Everything Old is New Again:

Commercial Paper Market and Regulatory Developments

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Agenda

- Commercial Paper
- Asset-backed Commercial Paper
- Commercial Paper Market Characteristics
- The Importance of Ratings
- Regulatory Developments
- Newly Established Conduits
- Appendix - ABCP

What is Commercial Paper?

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

Origins of Commercial Paper

- Pre-Civil War roots of commercial paper
- Started with merchants selling trade receivables to money market investors
- Transitioned to banks as the primary investors and then to corporates selling short-term securities to fund receivables
- Commercial paper came to be used for working capital: inventory, wages, receivables, operating expenses, etc.
- In 1933 Congress found commercial paper to be an oddity in the effort to regulate securities offerings; Treasury pushed for an exemption
- The result was Section 3(a)(3) of the Securities Act of 1933

Section 3(a)(3) – A Narrow Exemption

- If commercial paper was going to receive special treatment, it had to be defined narrowly:
  - SEC. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

    . . . . .

    (3) Any note, draft, bill of exchange, or banker's acceptance which arises out of a <u>current transaction</u> or the proceeds of which have been or are to be used for <u>current transactions</u>, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited;
- The SEC has issued numerous no action letters related to the interpretation of "current transaction"
- Most noteworthy, commercial paper cannot be used for capital transaction, including acquisitions

SEC Seminal Release

- In 1961, the SEC stated in Rel. 33-4412(emphasis added):
  - The legislative history of the Securities Act makes clear that Section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks.
  - [T]he staff of the Commission has interpreted Section 3(a)(3) to exclude as not satisfying the nine-month maturity standard, obligations payable on demand or having provisions for automatic "roll-over"

Section 3(a)(3) Requirements

- The SEC imposed six separate characteristics as necessary for qualifying for Section 3(a)(3):

  1. Negotiable
  2. Prime quality
  3. Eligible for discount at Federal Reserve banks
  4. Not ordinarily purchased by the general public
  5. Used to facilitate "current transactions"
  6. Maturity of nine months or less with no automatic roll-over

Section 4(a)(2) Commercial Paper

- Partly as a result of the restriction on the use of 3(a)(3) commercial paper to fund acquisitions, corporates began issuing short-term notes under Section 4(a)(2) to fund acquisitions
- Also 4(a)(2) commercial paper was not subject to the nine-month limitation of 3(a)(3) commercial paper
- For a while, 4(a)(2) commercial paper pricing suffered from being a restricted security. By the 1990's this difference had largely disappeared

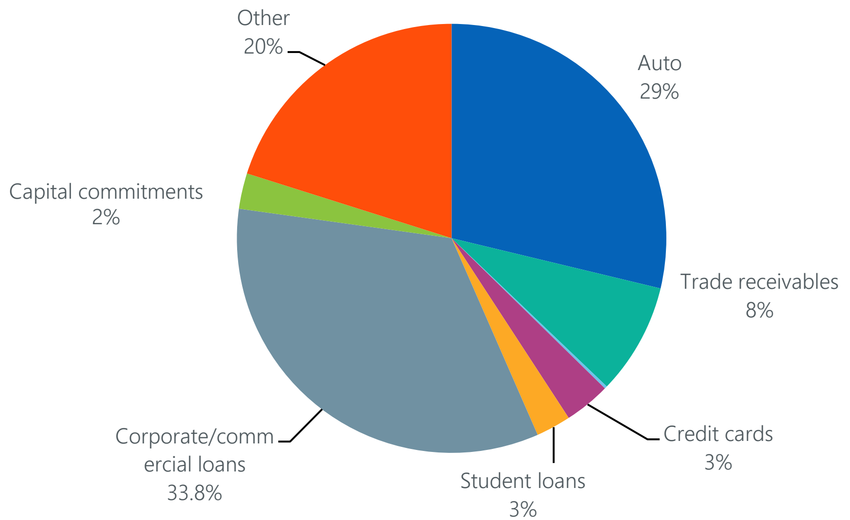
ABCP

- The development of securitization in the 1980s did not by-pass commercial paper
- Merrill Lynch developed receivables conduits, which would buy receivables from corporates funded by commercial paper issuance by the conduit. This provided many corporates with capital markets access and cheaper funding than available through bank loans
- In a defensive response, banks started their own competing conduits
- The success of the conduit structure led to funding other asset types, including mortgages, portfolio securities, ABS and short-term loans

ABCP

- A structured commercial paper conduit is a bankruptcy remote limited-purpose finance company that issues commercial paper to finance the purchase of assets;
- Asset types include receivables generated from trade, credit cards, auto loan/leases, equipment leases, and others;
- Programs are typically established and administered by commercial banks to provide flexible and competitive low cost financing to their customers;
- Unlike term securitizations, these programs are ongoing entities and do not wind down after a few years;
- Typically maturing CP is paid down with the proceeds of newly issued CP;
- The proceeds of collections from matured receivables are reinvested in newly generated receivables (assuming revolving period).

Fitch US Multi-Seller Asset Distribution



Source: Fitch Ratings

ABCP

Types of ABCP

- **Multi-seller ABCP:** Sponsor is generally a financial institution seeking to provide financing alternatives to its clients who are the sellers into the conduit. The multi-seller structure provides the flexibility to the conduit to purchase a variety of assets from many different sellers.

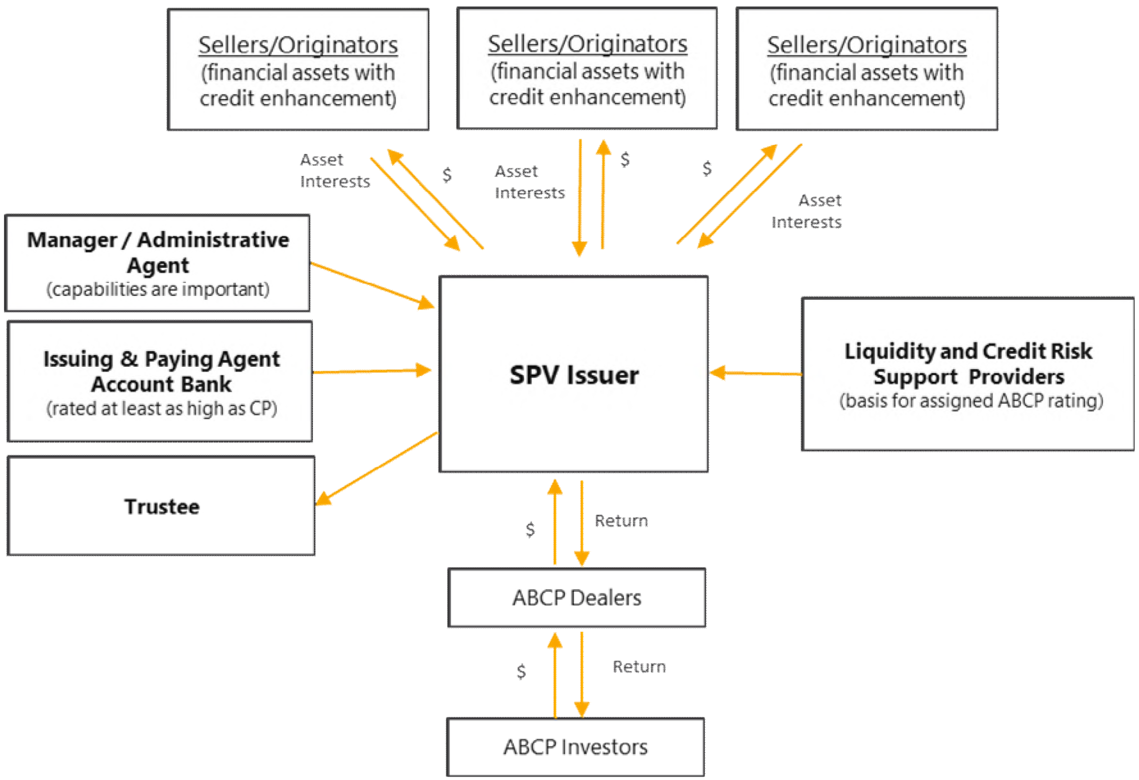
- **Single-seller ABCP:** Sponsor is typically the sole originator of assets financed through the program, principally as an alternative source of funding for its own business activities.

- **Match Funded Programs:** Structured with agreement(s) that have contractual obligations requiring the counterparty selling the assets to make payments in time to pay maturing CP.

- **Fully-supported Program:** A program is fully-supported when investors are insulated from asset performance and rely on a third party to ensure timely repayment of CP.

- **Partially-supported Program:** The rating of partially-supported programs depends on a joint analysis of the quality of the assets, the purpose of the program, the credit quality of the support providers and support agreement.

Structure



Source: Fitch Ratings

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Commercial Paper Market Characteristics

- Continuously offered
- Same day settlement
- Not purchased by the public
- Not SEC registered
- $200,000 minimum denominations
- 3(a)(3) offering is a public offering
- New issuance proceeds typically pay off maturing notes
- 80% to 90% issued with maturity < 10 days
- No involvement of counsel in daily issuances

Commercial Paper Market Characteristics *(cont.)*

- Capacity – measured by total outstanding, not total issuance
- Single master note – IPA tracks issuance/outstanding on its records
  - Dealer informs IPA of issuance daily - no issuer authentication
- A new CUSIP each day for each maturity/coupon/feature combination
- No tax opinion (generally)
- No 10b-5 letter
- Spare disclosure for corporate commercial paper
- Commercial paper desk – how does it work?
- Dealer as initial investor – no marketing period

Issuance Volumes

- Prior to the 2008 financial crisis, the combined CP and ABCP market exceeded $2 trillion outstanding. ABCP accounted for slightly more than half of this issuance.
- A number of CP and ABCP conduits perished in the crisis, with outstanding volumes shrinking to about $1 trillion.
- In the crisis, the Fed introduced emergency funding for the commercial paper market with the establishment of the Commercial Paper Funding Facility. The CPFF was resurrected again in the early days of the pandemic.
- Recently the market has grown to about $1.3 trillion as the ABCP market has recovered to about 20% of outstandings.
- Financial institutions account for about 60% of overall issuance.

Tenors

- Historically, almost 90% of all commercial paper was issued with maturities of 21 days or under
- With the match funding of asset maturities by ACBP conduits, longer maturities became more common
- Additionally, LCR considerations for banks have led to commercial paper with longer maturities
- The commercial paper market has also developed redeemable, extendible and puttable commercial paper, which has led to longer maturities. Banks in particular favor longer tenor, redeemable commercial paper for LCR reasons

CP Outstanding

Billions of dollars

Period	Total	Nonfinancial			Financial			Asset-backed	Other
		Total	Domestic	Foreign	Total	Domestic	Foreign		
Nov. 16	1,223.3	282.5	220.6	61.9	657.7	245.7	412.0	282.7	.4
Nov. 23	1,234.9	288.2	223.1	65.1	665.0	245.2	419.9	281.3	.4

Issuance Volumes and Tenors

Millions of dollars

Period	Amount 1								Number of issues						
	Total	Days to maturity							Total	Days to maturity					
		1 - 4 days	5 - 9 days	10 - 20 days	21 - 40 days	41 - 80 days	81+ days			1 - 4 days	5 - 9 days	10 - 20 days	21 - 40 days	41 - 80 days	81+ days
Nov. 22	119,578	73,987	22,101	3,604	4,578	2,668	12,641		4,828	2,539	955	291	262	208	573
Nov. 23	111,333	42,655	51,385	2,765	3,748	2,455	8,325		4,296	1,266	1,979	186	155	202	508

Tenors for Types of Issuers

AA asset-backed

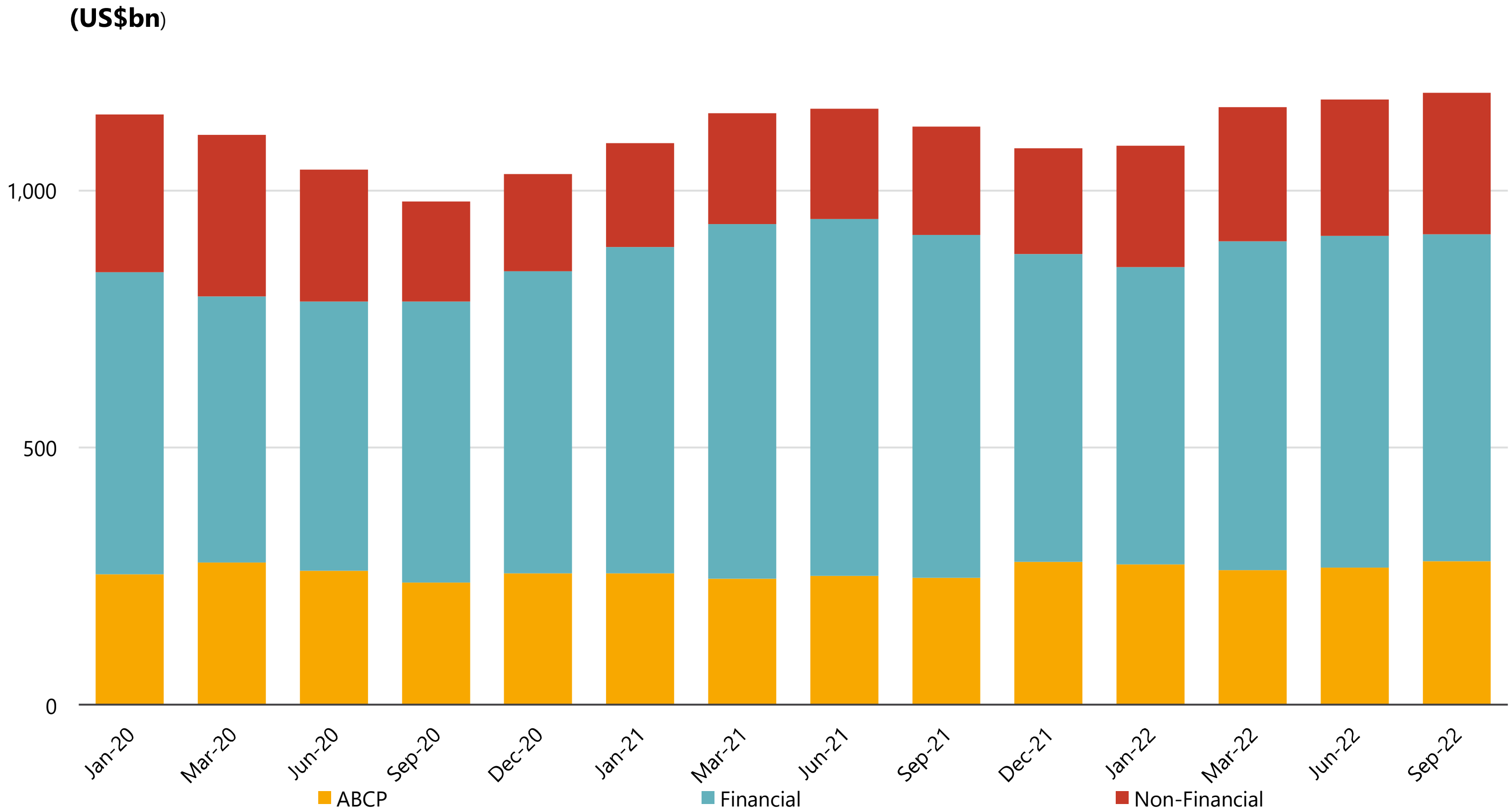
Period	Amount 1								Number of issues						
	Total	Days to maturity							Total	Days to maturity					
		1 - 4 days	5 - 9 days	10 - 20 days	21 - 40 days	41 - 80 days	81+ days			1 - 4 days	5 - 9 days	10 - 20 days	21 - 40 days	41 - 80 days	81+ days
Nov. 22	15,478	8,951	3,462	614	824	489	1,139		455	280	84	20	22	14	35
Nov. 23	17,385	2,410	11,928	316	714	494	1,522		543	88	343	11	16	25	60

AA Financial

Period	Amount 1								Number of issues						
	Total	Days to maturity							Total	Days to maturity					
		1 - 4 days	5 - 9 days	10 - 20 days	21 - 40 days	41 - 80 days	81+ days			1 - 4 days	5 - 9 days	10 - 20 days	21 - 40 days	41 - 80 days	81+ days
Nov. 22	6,779	6,024	600	125	0	0	30		167	143	17	6	0	0	1
Nov. 23	6,688	4,755	1,683	0	250	0	0		175	113	56	0	6	0	0

US Commercial Paper Market Update

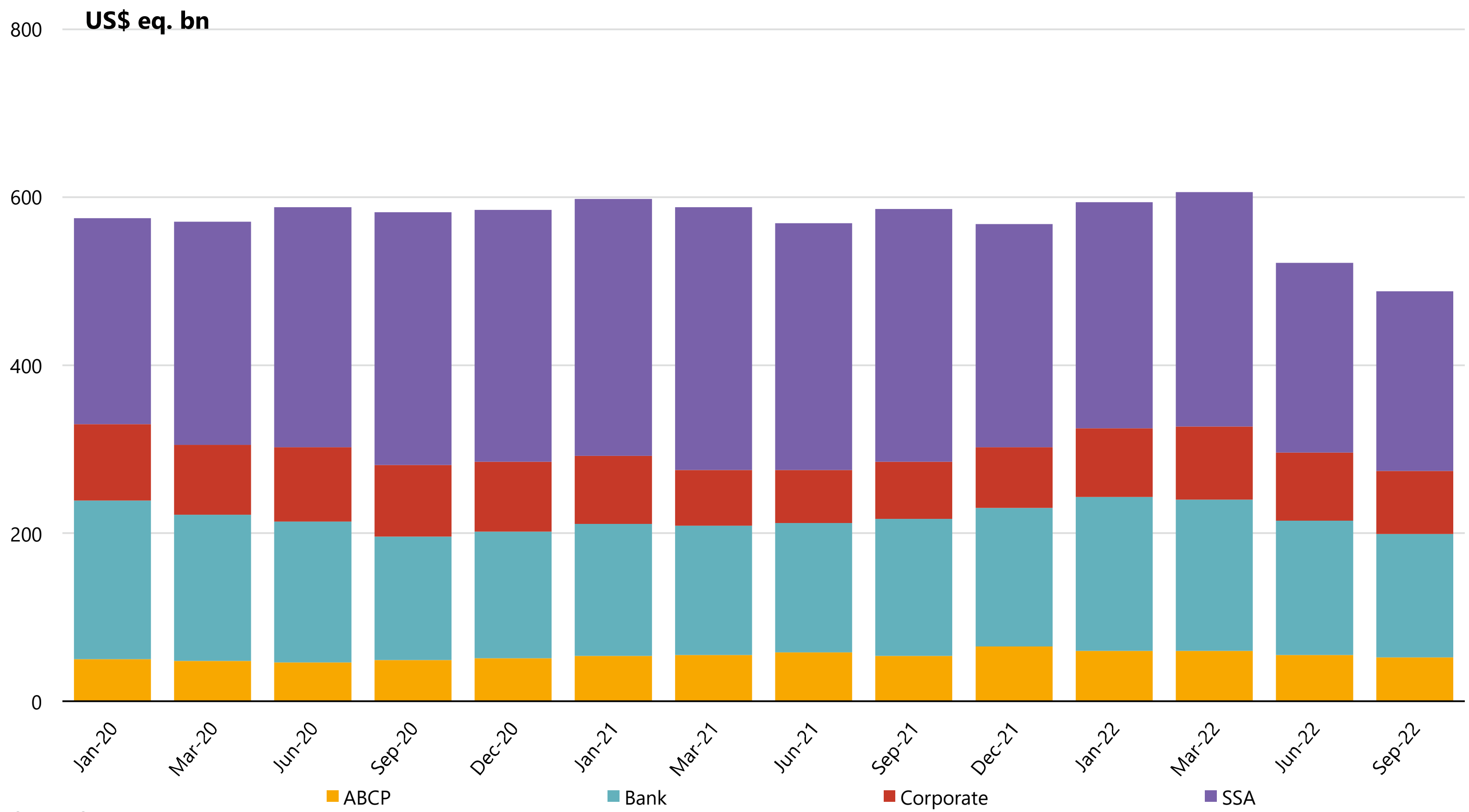
USCP Outstandings by Type



Source: Federal Reserve.

Euro Commercial Paper Market Update

ECP Outstandings by Sector



Source: CMD.

Commercial Paper Investors

- Corporate treasuries
- Municipalities
- Short-term bond funds
- Banks
- Money market funds
  - Prior to the 2008 financial crisis, money market funds purchased almost half of all commercial paper
  - In response to the pressures on MMFs in the crisis, the SEC adopted rule changes in 2014 (effective in October 2016) that have sharply reduced MMF purchases – today, e.g., about 15% of ABCP funding [*see* Release No. 33-9616]

Current Market Characteristics

- Current rate volatility – Fed inflation response
  - Fed increase in interest rates
  - Reduced tenors
  - Tension with end of year funding
- Discount, fixed rate, and floating rate commercial paper
- Puttable/callable/extendible commercial paper
- Foreign : domestic issuers
- Funding strategies

Importance of Ratings

- A-1/P-1/F-1 mostly essential
- The market for tier 2 paper is more difficult
- Liquidity is an important consideration in ratings
- The rating process
- Recent changes to rating criteria

Primacy of Liquidity

- Particularly for ABCP programs, but also for corporate issuers, available liquidity is a key rating factor
- Unlike term debt, there are no grace periods for commercial paper
- Accordingly, a commercial paper issuer must have access to same-day funds on very short notice; this is generally provided by bank lines of credit
- In the event an issuer is unable to issue commercial paper due to a market disruption, maturing commercial paper can still be paid timely through draws on liquidity

Regulatory Developments

- Money Market Fund proposed rules -swing pricing
  - 2016 reforms seen as not effective in the pandemic
  - Proposal would remove 2016 redemption gates and liquidity fees\
    See Rel. No. IC-34441 (Dec. 15, 2021)
  - Institute swing pricing
  - Increase minimum daily and weekly liquidity requirements
    - From 10% and 30% of <u>total assets</u> to 25% and 50% must be liquid assets
    - Increased need for short-term assets
  - Fed wants more conduit funding diversity
  - Short-duration ETFs and private funds as an alternative

Regulatory Developments *(cont.)*

- Regulatory capital – Liquidity Coverage Ratio (LCR)
  - Banks need HQLA against <30-day maturities
    - Increased need for longer-term liabilities for bank issuers
    - Will call liabilities before <30day to maturity
- Volcker Rule
  - Banks can't buy certain ABCP
    - Reliance on Section 3(c)(1) or 3(c)(7) under the Investment Company Act
- Accounting consolidation
  - Harder to obtain off balance sheet structures
  - Reduced incentive to securitize
- Jobs Act changes to 4(a)(2) offers
  - Bad actor rule reduces Reg D issuance

Regulatory Developments *(cont.)*

- Rule 15c2-11
  - New staff no action letter (Nov. 30, 2022)
  - SEC staff position introduces significant uncertainty
  - Greater uncertainty for short-term notes
  - Expect a decrease in:
    - Issuance
    - Investor interest
    - Liquidity
    - B-D revenue
  - And difficulties for:
    - Compliance
    - Auditing

Newly Established Conduits

- Repo conduits
- CCP conduits
- Risk protection provider
- TRS provider

Additional Resources

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APPENDIX

Types of ABCP Programs

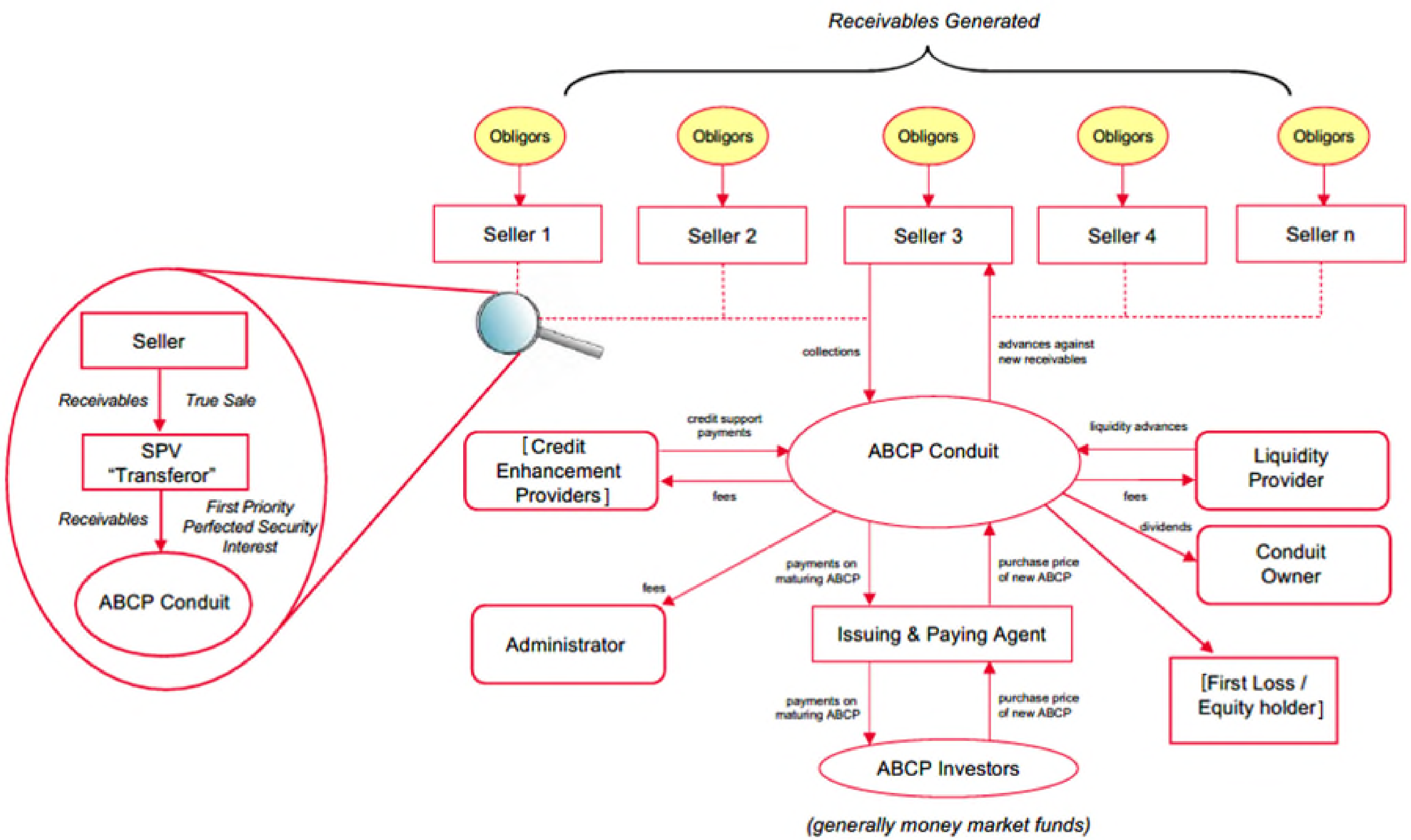
Types of ABCP Programs

- ABCP Program Structures employed today include the following:
    - Bank sponsored Multi-Seller
    - Aggregator sponsored Multi-Seller
    - Bank sponsored CCP/Repo
    - Aggregator sponsored CCP/Repo
    - Single Seller/Market Value Programs no longer exist as such.
    - Securities Arbitrage (including SIVs) no longer exist as such.

Types of ABCP Programs: Bank Sponsored Multi-Seller Programs

- A Multi-Seller ABCP Conduit is a limited purpose, bankruptcy-remote SPV that provides financing for receivables pools generated by multiple, unaffiliated originators/sellers.
- Multi-seller programs are most commonly established and “sponsored” by large commercial banks and typically provide financing to that bank’s corporate clients.
- These banks typically serve as Program Administrator or Administrative Agent for the Conduit, and commonly provide liquidity and credit support as well.
- Multi-seller Conduits are typically structured to:
  - Make loans against or purchase interests in receivables pools
  - “Warehouse” assets prior to a term ABS take-out, and/or
  - Purchase securities
- ABCP issued from a large multi-seller vehicle is typically perceived as low risk for investors due to
  - Originator diversification
  - Asset diversification and Deal-Specific Credit Enhancement
  - Program-Wide Credit Enhancement and 100% Liquidity Support
  - Bank Sponsorship

Types of ABCP Programs: Multi-Seller Schematic



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Types of ABCP Programs: Aggregator Sponsored Multi-Seller Programs

- These programs serve the same function as bank sponsored multi-seller programs.
- An aggregator entity (Guggenheim, Nearwater, Mountcliff, Paramax) receives small, but high volume, fees by providing CP access to funding for bank customer transactions fully backed by bank liquidity and credit support.
- Can have some off-balance sheet benefits for banks depending on bank's regulatory regime (RW capital, LCR, NSFR).
- Banks can be at mercy of liquidity shortage to aggregator.

Types of ABCP Programs: Bank Sponsored CCP/Repo Programs

- A Bank sponsored CCP (or repo) program can involve CP issued directly by the bank or through a limited purpose, bankruptcy-remote SPV.
- Typically designed as an alternative funding source for bank securities and/or loans.
- In addition to other legal issues that impact these programs, Reg U and Reg T issues are implicated.

Types of ABCP Programs: Aggregator Sponsored CCP/Repo Programs

- These programs function similarly to aggregator sponsored Multi-Seller Programs but typically fund securities books of banks/broker dealers, as opposed to customer transactions.

Considerations for Setting up an ABCP Conduit

ABCP program - General considerations

A. Location of CP issuance

- USCP
- ECP
- other
- currencies

B. Types of customer transactions

- typical private securitizations (trade, warehouses, etc.)
- subscription facilities
- repos
- other
- currencies

ABCP program - General considerations (cont'd)

C. Full support vs. partial support

D. CP tenor

   - all short term
   - longer term
   - extendible, puttable, callable

E. On balance sheet vs. off balance sheet

F. Wholly owned vs. third party owned

G. Identity of dealers

H. Identity of depositary, issuing and paying agent

I. Identity of collateral trustee, if applicable

J. Identity of rating agencies

K. Location of conduit issuer and desirability of US co-issuer

ABCP program – Legal considerations

A. US Investment Company Act exemption
B. US and other securities law exemptions
C. Volcker Rule “covered fund” analysis
D. US and EU risk retention compliance
E. Rating agency regulation, including US rule 17g-5 website
F. Tax domicile and related issues
G. Money market fund investor issues and 2a-7
H. US intermediate holding company (IHC) considerations

US Investment Company Act

- Prior to Volcker, most programs relied on 3(c)(1) or, more rarely, 3(c)(7)
- Bank programs now typically rely on 3a-7 or, more rarely, 3(c)(5) or, if ABCP Safe Harbor available for Volcker, 3(c)(1)
- Aggregator programs may still rely on 3(c)(1) / 3(c)(7)

US Securities Law Exemptions

- For Multi-Seller programs, generally 4(a)(2), although some may still rely on 3(a)(3)

- CCP/Repo programs may want both 4(a)(2) / 3(a)(3) in order to manage margin regulations

- Reg S can be difficult for US CP issuers

Volcker Rule Analysis

- Bank programs <u>must meet</u> an exemption at conduit <u>and</u> customer transaction level
- ➢ Conduit
  - ➔ 3a-7 exempt
  - ➔ 3(c)(5) exempt
  - ➔ Some conduits may satisfy ABCP safe harbor
- ➢ Underlying Deals
  - ➔ Also may satisfy 3a-7 or 3(c)(5)
  - ➔ SOTUS may be an option for non-US banks and non-US deals
  - ➔ LSE may be available
  - ➔ No ownership interest
- Aggregator Programs may use covered funds and rely on no ownership interest

US risk retention rules – options for ABCP conduits

- Standard risk retention options
  - Eligible vertical interest (EVI) – 5% of each class or single pro rata interest
  - Eligible horizontal interest residual interest (EHRI) – subordinated claim to principal and interest – 5% of fair value
  - Eligible horizontal reserve account (EHRA)
  - Any combination of above
  - Sponsor could buy 5% of conduit's ABCP, or
    provide 5% funded programme credit enhancement
  - EU bank sponsors comply through unfunded credit enhancement

- Specialised ABCP option for "eligible ABCP conduit"
  - Each ABCP interest acquired from an intermediate SPV, underwriter or initial purchaser at **initial issuance**
  - Each originator-seller retains via standard risk retention option or revolving pool securitisation option (Note: required even if transaction not otherwise required to comply)
  - 100% full support liquidity facility from regulated liquidity provider
  - Retention by sponsor via full support liquidity (unfunded) and by each originator-seller

- Safe harbour for "foreign" transactions
  - Securities Act registration not required
  - Not more than 10% of all issued ABS interests sold to US persons (defined more widely than in Reg S)
  - Neither sponsor nor issuer is US entity or branch
  - Not more than 25% of assets acquired from affiliate or branch in US

- Some aggregator conduits do not comply at all – no sponsor or no ABS

EU Money Market Funds Regulation – eligible ABCP

- ABCP is eligible if (liquid and good credit quality and) "issued by an ABCP programme which:
  1. is ***fully supported*** by a regulated credit institution that covers all liquidity, credit and material dilution risks as well as ongoing transaction costs and ongoing programme wide costs related to this commercial paper if necessary to guarantee towards the investor the full payment of any amount under the asset back commercial paper;
  2. is ***not a re-securitisation*** and the exposures underlying the securitisation at the level of each ABCP transaction do not include any securitisation position;
  3. does ***not include synthetic securitisations*** as defined by [Art. 242(11) CRR]."
- Maturity limits for eligible ABCP:
  - Short term MMF: residual maturity or legal maturity at issuance is 397 days or less;
  - Standard MMF : legal maturity at issuance or residual maturity is 2 years or less and time remaining until next interest rate reset date is 397 days or less
  - (No limit on maturity of underlying assets, though earlier proposed)
- Future change: a consultation has opened where the EU is taking information as to how well this regulation is functioning, no concrete proposals as of yet.

US Rule 2a-7 Issues

- Money market funds are important ABCP investors
- 2a-7 disclosure is a non-starter
- Multi-purpose strategies include:
  - Using RSPEs
  - Splitting among multiple conduits
  - Move to a "non-2a-7" conduit
  - Substitute bank as primary obligor
  - Particular issues during ramp up

IHC Considerations

- Are non-bank owned conduits affiliates of bank for IHC purposes?
  - ➔ recent changes presume yes if consolidated
  - ➔ <u>but</u> no need to move under IHC

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