

FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 81-117

June 11, 1981

POLICY STATEMENT

Sale of Third Party Commercial Paper

TO ALL MEMBER BANKS IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has adopted a policy statement setting forth guidelines governing the sale by a state member bank of commercial paper of issuers not related to the bank ("third party commercial paper"). The guidelines concern the type and amount of commercial paper that should be sold, the kind of records that should be maintained, and the purchasers to which such paper may be sold.

Although the policy statement is effective immediately, interested parties are encouraged to submit comments, for Board review, by July 31, 1981. Comments should refer to Docket No. R-0360 and should be mailed to the Secretary, Board of Governors of the Federal Reserve System, 20th and Constitution Avenue, N.W., Washington, D.C. 20551.

Printed on the following pages are copies of the Board's press release and the material submitted for publication in the Federal Register. These pages more fully explain the Board's action.

Any questions concerning the policy statement should be directed to Marvin C. McCoy, Ext. 6657, or Earl Anderson, Ext. 6275, of this Bank's Bank Supervision and Regulations Department.

Sincerely yours,

William H. Wallace

First Vice President

FEDERAL RESERVE press release



For immediate release

May 28, 1981

The Federal Reserve Board has adopted a policy statement providing guidelines to govern the sale by State member banks of commercial paper issued by firms not related to the bank.

The Board's guidelines concerning the sale of such third party commercial paper (promissory notes of corporations) are intended to assure safe and sound banking practices. The Board said it would monitor activity in this area closely and would modify or supplement its guidelines as indicated by experience.

The policy statement is effective immediately. However, the Board will accept comment, for review by the Board, through July 31, 1981.

The policy statement calls for:

- Limitation of sales to prime quality commercial paper meeting specifications in the statement.
- Careful analysis and monitoring by the seller of the creditworthiness of the issuer.
- Adoption by the selling bank of rules limiting the amount of commercial paper that may be sold for single or related issuers.
- Extensive record keeping and maintenance of records.
- No sales to fiduciary accounts over which the bank has investment discretion, or to the bank's parent bankholding company (unless it is a bank) or to a nonbank affiliate of the bank.
- Certain notices to buyers.

These guidelines are spelled out in the attached statement.

Attachment

FEDERAL RESERVE SYSTEM

POLICY STATEMENT CONCERNING THE SALE
OF THIRD PARTY COMMERCIAL PAPER BY
STATE MEMBER BANKS

[DOCKET NO. R-0360]

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy Statement

SUMMARY: Pursuant to its authority to restrain unsafe or unsound banking practices by State member banks, the Board of Governors of the Federal Reserve System adopts a policy statement setting forth guidelines governing the sale by a State member bank of commercial paper of issuers not related to the bank ("third party commercial paper"). The guidelines reflect the Board's judgment that certain practices may develop in the sale by a bank of third party commercial paper that may not be consistent with the principles of safe and sound banking. The guidelines concern the type and amount of commercial paper that should be sold, the kinds of records that should be maintained, and the purchasers to which such paper may be sold. The Board intends to monitor closely the activities of State member banks in this area and may modify or supplement this policy statement based on the Board's review of the experience of State member banks in conducting these activities.

EFFECTIVE DATE: May 26, 1981. Interested parties may submit comments on the policy statement that will be reviewed by the Board. Comments must be received on or before July 31, 1981.

ADDRESS: Comments should include reference to Docket No. R-0360 and should be mailed to the Secretary, Board of Governors of the Federal Reserve System, 20th and Constitution Avenue, N. W., Washington, D. C. 20551, or delivered to Room B-2223, 20th and Constitution Avenue, N. W., Washington, D. C. between 8:45 a.m. and 5:15 p.m. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m.

FOR FURTHER INFORMATION CONTACT: Robert S. Plotkin, Assistant Director, Division of Banking Supervision and Regulation, (202) 452-2782, or Richard Ashton, Senior Counsel, Legal Division, (202) 452-3750, Board of Governors of the Federal Reserve System, Washington, D. C. 20551.

SUPPLEMENTAL INFORMATION: On September 26, 1980, the Board took action with respect to the petitions of the Securities Industry Association (the "SIA") and of A. G. Becker Incorporated ("A. G. Becker") that the Board prohibit Bankers Trust Company, New York, New York ("Bankers Trust"), a State member bank, from selling third party commercial paper. The Board denied the petitions to the extent they alleged that Bankers Trust's commercial paper activities violate the Glass-Steagall Act or should be prohibited by general considerations of public policy. The Board also

stated that the sale of third party commercial paper by a commercial bank could involve, at least in some circumstances, potential unsafe or unsound practices. The Board thus took no action on the petitions' allegations of dangers to Bankers Trust or potential conflicts of interest pending development of general supervisory guidelines designed to avoid potential unsafe or unsound practices in the sale of third party commercial paper by State member banks.

In developing the guidelines that are set forth in the following policy statement, the Board has consulted with the staffs of the other federal banking agencies and has considered the allegations of unsafe practices made by the SIA and A. G. Becker and the comments of the Securities and Exchange Commission.

With respect to the possibility that a bank's commercial paper selling activities may lead the bank into investing its funds in imprudent investments, the Board recognizes that a bank's selling activity may result in the purchase of some commercial paper with the bank's own funds. However, the Board notes that banks have traditionally been permitted to purchase commercial paper for their own account and such purchases have been treated for supervisory purposes as commercial loans. In addition, since only large, well-known corporations with established credit ratings are able to market unsecured obligations, commercial paper is generally a low-risk instrument, even relative to some commercial loans.^{1/} Furthermore, the Board's guidelines provide that a bank should sell only prime quality paper and make a thorough credit analysis of each issuer and that all commercial paper sold by the bank should be fully supported by available lines of credit.^{2/} These guidelines would also minimize the danger that a bank selling commercial paper might be tempted to make unsound loans to an issuer which is encountering financial difficulties in order to protect the bank's reputation.

The SIA, A. G. Becker, and the SEC have also raised the possibility of loans by a selling bank to facilitate purchase of commercial paper being sold by the bank. However, because rates on commercial paper are usually lower than rates charged on bank loans, the use of borrowed funds to purchase commercial paper would be unprofitable and thus unlikely. Accordingly, there does not appear to be any practical substance to this concern.

^{1/} The Board notes that, at least on some occasions, significant losses have been suffered by commercial paper purchasers, for example, the 1970 collapse of Penn Central Transportation Company. However, banking functions, such as commercial lending, also involve some degree of risk and losses can and do occur.

^{2/} A selling bank could only participate in the line of credit up to the amount of its legal lending limit.

Another potential hazard cited in connection with bank sales of commercial paper is the possibility that the bank's salesman's interest might impair its existing obligations to its customers and might consequently damage the bank's good will and reputation. In particular, it is claimed that bank depositors might suffer losses on paper purchased from the bank, that "the bank's reputation for prudence and restraint would be abused," that the bank would lose its ability to provide disinterested investment advice, and that the bank might "unload" worthless commercial paper in its trust department.

Under the Board's guidelines, however, a bank may sell commercial paper only to financially sophisticated purchasers and may not advertise commercial paper for sale to the general public. Thus, there appears to be little likelihood that any but a small fraction of a bank's depositors would even consider purchasing commercial paper being sold by the bank. For the same reason, the potential for a bank abusing its reputation for "prudence and restraint" in selling commercial paper does not appear significant. Finally, with respect to potential inability to provide disinterested investment advice and "unloading" of worthless commercial paper in the bank's trust accounts, the guidelines provide that the bank should not sell commercial paper to fiduciary accounts over which the bank has investment discretion.

The Board intends to monitor closely the selling activities of Bankers Trust and any other State member bank that may initiate such services. Based on further experience in this area, the Board may modify or supplement these guidelines to assure that such activities are conducted in accordance with principles of safe and sound banking.

Accordingly, acting pursuant to its supervisory authority over State member banks contained in section 9 (12 U.S.C. 321, et seq.) and section 11 (12 U.S.C. 248) of the Federal Reserve Act and the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818(b)) and related provisions of law, the Board of Governors adopts the following policy statement.

POLICY STATEMENT CONCERNING
SALE OF THIRD PARTY COMMERCIAL PAPER
BY STATE MEMBER BANKS

The Board of Governors has recently determined that the sale of commercial paper by a State member bank for unaffiliated issuers ("third party commercial paper"*) did not violate the Glass-Steagall Act (12 U.S.C. §§ 24, Seventh, 378). The Board was concerned however, that the

*/ Excluding commercial paper issued by a parent bank holding company; the Board has previously advised bank holding companies concerning sales of bank holding company commercial paper (letter dated June 27, 1980).

sale of third party commercial paper**/ might, in some circumstances, involve unsafe or unsound practices. Accordingly, in the interest of safe and sound banking, the Board believes that any State member bank that may decide to engage in the sale of third party commercial paper should adhere to the following guidelines.***/

1. A State member bank should sell only prime quality commercial paper that qualifies for the exemption provided by section 3(a)(3) of the Securities Act of 1933 (15 U.S.C. 77c(a)(3)). The bank should take appropriate precaution to assure itself that the section 3(a)(3) exemption applies to the commercial paper it proposes to sell. In this regard, (i) the bank should determine that the commercial paper it proposes to sell is of prime quality; (ii) the bank may rely on representations of the issuer with respect to the use of proceeds; (iii) except as further limited by paragraphs 7 and 8, the bank should sell commercial paper only to financially sophisticated customers, such as customers that regularly purchase a variety of short-term credit instruments, and should not advertise commercial paper for sale to the general public; (iv) the bank should obtain periodically, and maintain in the bank's records, a current legal opinion of counsel that the section 3(a)(3) exemption is available. In addition, the bank should sell commercial paper in minimum denominations that are consistent with applicable law and, in no event, should sell commercial paper in minimum denominations of less than \$100,000.

2. The selling bank should maintain a complete credit analysis of the issuer at all times and should exercise due diligence in investigating the financial affairs of the issuer. Particular attention should be given to the liquidity position of the issuer and its lines of credit. All commercial paper sold by the bank should be fully supported by available lines of credit. Any participation by the selling bank in such lines of credit should be made only after consideration of the bank's legal lending limit.

3. Senior management should adopt internal limits for the amount(s) of commercial paper that may be sold by the bank for a single or related issuer(s). In determining the internal limits, senior management should consider the financial condition of the issuer, all lines of credit available to the issuer, and the bank's participation in the lines of

**/ Banks have traditionally purchased commercial paper upon the order, and for the account of, customers, whereas here the bank is essentially acting for the issuer; the former activity is not subject to the guidelines set forth in this Policy Statement.

***/ The Board does not expect to take enforcement action to restrain unsafe or unsound banking practices with respect to third-party commercial paper selling activities of any State member bank that conducts such activities within these guidelines.

credit and any other extensions of credit or commitments to the issuer by the bank (including commercial paper purchased by the bank for its own account.)

4. Chronological records of original entry should be maintained that contain an itemized daily record of all sales and purchases of commercial paper. The records should also contain:

- . A designation of the commercial paper,
- . nature of the transaction, e.g. purchase or sale,
- . trade and settlement dates,
- . contra-party name or designation,
- . net proceeds, discount rate, or yield to maturity.

5. Account records should be maintained for each issuer that reflect:

- . All sales and purchases of commercial paper placed by the bank for that issuer,
- . all lines of credit available to the issuer,
- . the amount of the bank's participation in the lines of credit,
- . a current balance of all extensions of credit and a description of other commitments to the issuer.

6. Account records should be maintained for each purchaser that reflect all sales and purchases of commercial paper for the account of that customer.

7. Commercial paper should not be sold to fiduciary accounts over which the bank has investment discretion.

8. Commercial paper should not be sold to the bank's parent holding company (unless it is a bank) or any nonbank affiliate of the bank.

9. The bank should furnish to all purchasers of commercial paper written advice in connection with all purchases that (1) the commercial paper is not an obligation of the bank, and is not insured by the FDIC, (2) the bank has no obligation to repurchase any of the paper sold, (3) the bank is under no obligation to lend funds to the issuer (except

pursuant to existing credit lines, or other commitments, if any), and (4) copies of the issuer's most recently published financial statements will be furnished upon request.

By order of the Board of Governors, May 26, 1981.

(signed) James McAfee

James McAfee
Assistant Secretary of the Board

(SEAL)