# Chapter 17

# COMMERCIAL PAPER

## INTRODUCTION

Commercial paper sits at the intersection of two questions: (i) Is virtue its own reward? And (ii) Wouldn't it be great if companies could bypass banks and raise working capital directly without SEC interference? For large, companies with strong balance sheets and cash flows, virtue is rewarded in the form of access to a specialized form of financing called commercial paper.

One of the most important features of commercial paper is that neither state nor federal registration is required. Companies that want to issue it, simply can. Another important feature of commercial paper is that its cost is lower than practically any other form of financing.

This chapter will define what qualifies as commercial paper; the statutory basis for its exemption from regulation; the mechanics of issuing commercial paper; problems and drawbacks with commercial paper; strategies for using commercial paper; the risk reward profile of commercial paper; and provide an analysis of commercial paper rates as compared other credit rates.

## SECURITIES REGULATION AND THE DEFINATION OF COMMERCIAL PAPER

Under the Securities Act of 1933, section 3(a) (3) debt instruments are exempt from registration if they mature in less than 9 months and are used for working capital. Such instruments are not securities within the meaning of the Securities and Exchange Act of 1934, section 3(a) (10) and are therefore exempt from regulation under this act as well.[1] The whole concept of commercial paper is therefore built on exemptions to these two major pieces of federal securities legislation. Trade practice and custom has built on this foundation so that commercial paper is now customarily defined as: (i) short term, usually 7 to 180 days, but up 9 months, (ii) unsecured, (iii) debt in the form of promissory notes, (iv) issued by companies, (v) for working capital. Most commercial paper matures in 30 days or less and is issued in denominations of $100,000 or more.[2]

## WHO CAN ISSUE COMMERCIAL PAPER?

Anyone can issue commercial paper. The real question is: Who will buy it? Because commercial paper is unsecured debt, only the best companies, with the strongest balance sheets find a market for their paper.

Currently about 1,700 companies in the United States issue commercial paper. As of 1990, 75 percent of commercial paper was issued by financial companies and 25 percent was issued by non-financial companies such as utilities, manufacturers, and industrial concerns.[3] However, in the aftermath Enron / Anderson questions about corporate accounting practices have resulted in fewer buyers of non-financial commercial paper. As of March, 2002 total commercial paper outstanding was about $1.4 trillion with 87% issued by financial institutions and only 13% issued by non-financial institutions.[4]

Generally companies must have a top credit rating to issue commercial paper. Commercial paper is rated by five organizations, although ratings are only quoted for companies with an Aa bond rating or equivalent. Figure 17-1 is an Analysis of Commercial Paper Rating Agencies.[5]

Unrated and lower rated paper is occasionally sold, but highly rated paper has the best acceptance in the marketplace. The primary investors in commercial paper include: pension funds, money market mutual funds, government units, bank trust departments, foreign banks and investment companies.[6]