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Frequently Asked Questions About 4(2) Commercial Paper

What is 4(2) Commercial Paper?
Commercial Paper is a short-term unsecured promissory note to repay a fixed amount on a certain future date. The product is exempt from SEC registration according to one of the following sections of the Securities Act of 1933: 3(a)(3), 4(2), and 3(a)2. Today, the US commercial paper market is the largest non-government debt market in the world; with large issuers of high credit ratings dominate much of the market. Traditionally, commercial paper programs for working capital needs are based on the 3(a)3 exemptions, although the 4(2) type has gained more notice in the last ten years; and is now virtually indistinguishable from the 3(a)3 programs among institutional investors.

How Does a 4(2) Paper differ from a 3(a)3 Paper?
The 4(2) paper differs from its more common sibling, the 3(a)3 paper, in that the 3(a)3 exemption deals with the borrower's use of the proceeds and the maximum debt maturity, while the 4(2) exemption addresses the manner in which paper is distributed and to whom it is sold.

Specifically, a borrower under the 3(a)3 exemption must use the proceeds for "current transactions", or working capital needs, with a maturity date of nine months or less. In comparison, section 4(2) requires that the issuer meet the following conditions in order to receive the registration exemption:

- The paper must be sold to "accreted investors".
- It may not be publicly offered or sold.
- The investor may not intend to resell the security.
- If the investor does choose to resell, 4(2) paper must be sold in an exempt transaction.

When Do Issuers Use 4(2) Commercial Paper?
Issuers choose to issue 4(2) commercial paper when they want to use the proceeds to finance non-current transactions such as acquisitions, stock repurchase programs or other long-term assets. Even though the 4(2) exemption does not limit maturities to nine months, legal opinions limit its issuances to normal commercial paper maturities.

Because of additional flexibility afforded to the issuers, many large corporate issuers maintain both programs and tap the commercial paper market for different capital needs. Today, most asset-backed commercial paper programs are 4(2).

Who Can Purchase 4(2) Commercial Paper?
In order to be able to purchase (2) commercial paper, one needs to be an "accredited investor". In Rule 501 of Regulation D, federal securities laws define the term "accredited investor" being applicable to eight groups of investors. One such group refers to "a charitable organization, corporation, or partnership with assets exceeding $5 million."

Yield Advantage over Conventional CP?
When 4(2) CP was first introduced on a widespread basis, investors required a higher interest rate from issuers. Now, because most investors believe that 4(2) commercial paper is no less liquid than other types of commercial paper, there is no premium required and it is sold at the same interest rate level as other types of commercial paper of the same credit quality.

Why, Then, Go Through the Trouble with 4(2) Paper At All?
The commercial paper market has experienced tremendous transformation over the last decade, particularly the growth of the asset-backed commercial paper (ABCP) market. According to Federal Reserve data, the ABCP outstanding at the end of 2003 was $717.3 billion, or 55% of all CPs outstanding in the US. As a percentage of the Tier 1 (investment grade) market, the ratio is even higher at 62%.

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What About the Rule 144A Concern as It Relates to 4(2) Commercial Paper?

Some investors, even so dealers, treat 4(2) commercial paper as Rule 144A private placement. This is a common misconception. The confusion lies in the way broker-dealers address the type of investment generically as 4(2)/144A. It is even possible that some securities report would list 4(2) commercial paper as private placement.

The determining factor of whether a particular piece of 4(2) is 144A is whether the CP dealer financed the transaction. In other words, when an accredited investor purchases the paper from the dealer as part of a new offering, the paper will not be a 144A issue. However, the paper retained by the dealer from the new offering or bought back from an investor will be considered a 144A security when re-offered to investors.

Why Bother With the Distinction Between 4(2) and Rule 144A?

There are two concerns with Rule 144A for certain clients of Capital Advisors Group. First, if a particular piece of 4(2) paper is classified as Rule 144A, some investment guidelines that prohibit private placement transactions will not be eligible to participate, even though the very rule was intended to improve liquidity by allowing trading among large institutions. The second concern is that only Qualified Intuitional Buyers (QIBs) are allowed to purchase 144A securities. A common definition of a QIB refers to an institution that in the aggregate owns and invests on a discretionary basis at least $25 million, a criterion that would limit many accounts below this threshold.