eligible for discount by Reserve Banks." *Id.* § 201.109(f). The SEC staff does not impose such a 90-day limit on the mortgage warehousing loans made with proceeds from section 3(a)(3) securities. See note 140 *infra*.

¹³⁹ See, e.g., SEC no-action letter (Trust Co. of Ga.), issued Mar. 3, 1975, [1975] CCH FED. SEC. MICROFILM, roll 3, frame 02576, at 02577.

¹⁴⁰ See, e.g., SEC no-action letter (Mercantile Bankshares Corp.), note 58 *supra*, where the staff's approval of a mortgage banker's plan to carry loans with maturities of 25 to 30 years was limited to an inventory where the loans were turned over at least once a year. *Id.* at 01584; SEC no-action letter (National Detroit Corp.), issued Dec. 27, 1974, [1975] CCH FED. SEC. MICROFILM, roll 1, frame 00188, 00193.

¹⁴¹ The staff apparently analogizes the mortgage banker's inventory of mortgage loans which will be turned over at least once a year to the "liquid inventories of an industrial or mercantile company" referred to in Release No. 4412, *supra* note 22, at 2571. See, e.g., SEC no-action letter (First Nat'l State Bancorp.), note 119 *supra*, where no-action treatment was extended to an issuer who planned to fund mortgage warehouse loans with proceeds from the sale of its commercial paper. Counsel for the issuer relied upon an interpretation of Regulation A by the Board of Governors of the Federal Reserve System, 12 C.F.R. § 201.109(d)-(f) (1976), which characterized mortgage warehousing loans as closely related to industry and commerce and described the temporary holding

An interpretative problem arises where the issuer making a mortgage warehousing loan is affiliated with the eventual permanent lender. Suppose, for example, that Company *A* relies upon section 3(a)(3) for the sale of its short-term notes. It plans to advance the proceeds to Company *B*, a wholly-owned subsidiary in the

of real estate mortgage loans as a non-permanent investment by the mortgage banking company. SEC no-action letter (First Nat'l State Bancorp.), *supra* note 119, at 03389 (letter of corporate counsel).

Although a mortgage warehouse loan appears to be as much a permanent investment as an inventory financing loan that is used by the borrower to purchase trucks, durable machinery or other heavy equipment, note 124 *supra*, it achieves its status as a current transaction because an established market in mortgages permits the lender to turn over its loans on a regular basis. The fact that some or all of a mortgage banker's loans could become worthless or unmarketable during the twelve-month period prior to packaging for resale is not considered relevant by the SEC staff in characterizing the issuer's mortgage warehousing loan as a current transaction. Equally irrelevant is the fact that the mortgage banker, faced with unmarketable mortgage loans, might default on its obligation to the issuer, thereby forcing the issuer to transform its short-term loan into a permanent investment by foreclosing on the underlying property. See generally text accompanying note 282 *infra*. If, however, the issuer acquires interests in real property as a result of foreclosure proceedings in satisfaction of mortgage warehousing loans and then seeks to maintain and carry the property with proceeds from the sale of unregistered commercial paper, the staff is likely to view the assets to be funded as permanent in character, *i.e.*, "not easily convertible into cash," Release No. 4412, *supra* note 22, at 2571, and deny the exemption under section 3(a)(3). See SEC no-action letter (First Wis. Corp.), issued June 25, 1976, [1976] CCH FED. SEC. MICROFILM, roll 7, frame 08731, where the issuer planned to distribute the proceeds from the sale of its commercial paper to two of its wholly owned subsidiaries, a mortgage company and a bank. Both of the subsidiaries owned interests in certain real properties acquired through foreclosure proceedings in satisfaction of short-term construction loans or other interim loans. Proceeds from the proposed offering of commercial paper were to be used to retire existing indebtedness incurred in acquiring, completing and carrying the real property, and to provide operating funds needed by the mortgage company in connection with the interim operation and management of the properties prior to sale within four years. Counsel for the issuer recognized that the assets to be funded with the proceeds were by their nature long-term, but argued that "the interests of the companies are purely in the nature of interim short-term investments." *Id.* at 08738. Analogizing the issuer's intended use of proceeds to "gap" or "standing" loans, counsel noted

that if the Mortgage Company's inventory of Eligible Assets was owned by one or more independent real estate developers, and was in the process of being marketed in the same manner, then a loan made by a lender to the developer to finance the cost of carrying the inventory prior to its sale would properly be regarded as financing a "current transaction." Such interim loans, variously referred to as "gap" or "standing" loans, have been the subject of favorable "no-action" letters to lenders which indicated that the exemption of Sec. 3(a)(3) applied to short-term paper issued by the lenders for the purpose of providing funds to make such loans. In this case, the Mortgage Company is engaging in the same activities as would such a developer in marketing its inventory of Eligible Assets.

Id. at 08739. The staff denied the requested exemption under section 3(a)(3) "particularly in view of the intended use of proceeds to carry real estate ownership interests acquired through foreclosure or otherwise in connection with lending activities" *Id.* at 08732.

mortgage banking business, so that *B* can make thirty-year loans on certain improved real estate. *B* intends to warehouse these loans for a period of less than twelve months until it can package them for sale to permanent investors, among which is Company *C*, another wholly-owned subsidiary of the issuer, *A*. The staff has approved the use of section 3(a)(3) under these circumstances¹⁴² even though purchasers of *A*'s commercial paper are in reality providing part of the permanent financing needed by *A*, through its subsidiary *C*, to invest in long-term real estate mortgages.

(4) Factoring. The alternative to financing accounts receivable through accounts receivable loans is the outright sale of such accounts by the businesses. Commercial finance companies which purchase accounts receivable are known as factors. While commercial finance companies that choose to lend funds on the pledge of accounts receivable do so "with recourse" against the borrower for any delinquent account,¹⁴³ factors have no recourse against the seller if collection is impossible. Factors examine the credit acceptability of each account and, if satisfied, assume complete financial responsibility for collection. The cost of factoring consists of a straight interest charge for the cash advance by the factor to the business and a commission to cover the cost of investigating credits, collection of fees and reserves for losses.¹⁴⁴

Issuers of commercial paper acting as factors may rely on section 3(a)(3) if the proceeds are used to purchase accounts receivable. SEC staff approval is limited, however, to the acquisition of accounts receivable which are due and payable within ninety days.¹⁴⁵ The use of the proceeds to purchase such accounts is by nature of short duration and thus qualifies as a current transaction.¹⁴⁶

¹⁴² See SEC no-action letter (National Detroit Corp.), *supra* note 140, at 00191.

¹⁴³ In most cases, the trade debtors are not informed that their account has been assigned to a finance company. Under "nonnotification" financing the trade creditor seeks to acquire needed funds without giving customers the impression of financial weakness. J. BOGEN, *supra* note 37, at 2-35. For a discussion of the availability of section 3(a)(3) in cases where the issuer intends to use proceeds for commercial loans secured by accounts receivable, see text accompanying note 117 *supra*.

¹⁴⁴ The interest charge is generally two or three percentage points above the prime rate at commercial banks and the commission is frequently one to two percent of the amount of the receivables. J. BOGEN, *supra* note 37, at 2-35.

¹⁴⁵ A substantial number of accounts receivable are due within 90 days. See, e.g., SEC no-action letter (Chase Manhattan Corp.), note 119 *supra*, where the accounts receivable were usually payable between 30 and 90 days from the time they came into existence; SEC no-action letter (First Nat'l State Bancorp.), note 119 *supra*, where the accounts were normally to be payable between 10 and 90 days from the time they came into existence. *Id.* at 03393.

¹⁴⁶ Notes are eligible for discount under Regulation A, note 46 *supra*,

(5) Preconstruction Loans. Land developers may be required to make site improvements before they can secure construction financing or commence work on a specific project.¹⁴⁷ Preconstruction loans, secured by a mortgage on the real property, provide developers with the funds necessary to make such improvements. Proceeds from subsequent construction financing or sale of the property are normally used to repay these loans.¹⁴⁸

Preconstruction loans fall within the current transactions requirement of section 3(a)(3) if they provide for maturity within thirty-six months.¹⁴⁹ The fact that a developer lacks a commitment for permanent funding at the time of the interim preconstruction loan will not necessarily prevent the issuer from claiming the section 3(a)(3) exemption. The SEC staff has permitted such an issuer to use proceeds from its commercial paper where it assured the staff that it would not make preconstruction loans unless it expected the developers to obtain construction financing within the period of the preconstruction loan. The issuer must also assure the staff that it will remove a preconstruction loan from the category of loans considered eligible for commercial paper funding if at any time the issuer determines that the developer cannot obtain construction financing.¹⁵⁰

(6) Construction Loans. These loans are used to finance the construction of income-producing properties such as shopping cen-

where the proceeds are used to purchase accounts receivable. 12 C.F.R. § 201.4 (a)(1) (1976).

¹⁴⁷ See generally Blumberg, *Short-Term Funds Through Interim Financing*, NAT'L REAL ESTATE INV. (Feb. 1965), cited in G. LEFCOE, *supra* note 136, at 601-04.

¹⁴⁸ *Id.*

¹⁴⁹ See, e.g., SEC no-action letter (Southwest Bancshares, Inc.), issued Aug. 27, 1974, [1974] CCH FED. SEC. MICROFILM, roll 9, frame 12311; SEC no-action letter (Security Pac. Corp.), note 128 *supra*. Apparently the staff views preconstruction financing to be so intimately connected to traditional construction financing, both by reason of the purposes of such financing and their time in relation to each other, that preconstruction loans should be treated the same as construction loans. See text accompanying notes 151-65 *infra*. If the loan to a land developer is not related to a specific plan of construction, the staff treats it as a development loan that does not qualify as a current transaction. See text accompanying notes 166-68 *infra*.

¹⁵⁰ See, e.g., SEC no-action letter (U.S. Bancorp Realty & Mortgage Trust), issued Apr. 25, 1974, [1974] CCH FED. SEC. MICROFILM, roll 5, frame 06650; SEC no-action letter (Equitable Life Mortgage & Realty Investors), issued Dec. 28, 1973, [1974] CCH FED. SEC. MICROFILM, roll 1, frame 00207, where the issuer assured the staff that

[i]f at any time the Trust were to determine that construction financing for the Improvement would not be obtained within twelve months, [the period of its preconstruction loans], the Preconstruction Loan would be removed promptly from the category of loans considered as eligible for commercial paper funding until the twelve-month requirement could be met.

Id. at 00210. For a discussion of the consequences under section 3(a)(3) where the issuer provides the developer with both preconstruction and construction financing, see text accompanying notes 158-64 *infra*.

ters, motels, hotels, office buildings, condominiums and industrial structures. Construction periods vary from several months for small projects to more than two years for apartment, industrial and commercial buildings. The period for an especially large project might be as long as five years.¹⁵¹ In the usual case a construction loan is secured by a first lien on real estate and has a stated maturity generally coinciding with the intended date of construction completion. Once the construction is completed, the developer's long-term lender is expected to provide the major financing, proceeds of which are used to pay the construction loan in full.¹⁵² At the time it seeks a construction loan the developer will, in some cases, have a binding agreement, called a takeout commitment, by a financially responsible lender to advance the full amount of the construction mortgage upon completion of construction.¹⁵³ Where a takeout commitment is not obtained prior to the extension of credit under the construction loan,¹⁵⁴ the lender will either assume the risk that permanent financing will not materialize at maturity¹⁵⁵ or it might itself provide a commitment to the

¹⁵¹ See, e.g., SEC no-action letter (Mercantile Bankshares Corp.), *supra* note 58, at 01583 (letter of corporate counsel).

¹⁵² *Id.*

¹⁵³ In some cases the takeout commitment is sought solely for the purpose of providing a basis for the commencement of construction. A builder may need a commitment for the permanent financing in order to secure a construction loan.

Many times, however, a maximum mortgage cannot be secured until the building is substantially leased. Rather than accept less favorable permanent first mortgage terms on the project in its formative stage, the builder may well decide to defer his permanent financing. He can still obtain his construction financing by having the interim financing agency issue a first mortgage takeout commitment to the construction lender, conditioned upon completion of the building in accordance with approved plans and specifications. In this way, the builder can realize a substantial saving through the use of a take-out commitment rather than accepting a less favorable first mortgage on the project in its formative stage. In many such cases, the take-out is never utilized because the builder realized adequate rentals and obtained favorable long-term institutional financing before the take-out expired.

Blumberg, *supra* note 147, at 602-03.

¹⁵⁴ There are several business reasons for not requiring a takeout commitment: (1) In some situations, the borrower's credit potential is so good that a takeout commitment is an unnecessary requirement for the interim lender; (2) it is often easier and less expensive to obtain a firm takeout commitment after a project is well under way or completed because the long-term lender has the opportunity to learn more about the project before he makes a commitment; (3) takeout commitments frequently contain so many conditions precedent to the long-term lender's takeout that the protection afforded the construction lender is illusory since it must bear the risk of difficulties during the construction. SEC no-action letter (First Bank Sys., Inc.), issued Sept. 9, 1974, [1974] CCH FED. SEC. MICROFILM, roll 10, frame 13437, 13441 (letter of corporate counsel). See also SEC no-action letter (Lomas & Nettleton Financial Corp.), issued July 8, 1974, [1974] CCH FED. SEC. MICROFILM, roll 8, frame 10852, 10857 (letter of corporate counsel).

¹⁵⁵ Construction loans without takeout are, for the most part, limited to a three-year period and require personal liability. They are normally structured to

borrower to furnish the permanent mortgage at a later date.¹⁵⁶ Conceivably the same lender could be the source of a developer's preconstruction, construction and long-term mortgage financing.¹⁵⁷

Although construction loans are deemed to meet the current transactions requirement of section 3(a)(3),¹⁵⁸ interpretative problems have arisen where the construction loan is made without a prior commitment from a non-affiliated permanent lender or where the loan is combined with either preconstruction or long-term financing. At one time the staff refused to recognize as current transactions those construction loans that were made without firm takeout commitments from someone other than the issuer or its affiliates.¹⁵⁹ Later the staff modified that position and

encourage the developer to pay off the loan at the earliest possible date. Lenders can accomplish this by including additional points on the loan. See Anderson, *Do You Use Special Financing for Special Situations?*, 1973 PROF. BUILDER 112, cited in G. LEFCOE, *supra* note 136, at 586.

¹⁵⁶ Such agreements are called standby commitments. Where a takeout agreement is not obtained prior to the making of the initial construction loan, the lender might provide the standby commitment solely for the purpose of providing a basis for the commencement of construction. The lender will therefore make the terms of

the long-term loan (rates of interest, discounts and commissions payable, payout schedule and equity participation) provided by the standby commitment substantially more onerous than those which would be expected to be available to the borrower at the time the commitment is to be performed with the intention that the borrower seek other sources for its long-term financing.

SEC no-action letter (First Nat'l State Bancorp.), *supra* note 119, at 03387 (letter of corporate counsel).

¹⁵⁷ The following business reasons often prompt a lender to include both the construction loan and the long-term financing in the same agreement: (1) reduction of the number of documents because documentation of the long-term is the same as the construction loan with a simple assignment of the existing mortgage note upon the purchase by the long-term lender; (2) avoidance of risks that might otherwise be involved in obtaining execution of any new mortgage loan document when construction has been completed; (3) savings in some jurisdictions on mortgage recording fees and taxes; and (4) the necessity in some cases of structuring the loan as long-term in order to obtain the guarantee and insurance benefits provided by various governmental agencies. *Id.* at 03386; SEC no-action letter (Security Pac. Corp.), *supra* note 128, at 09244 (letter of corporate counsel).

¹⁵⁸ See, e.g., SEC no-action letter (Wisconsin Gas Co.), issued Dec. 17, 1973, [1974] CCH FED. SEC. MICROFILM, roll 1, frame 00196; SEC no-action letter (Old Stone Corp.), issued Dec. 17, 1974, [1975] CCH FED. SEC. MICROFILM, roll 1, frame 00182. The staff has allowed construction loans with maturities as long as 60 months. See, e.g., SEC no-action letter (Wells Fargo Mortgage Investors), issued Mar. 6, 1974, [1974] CCH FED. SEC. MICROFILM, roll 4, frame 05051.

Notes given in connection with loans for the construction of residential and farm buildings are eligible for discount under the Federal Reserve Board's Regulation A. 12 C.F.R. § 201.4(c) (1976). Notes given in connection with loans for the purpose of construction of industrial or commercial buildings apparently are not eligible for discount under Regulation A. *Id.*

¹⁵⁹ See, e.g., SEC no-action letter (United Va. Bankshares, Inc.), issued Apr. 9, 1973, [1973] CCH FED. SEC. MICROFILM, roll 5, frame 08716; SEC no-

decided that section 3(a)(3) was available even though the construction loan was made without a commitment for permanent financing if such commitment was obtained prior to completion of construction and the issuer or an affiliate did not act as the long-term lender.¹⁶⁰ Although far from clear, it now appears that the staff has almost completely reversed its original attitude toward construction loans. Such loans may now be made without takeout commitments.¹⁶¹ The staff will permit an issuer to make construction loans if the permanent financing is obtained within a reasonable period following the completion of construction.¹⁶² Furthermore, the staff has abandoned its earlier requirement of a non-affiliated permanent lender, which was presumably designed to assure investors of an independent source of funds to redeem the commercial paper, and will now permit the issuer or its subsidiary to provide a developer with both construction and long-term loans.¹⁶³

Where the issuer or its subsidiary provides a developer with financing for more than one stage of the construction process and the loans are funded in whole or in part from the sale of unregistered commercial paper, there may be a problem under the current transactions requirement of the exemption. The staff has concluded, however, that certain combinations of loans funded from exempt commercial paper can qualify as current. Proceeds from section 3(a)(3) securities may be used to fund both preconstruction and construction financing for the same borrower.¹⁶⁴ Since

action letter (Equitable Life Mortgage & Realty Investors), issued Feb. 8, 1973, [1973] CCH FED. SEC. MICROFILM, roll 3, frame 04033; SEC no-action letter (Citizens & S. Realty Investors), issued Feb. 13, 1973, [1973] CCH FED. SEC. MICROFILM, roll 3, frame 04044.

¹⁶⁰ See, e.g., SEC no-action letter (First Wis. Mortgage Trust), issued June 26, 1973, [1973] CCH FED. SEC. MICROFILM, roll 7, frame 12377; SEC no-action letter (First Union Real Estate Equity & Mortgage Invs.), issued May 21, 1973, [1973] CCH FED. SEC. MICROFILM, roll 6, frame 10532; SEC no-action letter (Great Am. Mortgage Investors), issued June 26, 1973, [1973] CCH FED. SEC. MICROFILM, roll 7, frame 12381. It appears that the staff's decision to treat construction loans without takeout commitments as current transactions was based largely on the business reasons set forth in note 154 *supra*.

¹⁶¹ See, e.g., SEC no-action letter (Capital Mortgage Invs.), issued Feb. 22, 1974, [1974] CCH FED. SEC. MICROFILM, roll 3, frame 03370; SEC no-action letter (Lomas & Nettleton Financial Corp.), note 154 *supra*; SEC no-action letter (First Bank Sys., Inc.), note 154 *supra*.

¹⁶² See, e.g., SEC no-action letter (Rhodes, Inc.), note 131 *supra*.

¹⁶³ See, e.g., SEC no-action letter (U.S. Bancorp. Realty & Mortgage Trust), note 150 *supra*.

¹⁶⁴ See, e.g., SEC no-action letter (Equitable Life Mortgage & Realty Investors), note 150 *supra*, where the issuer indicated its intention to provide a developer with both preconstruction and construction financing and, as a matter of convenience, to provide such financing under one loan document denominated as a construction loan. *Id.* at 00210; SEC no-action letter (Capital Mortgage

long-term construction financing is not a current transaction for purposes of section 3(a)(3), proceeds from exempt commercial paper may not be used for such loans. However, the staff will permit the issuer or its subsidiary to finance a developer with both a construction loan from the proceeds of its exempt commercial paper and a subsequent permanent loan from other funds.¹⁶⁵

(7) Land Acquisition and Development Loans. These are loans secured by mortgages or deeds of trust that enable a borrower to purchase, refinance or improve vacant land which the borrower intends to develop at some point in the future. For example, a developer might enter into a three-year loan agreement with a lender that would provide funds necessary for the acquisition of a tract of land and the installation of utilities, drainage facilities, sewage systems, sidewalks and roadways so that the property eventually would be ready for use as a building site, should a builder become available. Such loans are usually repaid from the proceeds of construction loans or from the proceeds of the sale of the developed site.¹⁶⁶

Traditionally, the staff refused to treat land acquisition and development loans as current transactions.¹⁶⁷ However, in 1973 the staff abandoned its opposition to such loans and since then has issued favorable opinions where the proceeds from the is-

Invs.), *supra* note 161, at 03375; SEC no-action letter (Security Pac. Corp.), note 128 *supra*.

¹⁶⁵ *Id.*

¹⁶⁶ In most cases the borrower will not have a takeout commitment prior to the making of a development loan but will obtain it prior to the completion of the development. SEC no-action letter (Lomas & Nettleton Fin. Corp.), *supra* note 154, at 10857-58 (letter of corporate counsel).

¹⁶⁷ *See, e.g.*, SEC no-action letter (Chase Manhattan Mortgage & Realty Trust), issued Feb. 19, 1971, [1971] CCH FED. SEC. MICROFILM, roll 1, frame 00800; SEC no-action letter (American Fletcher Mortgage Investors), issued Mar. 2, 1971, [1971] CCH FED. SEC. MICROFILM, roll 1, frame 00822; SEC no-action letter (Continental Ill. Realty), issued Sept. 22, 1971, [1971] CCH FED. SEC. MICROFILM, roll 7, frame 14720. During the first half of 1972 the staff appeared to have reversed its position on land acquisition and development loans by granting no-action status to several issuers which planned to make such loans. *See, e.g.*, SEC no-action letter (Equitable Life Mortgage & Realty Investors), issued Mar. 1, 1972, [1972] CCH FED. SEC. MICROFILM, roll 4, frame 05729; SEC no-action letter (Chase Manhattan Corp.), issued Aug. 17, 1972, [1972] CCH FED. SEC. MICROFILM, roll 9, frame 14830, 14831. The staff, however, quickly reverted to its earlier interpretation, *see, e.g.*, SEC no-action letter (Gulf Mortgage & Realty Invs.), issued Aug. 17, 1972, [1972] CCH FED. SEC. MICROFILM, roll 9, frame 14845, and sent corrective letters rescinding no-action status for development loans to those who had been led to believe that the staff was viewing such use of proceeds as current transactions. *See, e.g.*, SEC no-action letter (Chase Manhattan Mortgage & Realty Trust), issued Oct. 30, 1972, [1972] CCH FED. SEC. MICROFILM, roll 11, frame 17500. *See also* SEC no-action letter (Equitable Life Mortgage & Realty Investors), issued Oct. 30, 1972, [1972] CCH FED. SEC. MICROFILM, roll 11, frame 17501; SEC no-action letter (U.S. Bancorp.), issued Oct. 30, 1972, [1972] CCH FED. SEC. MICROFILM, roll 11, frame 17507.

suance and sale of unregistered commercial paper are used to fund site acquisition and development in connection with specific projects for which there are definite plans.¹⁶⁸ The financing in such cases is indistinguishable from preconstruction loans.¹⁶⁹ The staff appears to require the borrower under land acquisition and development loans to secure a takeout commitment prior to the completion of the development.¹⁷⁰

¹⁶⁸ The turning point occurred in SEC no-action letter (First Penn. Mortgage Trust), issued Sept. 20, 1973, [1973] CCH FED. SEC. MICROFILM, roll 10, frame 17539, where counsel for the issuer requested that the staff reconsider its position on development loans. After such reconsideration, the staff decided not to recommend action to the Commission if the trust sold its notes in reliance upon section 3(a)(3) and used the proceeds for the acquisition and development of sites, provided that any acquisition and development was related to a specific plan of construction. According to the staff, a current transaction does not include an investment in and improvement of the land for some future, and as of the time of acquisition and/or improvement, undetermined use of the land. In short, development of land so that it will be available, someday, for use as a building site, should a builder become available, will not be consistent with a no-action position by this Division. Such a position will only be available where the acquisition and/or improvement of land is related to, and part of, a larger scheme involving a specific construction project

Id. For later cases, see, e.g., SEC no-action letter (First Bank Sys., Inc.), note 154 *supra*; SEC no-action letter (Connecticut Financial Servs. Corp.), issued July 1, 1975, [1975] CCH FED. SEC. MICROFILM, roll 8, frame 10139.

¹⁶⁹ Since a land acquisition and development loan that qualifies as current under section 3(a)(3) is indistinguishable from a preconstruction loan, one would expect the staff's attitude toward the availability of a takeout commitment to be the same for both types of loans. To date, however, the no-action letters for land acquisition and development loans have not contained the same limitations included in the case of loans denominated as "preconstruction." See note 150 *supra*.

¹⁷⁰ SEC no-action letter (First Bank Sys., Inc.), note 154 *supra*. See SEC no-action letter (First Penn. Mortgage Trust), note 168 *supra*, where counsel for the issuer advanced several arguments for treating land acquisition and development loans as current transactions for purposes of section 3(a)(3): (1) Such loans are often only part of a larger construction project and thus not "solely" land or development loans. *Id.* at 17542. (2) The staff's disapproval of these loans is inappropriate "in light of existing industry practices." *Id.* Construction financing of the type which also includes financing of site acquisition and development

is the usual and customary type of construction financing provided by real estate investment trusts and has been for many years. As of December 31, 1972 there were \$5.46 billion of first mortgage construction loans outstanding in portfolios of real estate investment trusts issuing commercial paper according to statistics provided by NAREIT [National Association of Real Estate Investment Trusts] We have been advised by the [issuer] that it can be reasonably assumed that a large percentage of this construction financing also includes financing of site acquisition and development and is already being financed with commercial paper issued in reliance upon the Section 3(a)(3) exemption and the numerous no-action letters of the Commission which refer to "construction loans."

Id. (3) Construction loans of all types are in actual practice temporary investments because most lenders and the borrowers are using the funds for current operational business requirements. *Id.* The Federal Reserve Board recognized this fact in an amendment to Regulation A that makes notes eligible for discount if the proceeds are used in "meeting current operating expenses." 12

(8) Standing Mortgage Loans. These secured loans are entered into with respect to completed or "standing" structures. They enable the borrower to purchase, refinance or refurbish the property on a temporary basis—usually no more than five years—during the period required to obtain or complete long-term financing. Such loans, which are sometimes referred to as "one-payout loans,"¹⁷¹ "carry-out loans"¹⁷² or "bridge loans,"¹⁷³ are normally repaid from the proceeds of long-term loans or from the sale of the property.¹⁷⁴

Standing mortgage loans are generally deemed to satisfy the current transactions requirement for the use of proceeds under section 3(a)(3).¹⁷⁵ The staff's opinion on the necessity of a permanent financing commitment for such loans has changed over the past four years, following the same pattern found in the staff's treatment of construction loans.¹⁷⁶ Standing mortgage loans are now considered current transactions regardless of the existence of a takeout commitment prior to the making of the loan.¹⁷⁷

(9) Short-Term Remaining Portions of Long-Term Loans. Lenders occasionally have the opportunity to make investments in existing notes and other evidences of indebtedness, both secured and unsecured, with periods of as much as five years remaining to

C.F.R. § 201.4(a)(3) (1976). It was in response to the arguments made by counsel in the First Pennsylvania Mortgage Trust no-action request that the staff announced its favorable opinion toward site acquisition and development loans.

¹⁷¹ See, e.g., SEC no-action letter (Capital Mortgage Invs.), *supra* note 161, at 03371.

¹⁷² See, e.g., SEC no-action letter (Wells Fargo Mortgage Investors), note 158 *supra*, where the issuer's standing mortgage loan, denominated a "carry-out loan," was designed to permit a real estate developer to "carry" a completed project until he could sell the project or obtain favorable long-term financing. *Id.* at 05054.

¹⁷³ See, e.g., SEC no-action letter (Detroitbank Corp.), note 118 *supra*, where the issuer planned to make temporary loans to owners of completed structures in order to "bridge" the gap of time needed for obtaining long-term financing. *Id.* at 09254.

¹⁷⁴ Standing mortgage loans normally provide for interest payments but not for amortization of principal which is paid in full at maturity.

¹⁷⁵ See note 177 *infra*.

¹⁷⁶ For example, in 1973 the staff expressed the same negative opinion on standing mortgage loans that were made without a firm takeout as it did on construction loans without prior commitments. See, e.g., SEC no-action letter (United Va. Bankshares, Inc.), note 159 *supra*. In 1974 this opinion changed, and the staff stated that a binding takeout agreement is no longer required prior to the making of standing mortgage loans. See, e.g., SEC no-action letter (National Central Commer. Corp.), issued Nov. 1, 1974, [1974] CCH FED. SEC. MICROFILM, roll 12, frame 16145.

¹⁷⁷ See, e.g., SEC no-action letter (Equitable Life Mortgage & Realty Investors), *supra* note 150, at 00212-13; SEC no-action letter (Southwest Bancshares, Inc.), note 149 *supra*. See generally text accompanying notes 158-63 *supra*.

maturity.¹⁷⁸ The SEC staff has allowed proceeds from unregistered commercial paper to be used for purchasing such notes if the period remaining to maturity is nine months or less.¹⁷⁹ In effect, the staff ignores the earlier portions of what would ordinarily be characterized as permanent investments and concentrates instead on the short-term portions of such loans.

(10) Ordinary Operating Expenses. Businesses may at times need short-term financing to meet certain current operational expenses.¹⁸⁰ The SEC staff recognizes such use of proceeds from unregistered commercial paper as consistent with the current transactions mandate in section 3(a)(3).¹⁸¹ The phrase "ordinary operating expenses" has not been defined by the Commission for purposes of section 3(a)(3) but the staff interprets it to include such items as wages,¹⁸² salaries,¹⁸³ profit-sharing contributions,¹⁸⁴ travel expenses,¹⁸⁵ tax obligations,¹⁸⁶ advertising¹⁸⁷ and rent.¹⁸⁸

(11) Temporary Investments. Immediate use of proceeds from the sale of commercial paper may not always be possible. As a result, an issuer may wish to invest such funds on a temporary

¹⁷⁸ See, e.g., SEC no-action letter (First Nat'l State Bancorp.), *supra* note 119, at 03390.

¹⁷⁹ *Id.* at 03382; SEC no-action letter (Capital Mortgage Invs.), *supra* note 161, at 03371. But see SEC no-action letter (Security Pac. Corp.), note 128 *supra*, where the staff allowed an issuer to finance the final 12 months of development mortgage loans of a type that did not fall within any of the categories approved as current transactions. The staff apparently concurred in the opinion of the issuer's counsel, who argued that once a developer had proceeded under a development loan to a point where construction was expected within 12 months, such a loan became indistinguishable from a preconstruction loan and therefore the final 12 months could qualify as a current transaction. *Id.* at 09244.

¹⁸⁰ See, e.g., SEC no-action letter (First Nat'l State Bancorp.), note 119 *supra*, where the issuer planned to use a portion of the proceeds from unregistered commercial paper to meet its own operating expenses. *Id.* at 03393 (letter of corporate counsel).

¹⁸¹ See, e.g., SEC no-action letter (Mercantile Bankshares Corp.), *supra* note 58, at 01580; SEC no-action letter (First Md. Bancorp.), *supra* note 135, at 10883; SEC no-action letter (Omaha Nat'l Corp.), issued Sept. 30, 1974, [1974] CCH FED. SEC. MICROFILM, roll 10, frame 13449. See also Regulation A of the Federal Reserve Board, which considers notes to be eligible for discount where the proceeds are to be used "in meeting current operating expenses of a commercial, agricultural, or industrial business." 12 C.F.R. § 201.4(a)(3) (1976).

¹⁸² See, e.g., SEC no-action letter (DAC Corp.), note 32 *supra*.

¹⁸³ See, e.g., *id.*; SEC no-action letter (Tektronix, Inc.), note 121 *supra*.

¹⁸⁴ See, e.g., SEC no-action letter (Tektronix, Inc.), note 121 *supra*.

¹⁸⁵ See, e.g., SEC no-action letter (First Nat'l State Bancorp.), *supra* note 119, at 3383; SEC no-action letter (DAC Corp.), note 32 *supra*.

¹⁸⁶ See, e.g., SEC no-action letter (Florida Power & Light Co.), note 120 *supra* (proceeds to be used for federal, state, county, municipal and other tax payments); SEC no-action letter (Tektronix, Inc.), note 121 *supra*.

¹⁸⁷ See, e.g., SEC no-action letter (Rhodes, Inc.), note 131 *supra*.

¹⁸⁸ See, e.g., *id.*; SEC no-action letter (DAC Corp.), note 32 *supra*.

basis in government securities or other prime quality debt securities.¹⁸⁹ The SEC staff treats these investments as a permissible use of proceeds under section 3(a)(3) provided they are temporary and are confined to government securities,¹⁹⁰ short-term certificates of deposit or short-term commercial paper.¹⁹¹ Prime quality corporate debt securities are not eligible forms of interim investment.¹⁹²

¹⁸⁹ See, e.g., SEC no-action letter (Omaha Nat'l Corp.), note 181 *supra*, where AgCo Corporation (AgCo), a wholly-owned subsidiary of a bank holding company, planned to sell its commercial paper in reliance upon section 3(a)(3). Counsel for the issuer explained the need for short-term investments of funds generated by the sale of the paper:

Even assuming the most prudent cash management, AgCo will possess an excess of funds on some occasions. . . . To the extent that AgCo is in possession of funds derived from the sale of its insured commercial paper, AgCo will remain obligated to pay daily interest on such funds. As a matter of prudent cash management AgCo must keep such funds invested in order to realize a return to offset the interest accruing on outstanding commercial paper. Any investment of excess funds will be incidental to the finance business of AgCo, and proceeds from the sale of insured commercial paper issued by AgCo would be invested in securities only on a temporary basis.

Id. at 13456.

¹⁹⁰ *Id.*; see also SEC no-action letter (Merrill Lynch & Co., Inc.), issued July 16, 1973, [1973] CCH FED. SEC. MICROFILM, roll 8, frame 14070, where the issuer, which owned all of the outstanding common stock of Merrill Lynch, Pierce, Fenner & Smith, Inc., intended to sell unregistered notes and advance the proceeds to its broker-dealer subsidiary to finance the purchases of securities by its customers. The staff refused to consider the proposed use of proceeds as a current transaction. More than a year later, the issuer suggested a different plan in which no part of the proceeds would be used for permanent or fixed investments, or to purchase any securities other than direct obligations of the United States and its agencies. This time the staff allowed the exemption. SEC no-action letter (Merrill Lynch & Co., Inc.), issued Aug. 19, 1974, [1974] CCH FED. SEC. MICROFILM, roll 9, frame 12265.

¹⁹¹ See, e.g., SEC no-action letter (Texas Am. Bancshares, Inc.), issued Oct. 10, 1974, [1974] CCH FED. SEC. MICROFILM, roll 11, frame 14940, where the staff allowed the issuer whose "open liquidity [was] excessive for its immediate needs," to use proceeds to purchase short-term certificates of deposit and commercial paper in the open market, the maturities of which were similar to the commercial paper that the issuer planned to sell, *id.* at 14941; SEC no-action letter (Fort Worth Nat'l Corp.), issued Dec. 4, 1972, [1973] CCH FED. SEC. MICROFILM, roll 1, frame 00194, where the issuer was permitted to purchase commercial paper with maturities not exceeding 270 days where its own liquidity was excessive for its immediate needs; SEC no-action letter (Security Pac. Corp.), note 128 *supra*, where the issuer planned to invest part of the proceeds in certificates of deposit limited to 270 days.

When the issuer uses proceeds from commercial paper to purchase short-term certificates of indebtedness from a wholly-owned bank subsidiary, the staff has not required the issuer, as a condition for a no-action position, to demonstrate that its subsidiary intends to use such funds for current transactions. See, e.g., SEC no-action letter, (Commercial Nat'l Corp.), issued Dec. 4, 1975, [1976] CCH FED. SEC. MICROFILM, roll 1, frame 00082, where the issuer planned to purchase certificates of deposit from its subsidiary bank in amounts not to exceed the smaller of \$30 million or the total United States Government bond portfolio of the subsidiary bank.

¹⁹² See, e.g., SEC no-action letter (Omaha Nat'l Corp.), note 181 *supra*,

(12) Discharge of Certain Existing Indebtedness. An issuer of commercial paper has a contractual obligation to redeem its short-term notes at maturity. If the issuer lacks the funds to repay the investors, it "rolls over" the indebtedness by selling new short-term notes and using the proceeds to discharge the obligations of earlier securities.

The Commission interprets the current transaction requirement as prohibiting the use of proceeds for the discharge of existing indebtedness "unless such indebtedness is itself exempt under section 3(a)(3)."¹⁹³ The Commission and staff apparently feel that restricting the type of indebtedness that an issuer can discharge with proceeds from commercial paper limits the use of proceeds to current transactions.¹⁹⁴ Since the existing indebtedness to be discharged must itself be exempt under section 3(a)(3), it must have been created within the preceding nine months. The discharge of that obligation is, therefore, a current transaction. Under this analysis, nothing prevents an issuer from continually rolling over its "short-term" indebtedness under section 3(a)(3).¹⁹⁵

where counsel argued that short-term investments in prime quality corporate obligations were appropriate for its client since the commercial paper was fully guaranteed by the Aetna Casualty & Surety Co. under a bond of indemnity protected by reserves maintained in accordance with state banking requirements. *Id.* at 13456. Counsel further argued:

The Commercial paper issued by AgCo consists of unilateral instruments containing an express and absolute promise to pay the holder a definite sum of money on a certain date. Holders of the commercial paper in no way participate with AgCo in, or have any interest in profits or losses which AgCo may incur through, the temporary investment of excess funds. Accordingly, whether temporary investments include only government securities, or include a mixture of government and prime-quality corporate securities, is irrelevant from the holder's standpoint, and goes only to the ability of AgCo to pay the commercial paper at maturity.

Id. at 13457. The staff disagreed with counsel's position and limited temporary investments to government securities. *Id.* at 13449-50.

¹⁹³ Release No. 4412, *supra* note 22, at 2570.

¹⁹⁴ The staff has strictly construed the Commission's limitation on the type of indebtedness to be discharged even where the existing indebtedness was represented by securities exempted by another provision under the Act. In SEC no-action letter (Republic of Texas Corp.), issued Aug. 14, 1974, [1974] CCH FED. SEC. MICROFILM, roll 9, frame 12259, the issuer planned to use some of the proceeds from its commercial paper for loans to an affiliated corporation. The affiliate intended to use the proceeds from the loan to redeem its outstanding short-term notes which were similar to those to be sold by the issuer under section 3(a)(3) but which had been issued in reliance upon the exemption provided by section 3(a)(2) of the 1933 Act, 15 U.S.C. § 77c(a)(2) (1970). The staff refused to allow the issuer to use the proceeds for such loans, citing that portion of Release No. 4412 which requires that the indebtedness to be discharged be itself exempt under section 3(a)(3). *Id.* at 12260.

¹⁹⁵ For a discussion of commercial paper that is rolled over under section 3(a)(3), see text accompanying notes 283-86 *infra*.

b. *Non-Current Transactions.* A transaction is likely to fail the current transactions requirement of section 3(a)(3) in one of three ways. An issuer might plan to use proceeds from the sale of unregistered commercial paper in a transaction that is structured to comport with one of the transactions already identified by the staff as current, only to be denied a favorable response from the staff because the issuer's plan fails to satisfy all of the administratively imposed requirements within a particular current transaction category.¹⁹⁶ Even where the staff's requirements within a particular category are satisfied, an issuer might be denied no-action treatment because of a staff decision to reverse its earlier position or to withhold any judgment pending further study.¹⁹⁷ Finally, an issuer might find section 3(a)(3) unavailable simply because the contemplated use of proceeds, when considered by the staff for the first time, is found to be inconsistent with the basic requirement that proceeds be used for interim financing, not permanent investment. The staff has identified the following two categories of transactions as falling outside the current transactions standard of section 3(a)(3):

(1) **Second Mortgage Loans for the Purchase or Improvement of Real Property.** Certain lenders extend credit to persons who are willing to execute a second mortgage on their real property as collateral for the loan. Proceeds from such loans may be used by the borrower as part of the consideration to purchase the land, for capital improvements or for purposes totally unrelated to the real property. Under the terms of a second mortgage loan, the borrower may have as long as ten years to repay the indebtedness pursuant to a monthly amortization schedule.

¹⁹⁶ For examples of issuers' attempts to structure a transaction to satisfy the statutory conditions of section 3(a)(3) where the staff denied a no-action response because of non-compliance with administratively-imposed requirements, see SEC no-action letter (MGIC Mortgage Corp.), issued Mar. 8, 1974, [1974] CCH FED. SEC. MICROFILM, roll 4, frame 05059; SEC no-action letter (Westinghouse Credit Corp.), issued Dec. 18, 1973, [1974] CCH FED. SEC. MICROFILM, roll 1, frame 00200.

¹⁹⁷ See, e.g., SEC no-action letter (Cabot, Cabot & Forbes Land Trust), issued Jan. 4, 1974, [1974] CCH FED. SEC. MICROFILM, roll 2, frame 01560, where the trust planned to use proceeds from the sale of unregistered commercial paper to make standing mortgage loans and construction loans that might have involved an option for the trust to purchase land to be improved by its loans. In the event that the trust exercised the option, it intended to lease it back to the seller on a long-term basis. The staff reversed its earlier favorable position on this type of loan agreement, SEC no-action letter (Cabot, Cabot & Forbes Land Trust), issued Jan. 15, 1973, [1973] CCH FED. SEC. MICROFILM, roll 2, frame 01724, and concluded that such an agreement would not be eligible for the section 3(a)(3) exemption. Presumably the staff viewed the option clause as a mechanism for turning a short-term loan agreement into a permanent real estate investment. See also note 204 *infra*.

In analyzing second mortgage loans for purposes of the current transactions test, the staff has distinguished between loans which enable a borrower to acquire or improve real property and those which provide funds earmarked for general purposes. The staff has regularly rejected the former type of second mortgage loan, presumably because the proposed investments are relatively illiquid and the proceeds from the notes will be invested in assets whose lives far exceed the maturities of the notes.¹⁹⁸ The SEC staff views the second mortgage loan that is used for the acquisition or improvement of real property in the same light as the mortgage warehouse loan that is not turned over at least once a year. In both cases the loans take on the character of a permanent investment in real property and therefore are not considered current transactions.¹⁹⁹ Where, however, the second mortgage loan is used by the borrower for such nonpermanent purposes as debt consolidation, college tuition, vacation funds or consumer goods, the issuer has been successful in analogizing the loan to consumer credit loans which are recognized by the staff as meeting the current transactions test.²⁰⁰

(2) Current Maturities of Long-Term Loans. Lenders occasionally provide temporary financing for business ventures that will eventually require long-term loans. Under this type of loan, the lender expects the borrower to arrange for permanent financing during the period of the short-term loan. Once the funds from the permanent financing are secured, the borrower repays the short-term lender.

¹⁹⁸ See, e.g., SEC no-action letter (Bank of Va. Co.), issued Dec. 6, 1972, [1973] CCH FED. SEC. MICROFILM, roll 1, frame 00203. See also SEC no-action letter (Citizens & S. Holding Co.), issued Oct. 5, 1972, [1972] CCH FED. SEC. MICROFILM, roll 11, frame 17467 (exemption denied for second mortgage loans that would have averaged approximately \$4,000 each and would have matured over five to ten years); SEC no-action letter (Union Trust Bancorp.), issued Aug. 6, 1974, [1974] CCH FED. SEC. MICROFILM, roll 9, frame 12252 (exemption denied for second mortgage loans on residential properties of between one and four units having maturities of not more than five years.)

¹⁹⁹ See note 141 *supra*.

²⁰⁰ See, e.g., SEC no-action letter (Security Mortgage Investors), issued Jan. 29, 1973, [1973] CCH FED. SEC. MICROFILM, roll 2, frame 01764, where an exemption was granted for loans ranging from \$1,000 to \$3,000 with an average maturity of five to six years. The proceeds were to be used for general purposes including consolidation and discharge of debt, college tuition for borrower's children, recreational equipment, vacation funds and unrestricted spending money. See also SEC no-action letter (Horizon Bancorp.), note 135 *supra*, where an exemption was granted for loans made to consolidate existing debts and to finance costs of college education. The staff also permitted such loans to be used for financing home improvements (but not for financing the purchase of real estate) so long as the second mortgage loans were made under the provisions of the Secondary Mortgage Loan Act of New Jersey, N.J. REV. STAT. §§ 17.11A-34 *et seq.* (1976), and would mature within five years. See text accompanying notes 126-35 *supra*.

Issuers of commercial paper have argued that such short-term loans are current transactions. In the case of certain loans, such as preconstruction and construction loans, the issuers have received staff approval.²⁰¹ By permitting issuers to fund transactions that are in reality part of a larger business plan which will eventually require permanent financing, the staff has been willing to recognize these short-term loans as capable of independent status although related to the permanent loans.

An issuer may try to use this independent status argument to qualify a short-term loan as a current transaction despite the fact that it is part of a transaction that by itself would not satisfy the current transactions requirement of the exemption. Such an argument was advanced by Capital Mortgage Investments²⁰² which planned to fund the first nine months of a five-year development loan. Since the loan was not related to any specific construction project, it could not qualify as a current transaction. The issuer argued that its financial involvement would be limited to the first nine months of the long-term loan, *i.e.*, the current maturity, and, therefore, its use of proceeds was permissible under section 3(a)(3). The staff rejected the issuer's argument, describing the current maturity portion of the loan as an integral part of a permanent investment.²⁰³

c. Staff Neutrality—A Transaction Under Review. The SEC staff regularly modifies interpretations of the securities laws. In most cases, including those arising out of the current transactions requirement of section 3(a)(3), newly formulated positions are announced in staff responses to no-action letter inquiries or, where major changes are made, in formal Commission releases. One notable exception to this procedure is the staff's refusal since the middle of 1974 to express an opinion on the availability of section 3(a)(3) where proceeds are used to finance leasing transactions.²⁰⁴

²⁰¹ See notes 147-65 & accompanying text *supra*.

²⁰² SEC no-action letter (Capital Mortgage Invs.), note 161 *supra*.

²⁰³ See, *e.g.*, SEC no-action letter (Capital Mortgage Invs.), *supra* note 161, at 03371-72. A recent staff response to this type of transaction indicates, however, that the staff may be reviewing its position. In SEC no-action letter (Horizon Bancorp.), issued Jan. 24, 1975, [1975] CCH FED. SEC. MICROFILM, roll 2, frame 01175, the staff refused to express any opinion on so-called "current maturities of long-term loans" that the issuer planned to make with the proceeds from unregistered commercial paper. Specifically, the issuer planned to purchase sales finance contracts from sellers of permanent equipment. The issuer would have limited its loan to 12 months and would have arranged long-term financing within that period. After the long-term, permanent financing arrangement, the issuer intended to continue its ownership of the finance contracts. *Id.* at 01181-82. Loans for the purchase of permanent equipment do not qualify as current transactions. See note 123 *supra*.

²⁰⁴ The staff has stated that it is studying whether loans for equipment

Leasing of personal property, such as computers, automotive vehicles and manufacturing equipment, generally referred to as equipment leasing, has become a major part of our economic life.²⁰⁵ Proceeds from the sale of commercial paper are sometimes used to provide interim financing for the purchase of such personal property and equipment for leasing to others.²⁰⁶ Lease agreements are of varying form²⁰⁷ and maturity but the lessor typically accumulates the leases from time to time and arranges for long-term, permanent financing.²⁰⁸ The proceeds from the permanent

leasing are consistent with the current transactions requirement of section 3(a) (3). It has taken a similar stance on certain inventory financing loans. See note 124 *supra*.

²⁰⁵ See generally Riordan & Duffy, *Lease Financing, A Discussion of Security and Other Considerations from the Institutional Lender's Point of View*, 24 BUS. LAW. 763 (1969); Symposium, *Equipment Leasing*, 1962 ILL. L.F. 1.

²⁰⁶ See, e.g., SEC no-action letter (CBT Corp.), note 117 *supra*, where the issuer's subsidiaries planned to use part of the proceeds from the sale of unregistered commercial paper to purchase office equipment, laboratory equipment, computers, store furniture and fixtures, manufacturing equipment, machine tools, moveable modular structures and construction equipment, aircraft and railroad stock for the purpose of leasing to customers. *Id.* at 09279.

²⁰⁷ At least five different types of leases are available. In *short-term*, or *non-payment*, leases, the lessee rents the personal property for a period which is less than its useful life and for lease payments totaling less than the purchase price of the equipment. With this type of lease the lessor bears all of the responsibilities for maintenance, insurance and taxes. Under a *finance lease*, the lessee rents the equipment for a period that is equal to the item's useful life and assumes all the costs and risks of ownership; a *maintenance*, or *service*, lease is similar to the finance lease except that under a maintenance lease the lessor assumes responsibility for repair and replacement and sometimes pays taxes and license fees. A *net lease* is also similar to a finance lease. Here, however, the lessee guarantees that at the end of the lease term the lessor will realize a minimum residual value through the sale of the equipment. If the sale fails to produce the agreed residual value, the lessee is required to pay the difference to the lessor. A profit from the sale in excess of the residual value belongs to the lessee. The *tax shelter*, or *leverage*, lease is designed to pass along the tax benefits and any finance savings on the purchase of the equipment realized by the lessor to the lessee in the form of lower rental payments. Shapiro, *The ABC's of Leasing*, in *PLI EQUIPMENT LEASING IN THE 1970's*, at 11, 12-14 (S. Shapiro & A. Reisman eds. 1973).

²⁰⁸ See, e.g., SEC no-action letter (CBT Corp.), note 117 *supra*, where the subsidiaries of the issuer of unregistered commercial paper intended to use the funds advanced to them from the issuer for interim financing in one or both of the following ways: (1) to accumulate a sufficient volume of leased personal property (between \$2 to \$5 million of lease receivables) until long-term financing could be obtained from institutional investors to fund the balance of the lease term, or (2) to finance that portion of the cost of the personal property equivalent at any given time to the amount of lease receivables accruing with respect to that property during the next 12 months. *Id.* at 09279. Counsel for the issuer stated that the first method was believed necessary in view of the unwillingness of institutional investors to extend long-term credit to finance leasing companies at reasonable rates and maturity terms in amounts less than \$2 to \$5 million. The second method was intended to give the subsidiary engaged in leasing the ability at any given time to avoid issuing long-term obligations against receivables due within 12 months. The following example was offered as an explanation of the second method. If a subsidiary purchased an item of personal

financing are then applied against the outstanding balance due on the issuer's commercial paper.

The staff originally viewed such use of proceeds from unregistered commercial paper as functionally and logically equivalent to the use of the proceeds to acquire mortgage loans for warehousing. The staff seemed to feel that since this method of financing was not designed to fully finance purchases of personal property because of the subsequent long-term financing, it was a current transaction for purposes of section 3(a)(3).²⁰⁹ The staff's early favorable response to the financing of equipment leasing was limited to transactions where the leases were for "non-permanent" property²¹⁰ with limited maturities.²¹¹ In 1974, after equipment leasing had reached wide acceptability as a method of financing, the staff suddenly withdrew its limited approval of loans for the purchase of equipment to be leased.²¹² Since then the staff has

property on January 1, 1973, to be leased for a five-year term, it would use funds advanced to it by the issuer to accumulate additional leases during 1973 to support long-term financing. Assuming a package sufficient to support long-term financing was accumulated within six months, on July 1, 1973 the subsidiary would have received six months of rental installments and would then have to obtain funds equivalent to the remaining four and one-half years of lease installments in order to repay the funds advanced by the issuer. At that point the subsidiary might fund the balance either by obtaining long-term financing equivalent to the full amount of the balance, or by financing an amount equivalent to the immediate next 12 months of lease receivables from the proceeds of a later sale of commercial paper and the balance from long-term financing. *Id.* at 09280.

²⁰⁹ See, e.g., SEC no-action letter (Continental Ill. Corp.), issued June 9, 1972, [1972] CCH FED. SEC. MICROFILM, roll 7, frame 11388; SEC no-action letter, (First Nat'l City Corp.), issued Jan. 15, 1973, [1973] CCH FED. SEC. MICROFILM, roll 2, frame 01732; SEC no-action letter (Ziegler Co., Inc.), issued Aug. 24, 1973, [1973] CCH FED. SEC. MICROFILM, roll 9, frame 16094.

²¹⁰ SEC no-action letter (Hospital Trust Corp.), issued May 24, 1973, [1973] CCH FED. SEC. MICROFILM, roll 6, frame 10542; see also SEC no-action letter (Mercantile Bancorp., Inc.), issued June 6, 1973, [1973] CCH FED. SEC. MICROFILM, roll 7, frame 12322, 12323. The staff's attitude on the type of personal property that would qualify for leasing transactions was modeled on an interpretation of the Federal Reserve Board. The Board of Governors of the Federal Reserve Board ruled that notes, the proceeds of which have been used for "permanent or fixed investments of any kind, such as land, buildings or machinery, or for any other fixed capital purpose" are not eligible for discount. But the Board drew a distinction between permanent equipment and non-permanent equipment which wears out rapidly and has to be replaced within a relatively short time. See Regulation A, revised effective Feb. 15, 1955, 41 FED. RES. BULL. 9, 10 (1955).

²¹¹ See, e.g., SEC no-action letter (Continental Ill. Corp.), issued June 22, 1973, [1973] CCH FED. SEC. MICROFILM, roll 7, frame 12361, where the staff concluded that the length of the lease obligations, between 4 and 25 years, removed the arrangement from the current transactions category; SEC no-action letter (New England Merchants Co., Inc.), issued Oct. 5, 1973, [1973] CCH FED. SEC. MICROFILM, roll 11, frame 19072, where the staff rejected the leasing transactions that would have included net full payout leases with maturities of between 1½ and 25 years, the majority of which would have been between 3 and 8 years.

²¹² See, e.g., SEC no-action letter (New England Merchants Co., Inc.),

refused to take a position,²¹³ leaving attorneys and others to make their own decision on how to proceed.²¹⁴

While the use of proceeds from unregistered commercial paper to finance the purchase of equipment to be leased may not be permissible under section 3(a)(3), the staff has approved an alternative method of financing leasing transactions which was suggested in a no-action inquiry by A. G. Becker & Co., Inc.²¹⁵ The plan was designed for situations where a parent company with a strong credit rating had one or more subsidiaries engaged in a business, such as equipment leasing, which requires substantial financing of transactions that might not be deemed current transactions under section 3(a)(3). Under the plan the parent company was to issue commercial paper or open market notes under section 3(a)(3) and the subsidiaries were to issue unsecured notes, guaranteed by the parent in private placements under section 4(2).²¹⁶

issued Jan. 9, 1974, [1974] CCH FED. SEC. MICROFILM, roll 2, frame 01586; SEC no-action letter (Fidelity Am. Bankshares, Inc.), note 127 *supra*. It appears that the staff's retreat to neutrality on equipment leasing transactions was due to its "serious question about the use of commercial paper proceeds for the financing of personal property and equipment to be leased for substantial periods of time." SEC no-action letter (First Md. Bancorp.), issued Oct. 1, 1974, [1974] CCH FED. SEC. MICROFILM, roll 10, frame 13458.

²¹³ See, e.g., SEC no-action letter (First R.R. & Banking Co. of Ga.), note 2 *supra*.

²¹⁴ The staff's indecision on equipment leasing transactions may actually provide more flexibility to persons wishing to rely upon section 3(a)(3) for such use of proceeds. In connection with a request from New England Merchants Co., Inc., SEC no-action letter, note 212 *supra*, counsel suggested three alternatives for the staff's consideration in deciding how to deal with equipment leases. First, the staff could allow equipment leasing transactions where the leases have average stated lease terms of seven or eight years down to three years or less (with room for an occasional lease with a slightly longer term), the majority being five years or less. It was suggested that this approach would permit a prospective issuer much of the financing flexibility which it desires and would exclude principally the longer term tax-motivated leveraged lease transaction. A second approach would permit leases that have stated average terms of five years or less, again with room for an occasional lease for a somewhat longer term. As the third alternative, counsel suggested that if recognition of any type of equipment lease was impossible, the staff should respond by indicating that it is unable to conclude whether use of proceeds for equipment leasing transactions "would or would not appear consistent with the current transaction requirement of Section 3(a)(3)." *Id.* at 01591. Counsel stated that this third alternative

would allow me to make my own judgments as to proper advice to my client, for which of course I will have to take full responsibility. It would allow me to consider and give advice in that context with respect to such matters as my client's intentions with respect to refinancing leasing transactions with banks or other institutional lenders after some point in time.

Id. It appears that the staff has opted for this third suggested alternative.

²¹⁵ SEC no-action letter (A.G. Becker & Co., Inc.), issued Jan. 17, 1975, [1975] CCH FED. SEC. MICROFILM, roll 2, frame 01169.

²¹⁶ See note 82 *supra*. The parent corporation planned to sell its notes directly. The private placement was to be made through A. G. Becker & Co. on a restricted list basis. The open market notes to be issued by the parent were

Proceeds from open market notes were to be used only by the parent to satisfy cash needs for current transactions, as defined for purposes of section 3(a)(3). Proceeds from section 4(2) offerings were to be employed by subsidiaries for activities not considered to be current transactions. Although the parent was to guarantee payment of the subsidiaries' paper, no transfer of funds from either offering and no short-term advances of any type were to be permitted between the respective companies. The parent, however, was to be free to make equity investments in and long-term loans to the subsidiaries so long as no proceeds from the open market offering were used. Similarly the subsidiary could pay dividends and make other payments in the ordinary course of business to the parent. The staff concluded that the offering of the section 3(a)(3) commercial paper simultaneously with the offering of unregistered commercial paper under section 4(2) would not require integration of the offerings so as to preclude section 3(a)(3) "provided that proceeds of the offerings made in reliance on Section 3(a)(3) are not used to honor the parent's guarantee of the restricted subsidiary's paper issued in reliance on Section 4(2)."²¹⁷

2. Tracing the Proceeds

Once an issuer of unregistered commercial paper is satisfied that a contemplated use of proceeds fits within the staff's definition of current transactions, its problems with section 3(a)(3) may not be finished. Anyone claiming an exemption from the registration requirements of the 1933 Act has the burden of proving compliance with all of the conditions for exemption.²¹⁸ In the case of section 3(a)(3), the burden of proof could conceivably require an issuer to trace proceeds from the sale of the short-term notes to specific current transactions.

Where the issuer intends to use the proceeds from a multi-million dollar offering of commercial paper in several different transactions, tracing dollar of proceed to dollar spent may not be practicable. The staff has recognized the practical problems of proof for such an issuer and until recently took the position that if the aggregate amount of the unregistered paper outstanding at any time did not exceed the amount of proceeds invested in current transactions, there was no necessity of tracing dollars to establish that funds received were actually invested in specific current trans-

to have maturities of 30 days or less with the average maturity being 15 days. SEC no-action letter (A.G. Becker & Co., Inc.), *supra* note 215, at 01169.

²¹⁷ *Id.* at 01170. See also SEC no-action letter (Liberty Nat'l Corp.), issued Jan. 7, 1976, [1976] CCH FED. SEC. MICROFILM, roll 2, frame 01306.

²¹⁸ SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).

actions.²¹⁹ In effect, this administrative position eliminated the need for tracing and served as a mere admonition to the issuer to be sure that every use of proceeds satisfied the current transactions requirement.

The staff is currently reevaluating this formula and will no longer pass on its correctness.²²⁰ Although the staff has yet to declare formally a new position, it has on occasion included in no-action responses a limitation on an issuer's offering that suggests it is considering the use of another standard to assure the availability of liquid assets.²²¹ Instead of permitting an issuer to have as much commercial paper outstanding as it desires, the staff appears to be examining the issuer, its business and the contemplated use of proceeds to arrive at a particular formula, tied to the issuer's assets, that will serve as a ceiling on the aggregate principal amount of commercial paper that the issuer can have outstanding at any one time.

An illustration of what appears to be the staff's new ad hoc view aimed at protecting investors against the possibility of their funds being used for non-current transactions was presented in a request by Tektronix.²²² Tektronix, the issuer, planned to use proceeds from the sale of commercial paper for a variety of purposes including the purchase of inventories, the payment of salaries and other current operating expenses. In what appears to have been a limitation worked out between the issuer and the staff as a condition for no-action treatment, Tektronix agreed to restrict the amount of commercial paper outstanding at any one time to an amount less than the sum of the dollar amount of accounts receivable for products sold to customers and affiliates, and fifty percent of the cost of its finished inventory.²²³ A partial explanation for this limitation was included in the no-action letter request:

The cost of finished inventory includes production salaries and wages, production overhead and material costs, all of which are directly related to the production of goods sold by Tektronix. Finished inventory costs have historically been less than forty percent of catalogue sales prices. The limit of fifty percent of the cost of finished inventory is calculated to remove all possibility that the limit might exceed the amount used for current transactions.²²⁴

The staff agreed to take a no-action position.

²¹⁹ See, e.g., SEC no-action letter (Mercantile Bankshares Corp.), *supra* note 58, at 01580.

²²⁰ See, e.g., SEC no-action letter (Capital Mortgage Invs.), note 161 *supra*.

²²¹ See, e.g., SEC no-action letter (E.I. duPont de Nemours & Co.), issued Sept. 4, 1974, [1974] CCH FED. SEC. MICROFILM, roll 10, frame 13431.

²²² SEC no-action letter (Tektronix, Inc.), note 121 *supra*.

²²³ *Id.*

²²⁴ *Id.* at 16162.

In short, it appears that the staff is avoiding the problem of tracing altogether by adopting an entirely different approach that seeks to protect investors by restricting the aggregate amount of unregistered commercial paper that an issuer may have outstanding at any one time to a certain percentage of the issuer's assets.²²⁵ It also appears that the staff is concluding that investors may not be adequately protected under the current transactions test as interpreted by the staff.

II. ASSESSMENT OF SECTION 3(a)(3) AS INTERPRETED— THE NEED FOR REFORM

This evaluation of section 3(a)(3) examines the Commission and staff interpretation of the exemption as it relates to the legislative history behind the provision. The examination reveals a need for certain reforms in the treatment of section 3(a)(3).

A. *Assessment of Section 3(a)(3)*

1. Legislative History of Section 3(a)(3)

Congress designed a system of disclosure in the federal securities statutes to protect individual investors and to assure the maintenance of fair and honest security markets.²²⁶ The registration requirements of section 5 of the 1933 Act²²⁷ form an integral part of this disclosure system. Sections 3 and 4 contain specific exemptions from these registration requirements for certain securities and certain transactions.²²⁸ The exemptions in sections 3(a)(2) through 3(a)(8) turn on the intrinsic nature of the securities or the impropriety of further governmental regulation.²²⁹ The other

²²⁵ See, e.g., SEC no-action letter (Union Pac. Corp.), issued July 22, 1975, [1975] CCH FED. SEC. MICROFILM, roll 8, frame 10150, where the issuer stated that it would limit the aggregate amount of short-term notes outstanding at any one time to (1) one-half of the dollar amount of the sum of its consolidated current accounts receivable and inventories, or (2) the aggregate of its consolidated cash, temporary cash investments and the unborrowed portion of commitments under its existing contractual credit agreement, whichever is less; SEC no-action letter (Commercial Nat'l Corp.), note 191 *supra*, where the issuer stated that the amount of its commercial paper outstanding at any one time would be limited to twice the amount of its capital surplus and retained earnings.

²²⁶ The SEC contends that Congress intended such a continuous disclosure system when it adopted the 1933 and 1934 Acts. See, e.g., SEC Securities Act Release No. 5450, *supra* note 15, at 83,649; SEC Securities Act Release No. 5316, *supra* note 15, at 82,197; SEC Securities Act Release No. 5223, *supra* note 15, at 81,051; cf. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-48 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (discussion of a similar statutory purpose behind the 1934 Act).

²²⁷ 15 U.S.C. § 77(e) (1970).

²²⁸ 15 U.S.C. § 77(c)-(d) (1970).

²²⁹ See generally Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 L. & CONTEMP. PROB. 89, 92-93 (1937).

exemptions in sections 3 and 4 are tied to specific transactions which for a variety of reasons do not justify full and detailed compliance with section 5.²³⁰ Some of the transaction exemptions require certain disclosures to investors as a condition for exemption,²³¹ while other exemptions, including section 3(a)(3), do not. In view of the disclosure requirements for other exemptions and the significance of the commercial paper market, it is important to ask why Congress decided to spare short-term notes from the disclosure requirements of the 1933 Act.

Although the legislative history of section 3(a)(3) is somewhat sparse, there appear to be three main factors which contributed to Congress' decision. First, Congress was persuaded that registration of short-term paper was unnecessary.²³² Unlike speculative securities that often proved worthless, short-term notes were described during legislative hearings as the safest investment available other than governmental obligations.²³³ As evidence of their safety, supporters of an exemption pointed to thirty-two state blue sky laws which excluded commercial paper from their regulation.²³⁴ Furthermore, the sale of commercial paper was "almost wholly a banking proposition"²³⁵ that rarely involved private investors.²³⁶

²³⁰ *Id.*

²³¹ See, e.g., section 4(2), 15 U.S.C. § 77d(2) (1970), and rule 146, 17 C.F.R. § 230.146 (1976).

²³² According to the House Report that accompanied the final version of the 1933 Act, the bill "carefully exempts from its application certain types of securities and securities transactions where there is no practical need for its application or where the public benefits are too remote." H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933).

²³³ One commercial paper dealer stated in a letter to Senator Fletcher, Chairman of the Committee on Banking and Currency, that

all through this depression we have had a demand for commercial paper way in excess of our ability to meet it, and the loss to banks buying commercial paper has been such a negligible fraction of 1 percent that this type of investment is in strong demand today, second only to government bonds.

Letter from Lane, Roloson & Co. to Senator D. Fletcher, Apr. 1, 1933, in *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 94 (1933) [hereinafter cited as *Hearings on S. 875*]. See also Letter from McCluney & Co. to Senator D. Fletcher, Apr. 1, 1933, in *id.* at 95.

²³⁴ *Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 179 (1933) [hereinafter cited as *Hearings on H.R. 4314*].

²³⁵ *Id.* at 182; *Hearings on S. 875*, *supra* note 233, at 94.

²³⁶ *Hearings on H.R. 4314*, *supra* note 234, at 181-84. Mr. William C. Breed of Breed, Abbot & Morgan, counsel to two investment bankers' associations, addressed the issue of commercial paper and private investors in the following manner:

Is this bill built to make it difficult for ordinary commerce, in order to catch one little possibility, one possible issue that is wrong, or is it built with due regard to business? For example you take the commercial paper of this type that matures in short periods, less than 12 months. There probably is not one case in one hundred thousand of the sale of that paper to an individual. It might be that a great big rich man would say, "Well, I will take some of this short-term paper," and he might buy

Second, Congress did not wish to interfere with the ordinary procedures of finance and commerce.²³⁷ At a time when the national economy was sinking into its worst depression, further restrictions on commerce were to be avoided.²³⁸ Congress evidently believed representatives of banks, mercantile corporations and dealers who characterized commercial paper as a critical money market instrument which could no longer be used if registration requirements were imposed.²³⁹ Third, the Federal Reserve Board exercised jurisdiction over a variety of credit instruments including short-term notes and did not wish to share its authority with another federal agency.²⁴⁰ The Board contended that the 1933 Act should apply only to investment securities which were issued for the purpose of obtaining capital funds for business enterprises and which were purchased by persons for investment.²⁴¹

it from his bank, but the ordinary public would have nothing whatever to do with it.

Id. at 181. See also H.R. REP. No. 85, 73d Cong., 1st Sess. (1933), where section 3(a)(3) was described as exempting "short-term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors." *Id.* at 15.

²³⁷ See, e.g., *Hearings on H.R. 4314, supra* note 234, at 180; *Hearings on S. 875, supra* note 233, at 94, 98.

²³⁸ The avoidance of unnecessary restrictions on business and finance was no doubt prompted in part by political reasons. One commentator pointed out:

. . . [I]f it is made so that every individual industry, corporation, small or large, would have to register down here in Washington all of the facts that are required, before they could issue some 4 months' paper, why, I think that there would be a holler that would go up to heaven.

Hearings on H.R. 4314, supra note 234, at 181 (Breed).

²³⁹ See, e.g., *Hearings on S. 875, supra* note 233, at 94, where a commercial paper dealer argued in a letter to Senator Fletcher, Chairman of the Committee on Banking and Currency, that the proposed securities act

does not aim to eliminate the dealers in commercial paper and bankers' acceptances, yet if the dealers are forced to fulfill all the requirements of it, it in fact will eliminate them. A merchant or manufacturer borrows through the medium of commercial paper for the purpose of financing a merchandise transaction. Time is frequently the essence of this transaction, and it would not be possible to wait in order to comply with all the requirements of the act. A grain merchant or a cotton merchant might want to buy either of those commodities and is forced to act quickly.

Letter from Lane, Roloson & Co. to Senator D. Fletcher, Apr. 1, 1933, in *Hearings on S. 875, supra* note 233, at 94.

²⁴⁰ Letter from Chester Morrill, Secretary, Federal Reserve Board, to Rep. Sam Rayburn, Apr. 3, 1933, in *Hearings on H.R. 4314, supra* note 234, at 180-81; Letter from Chester Morrill, Secretary, Federal Reserve Board, to Senator D. Fletcher, Apr. 3, 1933, in *Hearings on S. 875, supra* note 233, at 120. The Federal Reserve Board was concerned that the proposed securities bill, which included commercial paper with the definition of "security," would interfere with [its] operations." *Hearings on S. 875, supra* note 233, at 101. See also *id.* at 75.

²⁴¹ *Id.* The Federal Reserve Board submitted the following proposal as an amendment to S. 875 and H.R. 4314:

Provided, however, that the term "security" shall not include any note, draft, bill of exchange, or bankers' acceptance which arises out of a cur-

In summary, the commercial paper exemption under section 3(a)(3) exists because Congress believed that such securities were safe, both because they were virtually riskless and because they were generally unavailable to the average, unsophisticated investor; registration of commercial paper would be harmful to business; and the Federal Reserve Board could adequately regulate such short-term credit instruments.

2. The Exemption Interpreted

The Commission's interpretation of section 3(a)(3), as formulated in Release No. 4412, is based on the Commission's view of legislative history of the 1933 Act.²⁴² As noted earlier,²⁴³ the SEC limits the exemption to commercial paper that is prime quality, not ordinarily purchased by the general public, eligible for discounting by the Federal Reserve banks, and used to finance current transactions. It is necessary to inquire whether these four factors should be the test of eligibility in view of the legislative history of section 3(a)(3), and whether the SEC staff's interpretation of the four factors is consistent with the original purposes of the exemption as defined by Congress.

a. *Prime Quality.* The legislative history of the 1933 Act unquestionably supports the SEC's contention that section 3(a)(3) exempts securities by reason of the character of the security, because of Congress' belief in the low risk involved for investors.²⁴⁴ But the Commission's requirement of "prime quality" commercial paper, as currently interpreted, adds very little to the process of distinguishing the exempt from the non-exempt security. The Commission has not yet defined the term.²⁴⁵ The staff's response to the

rent commercial, agricultural, or industrial transaction or the proceeds of which have been or are to be used for current commercial, agricultural, or industrial purposes, and which has a maturity at the time of issuance not exceeding 9 months, exclusive of days of grace.

Id. The Senate accepted the substance of the amendment offered by the Federal Reserve Board and it was incorporated into S. 875 as adopted. S. REP. NO. 47, 73d Cong., 1st Sess. 3-4 (1933). The House version included commercial paper within the definition of a "security" but exempted it in language that eventually became section 3(a)(3) of the 1933 Act. H.R. REP. NO. 85, 73d Cong., 1st Sess. 11, 14-15 (1933).

²⁴² See note 41 *supra*.

²⁴³ See text accompanying notes 41-43 *supra*.

²⁴⁴ See notes 233-36 *supra*.

²⁴⁵ Some state blue sky administrators have attempted to define "prime quality" commercial paper for purposes of their exemptive provisions. See, e.g., the regulation of the Pennsylvania Securities Commission, 2 CCH BLUE SKY REP. ¶ 41,302, § 2.23 (1975), which defines "prime quality" for purposes of the commercial paper exemption in the Pennsylvania blue sky statute to mean:

(i) that the issuer of such notes must be rated within the three highest ratings as determined by Standard & Poor's (A-1, A-2 or A-3)

Commission's absence of direction has been to equate "prime quality" with the more objective standard of eligibility for discount under Regulation A of the Federal Reserve Board.²⁴⁶ The wisdom of such continued dependence on the Board of Governors for guidance in the enforcement of the securities laws is questionable.²⁴⁷

b. *Not Available to the Public.* One of the clearest messages in the legislative history of section 3(a)(3) is that exempted commercial paper should be "of a type which rarely is bought by private investors"²⁴⁸ because of the legislature's interest in protecting unsophisticated investors. The Commission has honored this directive in its interpretations of the exemption,²⁴⁹ and the staff is enforcing it with restrictions on the denomination of short-term notes,²⁵⁰ the manner of sale²⁵¹ and the type of purchaser.²⁵² Although it is possible to use the legislative history as authority for a less restrictive interpretation of section 3(a)(3),²⁵³ the SEC's

or Moody's Investors Service (P-1, P-2 or P-3) or the two highest ratings as determined by Fitch Investors Service (F-1 or F-2) or have an equivalent rating by a national rating service which the Commission may by order specify; or, (ii) that upon application to the Commission the issuer of such notes has been determined by the Commission to have credit characteristics equivalent to comparable issuers so rated, such determination by the Commission to be made upon a review of the issuer's net worth, liquidity position, recent financial performance, aggregate indebtedness and access to additional channels of borrowing.

Id. at 37,404.

²⁴⁶ See note 46 & accompanying text *supra*.

²⁴⁷ See text accompanying notes 267-68 *infra*.

²⁴⁸ H.R. REP. NO. 85, 73d Cong., 1st Sess. 15 (1933). See note 236 *supra*.

²⁴⁹ See SEC Securities Act Release No. 401, note 22 *supra*; Release No. 4412, note 22 *supra*.

²⁵⁰ See note 51 & accompanying text *supra*.

²⁵¹ See text accompanying notes 97-106 *supra*.

²⁵² See text accompanying notes 75-89 *supra*.

²⁵³ In the course of litigation surrounding SEC v. Perera Co., 47 F.R.D. 535 (S.D.N.Y. 1969), discussed at notes 45 & 98 *supra*, the defendants challenged the Commission's interpretation of section 3(a)(3) as reflected in Release No. 4412, note 22 *supra*. The SEC argued that its release made it clear "that only notes which are not sold on the public market fall within the Section 3(a)(3) exemption, thereby excluding the Perera notes which are in fact offered for public sale." *Id.* at 536. The defendants contended that not only did their notes fall within the express language of section 3(a)(3) but also, and of prime importance, the only language in the release which speaks of the public sale factor relates to a totally different and irrelevant legislative bill which was never passed by Congress. *Id.* Release No. 4412 contains the following statement and quotation:

Thus the Senate Report on the Securities Act of 1933 explained the purpose of Section 3(a)(3) as follows:

*Notes, drafts, bills of exchange, and bankers' acceptances which are commercial paper and arise out of current commercial, agricultural or industrial transactions and which are not intended to be marketed to the public, are exempted * * ** It is not intended under the bill to require the registration of short-term commercial paper which, as is the usual practice, is made to mature in a few months and ordinarily is not advertised for sale to the general public.

present policy is certainly defensible. Since increasing quantities of unregistered commercial paper have, on occasion, found their way to small, private investors, the narrow administrative policy may be warranted.²⁵⁴

c. *Eligibility for Discounting by the Federal Reserve Board.* The legislative history of section 3(a)(3) reveals an abortive attempt by the Federal Reserve Board to have commercial paper excluded from the definition of a "security."²⁵⁵ Having failed at that effort, the Board successfully urged Congress to recognize its jurisdiction over the regulation of short-term credit instruments and to exempt commercial paper in terms consistent with the Board's standards for determining eligibility for discount.²⁵⁶

Congress adopted section 3(a)(3) to exempt "short-term paper of the type available for discount at a Federal Reserve Bank"²⁵⁷ and incorporated into the section a set of standards developed by the Board to assure the availability of liquid assets at the maturity of a discounted note. The Board's liquidity test was an appropriate form of protection in the case of unregistered commercial paper since it ensured that when investors presented their notes for redemption, the issuer would have sufficient funds to pay them. The Commission and the staff continue to rely upon Federal Reserve Board Regulation A ostensibly for the same goal. For reasons that will be developed below,²⁵⁸ such reliance should no longer continue.

Release 4412, *supra* note 22, at 2569-70, quoting S. REP. No. 47, 73d Cong., 1st Sess. 3-4 (1933) (emphasis added). The defendants asserted that the three asterisks inserted in the above-quoted portion of the release

reflect the omission of the words "section 2(a)" indicating that the preceding underlined language related to a bill offered by the Senate and rejected by the Congress rather than [to] the appropriate bill relating to Section 3(a)(3) which was . . . ultimately passed.

SEC v. Perera Co., Inc., *supra* at 536. The district court concluded that "the S.E.C. appears suspect in the formulation of the release in issue" but denied any relief to the defendants since "it is obvious that defendants simply never relied on its provisions." *Id.* at 537 (emphasis in original). See also 1 L. Loss, *supra* note 19, at 567, where the author suggests that restricting section 3(a)(3) to paper which is privately offered would make the section redundant in view of the exemption in section 4(2) for private offerings generally.

²⁵⁴ SEC STAFF REPORT, *supra* note 3, at 273-75; Harrington, *Use of the Proceeds of Commercial Paper Issued by Bank Holding Companies*, 29 BUS. LAW. 207, 224 (1973). In 1974 a significant number of individual investors were attracted to commercial paper for short-term investments since interest rates on such securities were higher than the rate of return on treasury bills or certificates of deposit. Interviews, note 1 *supra*. Private investors purchase most of their commercial paper directly from the issuer or indirectly through a local bank. *Id.*

²⁵⁵ See note 241 *supra*.

²⁵⁶ *Id.*

²⁵⁷ H.R. REP. NO. 85, 73d Cong., 1st Sess. 15 (1933). See notes 240-41 *supra*.

²⁵⁸ See text accompanying notes 267-68 *infra*.

d. *Current Transactions.* The current transactions test in section 3(a)(3) was borrowed by Congress from section 13 of the Federal Reserve Act of 1913.²⁵⁹ Although the Reserve Act was concerned with an entirely different problem from that facing Congress in 1933—the regulation of credit and the discount mechanism of the banking industry²⁶⁰—its limitations on commercial paper were necessary if investors were to purchase short-term notes without the disclosure protections of the 1933 Act.

According to the legislative history of the Reserve Act, section 13 was designed to ensure that only self-liquidating paper was eligible for rediscount.²⁶¹ The test of eligibility was not based on the transaction's "intrinsic soundness," but instead on its liquid character. Under this approach the inquiry focused on the speed with which the assets could be sold, rather than on their value.

Corporate stocks and bonds, lands, and buildings are fixed investments. However valuable they may be, their conversion into cash depends upon finding some one who believes that under all the circumstances it will be profitable for him to buy them as an investment. Growing crops, goods in process of manufacture or in transit, and mercantile stocks are commercial or liquid assets, generally speaking; certainly they are liquid to the extent that they are products on some stage of the way toward consumption. The sale of such products does not depend upon finding a willing investor and does not have to be forced, but comes about naturally in response to the ordinary demand arising from the necessities of mankind. Such assets constantly liquidate themselves, because, of necessity, they must be paid for when consumed.²⁶²

Shortly after the enactment of the Federal Reserve Act, the Federal Reserve Board promulgated Regulation A in order to define the general character of those notes, drafts, and bills of

²⁵⁹ 12 U.S.C. § 343 (1970).

²⁶⁰ The Federal Reserve Act, 12 U.S.C. §§ 221 *et seq.* (1970), was remedial legislation designed to correct abuses within the country's banking and currency system. See generally P. STUDENSKI & H. KROOS, FINANCIAL HISTORY OF THE UNITED STATES (2d ed. 1963). A series of recurring financial panics during the latter half of the nineteenth century and again in 1907 caused many observers in Congress to conclude that the banks, by pyramiding their cash reserves for use in stock speculation, were responsible for the country's economic ills. "Overnight the money barons of New York broke down the banking system and the next morning at his doorstep every American citizen found it there crumpled up like a broken toy balloon." 50 CONG. REC. 4665 (1913) (remarks of Rep. Murdock). The Federal Reserve Act was expected "to cure this evil; to withdraw the reserve funds of the country from the congested money centers and to make them readily available for business uses in the various sections of the country to which they belong." *Id.* at 4648.

²⁶¹ S. REP. NO. 133, 63d Cong., 1st Sess. 26 (1913). "Such bills have behind them actual merchandise for which a purchaser has been found, and these bills are held in their [the banks'] portfolios as almost the exact equivalent of cash." *Id.* at 248.

²⁶² 50 CONG. REC. 4778 (1913) (remarks of Rep. Bulkley).

exchange that comply with the liquidity requirements of the Federal Reserve Act and are thus eligible for discount.²⁶³ Adhering to the spirit of the Reserve Act's legislative history, the Board's early policy limited the types of instruments eligible for discount. The use of proceeds was considered a crucial element in determining eligibility.²⁶⁴ Proceeds could not be used for permanent investments, such as land, buildings or machinery, for investments of a purely speculative character or for loans to other borrowers.²⁶⁵ It was the theme of liquidity, or "asset currency,"²⁶⁶ reflected in both the Federal Reserve Act and early versions of Regulation A, that convinced Congress in 1933 that short-term commercial paper "of the type available for discount at a Federal Reserve Bank" could be exempted from the registration requirements of the 1933 Act.

Given these origins of the current transactions requirement of section 3(a)(3), it is not surprising that SEC staff interpretations of this requirement have tended to follow Board interpretations of "actual commercial transactions" in section 13 of the Federal Reserve Act. So long as the Board limited discounting to notes arising out of "transactions which liquidate themselves within a comparatively short time without undue pressure on the borrower,"²⁶⁷ the Commission's endorsement of Board interpretations was appropriate. Purchasers of unregistered securities were assured that the issuer would channel the proceeds into liquid assets that could be sold, if necessary, to repay the investors when the notes matured. Over the years, however, amendments to the Board's

²⁶³ 6 FED. RES. BULL. 1179, 1179-81 (1920). Section 13 of the Federal Reserve Act left to the Board the problem of defining the character of the paper eligible for discount. *Cf. id.* at 1176.

²⁶⁴ *See, e.g., id.* at 1179 (the 1920 version of Regulation A).

²⁶⁵ *Id.*

²⁶⁶ The term asset currency was used to describe the economic philosophy of the Glass bill which eventually became the Federal Reserve Act.

The general plan of the Glass bill is to allow banks which are members of the reserve associations to discount with the associations prime commercial paper and to take therefor note issues of the reserve associations, which will form an expansive currency which will meet the needs of business in different localities. This currency must be secured by a gold reserve as well as by deposits of the discounted securities, and therefore it will retire itself rapidly when not needed. This has been called "asset currency", and so it is. We have never had anything but "asset currency" in this country, except the gold and silver certificates and the greenbacks. All of our national-bank notes are "asset currency," except that they are secured on one form of assets, to wit, Government bonds. The asset currency provided for in the Glass bill is secured upon current commercial transactions which liquidate themselves within a comparatively short time without undue pressure on the borrower. The difference between short-time paper and long-time paper is not the difference in its intrinsic soundness, but a difference in what the bankers call its liquid character.

²⁶⁷ 50 CONG. REC. 4731 (1913) (remarks of Rep. Borland).

²⁶⁷ *Id.*

early forms of Regulation A have so diluted its restrictions that present Board interpretations no longer limit discounting to short-term, self-liquidating commercial paper.²⁶⁸ As a result, the standards developed for controlling the availability of credit can no longer be trusted to protect purchasers of securities.

An examination of specific types of transactions that the staff deems current for purposes of section 3(a)(3) demonstrates what has happened to the Commission's commitment to current transactions "composed of assets easily convertible into cash."²⁶⁹ Such an assessment necessitates an inquiry into each category of current transactions to determine the probability that the assets acquired or carried with the proceeds from the sale of commercial paper could be converted into cash within a relatively short period of time, and in an amount sufficient to repay the holders of the commercial paper at maturity.

In the transactions discussed earlier,²⁷⁰ the assets acquired or carried with proceeds from commercial paper may be put into four categories. The first category contains commercial and consumer notes, including consumer credit loans,²⁷¹ mortgage warehousing loans,²⁷² preconstruction²⁷³ and construction loans,²⁷⁴ land acquisi-

²⁶⁸ See, e.g., the 1923 series of Regulation A, 9 FED. RES. BULL. 892, 892-95 (1923), where the Board partially reversed its position on the eligibility of certain finance paper. The 1937 series expanded the discount power even further and allowed finance paper of all types to qualify for rediscount so long as the proceeds were ultimately used in the prescribed manner. 23 *Id.* 984-86 (1937). The 1955 series is significant since it contained no reference to a policy of strictly limiting the discount power to specific types of commercial transactions. 41 *Id.* 8, 8-14 (1955). Instead, it advised Federal Reserve banks that were considering a request for credit accommodation to give due regard to "the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally." *Id.* at 9. In 1972, the Board recommended further liberalization of the rules governing eligibility of paper for discount. 37 Fed. Reg. 25177 (1972). Regulation A had always made ineligible any paper the proceeds of which were used for "permanent or fixed investments of any kind, such as land, buildings, or machinery, or for any other fixed capital purposes." The Board of Governors recommended that this provision be omitted

so that paper given for such purposes would be eligible for discount or as collateral for advances if it meets the 90-day maturity requirement of the law and if the funds are not used merely for investment purposes. The revision would also make it clear that paper given for the purchase of services, as well as tangible goods, would be eligible for discount and as collateral for advances.

Id. The proposed revisions to Regulation A became effective April 19, 1973, 38 *id.* 9076 (1973), in section 201.4(a) of the Regulation. 12 C.F.R. § 201.4(a) (1976).

²⁶⁹ Release No. 4412, *supra* note 22, at 2571.

²⁷⁰ See text accompanying notes 117-92 *supra*.

²⁷¹ See text accompanying note 126 *supra*.

²⁷² See text accompanying note 136 *supra*.

²⁷³ See text accompanying note 147 *supra*.

²⁷⁴ See text accompanying note 151 *supra*.

tion and development loans,²⁷⁵ standing mortgage loans²⁷⁶ and short-term remaining portions of long-term loans.²⁷⁷ The second category is personal property, where the assets include inventories²⁷⁸ such as raw materials, goods in process, mortgages awaiting warehousing and factors' accounts receivable.²⁷⁹ The third category of asset acquired with proceeds from commercial paper is services. The staff has allowed issuers relying upon section 3(a)(3) to spend proceeds for ordinary operating expenses²⁸⁰ incurred because of services rendered, such as salaries, travel expenses, and rent, in addition to tax obligations. The fourth category of asset, securities, includes government securities, short-term certificates of indebtedness or short-term commercial paper in which funds from exempt commercial paper may be invested temporarily.²⁸¹

The assets generated by the staff-approved use of proceeds are presumably available to an issuer as protection against default on the short-term notes. Is it probable, though, that the potential cash flow from these assets would materialize for an issuer otherwise unable to honor its obligations on commercial paper? If the proceeds have produced consumer and commercial notes, the assets in the first category, the answer depends on several factors: the maturity of the notes, the likelihood of discounting them for cash if they are premature, and the security, if any, that might exist if the borrower defaults.²⁸² In the case of personal property, the second category, the issuer is dependent upon a ready market for its property. The difficulty of finding such a market may be compounded where commercial paper proceeds are tied up in inventories which may be in an unfinished and less valuable

²⁷⁵ See text accompanying note 166 *supra*.

²⁷⁶ See text accompanying note 171 *supra*.

²⁷⁷ See text accompanying note 178 *supra*.

²⁷⁸ See, e.g., note 121 *supra*.

²⁷⁹ See text accompanying note 143 *supra*.

²⁸⁰ See text accompanying notes 180, 193 *supra*.

²⁸¹ See text accompanying note 189 *supra*.

²⁸² For example, a problem may arise where there is a three-year construction loan financed out of the proceeds from the sale of exempt commercial paper. Even if the developer is obligated to secure a takeout commitment prior to completion of construction, and the construction loan is secured by a first lien on the real estate to be developed, the issuer may have difficulty redeeming its commercial paper. If, when the commercial paper matures, the issuer lacks the cash needed to repay the investors and is unable to secure credit from any other source, its rights as a lender under the construction loan agreement may not provide the cash it needs. Since the developer's obligation to repay its debt to the issuer is more than two years off, the issuer must look elsewhere for help. Any hopes of discounting the issuer's potentially profitable construction loan agreement could be destroyed by a slump in the real estate market, financial setbacks for the developer or the unavailability of long-term financing for the proposed construction project.

state. The assets represented in the third category, services, offer the least protection since for the most part they are not capable of being converted into cash. Although the assets in the fourth category, securities, are subject to market fluctuations, they offer the most protection to the investors because of the staff's conservative stance as to which securities are eligible under the 3(a)(3) exemption. In the event that the assets represented by these four categories of interim investments cannot be converted into cash, the holders of the issuer's commercial paper are in no better position than they would have been had the issuer been free to use the proceeds for a permanent, noncurrent transaction.

Commission and staff interpretations of section 3(a)(3) have not only given a broad meaning to the current transactions test, but also have permitted issuers to rely heavily on the sale of commercial paper as a means of financing long-term investments. As noted earlier,²⁸³ an issuer may use proceeds from commercial paper to discharge indebtedness previously created by an offering of commercial paper that was itself exempt under section 3(a)(3). Furthermore, an issuer is not required to trace such proceeds to specific transactions.²⁸⁴ Although section 3(a)(3) was designed for short-term borrowing, an issuer could take advantage of these interpretations of the exemption by continually rolling over its commercial paper as if it were long-term financing. Consider, for example, an issuer that has at any one time forty million dollars tied up in projects that would satisfy the staff's liberal interpretation of the current transactions requirement. Where the issuer wishes to fund a major ten-year construction project, which would not qualify as current without resorting to the usual sources of permanent financing, the issuer can use the commercial paper market. By turning to that market to raise twenty million dollars for the apparent purpose of funding the smaller projects that qualify as current transactions, the issuer could divert twenty million dollars previously committed to other corporate purposes to the long-term construction project. Section 3(a)(3) would be satisfied since the proceeds from the offering would be used for current transactions and the twenty million dollars of unregistered commercial paper outstanding would not exceed the amount of proceeds invested in current transactions.²⁸⁵ In order to have funds for its short-term notes at maturity, the issuer could sell more commercial paper to raise the twenty million dollars needed for redeeming the first issue

²⁸³ See text accompanying note 193 *supra*.

²⁸⁴ See text accompanying note 219 *supra*.

²⁸⁵ See text accompanying note 219 *supra*; but see text accompanying note 220 *supra*.

of short-term notes, a use of proceeds that qualifies as a current transaction.²⁸⁶ This process could then be repeated for the life of the major construction project or until the issuer decided to use more traditional financing.

What emerges from a study of the staff's interpretations of the current transactions requirement is far from comforting. The Commission's goal of restricting the use of proceeds under section 3(a)(3) to transactions "composed of assets easily convertible into cash" has been abandoned.²⁸⁷ With the passing of that objective, some of the protection originally afforded investors has also been lost. The staff's interpretation has thus become inconsistent with the purpose of the exemption, which was to assist issuers in meeting short-term needs while adequately protecting investors by guaranteeing that they could be easily repaid when the paper matured. Instead, section 3(a)(3) has become a license to raise capital for long-term financing.

B. *Suggestions for Reform*

The preceding examination of section 3(a)(3) as perceived by Congress, as interpreted by the Commission and its staff, and as used by participants in the commercial paper market, reveals an exemption in need of reform. The scope of this reform should depend on the extent to which the exemption as applied conflicts with Congressional goals and limitations.

From available evidence,²⁸⁸ it appears unnecessary to embark upon a sweeping reform of section 3(a)(3) to cure a few specific weaknesses. The exemption, even under present interpretations, is not entirely inconsistent with Congressional goals. First, commercial paper continues to be an inherently sound investment. Except for the default by the Penn Central Company on its short-term notes, commercial paper obligations have been regularly honored by issuers.²⁸⁹ Where economic hardships have forced businesses into insolvency or bankruptcy,²⁹⁰ the money market has usually

²⁸⁶ The issuer would have to be careful to avoid having an aggregate amount of unregistered commercial paper outstanding that exceeded the amount of proceeds invested in current transactions. In the illustration in the text, the issuer would protect itself by limiting the aggregate amount of commercial paper outstanding to one-half of the amount it had invested in transactions that would otherwise qualify as current under section 3(a)(3).

²⁸⁷ Release No. 4412, *supra* note 22, at 2571.

²⁸⁸ See text accompanying notes 232-41 *supra*.

²⁸⁹ There have been other defaults on commercial paper. See Harrington, *supra* note 254, at 224. However, representatives of the industry believe that such defaults have been rare. Interviews, note 1 *supra*.

²⁹⁰ For example, several REIT's encountered economic difficulties in 1972 when housing construction peaked and then began to plummet, vacancy rates

responded with its own controls to deny such businesses the use of commercial paper.²⁹¹ Furthermore, where financially troubled issuers have relied upon banks or other lending institutions to honor moral or legal commitments under lines of credit so that issuers could redeem outstanding short-term notes, the commitments have been kept.²⁹²

Second, unregistered commercial paper does not pose a significant threat to private investors. Most individual investors know little or nothing about commercial paper or the mechanics of acquiring it. Even if a private person has such knowledge, the substantial minimum denomination will probably continue to serve as a deterrent. The wealthy and sophisticated individual is likely to eschew commercial paper since it typically offers a lower interest yield than other short-term or medium-term instruments.²⁹³ The Commission's stated policy against general advertising protects private investors when economic conditions transform commercial paper into a more attractive investment.

Third, institutional investors which are the primary market for commercial paper are usually sophisticated and can fend for themselves. Whether the seller is the issuer or a commercial paper dealer, most short-term notes will carry the professional opinion of at least one and possibly two rating services.²⁹⁴ Most direct paper is sold by finance companies which are constantly in the market with their short-term notes. Consequently, investors are familiar with the finance companies and can easily secure current business and financial information about them.²⁹⁵ If dealer paper is being

increased and tight money market conditions and inflation forced up mortgage rates to record levels. See generally Gumpert & Starr, note 59 *supra*.

²⁹¹ Interviews, note 1 *supra*; C. Stabler, *The Morning After: "Problem Loans" Follow Easy Credit, Causing Headaches for Bankers*, Wall St. J., Aug. 20, 1975, at 1, col. 6. See generally *Troubled REITs Swap Assets for Cash*, BUS. WEEK, July 21, 1975, at 68.

²⁹² Interviews, note 1 *supra*.

²⁹³ *Id.* But see note 254 *supra*.

²⁹⁴ On June 26, 1975, the Commission announced the adoption of a uniform net capital rule, rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1976), for use by brokers and dealers subject to the 1934 Act. SEC Exchange Act Release No. 11497 (June 26, 1975), [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,212. Paragraph (c)(2)(vi) of the rule requires that in computing "net capital" the net worth of a broker or dealer shall be adjusted by applying certain prescribed deductions for commercial paper notes held by the broker or dealer. Brokers and dealers are able to take advantage of such deductions only if the commercial paper is "rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations." 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E) (1976). For the period between January 1, 1976 and December 31, 1976 the SEC staff has determined that in certain instances the requirement of having two ratings for commercial paper will not be applied in order to avoid disruption of the commercial paper market. See SEC no-action letter (Lehman Com. Paper Inc.), issued Mar. 18, 1976, [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,513.

²⁹⁵ See note 55 *supra*.

marketed, an institutional investor knows that an independent evaluation has been made of each issuer by the dealer's credit department because the dealer would not place its reputation behind an issue of commercial paper without an investigation.²⁹⁶

Fourth, the economy would suffer if businesses were required to comply with the registration requirements of the 1933 Act. The legislative history of section 3(a)(3) reflects Congress's belief that registration of commercial paper would interfere with the ordinary operations of finance and commerce.²⁹⁷ With approximately fifty billion dollars of commercial paper outstanding in today's market,²⁹⁸ registration would be both disruptive and expensive. Requiring issuers to register short-term notes might even drive businesses out of the commercial paper market entirely and force them to consider costlier conventional sources for their short-term needs.²⁹⁹

Although elimination of the section 3(a)(3) exemption is unnecessary, a strong argument can be made for at least modest reforms. Suggested changes include both improvements on existing SEC and staff interpretations of the exemption and the possible addition of some form of mandated disclosure.

1. Reforms Based on Existing Requirements

Although the Commission's position in Release No. 4412 has been partly eroded over the years,³⁰⁰ the four-part test it outlined³⁰¹ is still a valuable model for suggesting improvements since all four conditions are intended to protect investors. The first three criteria mentioned in that release, prime quality, unavailability to the general public, and discountability at a federal reserve bank, need little reform. The fourth criterion, correct use of proceeds, poses greater difficulty.

The first requirement of the four-part test limits section 3(a)(3) to prime quality commercial paper, but neither the Commission nor the staff has specified the qualifications for such a rating. To add to the confusion, current SEC staff interpretation of prime quality suggests that in making the critical judgment it is focusing more on the security itself than on the issuer. The staff appears to concentrate on the issuer only in cases where the issuer is unseasoned or insolvent. Yet the legislative history of section

²⁹⁶ Interviews, note 1 *supra*.

²⁹⁷ See note 237 *supra*.

²⁹⁸ As of February 1976, \$49.927 billion of commercial paper was outstanding, of which \$31.534 billion was placed directly by financial companies. 62 FED. RES. BULL. A25 (May 1976).

²⁹⁹ Interviews, note 1 *supra*.

³⁰⁰ See note 268 & accompanying text *supra*.

³⁰¹ See text accompanying notes 4-43 *supra*.

3(a)(3), as interpreted by the Commission and the courts, indicates that it was intended to exempt only "well recognized commercial paper"³⁰² issued by the country's strongest businesses.³⁰³ Commercial paper which is truly prime quality deserves its rating because the issuer has met standards of achievement that professionals in the money market associate with proven success. If the Commission intends to apply a "prime quality" test in conformity with the legislative history of the exemption, it should shift the focus to the issuer³⁰⁴ and establish minimum standards relating to an issuer's financial strength that would aid issuers in determining whether they will satisfy the prime quality aspect of the exemption.

The second requirement for section 3(a)(3), that the paper ordinarily not be purchased by the general public, continues as an essential part of the exemption. Here too, administrative guidelines would be helpful in defining the acceptable levels of advertising and the minimum denominations of short-term notes.³⁰⁵ The Commission is certainly aware that some finance companies which sell their paper directly and certain major commercial paper dealers openly solicit individual investors.³⁰⁶ The staff must also realize that its informal requirement of \$25,000 minimum denominations for short-term notes³⁰⁷ is not always followed and that its ad hoc rulings on proposed offerings on occasion have produced eligible minimum denominations of \$5,000.³⁰⁸ Yet the Commis-

³⁰² See *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1079 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

³⁰³ SEC Brief, *supra* note 45, at 14.

³⁰⁴ See *Franklin Savings Bank v. Levy*, 406 F. Supp. 40 (S.D.N.Y. 1975), where the court discussed whether certain commercial paper of Penn Central Co., Inc. was "prime quality" at the time of purchase. In concluding that the short-term notes were not prime quality, the court analyzed the financial strengths and weaknesses of the issuer.

³⁰⁵ The Commission occasionally issues releases that set forth guidelines for persons trying to comply with administrative regulations. See, e.g., SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2270 (1975), where the Commission identified five factors that relate to the question of integration.

Since the commercial paper market has been generally successful in limiting the flow of short-term notes to those companies that are capable of redeeming their paper at maturity, a strong argument can be made for not requiring an issuer to meet certain administratively imposed criteria as a condition for an exemption under section 3(a)(3). If the situation subsequently warrants stricter regulation, the Commission has several precedents for conditioning section 3(a)(3) upon the issuer's business or earning history. See, e.g., rule 237, 17 C.F.R. § 230.237 (1976).

³⁰⁶ Interviews, note 1 *supra*; see also, e.g., the two-page advertisement by Goldman, Sachs & Co. offering investment opportunities in commercial paper to institutions and "Substantial Individual Investors." *Wall St. J.*, June 22, 1976, at 24-25, Oct. 12, 1976, at 24-25, on file at the UCLA Law Review.

³⁰⁷ Interviews, note 1 *supra*.

³⁰⁸ See, e.g., SEC no-action letter (Lumbermans Acceptance Corp.), issued

sion and staff continue to assert that section 3(a)(3) may not be used by issuers that advertise or offer their short-term notes to members of the public.³⁰⁹ The Commission or the staff may have determined that issuers and dealers should be free to offer unregistered commercial paper to certain categories of private investors. Therefore, while a minimum denomination of commercial paper is deemed essential to the SEC's interpretation of the exemption, the staff will make exceptions in certain cases.³¹⁰ If so, sound regulatory policy requires that the agency publicize the standards it uses in making such determinations.³¹¹

Third, determining eligible commercial paper in terms of its discountability at a federal reserve bank may have once served as a valuable standard. It suffers, however, from many of the same difficulties that beset the related current transactions aspect of the exemption³¹² and no longer assures investors receipt of commercial paper that is self-liquidating. Consequently, the Commission's third criterion should be eliminated from any proposed test.³¹³

Finally, the current transactions requirement of section 3(a)(3) presents the greatest need for reform. This aspect of the exemption was intended by Congress to guarantee that proceeds from commercial paper would be composed of assets easily convertible into cash. As conceived, the self-liquidating requirement would protect investors against the possibility of an issuer not having sufficient funds to redeem its short-term notes. In practice, however, the current transactions requirement is not applied as originally intended. Most of the commercial and consumer financ-

July 22, 1974, [1974] CCH FED. SEC. MICROFILM, roll 8, frame 10892; SEC no-action letter (National Rural Util. Coop. Fin. Corp.), issued June 4, 1974, [1974] CCH FED. SEC. MICROFILM, roll 7, frame 09258; SEC no-action letter (Exchange Int'l Corp.), issued Feb. 26, 1973, [1973] CCH FED. SEC. MICROFILM, roll 3, frame 04083.

³⁰⁹ See, e.g., Release No. 4412, note 22 *supra*; text accompanying note 79 *supra*.

³¹⁰ There is some support for imposing a minimum denomination on commercial paper as a condition for exemption. The proposed Federal Securities Code includes an exemption for commercial paper that is sold in minimum denominations of \$100,000. See ALI FED. SEC. CODE § 30(n), Comment 3, at 71 (Tent. Draft No. 1, 1972); § 216A, Comment 2, at 7, § 301(l) (Rev. Draft, 1974).

³¹¹ In the letter of transmittal accompanying the *SEC Staff Report*, note 3 *supra*, the Chairman of the SEC urged Congress to consider amending section 3(a)(3)

to provide more definite standards, for example, as to such matters as the denominations in which it [commercial paper] may be offered and sold, in order to prevent this type of unregistered security finding its way into the hands of the investing public in general, rather than financial institutions, as it appears Congress originally intended.

Id. at vii-ix.

³¹² See text accompanying notes 267-68 *supra*.

³¹³ See text accompanying note 267 *supra*.

ing transactions described earlier³¹⁴ involve loan agreements that do not mature within the life of the exempt commercial paper. The staff's liberal interpretation of this requirement is no doubt due to a judgment that the self-liquidating objective does not comport with the economic reality of commercial paper or with ordinary commercial and financial practices.³¹⁵ However, in the process of constructing its own limitations on the use of proceeds from commercial paper, the staff has created confusion for issuers. The Commission should honor the legislative intent of section 3(a)(3) and limit an issuer's expenditures to those transactions that are truly self-liquidating within a period of nine months.

A further problem with the current transactions requirement, even where it is strictly applied, is how to determine whether proceeds from exempt short-term notes have in fact financed eligible transactions. Tracing dollars raised to dollars spent would place an onerous burden on an issuer and would not prevent an indirect use of section 3(a)(3) for long-term, permanent financing.³¹⁶ Since tracing is not acceptable, the staff may intend to limit the aggregate amount of commercial paper that an issuer may have outstanding to a certain percentage of its liquid assets as a substitute form of protection for investors.³¹⁷ Again, however, the staff has used ad hoc rulings on proposed offerings as the method for embarking on what appears to be a new administrative policy. It is hardly surprising that confusion and inconsistency have followed.³¹⁸ If new criteria are to become part of the exemption, a Commission release should discuss them in detail.

³¹⁴ See text accompanying note 117 *supra*.

³¹⁵ See Schweitzer, *supra* note 19, at 1249, where the author contends that the self-liquidating theory of commercial paper does not reflect the economic realities of the borrowing transaction and was the invalid assumption upon which Congress adopted section 3(a)(3).

³¹⁶ See text accompanying notes 283-86 *supra*.

³¹⁷ See text accompanying notes 222-24 *supra*.

³¹⁸ See, e.g., note 225 *supra*, for types of limitations on the amount of commercial paper that an issuer may have outstanding. A recent staff response to a no-action request suggests that the type of limitation will depend on the nature of the issuer. In SEC no-action letter (Public Serv. Co. of N.M.), issued Apr. 22, 1976, [1975-1976 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,552, the issuer sought no-action treatment for a proposed sale of unregistered commercial paper in an amount not to exceed 25 percent of revenues received by the company over the preceding 12 months. The suggested limitation, which was the formulation used by other utilities, had been the basis for a previously issued no-action letter, SEC no-action letter (Tucson Gas & Elec. Co.), issued July 15, 1974, [1974] CCH FED. SEC. MICROFILM, roll 8, frame 10872. In allowing the issuer to claim the exemption, the staff announced the following policy:

It is the present policy of the Division [Corporation Finance] that commercial paper may be sold by public utility companies in amounts equal to the total accounts receivable for the most recent fiscal year plus the

Disclosure in connection with the sale of short-term notes would become more common if the SEC honored the congressional intent of section 3(a)(3) by limiting the exemption to self-liquidating commercial paper. Many issuers would be forced either to rely on another exemption, or to comply with the registration requirements of the 1933 Act.

The private placement exemption, section 4(2) of the 1933 Act,³¹⁹ is the only exemption likely to inherit commercial paper offerings excluded by tighter administrative interpretations of section 3(a)(3).³²⁰ Unlike the commercial paper exemption, section 4(2) requires issuers to furnish investors with the type of information that would be available in a registered offering. Section 4(2)'s prohibition against advertising³²¹ might prove too restrictive for sellers of commercial paper, but if the Commission believed that limited soliciting of institutional investors was a business necessity, it could easily modify its position in a release.

A more restrictive view of the current transactions aspect of section 3(a)(3) might also force some issuers into registration. Although full registration of each issue of commercial paper would probably destroy the utility of commercial paper as a money market instrument,³²² several commentators have suggested a variant of shelf registration as a practical solution.³²³ As proposed, the

total fuel inventory of the utility at the time of the issuance of the commercial paper.

SEC no-action letter (Public Serv. Co. of N.M.), *supra* at 86,421. It has been suggested that the SEC staff has always interpreted section 3(a)(3) in reference to the type of issuer claiming its protection. Schweitzer, *supra* note 19, at 1250-53.

³¹⁹ 15 U.S.C. § 77d(2) (1970); *see* note 46 *supra*.

³²⁰ Interviews, note 1 *supra*. For an example of how commercial paper issuers are already using the private placement exemption to avoid the current transactions requirement of section 3(a)(3), *see* text accompanying notes 215-17 *supra*.

³²¹ A person claiming an exemption under section 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1970), must prove that each offeree and purchaser has the necessary information available concerning the issuer and can fend for himself. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). As a result, general advertising or general solicitation in connection with a nonpublic offering is inconsistent with the elements of the private placement exemption. Rule 146(c), note 82 *supra*, specifies limitations on the manner in which the securities can be offered and sold, including prohibitions against general advertising and general solicitation.

³²² Each offering of commercial paper involves a new decision by the issuer on the terms and amounts, both of which are subject to fluctuating market conditions. Furthermore, the costs of the registration process in both time and expense would be prohibitive. Even with the SEC's amended rule 457, 17 C.F.R. § 230.457 (1976), which was designed to encourage registration by reducing filing fees, the legal and printing costs would be substantial for issuers that continuously roll over their paper. *Cf. Commercial Paper Market*, *supra* note 2, at 393; Harrington, *supra* note 254, at 224.

³²³ *See, e.g., Commercial Paper Market*, *supra* note 2, at 394; Harrington, *supra* note 254, at 225.

Commission would create a new registration form for issuers of commercial paper which would be continuously updated with post-effective amendments disclosing any new material information, the terms of each offering and the proposed use of proceeds.³²⁴ An issuer would be required to deliver an abbreviated or summary prospectus to investors at the time of purchase and to update it with quarterly reports.³²⁵

2. Mandated Disclosure

Section 3(a)(3) provides issuers of commercial paper with an exemption from the registration requirements of the 1933 Act. Investors interested in purchasing short-term notes are thereby forced to make their investment decisions on the basis of an independent analysis of issuers and their securities, which is practically difficult,³²⁶ or, more likely, the information or recommendations provided by issuers, dealers selling the paper, rating services and the public media.³²⁷ Since an investor has no guarantee that it will discover current material facts, it is worth asking whether an offering of commercial paper should include certain mandated disclosures and, if so, what form they should take. Such an inquiry is even more appropriate in view of the Commission's avowed commitment "to coordinate and integrate the [continuous] disclosure system with the exemptive provisions provided by [the 1933 Act]."³²⁸

Even in its present form, the commercial paper exemption appears to provide issuers and investors with most of the protections contemplated by Congress. Issuers are relieved from the costly and time-consuming registration requirements and investors are offered generally safe, short-term investments. Even after the collapse of Penn Central and its default on eighty-two million dollars of commercial paper, the Commission did not conclude, as it did with section 3(a)(6), that the commercial paper exemption

³²⁴ See, e.g., authorities cited in note 323 *supra*.

³²⁵ See, e.g., Schweitzer, *supra* note 19, at 1258-59. Some representatives of the commercial paper market believe that any form of registration requirement, including the shelf-registration variety, would be too costly. Interviews, note 1 *supra*.

³²⁶ See SEC STAFF REPORT, *supra* note 3, at 272: "[B]ecause of the short-term nature of the investment and the speed and the manner in which it is made, investors do very little investigation on their own either into the issuer or the investment merits of the security." *Id.* See also *id.* at 276, note 16 *supra*.

³²⁷ *Id.* at 276; see note 16 *supra*. With dealer paper, it is customary for the dealers to prepare a dealer memorandum which briefly describes the issuer. See note 98 *supra*. See also *Franklin Savs. Bank v. Levy*, 406 F. Supp. 40, 46 (S.D.N.Y. 1975).

³²⁸ SEC Securities Act Release No. 5450, *supra* note 15, at 83,649.

should be rescinded or strengthened with mandatory disclosure requirements.³²⁹ Therefore, unless there is evidence that section 3(a)(3) is not protecting private investors or unsophisticated institutional investors, disclosure requirements are unnecessary, especially if the staff establishes clearer standards for its opinions and narrows the current transactions requirement along the lines suggested above. The conclusion that mandated disclosure is unnecessary does not constitute a departure from the Commission's commitment to a continuous disclosure system. When the Commission embarked on its course of integrating the exemptive provisions of the 1933 Act with the continuous disclosure requirements of the 1934 Act, it was focusing on "those continuing disclosures which benefit the trading markets in securities."³³⁰ Since there is no secondary market where investors can sell commercial paper before maturity,³³¹ the reason for providing current information for the trading markets never arises and the goals of such disclosure are inapplicable.

If, however, at some point in the future, section 3(a)(3) poses a serious threat to investors, the protections of the disclosure system could be invoked. Congress could, for example, amend the 1933 Act and either eliminate the commercial paper exemption or amend it to include disclosure requirements. Alternatively, congressional relief might result in mandatory disclosure obligations for all of the major participants in the market, including the issuer, commercial paper dealers, banks and separately identifiable departments of banks, much as the Securities Act Amendments of 1975 have modified regulation of municipal securities.³³² Even without congressional intervention, a defective exemption could be cured by the Commission which has the power to encourage issuers and commercial paper dealers to provide current material information to investors.

³²⁹ See the letter of transmittal from the Chairman of the SEC that accompanied the *SEC Staff Report*, set forth in note 311 *supra*.

³³⁰ WHEAT REPORT, *supra* note 15, at 11. Rule 144, 17 C.F.R. § 230.144 (1976), limits the freedom of a controlling stockholder and a person who has acquired restricted securities to transfer their securities. One of the primary purposes of this rule was to effectuate the underlying policy of the 1933 Act, the protection of investors, by requiring "that there be current information concerning the issuer, whether the resales of securities by persons result in a distribution or are effected in trading transactions." SEC Securities Act Release No. 5223, *supra* note 15, at 81,053.

³³¹ Interviews, note 1 *supra*; N. BAXTER, *supra* note 2, at 109-18.

³³² The Securities Act Amendments of 1975 extend federal regulation to municipal securities dealers and brokers, including banks engaged in such activities. As a result of the 1975 Amendments, a Municipal Securities Rulemaking Board has been created which is charged with ensuring that potential lenders have adequate information about the municipal issuers to make informed investment judgments.

If commercial paper were to lose its reputation as having "a record of safety only second to Government bonds"³³³ and investors needed the disclosure protections that were considered superfluous by Congress in 1933, the Commission could modify section 4(2) to make it more attractive to issuers of commercial paper or adopt a shelf-registration form for easier use.³³⁴ Another option for the Commission would be to utilize the antifraud and civil liability provisions of the 1933 Act. Sections 12(2) and 17, respectively,³³⁵ render misrepresentation unlawful and authorize civil recovery for such misrepresentation by "any person" who sells a security, including one exempted by section 3(a)(3). If an issuer or commercial paper dealer effects the sale of short-term notes by an untrue statement of material fact or a material omission of fact, purchasers may recover damages under section 12(2) unless the seller can prove that it "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."³³⁶

If section 3(a)(3) were to pose a threat to investors, the SEC could interpret the failure of issuers and commercial paper dealers to provide investors with certain specified information as a deceptive act or practice. Such an administrative release would place a greater obligation on commercial paper dealers to inform investors

³³³ *Hearings on S. 875, supra* note 233, at 94-95.

³³⁴ *See* text accompanying note 320 *supra*.

³³⁵ 15 U.S.C. §§ 77g, 77l(2) (1970).

³³⁶ *Id.* § 77l(2). On occasion, the Commission issues releases which discuss conduct by issuers or dealers considered violative of the anti-fraud provisions of the 1933 Act. *See, e.g.*, SEC Securities Act Release No. 5226 (Jan. 10, 1972), [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,483, which was concerned with the applicability of the antifraud provisions of the Act to certain conduct in connection with the offering and sale of securities in non-public offerings; SEC Securities Act Release No. 4445 (Feb. 2, 1962), [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 22,753, which expressed the Commission's view on the type of investigation that brokers and dealers should make prior to selling unregistered securities so as to avoid violations of the federal securities laws; SEC Securities Act Release No. 5121 (Dec. 30, 1970), [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,943, where the Commission urged issuers to take certain precautions in the private placement of securities or risk the unavailability of the expected section 4(2) exemption. *Cf.* rule 15c2-11 under the 1934 Act, 17 C.F.R. § 240.15c2-11 (1975), where the Commission deems it a fraudulent, manipulative and deceptive practice within the meaning of section 15(c)(1) of the 1934 Act, 15 U.S.C. § 78o(c)(1) (1970), for a broker or dealer to enter any quotation medium in connection with the securities of companies that do not file reports under the 1934 Act unless certain specified information is available to the public. Presumably, the Commission would find it difficult to regulate commercial paper dealers in the manner used in rule 15c2-11. The SEC finds its authority to regulate brokers and dealers of securities in section 15 of the 1934 Act. However, commercial paper is excluded from the definition of "security" in section 3(a)(10) of that statute and is specifically excluded again in section 15.

and would increase an already heavy burden of proof in the event of litigation.³³⁷

If the Commission expressed the opinion that the antifraud provisions of the 1933 Act were violated when certain basic information was withheld from investors, the Commission would have to decide whether to place the onus of disclosure on the issuer or on the seller. A special problem arises when the securities involved are short-term notes since the company that places its commercial paper directly is both an issuer and seller whereas the dealer is only a seller. Consequently, an administrative release aimed at minimum disclosure in commercial paper offerings should recognize the differing roles of commercial paper sellers and establish obligations that vary depending on the type of paper offered.

Directly-placed paper is sold for the most part by large, well-known firms that have such a constant demand for short-term financing that they can afford the costs of selling their own commercial paper.³³⁸ Many of these issuers will also be selling mid-term and long-term debt securities that require registration and will, therefore, be subject to the periodic reporting requirements of the 1934 Act. Public disclosure of material information about such issuers is accomplished under the 1934 Act. However, investors purchasing directly from an issuer are not afforded the independent evaluation of a commercial paper dealer. Therefore, the Commission might conclude, in the event that section 3(a)(3) ceases to effectuate congressional intent, that certain direct-paper issuers should provide investors with the type of information that is particularly relevant to a short-term investment in which liquidity of assets is the important concern. Such information might include the extent of an issuer's current debt maturities, liquidity needs, unencumbered or unpledged assets, cash flow, and sources and use of cash resources.³³⁹

Dealer paper could present a special problem for investors if the securities offered under section 3(a)(3) proved to be speculative. In general, businesses with only seasonal needs for funds or with a name not well enough known to market commercial paper without dealer contacts sell indirectly through dealers. In either

³³⁷ In view of the recent Supreme Court opinion in *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375 (1976), which held that a private cause of action for damages is not available under section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1976), in the absence of an allegation of "scienter," purchasers of commercial paper might prefer to base a claim for damages on section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77i(2) (1970), *University Hill Foundation v. Goldman, Sachs & Co.*, CCH FED. SEC. L. REP. ¶ 95,749 (S.D.N.Y. 1976), since a negligent misrepresentation is actionable. *Gould v. Tricon Inc.*, 272 F. Supp. 385 (S.D.N.Y. 1967).

³³⁸ See notes 87, 93 *supra*.

³³⁹ See generally SEC STAFF REPORT, *supra* note 3, at x-xi.

case, investors are likely to view the commercial paper dealers as experts who would only offer the paper of an issuer which it considers to be creditworthy and without substantial risk, and who would inform purchasers of any adverse developments concerning the issuer.³⁴⁰ At least two courts have suggested that commercial paper dealers have such duties to their customers.³⁴¹ Since commercial paper dealers sell an issuer's short-term notes as principals, operating in much the same way as they would in a firm commitment underwriting, and since the level of sophistication expected from investors under section 3(a)(3) appears to be lower than that imposed by section 4(2),³⁴² the Commission would be justified in aiming reforms of section 3(a)(3), if necessary, at the dealers. Such reforms could require a commercial paper dealer to possess the type of information needed for an informed investment decision and to furnish purchasers with all of its information relating to the ability of the issuer to redeem its commercial paper at maturity.

At least one commercial paper dealer has already incorporated the proposed disclosure requirements into its operations. As a result of a consent decree with the Commission,³⁴³ Goldman, Sachs & Co., the nation's largest commercial paper dealer, is required to comply with the following four requirements in the sale of any commercial paper: (1) Before the firm makes an initial purchase of commercial paper from an issuer for purposes of resale as a dealer or broker, it must make a thorough examination of the issuer

³⁴⁰ *Id.* at 276.

³⁴¹ *Sanders v. John Nuveen & Co., Inc.*, 524 F.2d 1064 (7th Cir. 1975), *vacated & remanded for further consideration in light of Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375, 1659 (1976); *Franklin Savs. Bank v. Levy*, 406 F. Supp. 40 (S.D.N.Y. 1975); *University Hill Foundation v. Goldman, Sachs & Co.*, CCH FED. SEC. L. REP. ¶ 95,749 (S.D.N.Y. 1976). In *Sanders v. John Nuveen & Co., Inc.*, the court found an underwriter of short-term commercial paper, who acted in the mistaken but honest belief that financial statements prepared by certified public accountants correctly represented the conditions of the issuer, liable under section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1976).

In reaching this conclusion we have taken into consideration the fact that the security was short term commercial paper rather than stock or long term indebtedness. The nature of this security minimized the investor's interest in the long range prospects of the issuer and therefore would justify a lesser consideration by the underwriter of such matters as growth prospects and dividend policies. On the other hand, the fact that the investor's concern was limited on the issuer's ability to pay its bills in the immediate future enhanced the importance of determining the basic integrity of the issuer's financial statements. Although the underwriter cannot be a guarantor of the soundness of any issue, he may not give it his implied stamp of approval without having a reasonable basis for concluding that the issue is sound.

524 F.2d at 1071.

³⁴² See text accompanying note 88 *supra*.

³⁴³ SEC v. Goldman, Sachs & Co., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,556 (May 2, 1974).

and its corporate records so that the firm has reasonable grounds to believe that the issuer would have the ability to pay for its commercial paper as it matures. (2) So long as an issuer continues to sell its paper through Goldman, Sachs & Co., the dealer must secure from the issuer all reports filed with the Commission, or if the issuer is not a reporting company under the 1934 Act, any information that will enable the firm to evaluate the commercial paper of the issuer. (3) The firm must review all current information on each issuer so that it may conclude that it has no reason to believe that an issuer will be unable to redeem its commercial paper. (4) Goldman, Sachs & Co. must furnish (unless the purchaser advises otherwise) each purchaser with information which is consistent with that on which it based its conclusion as to the ability of the issuer to redeem its short-term notes.

CONCLUSION

Commercial paper enjoys the status of an exempt security under section 3(a)(3) of the 1933 Act. Had Congress not been convinced of the special values inherent in such debt instruments, as limited by the requirements of section 3(a)(3), it might have subjected commercial paper to the full registration requirements of the 1933 Act or exempted it only in certain transactions. But Congress was persuaded that commercial paper could be safely exempted since, under the terms of the exemptive provision, investors were guaranteed high quality securities that matured within a relatively short period of time. Furthermore, investors were assured that proceeds from the sale of commercial paper would be used to acquire assets that could, if necessary, be easily converted into cash to redeem the outstanding paper. Under these circumstances the exemption was consistent with the objectives of the 1933 Act.

Over the years the commercial paper exemption has worked well for both issuers and investors. Staff interpretations, however, have allowed the exemption to stray from some of the limitations imposed by Congress, especially with respect to the self-liquidating nature of the provision. The Commission should clarify its interpretation of the exemption with objective criteria and restrict the current transactions aspect of section 3(a)(3) to its original scope. A stricter interpretation of the exemption would probably force issuers of commercial paper to rely more heavily upon section 4(2). In this event the Commission should offer such issuers guidelines for invoking the section 4(2) exemption. A practical form of shelf registration would also aid issuers who could no longer rely on section 3(a)(3).

Despite its imperfections, section 3(a)(3) should be allowed to function as an exemption that depends on the self-policing forces of the commercial paper market as a substitute for disclosure requirements. If the exemption should fail to protect investors, Congress or the Commission could take steps to align section 3(a)(3) with the disclosure system of the 1933 Act.

APPENDIX

The regulation of short-term promissory notes and commercial paper under state blue sky laws is for the most part similar to that under the 1933 Act. All of the states except Connecticut, Florida, Nevada and New Hampshire exempt such securities from the registration requirements of their blue sky statutes. In one state, Maine, commercial paper is excluded from the definition of a "security." 1A BLUE SKY L. REP. ¶ 22,101 (1975). In the other jurisdictions, many of the exemptions are modeled after section 402(a)(10) of the Uniform Securities Act, 1 *id.* ¶ 4932, at 731, which exempts

any commercial paper which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which evidences an obligation to pay cash within nine months of the date of issuance, exclusive of days of grace, or any renewal of such paper which is likewise limited, or any guarantee of such paper or of any such renewal

Some state blue sky exemptions for commercial paper differ from the exemption in the Uniform Securities Act as to when the commercial paper must mature and how it can be offered.

Maturity Date: The following states exempt commercial paper that matures in a period less than or greater than the nine months required by section 3(a)(3) of the 1933 Act and section 402(a)(10) of the Uniform Securities Act: Indiana, 1A *id.* ¶ 17,102 [12 months]; Michigan, *id.* ¶ 25,314 [12 months]; Mississippi, *id.* ¶ 27,125 (as interpreted by Mississippi Sec'y of State, *id.* ¶ 27,603, at 23,516) [12 months]; New Jersey, 2 *id.* ¶ 33,104 [12 months]; North Dakota, *id.* ¶ 37,105 [12 months]; Rhode Island, 3 *id.* ¶ 42,107 [11 months]; South Dakota, *id.* ¶ 44,175 [6 months]; Tennessee, *id.* ¶ 45,119 [12 months]; Texas, *id.* ¶ 46,106 [24 months]; and West Virginia, *id.* ¶ 51,182 [12 months]. In Arizona, New York and Vermont, the maximum maturity time for exempt commercial paper turns on when it was sold and when issued: Arizona, 1A *id.* ¶ 6133 ["if the issue of such notes or paper matures in not more than twelve months from date of issue and is issued within three months after the date of sale . . .," *id.* at 2305-3]; New York, 2 *id.* ¶ 35,116 [same]; and Vermont, 3 *id.* ¶ 48,104 ["maturing within six months from the date of issue and issued within three months after date of sale," *id.* at 44,302].

Limitations on Manner of Offering. In the following states, the commercial paper exemption is limited either statutorily or administratively to securities that are not offered to the public: Georgia, 1A *id.* ¶ 14,128; Minnesota, *id.* ¶ 26,175; Missouri, 2 *id.* ¶ 28,164 (as interpreted by the Missouri Securities Commissioner, *id.* ¶ 28,609, at 24,536); Montana, *id.* ¶ 29,213 (exemption limited to sales to banks or insurance companies, *id.* at 25,413); North Dakota, *id.* ¶ 37,105; Ohio,

id. ¶ 38,102 (as interpreted by the Ohio Division of Securities, the exemption is restricted to sales to officers and directors only; commercial paper otherwise offered to existing security holders, employees and all other natural persons is deemed to be offered to the public, *id.* ¶ 38,614, at 34,502; *see also* interpretation at *id.* ¶ 38,753, at 34,531-32); Oklahoma, *id.* ¶ 39,151 (exemption limited to sales to certain institutions, *id.* at 35,319); Oregon, 3 *id.* ¶ 40,203; Washington, *id.* ¶ 50,132 (exemption limited to sales to banks or insurance companies, *id.* at 46,216); and Wisconsin, *id.* ¶ 52,212 (as interpreted by the Commissioner of Securities, *id.* ¶ 52,602, at 48,502, *id.* ¶ 52,730, at 48,561). In three states, the exemptive provision allows public offerings of commercial paper except where the paper is offered or sold to the public in units of less than \$5,000 to any one person. California, 1 *id.* ¶ 8131; Iowa, 1A *id.* ¶ 18,152; and Pennsylvania, 3 *id.* ¶ 41,112.

Other Restrictions. In the following states, the exemption for commercial paper carries certain restrictions not found in most state statutes: Mississippi, 1A *id.* ¶ 27,603 (the Mississippi Secretary of State has interpreted the exemption as available only to an issuer in operation for not less than 5 years having had a net profit in the preceding 2 years prior to the application for exemption, *id.* at 23,516); North Dakota, 2 *id.* ¶ 37,105 (the exemption is explicitly limited to commercial paper that is "not convertible into and does not carry an option or right to receive payment or any bonus in any other security," *id.* at 33,205); Pennsylvania, 3 *id.* ¶ 41,302 (the Pennsylvania Securities Commission has adopted special regulations for commercial paper issued by bank holding companies, *id.* at 37,404); and South Dakota, *id.* ¶ 44,175 (the exemption does not apply to "investment certificates or thrift notes sold or offered for sale to the public by loan or investment companies," *id.* at 40,316).

Relationship to Federal Exemption. Not surprisingly, some state securities administrators look to the administrative and judicial interpretations of section 3(a)(3) for guidance in construing the commercial paper exemption under state law. *See, e.g.,* Arkansas, 1 *id.* ¶ 7614, at 3539; Massachusetts, 1A *id.* ¶ 24,606, at 20,514; Michigan, *id.* ¶ 25,677, at 21,519; and Minnesota, *id.* ¶ 22,610, at 22,561-64.