Bank Financing Programs: Commercial Paper and Certificate of Deposit Programs

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CDs: Topics to Be Covered

- Types of Programs
- Features of Brokered CDs
- Federal Securities Law Issues
- FDIC Insurance
- Truth in Savings Act Issues
- FINRA Issues
- Use of Third Party Dealers
- Documentation
Types of CDs

• Can be “plain vanilla”.
  • Fixed rate, floating rate.
  • Akin to a traditional CD, but held through brokerage account.

• Can be structured CDs, linked to an underlying asset.

• Can be “lightly structured”.
  • Needless to say, not a legal term.
  • Fixed to floating rate CDs, step up callables, CMS-linked.
  • May have an “embedded derivative.”
Structured CDs - Features

- Can link to assets that are similar to those of registered notes: indices, ETFs, single stocks, currencies, interest rates.
- Technically, possible to link to a broader range of assets, since the SEC’s “Morgan Stanley” letter doesn’t apply.
  - Small cap stocks.
  - Non-U.S. stocks that are not registered in the U.S.
  - Credit-linked instruments.
  - BUT – investor suitability needs to be considered, and issuances of this kind aren’t frequent, especially in the case of retail investors.
- Interest bearing or non-interest bearing.
- Fixed, floating or indexed interest payments.
- Callable vs. non-callable.
- Participation rate – greater than, equal to, or less than, any increase in the underlying asset.
Structured CDs – Features (con’t)

• Survivor’s Option: upon death (or incompetency) of investor, estate can obtain deposit amount prior to maturity.
  • Feature is associated with some, but not all, structured notes.
  • Typically subject to aggregate limits in the course of a year.
• Key difference from structured notes: may not pay less than principal at maturity. Otherwise, the FDIC would take the position that they are not “deposits”, and not subject to FDIC insurance.
  • But: may sell for less than principal if sold prior to maturity.
  • That is, “principal protection” applies only at maturity.
Limitations on Brokered Deposits

• Brokered deposits are considered by some to be a risky banking tool.
  • Less likely to be rolled over at maturity, since another bank may offer better rates.
  • Not as much “brand loyalty.”
• FDIC 337.6 (Under Section 29 of the Federal Deposit Insurance Act): restricts use of brokered deposits and limits rates paid on interest-bearing deposits that are solicited by insured institutions that are less than “well-capitalized”.
• If less than well-capitalized, issuer must seek a waiver to accept new brokered deposits.
  • FDIC will consider traditional safety and soundness concerns in determining whether to grant a waiver.
• The rates on these CDs cannot “significantly exceed” the prevailing rates in the applicable market area.
Securities Law Issues

- “Certificates of deposit” are included in the 1933 Act’s definition of a “security.”
- However, under relevant case law, FDIC insured CDs are typically not treated as a “security”.
  - Guaranteed payment of principal.
  - Other regulatory protections provided to holders under applicable banking laws.
  - Similar concept of exemption from OCC registration for national banks.
- When is a certificate of deposit a security?
  - See “Gary Plastics”, a 1985 Second Circuit decision.
  - Bad facts:
    - Broker marketed CDs that it had obtained from other banks.
    - Broker promised to maintain a secondary market to guarantee liquidity.
    - Broker represented to investors that it had reviewed the financial soundness of the issuing banks.
  - Today’s structured CD offering documents are drafted with these concerns in mind.
FDIC Insurance

- Current limit is $250,000
- Application may vary, depending upon type of investment account.
  - Guidance is available to the public on the FDIC’s website.
- Not all payments are guaranteed:
  - Principal and guaranteed interest payments are covered.
  - The FDIC has taken the position that contingent payments at maturity, and any indexed interest payments, are not insured until determined.
    - Impact: if bank fails before a “determination date,” that payment will not be covered by FDIC insurance.
  - FDIC insurance will not cover any amount paid in excess of principal, such as the payment of a premium in a secondary market transaction.
    - e.g., investor pays $1,001 for a CD with a face amount of $1,000. That additional dollar is not insured.
Truth in Savings Act

- Federal Reserve Regulation DD implements the Truth-in-Savings Act.
- Provisions are applicable to the issuing banks, as well as to deposit brokers.
- Banks may not advertise deposits in any way that is inaccurate or misleading, and the regulation provides examples.
- Required disclosures of “annual percentage yield,” “penalty fees” that may be imposed for early withdrawals, and any other fees.
- In addition, the Federal Trade Commission Act prohibits unfair or deceptive acts or practices.
  - Applies to all aspects of a depository institution's consumer products and services, including advertisements.
Because structured CDs are (usually) not “securities,” a variety of FINRA rules do not technically apply.
  - e.g., corporate financing rule, suitability.
  - However, most broker-dealers apply a comparable degree of compliance procedures to these instruments as they do in the case of securities.

Key areas of FINRA regulation implicated by structured CDs:
  - Retail communications – accuracy and completeness.
    - FINRA has made substantive comments to broker-dealer marketing materials for these instruments.
  - Training.
  - New product approvals.
Third Party Distribution and KYD

- Many structured CDs are distributed through third party brokers.
- Often subject to a dealer agreement between (a) the dealer that is in privity with the issuer and (b) downstream distributors.
  - A separate form of agreement is typically needed that differs from the type used for securities.
    - Different regulatory regime.
    - FDIC record-keeping requirements.
- Market-wide concern that “bad acts” by downstream distributor could result in liability or reputational risk for issuer or primary distributor.
  - Agreements are filled with negotiated representations and warranties, covenants and indemnification, usually for the benefit of the primary distributor.
  - To date, FINRA’s proceedings with respect to structured products have generally imposed liability on the responsible entity.
- FINRA’s 2013 Report re Conflicts of Interest
  - Recommends know-your-dealer diligence procedures.
Disclosure Documents for CDs

• No specific form requirements. (In contrast, registered securities are subject to the form requirements of S-3/F-3 and Regulation S-K.)
• Truth-in-Savings Act, FINRA communication rules, and “best practices” require full and accurate disclosure.
• Often quite similar to the offering documents for registered notes – similar set of brokers, similar set of investors.
• Estimated Value Disclosures:
  • CDs are not subject to the 2012 SEC “sweep letter.”
  • However, many regard it as a good disclosure, any many distributors request its disclosure.
Additional Documentation for CD Programs

- Program or similar agreement with lead dealers.
  - Similar in some respects to agreements used for registered notes, but tailored for the bank regulatory structure.
- If applicable, paying agency agreement with third party paying agent.
- Forms of master certificates representing the issuances.
- Agreements with hedging counterparties.
Commercial Paper
What Is Commercial Paper?

- Commercial paper is a term that tends to be used to refer to corporate short-term debt securities. Typically maturities are 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.
The legislative history of the Securities Act of 1933 provides an explanation of the genesis of Section 3(a)(3).

Commercial paper was issued by merchants and manufacturers for short-term financing of operations and was sold primarily to banks through commercial paper dealers.

There was a concern that if short-term paper that arises out of or finances current transactions and rarely bought by private investors were required to be registered, it would radically interfere with commercial banking transactions.

The original Federal Reserve Act included commercial paper as an investment rediscountable by Federal Reserve banks.

In 1933, the Federal Reserve requested an exemption for commercial paper and provided the language that became Section 3(a)(3).
Section 3(a)(3) Requirements

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

[T]he staff of the Commission has interpreted Section 3(a)(3) to exclude as not satisfying the nine-month maturity standard, obligations payable on demand or having provisions for automatic “roll-over.”
The SEC imposed six separate characteristics as necessary for qualifying for Section 3(a)(3):

- Negotiable
- Prime quality
- Eligible for discount at Federal Reserve banks
- Not ordinarily purchased by the general public
- Used to facilitate current transactions
- Maturity of nine months or less with no automatic roll-over.
‘Current Transactions’

- Through a long series of no-action letters, the staff has defined current transaction for various types of businesses.
- Traditionally, it was necessary to trace the use of proceeds to identifiable current transactions.
- Today, following a 1986 staff response, it is only necessary to demonstrate that current transactions on the balance sheet exceed the amount of commercial paper outstanding at any time.
- Inventories and accounts receivable have long been accepted. Also operating expenses, such as salaries, short-term lending, federal, state and local taxes, and various types of bank loans with maturities not exceeding five years, have been accepted.
- However, acquisition financing is NOT considered a current transaction.
Section 3(a)(3) as Public Offering

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

- Commercial paper is issued in continuously offered programs.
- Typical maturities are in the range of 7 to 21 days
  - See FRB H.15 releases and the Commercial Paper releases for maturity distributions and other statistics.
- Proceeds of commercial paper are often used to pay off maturing commercial paper.
- In the days before shelf registration, it would have been impossible to issue this frequently if registration were required.
- And even today, the registration costs would be prohibitive considering the high frequency of issuance.
Book-entry Considerations

- Since 1990, virtually all commercial paper is issued in book-entry form through DTC or other clearing entities.
- The issuing and paying agent (or depositary bank) holds a master note for the benefit of DTC and records on its records daily issuance and redemptions.
- There is generally no involvement of counsel in daily issuance.
- Companies issue commercial paper by direct calls to a dealer’s commercial paper desk.
- Upon agreement on terms, dealers will buy the entire daily issuance and resell to investors.
Nowadays, commercial paper may also be issued under Section 4(a)(2) of the Securities Act as a private placement of securities.

Historically, the 3(a)(3) market was larger and deeper than the 4(a)(2) market because privately placed securities are restricted securities.

Today the two markets provide about the same liquidity.

The advantage of Section 4(a)(2) is that the section does not have any maturity limitations, so longer dated paper can be issued, and there is no restriction on use of proceeds.

Most privately placed commercial paper is issued in Rule 144A programs, although some programs still issue to institutional accredited investors.
4(a)(2) Requirements

• Historically, private placements were conducted under old Section 4(2) with resales to a limited number of investors under the so-called Section 4(1½) exemption. This sharply limited the size of the market.

• Today, between Regulation D and Rule 144A, the private placement market is approaching the public securities market in size.

• Until the recent enactment of the JOBS Act, the prohibition on general solicitations in Rule 502(c) applied to commercial paper issued under Section 4(a)(2).
  • Occasionally, issuers would trip over this limitation and have to stay out of the market for 30 to 60 days.
JOBS Act Changes to 4(a)(2) Offers

- Title II of the Jumpstart Our Business Startups (JOBS) Act of 2012 directed the SEC to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 of Regulation D and under Rule 144A.
- Under the SEC rulemaking, new paragraph (c) was added to Rule 506 to permit general solicitations under certain circumstances.
- Incidentally, this rulemaking now permits general solicitation in an offering even though the issuer is relying on Section 3(c)(1) or 3(c)(7) of the Investment Company Act, which prohibits a public offering.
- Thus, a Rule 144A program no longer risks being out of the market for 30 to 60 days as a result of an inadvertent publicity problem.
Use of Proceeds of 4(a)(2) Paper

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

• 4(a)(2) commercial paper is still a “restricted security.”
• Some investors have limits on the amount that they can invest in restricted securities.
• This might have some impact in the secondary market, but generally the secondary market is a dealer market, i.e., most sales in the secondary market are back to dealers who may hold or may resell the paper to other customers.
Conversion of 3(a)(3) to 4(a)(2)

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

• Some issuers still operate side-by-side 3(a)(3) and 4(a)(2) programs.
• Historically, there had to be careful segregation of proceeds and use of proceeds, and perhaps different maturities to deal with the integration issue.
• Today, after the JOBS Act, the integration concern from general solicitation is removed but also perhaps there is no longer a reason to operate two programs.
Starting in the 1980s, asset-backed commercial paper programs become common.

Under accounting rules at the time, the sponsor of the program could operate the program off-balance sheet, so no capital was required to be held against the assets.

Numerous ABCP programs foundered during the financial crisis and today they are much less common; ABCP volumes have declined from a high of about $1.2T to around $300B today.

Revised accounting rules and other regulatory developments have made it increasingly difficult to maintain these programs off-balance sheet, so much of the reason for their separate existence is gone.

They are still used, however, for trade receivables financing and other short-term, maturity-matched lending situations.
1940 Act Considerations

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

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

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

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

- No Section 11 liability for issuers either under 3(a)(3) or 4(a)(2) programs.
- After Gustafson v. Alloyd, there is not Section 12(a)(2) liability for privately placed commercial paper.
- Securities Act Section 17 will support SEC actions, but not investor actions.
- Sections 12(a)(2) and 17 apply to 3(a)(3) commercial paper notwithstanding the exemption provided by Section 3(a)(3).
- For investors, Rule 10b-5 provides principal remedy against both dealers and issuers.
  - Consider the exclusion from the definition of a “security” in Section 3(a)(10) of the Securities Exchange Act for “any note which has a maturity at the time of issuance of not exceeding nine months,” which appears to exclude 3(a)(3) commercial paper. However, notes which fail the ‘prime quality’ standard have been held to fall outside this exclusion.
Securities Law Liability (cont)

• After the SEC’s enforcement proceeding settlement against Goldman Sachs in the 1974 arising out of the *Penn Central* bankruptcy and commercial paper default, many dealers have assumed that they will be unable to avoid liability for any defaulted commercial paper.

• The SEC stated that Goldman had failed to conduct a reasonable investigation of Penn Central and had implicitly represented to its customers that the issuer was creditworthy.
Due Diligence Defense

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