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The Securities Acts' Treatment of Notes Maturing in Less than Nine Months: A Solution to the Enigma

By Wendy Gerwick Couture*

I. Introduction

The treatment of notes maturing in less than nine months under the Securities Act of 1933 and the Securities Exchange Act of 1934 can be logically interpreted in numerous ways. This wealth of plausible interpretations is created by the interaction of six principles:

(1) both the 1933 Act and the 1934 Act include "any note" within the definition of security, but this language is not interpreted literally;[1]

(2) §3(a)(3) of the 1933 Act exempts notes maturing in less than nine months from the registration provisions of the 1933 Act;[2]

(3) §3(a)(10) of the 1934 Act excludes notes maturing in less than nine months from the definition of "security;"[3]

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[1]*Reves v. Ernst & Young*, 494 U.S. 56, 63 (1990).

[2]Specifically, under the 1933 Act, "unless the context otherwise requires," "any note" is within the definition of "security." Section 3(a)(3) exempts the following from the registration provisions of the 1933 Act: "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[.]" Securities Act of 1933, §3(a)(10).

[3]Under the 1934 Act, "unless the context otherwise requires," "any note" is within the definition of "security" except for the following: "[A]ny note, draft, bill of exchange, or banker's acceptance 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." Securities Exchange Act of 1934, §3(a)(10).

(4) the definitions of "security" in the 1933 Act and the 1934 Act are interpreted to be "virtually identical;"[4]
(5) it is unclear whether §3(a)(3) and §3(a)(10) are synonymous, and
(6) the scope of the §3(a)(3) exemption and of the §3(a)(10) exclusion is unsettled.

Depending on how these six principles interact, numerous plausible interpretations of §3(a)(3) and §3(a)(10) emerge. In order to determine which of these interpretations should be adopted, this article will first analyze whether §3(a)(3) and §3(a)(10) should be interpreted synonymously and, if so, whether they should be applied literally or limited to a specific type of "commercial paper."[5] After concluding that these provisions should both be interpreted as applying only to specified "commercial paper," this article will explore the interpretation of "commercial paper" applied by the Securities and Exchange Commission (SEC). After concluding that the SEC's "prime quality commercial paper" interpretation is tenable, this article will analyze how to reconcile §3(a)(3)'s status as an exemption from registration and §3(a)(10)'s status as an exclusion from the definition of "security" with the Supreme Court's holding that the definitions of "security" under both Acts are "virtually identical." This article will conclude that, despite the "virtually identical" language, commercial paper should be excluded only from the registration provisions of the 1933 Act and entirely from the definition of "security" under the 1934 Act. Thus, this article interprets §3(a)(3) and §3(a)(10) as excluding prime quality commercial paper from the registration provisions of the 1933 Act and entirely from the 1934 Act.

Then, in light of this interpretation of §3(a)(3) and §3(a)(10), this article explores the interaction between the *Reves v. Ernst & Young*

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[4]*Tcherepnin v. Knight*, 389 U.S. 332, 335–36 (1967).

[5]" 'Commercial paper' refers generally to unsecured, short-term promissory notes issued by commercial entities. *Securities Industry Ass'n v. Board of Governors*, 468 U.S. 137, 140 n.1 (1984).rdquot; "Commercial paper is short-term, unsecured debt typically issued by large capitalized firms to finance their day to day cash needs. Maturities range from overnight to 270 days. Commercial paper is generally considered to be the highest yielding money market investment. Commercial paper is zero coupon debt, meaning that the investor buys the bond at a discount from face value (par), holds the bond until maturity, and earns interest income based on the difference between the buy price and the face value." Fidelity Investments, Commercial Paper: Product Overview, at http://personal.fidelity.com/products/fixedincome/pocommercial.shtml (last visited Apr. 17, 2002).

"family resemblance" test[6] for determining whether an instrument is a "note" under the Acts and the §3(a)(3) and §3(a)(10) analyses. Although formulated differently, the *Reves* family resemblance test and the §3(a)(3) and §3(a)(10) analyses essentially examine the same factors. This article suggests that, because §3(a)(3) and §3(a)(10) only apply to specific commercial paper, any instrument satisfying the strict requirements of §3(a)(3) and §3(a)(10) would similarly not qualify as a "note" under *Reves*. Therefore, §3(a)(3) and §3(a)(10) appear to be subsumed by the family resemblance test. This article closes with an exploration of the ramifications of allowing the family resemblance test to swallow the §3(a)(3) and §3(a)(10) analyses, concluding that many of the analytical difficulties presented by §3(a)(3) and §3(a)(10) would be solved.

II. Interpretation of §3(a)(3) and §3(a)(10)

A. *Reves v. Ernst & Young*

In *Reves v. Ernst & Young*[7] the Supreme Court had the opportunity to interpret the meaning of "any note" and the scope of the 1934 Act exclusion for notes maturing in less than nine months. Because the Court found that the instrument in question matured in more than nine months, the Court did not address the scope of the exclusion for notes maturing in less than nine months. The Court did, however, articulate a test for determining whether an instrument is a "note" within the Securities Acts.

In *Reves*, the Court was faced with the issue of whether certain demand notes were "securities" under the 1934 Act. The circuits were split on the appropriate test for determining whether an instrument is a "note" under the Securities Acts. The Court rejected the approach of those courts that used the *Howey* test to determine whether an instrument was a "note" because such an interpretation would render the " 'Acts' enumeration of many types of instruments superfluous.' "[8] Next, the court chose the "family resemblance" test over the "investment versus commercial" test because,

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[6]*Reves*, 494 U.S. 56 at 65.

[7]*Id.* at 63.

[8]*Id.* at 64 (quoting *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985)).

although both tests "are really two ways of formulating the same general approach," the "family resemblance" test is a "more promising framework for analysis."[9]

The "family resemblance" test begins with the presumption that every note of over nine months is a security. That presumption can be rebutted by showing that the note bears a strong resemblance to one of the following categories of instruments:

(1) the note delivered in consumer financing,
(2) the note secured by a mortgage on a home,
(3) the short-term note secured by a lien on a small business or some of its assets,
(4) the note evidencing a 'character' loan to a bank customer,
(5) short-term notes secured by an assignment of accounts receivable,
(6) a note which simply formalizes an open-account debt incurred in the ordinary course of business, and
(7) notes evidencing loans by commercial banks for current operations.[10]

In order to analyze whether the instrument in question bears a strong resemblance to one of these categories, the instrument should be evaluated in terms of the following four factors:

(1) "the motivations that would prompt a reasonable seller and buyer to enter into it,"
(2) "the 'plan of distribution' of the instrument,"
(3) "the reasonable expectations of the investing public," and
(4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."[11]

Further, even if a note does not bear a strong resemblance to one of the enumerated categories, "the decision whether another category should be added is to be made by examining the same factors."[12]

Applying the "family resemblance" test to the demand notes in question, the Court concluded that they were "notes" within the term "note" in §3(a)(10).[13] The Court then considered whether they were nonetheless excluded from the definition of "security" by the exclusion for notes maturing in less than nine months. Because the Court concluded that demand notes do not have a maturity of less

[9] *Id.* at 64–65.

[10] *Id.* at 65.

[11] *Id.* at 66–67.

[12] *Id.* at 67.

[13] *Id.* at 70.

than nine months, the Court did not address the scope of the §3(a)(10) exemption.[14]

Notably, Chief Justice Rehnquist, with whom Justices White, O'Connor, and Scalia joined, concurred in the adoption of the "family resemblance" test but dissented from the Court's finding that §3(a)(10) was inapplicable.[15] Because these Justices interpreted demand notes as maturing at the time of issuance, they reached the issue of how the exclusion for notes maturing in less than nine months should be interpreted.[16] These Justices interpreted the exclusion as applying to exclude literally all notes maturing in less than nine months.[17]

Since *Reves* failed to resolve the issue, the meanings of the §3(a)(3) exemption and the §3(a)(10) exclusion are open to several interpretations: (1) one or both of the provisions could be applied literally as construed by the *Reves* dissent, or (2) the applicability of one or both of the provisions could be limited to specific "commercial paper." Further, if the provisions are limited to specific "commercial paper," then this test must be articulated.

B. Plausible Interpretations of §3(a)(3) and §3(a)(10)

As a result of the issues left unresolved by *Reves*, the six principles listed in the opening paragraph of this article interact to form seven plausible interpretations of the treatment of notes maturing in less than nine months. A brief explanation of each plausible interpretation is useful in formulating the issues that must be resolved in order to determine the best interpretation.

First, the majority interpretation is that "commercial paper" maturing in less than nine months is exempt from Securities Act registration and excluded altogether from the 1934 Act.[18] For example, the Seventh Circuit cited Professor Loss with approval: "Short-term notes of the type which are exempted from registration under the Securities Act by §3(a)(3) are excluded from the defini-

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[14] *Id.* at 73.

[15] *Id.* at 76.

[16] *Id.* at 79.

[17] *Id.* at 81.

[18] *See, e.g., Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 800 n.6 (2d Cir. 1973); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1079 (7th Cir. 1972); *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 2d 705, 708 (D. Minn. 1968).

tion of 'security' in the Exchange Act.' "[19] This interpretation is attractive because it limits the potential for a cunning issuer to evade the Securities Acts by issuing notes that are not commercial paper but mature in less than nine months. Further, the treatment of §3(a)(3) as merely an exemption from registration and §3(a)(10) as an exclusion from the definition of "security" is consistent with the Acts' organization. This interpretation is slightly marred, however, because it appears to conflict with the Supreme Court's holding that the definitions of "security" under the 1933 Act and the 1934 Act are "virtually identical." Further, this interpretation requires the formulation of a workable definition of "commercial paper."

Second, one could literally interpret the provisions and argue that any note maturing in less than nine months is exempt from registration and excluded from the 1934 Act. This interpretation is attractive because it is consistent with the plain language of the statutes and would be easy to apply. Further, the treatment of §3(a)(3) as merely an exemption from registration and §3(a)(10) as an exclusion from the definition of "security" is consistent with the Acts' organization. This interpretation is marred, however, because it would allow a cunning issuer to avoid 1934 Act liability by issuing notes with a maturity of less then nine months. Further, the inconsistent definitions of "security" are troubling in light of the Supreme Court's holding that the definitions of "security" under the Securities Acts are "virtually identical."

Third, one could logically argue that "commercial paper" maturing in less than nine months is excluded from both the 1933 Act and the 1934 Act. This argument is appealing because it would prevent an issuer from purposefully evading coverage of the Securities Acts by issuing notes that are not commercial paper but mature in less than nine months. Further, this interpretation literally applies the Supreme Court's holding that the definitions of "security" under the 1933 Act and the 1934 Act are "virtually identical" by reading the 1934 Act exclusion into the 1933 Act definition. However, this interpretation would require one to ignore the clear implication that, since §3(a)(3) exempts these notes solely from registration, these notes are securities under the 1933 Act. Further, no court has followed this interpretation.

Fourth, one could logically argue that any note maturing in less

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[19] *Sanders*, 463 F.2d at 1079 (quoting 2 LOSS, SECURITIES REGULATION 796 (1961)).

than nine months is excluded from both the 1933 Act and the 1934 Act. This interpretation, like the third interpretation, is appealing because it literally applies the Supreme Court's holding that the definitions of "security" under the 1933 Act and the 1934 Act are "virtually identical" by reading the 1934 Act's exclusion into the 1933 Act definition. However, like the third interpretation, it ignores the clear implication from §3(a)(3) that notes maturing in less than nine months are securities under the 1933 Act. Further, this interpretation would allow a savvy issuer to avoid liability entirely under the 1933 Act and the 1934 Act merely by issuing notes that mature in less than nine months.

Fifth, one could argue that "commercial paper" maturing in less than nine months is exempt from registration but the 1933 Act and 1934 Act antifraud provisions apply. This interpretation is appealing because it relies on the Supreme Court's "virtually identical" language to read the exclusion for notes maturing in less than nine months entirely out of the 1934 Act. This interpretation would prevent issuers from avoiding private §10(b) antifraud liability by fashioning their instruments to fit into the §(3)(a)(10) exclusion and would require registration of all notes but "commercial paper." This interpretation requires one to ignore completely the language in §3(a)(10), however. Further, no court has supported this interpretation.

Sixth, one could argue that any note maturing in less than nine months is exempt from registration but the 1933 Act and 1934 Act antifraud provisions apply. Like the fifth interpretation, this interpretation is appealing because it is faithful to the "virtually identical" language and would prevent savvy issuers from avoiding antifraud coverage. Like the fifth interpretation, however, this interpretation requires one to ignore completely the language in §3(a)(10). Further, no court has supported this interpretation.

Seventh, one could argue that any note maturing in less than nine months is excluded from the definition of "security" under the 1934 Act and that commercial paper is exempt from the registration provisions of the 1933 Act. This interpretation is appealing because it accounts for the slight variation in the language of §3(a)(3) and of §3(a)(10). The dissent in *Reves* interprets §3(a)(10) as applying to all notes maturing in less than nine months and suggests that a more

restrictive interpretation of §3(a)(3) is plausible.[20] This interpretation is somewhat illogical, however, because some notes subject to the registration provisions of the 1933 Act would be exempt from the antifraud provisions of the 1934 Act.

C. Statement of Issues

As delineated by the above plausible interpretations, the following issues must be resolved in order to choose the best interpretation: (1) Are §3(a)(3) and §3(a)(10) synonymous? (2) Should §3(a)(3) and §3(a)(10) be interpreted to apply literally or to apply only to specific commercial paper? (3) If §3(a)(3) and §3(a)(10) should apply only to specific commercial paper, what are the elements of the specific commercial paper? (4) How should the Supreme Court's "virtually identical" language be reconciled with §3(a)(3)'s status as an exemption from registration and §3(a)(10)'s status as an exclusion from the definition of security? (5) Which party has the burden of proving the applicability or inapplicability of §3(a)(3) and §3(a)(10)?

III. Are §3(A)(3) and §3(A)(10) Synonymous?

Almost every court addressing the issue has held that the §3(a)(3) exemption and the §3(a)(10) exclusion apply to the same notes. For example, in *Anderson v. Francis I. duPont & Co.*, the court stated: "The exclusionary language of §78c(a)(10) [§3(a)(10)] is virtually identical to the language of §3(a)(3) of the 1933 Act and applies to the same type of short-term notes as the 1933 Act."[21] Further, in *Sanders v. John Nuveen & Co*, the court applied the SEC's interpretation of §3(a)(3) of the 1933 Act to §3(a)(10) of the 1934 Act.[22] Similarly, Justice Stevens in his *Reves* concurrence referred to §3(a)(3) of the 1933 Act as "the 1933 Act's counterpart to §3(a)(10) of the 1934 Act."[23] Justice Stevens further stated: "As the Courts of Appeals have agreed, there is no apparent reason to construe §3(a)(10) of the 1934 Act differently [from §3(a)(3) of the 1933

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[20] *Reves*, 494 U.S. 56 at 80.

[21] *Anderson*, 291 F. Supp. 2d at 708.

[22] *Sanders*, 463 F.2d at 1079.

[23] *Reves*, 494 U.S. at 75 (Stevens, J., concurring).

Act]."[24] In his oft-cited article *The Commercial Paper Market and the Securities Acts*, Kenneth V. Handal supported construing the provisions synonymously:

> The construction of the exclusionary provision of section 3(a)(10) of the 1934 Act in terms of the legislative history of the section 3(a)(3) exemption of the 1933 Act is particularly proper in this instance because of the companion scope and aims of the two federal securities acts and because of the absence in the legislative history of an explanation for the exclusionary language of section 3(a)(10).[25]

In contrast, the *Reves* dissent argues that, because §3(a)(10) lacks the phrase "which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions," §3(a)(10) should be interpreted less restrictively than §3(a)(3).[26] This argument ignores the absence of any committee comment or floor debate when §3(a)(10) was enacted, suggesting that §3(a)(10) was not intended to be interpreted differently from the otherwise identical §3(a)(3).

Further, the *Reves* dissent argues that, because the §3(a)(3) exemption does not exempt the covered instruments from the 1933 Act antifraud provisions but the §3(a)(10) exclusion does exempt the covered instruments from the 1934 Act antifraud provisions, it follows that the instruments covered by §3(a)(3) and §3(a)(10) are different.[27] This argument is unconvincing because it essentially argues that Congress was concerned enough about investors to ensure that the limited number of instruments covered by §3(a)(3) are subject to the 1933 Act antifraud provisions but that Congress was so unconcerned about investors that it excluded a broad category of instruments from the 1934 Act.

In light of the unconvincing nature of the dissent's arguments and the consensus among the Courts of Appeals, it is more tenable to interpret §3(a)(3) and §3(a)(10) as synonymous.

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[24] *Id.* at 76.

[25] Kenneth V. Handal, Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L.R. 362, 400 (1971–72).

[26] *Reves*, 494 U.S. at 80.

[27] *Id.* at 80–81.

IV. Should §3(a)(3) and §3(a)(10) Be Applied Literally or Only to Specific Commercial Paper?

The next issue is whether §3(a)(3) and §3(a)(10) should be interpreted to apply literally to all notes maturing in less than nine months or whether the applicability of these provisions should be limited to specific commercial paper.

A. Commercial Paper Interpretation

In 1961, the SEC interpreted the scope of §3(a)(3) of the Securities Act, basing its analysis on legislative history. The SEC rejected a literal reading of the provision and promulgated a more restrictive interpretation of the scope of Section 3(a)(3):

> "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 eligible for discounting by Federal Reserve banks."[28]

In 1968, a Minnesota district court was the first court to determine whether the exclusionary language of §3(a)(3) of the 1933 Act and §3(a)(10) of the 1934 Act should be interpreted literally.[29] The court interpreted the two provisions as synonymous and found that Congress, rather than intending the provisions to be interpreted literally, had intended the provisions to apply to "short term paper of the type available for a discount at a Federal Reserve bank and of a type available for discount at a Federal Reserve bank and of a type which is rarely bought by private investors."[30] The court partially based this non-literal interpretation on three cases where promissory notes maturing in less than nine months "were held to be securi-

[28]Securities Exchange Act of 1933, SEC Release No. 33-4412, 1961 WL 61632 (Sept. 20, 1961).

[29]*Anderson*, 291 F. Supp. 2d at 708.

[30]Id. (quoting 2 LOSS, SECURITIES REGULATION 566–68 (2d ed. 1961)).

ties" under the 1934 Act.[31] The court failed to mention that none of these three cases considered the issue of whether §3(a)(10) of the 1934 Act would apply to the promissory notes. In addition to relying on this questionable authority, the court relied on the legislative history of the 1933 Act and the Supreme Court's "admonition to construe the Securities Acts broadly in order to effectuate their purposes."[32] Although the SEC had issued Release No. 33–4412 in 1961, the court did not cite the SEC's interpretation. Albeit independently, the court, like the SEC, rejected a literal interpretation of the provisions.

Subsequent caselaw has gleaned a four-part test from the SEC's interpretation:

(1) prime quality negotiable commercial paper;

(2) of a type not ordinarily purchased by the general public;

(3) paper issued to facilitate well-recognized types of current operational business requirements;

(4) of a type eligible for discounting by Federal Reserve banks.[33]

B. Literal Interpretation

In contrast to the commercial paper interpretation, many litigants argue that §3(a)(3) and the corresponding language in §3(a)(10)

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[31] Id. (citing *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953); *SEC v. Wickham*, 12 F. Supp. 245 (D. Minn. 1935); *SEC v. Vanco, Inc.*, 166 F. Supp. 422 (D.N.J. 1958), *aff'd*, 283 F.2d 304(3d Cir. 1960)).

[32] *Id.* at 708–09.

[33] *Sanders*, 463 F.2d at 1079. Although most courts that apply Release No. 33–4412 agree with this four-part test, a district court in the District of Columbia rejected the second two criteria based on the SEC's use of the phrase "that is" between the first two criteria and the second two. *In re NBW Commercial Paper Litig.*, 813 F. Supp. 7, 17 n.14 (D.D.C. 1992). The court stated: "[T]he 'that is' indicates that the second two criteria (dealing with business requirements and discounting) are not independent criteria but rather modifiers of the first two criteria ('prime quality' and 'not ordinarily purchased by the general public'). Thus, the court applies only the first two criteria to its analysis." Id. Although this interpretation does seem initially tempting, it is ultimately unconvincing. First, since the SEC amicus brief in that case presented the four criteria, the SEC clearly embraces the application of all four criteria. Id. Further, the SEC and court interpretation of the current operations requirement is distinct from the prime quality and non-public requirements, as discussed *infra*.

should be interpreted literally.[34] Notably, the dissent in *Reves* followed this interpretation with respect to §3(a)(10), stating that "there is no justification for looking beyond the plain terms of §3(a)(10)." Especially in light of the literalist approach that the Supreme Court has applied to the Securities Acts in cases like *Central Bank of Denver v. First Interstate Bank of Denver*,[35] this interpretation is plausible.

C. Commercial Paper Interpretation is Preferable to Literal Interpretation

1. Legislative History of 1933 Act

The legislative history of §3(a)(3) sheds light on the proper interpretation of §3(a)(3) and its 1934 Act counterpart §3(a)(10). In support of it four-element interpretation of §3(a)(3), the SEC cites Senate Report Number 47 (S. Report No. 47) as follows:

> Notes, drafts, bills of exchange, and bankers' acceptances which are commercial paper and arise out of current commercial, agricultural, or industrial transactions, and which are not intended to be marketed to the public, are exempted... It is not intended under the bill to require the registration of short-term commercial paper which, as is the usual practice, is made to mature in a few months and ordinarily is not advertised for sale to the general public.[36]

In citing S. Report No. 47, the SEC fails to consider that this report interprets Senate Bill 875, which differs substantially from §3(a)(3) of the Securities Act. Section 2(a) of Senate Bill 875 exempts from the definition of "security" any "notes, drafts, bills of exchange, or banker's acceptances which are commercial paper and arise out of current commercial, agricultural, or industrial purposes when such

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[34] *E.g., UBS Asset Mgmt (New York) Inc. v. Wood Gundy Corp.*, 914 F. Supp. 66, 68 (S.D.N.Y. 1996); *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 775 (D.C. Cir. 1981); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 799 (2d Cir. 1973).

[35] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994) (holding that §10(b) does not impose aiding and abetting liability because "the text of the 1934 Act does not itself reach those who aid and abet a §10(b) violation").

[36] S. Rep. No. 47 (1933).

paper is not offered or intended to be offered for sale to the public."[37] Unlike §3(a)(3) of the Securities Act, Senate Bill 875 explicitly applies to "commercial paper" that "is not offered or intended to be offered for sale to the public."[38] This discrepancy in the SEC's analysis was criticized by Professor Loss in 1969.[39] Further, in *SEC v. Perera Co.*, the court commented: "[T]he SEC appears suspect in the formulation of the release in issue, inasmuch as the release interprets Section 3(a)(3) as exempting from the registration requirements only commercial paper which is not intended to be marketed to the public."[40]

In addition to relying on S. Report No. 47, however, the SEC quotes House Report Number 85 (H. Report No. 85), which accompanied House Bill 5480: "Paragraph (3) exempts short-term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors."[41] Unlike Senate Bill 875, House Bill 5480 closely resembles §3(a)(3) of the Securities Act. Therefore, despite the SEC's misguided reliance on S. Report No. 47, the SEC's interpretation has some basis in the legislative history of the Act. The Second Circuit similarly concluded that, since H. Report No. 85 was relied on by the SEC, the criticism of the SEC's reliance on S. Report No. 47, "though technically correct, does not seem to undermine the validity of the SEC's position."[42] It should be noted, however, that the House Report does not state that Paragraph (3) exempts *only* "short term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investor."[43]

In light of the questionable basis for the SEC's interpretation of §3(a)(3) of the Securities Act, it is useful to look more closely at the legislative history to determine whether it supports the SEC's non-literal interpretation of §3(a)(3).

In the Hearings before the House Interstate and Foreign Commerce Committee on House Bill 4314, Mr. William C. Breed,

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[37] S. 875, 73rd Cong. §2(a) (1933).

[38] Id.

[39] *Zeller*, 476 F.2d at 800 n.6 (citing 4 LOSS, SECURITIES REGULATION 2590 (Supp. 1969)).

[40] *SEC v. Perera Co.*, 47 F.R.D. 535, 537 (S.D.N.Y. 1969).

[41] H.R. Rep. No. 85 (1933).

[42] *Zeller*, 476 F.2d at 800 n.6.

[43] H.R. Rep. No. 85 (1933).

counsel for the Investment Bankers Association of America, proposed that the following provision be added to the list of exempted securities: "Negotiable promissory note or commercial paper maturing within twelve months of the date of issue."[44] In support of his proposal, Mr. Breed cautioned: "They must be exempted unless you wish to stop the trade of the country in its ordinary rules."[45] Had this proposed language been incorporated into §3(a)(3), Mr. Breed's comments would support the SEC's interpretation of §3(a)(3). However, Mr. Breed's proposed language was neither included in House Bill 5480 nor adopted in §3(a)(3).

Rather, §3(a)(3) is strikingly similar to the Federal Reserve Board's proposal. The Federal Reserve Board recognized that the definition of "security" "seems broad enough to include bankers' acceptances and commercial paper."[46] As a solution, the Federal Reserve Board proposed that the following limiting language be added to the definition of "security":

> Provided, however, that the term 'security' shall not include any note, draft, bill of exchange, or banker's acceptance which arises out of a current commercial, agricultural, or industrial transaction or the proceeds of which have been or are to be used for current commercial, agricultural, or industrial purposes, and which has a maturity at the time of issuance not exceeding 9 months, exclusive of days of grace." (sic)[47]

The Federal Reserve Board's proposal, which is very similar to §3(a)(3), was intended to exempt "bankers' acceptances and commercial paper." Although the proposal was read into the record immediately following Mr. Breed's cautionary statements, neither Mr. Breed nor the other attendees at the hearing recognized that the Federal Reserve Board's proposal was potentially more far-reaching than Mr. Breed's proposal, suggesting that the two proposals were viewed as synonymous.

The House committee's treatment of the Federal Reserve Board's proposal as synonymous with Mr. Breed's proposal, together with

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[44] *Hearing on H.R. 4314 Before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 192 (1933).

[45] *Hearing on H.R. 4314 Before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 179 (1933).

[46] *Hearing on H.R. 4314 Before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 180 (1933).

[47] *Hearing on H.R. 4314 Before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 181 (1933).

the language of H. Report No. 85, bolsters the SEC's conclusion that the House did not intend for §3(a)(3) to apply beyond the context of commercial paper.

In the Hearings before the Senate Banking and Currency Committee, the need to exclude commercial paper from the registration requirements was raised numerous times. For example, Mr. Arthur H. Dean, an attorney representing industrial and public-utility clients and investment bankers, stated: "The bill at present time also includes commercial paper. That is customarily short-term paper dealt in by banks, and most of that paper would mature before the statements required by section 5 could be filed. The Uniform Securities Act exempts such commercial paper, and I think it should be exempted by this bill."[48] Lane, Roloson & Co. and McCluney & Co. similarly objected to the inclusion of commercial paper.[49] Further, Mr. Breed and the Federal Reserve Board proposed the same amendments that they proposed in the Hearings before the House Interstate and Foreign Commerce Committee.[50]

The record clearly documents the Senate committee's concern with the inclusion of commercial paper, and this concern was reflected in Senate Bill 875, which explicitly excluded "commercial paper." It is less clear why, in formulating the exclusion for commercial paper, the Senate committee chose to exclude "commercial paper" specifically rather than adopting the formulation proposed by the Federal Reserve Board. It is possible that the Senate committee foresaw the potential for the Federal Reserve Board's language to exclude more than merely commercial paper. After the Conference Report, the Senate ultimately passed a version of the exemption that used the Federal Reserve Board's language, excluding any note "which has a maturity at the time of issuance not exceeding 9 months," rather than the more explicit language, excluding "commercial paper." It is possible that, in so doing, the Senate intended to adopt a broader exemption than originally provided for in Senate Bill 875.

This possibility is unlikely, however, for two reasons. First, when Senator Carter Glass introduced the Federal Reserve Board's pro-

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[48]*Hearing on S. 875 before the Senate Banking and Currency Committee*, 73rd Cong. 154–55.

[49]*Hearing on S. 875 before the Senate Banking and Currency Committee*, 73rd Cong. 94–95.

[50]*Hearing on S. 875 before the Senate Banking and Currency Committee*, 73rd Cong. 335, 120.

posal in the Hearings before the Senate Banking and Currency Committee, he stated: "I do not think it would cover any securities that have gone into default. . . . This is 9 months' commercial paper and not bonds at all."[51] Second, there is no indication in the record that any of the attendees recognized that the Federal Reserve Board's formulation potentially excluded more than commercial paper. This record suggests that, like the House committee, the Senate committee viewed the Federal Reserve Board's proposal as synonymous with a proposal explicitly excluding commercial paper.

Therefore, the SEC's conclusion that §3(a)(3) was not intended to apply beyond the context of commercial paper is supported by the legislative history of the Act.

2. Interaction of 1933 Act With Other Acts

The Seventh Circuit, recognizing that the Supreme Court's sanctions of the use of "companion legislative enactments" as an interpretative tool, looked at the way short-term notes are treated under the Public Utility Holding Company Act of 1935[52] and the Investment Company Act of 1940.[53] The court concluded that §3(a)(3) should apply only to specified commercial paper: "In other words, when Congress spoke of notes with a maturity not exceeding nine months, it meant commercial paper, not investment securities."[54]

3. Conclusion: Follow Non-literal Approach

In light of the legislative history of the 1933 Act and the treatment of short-term notes under companion legislative enactments, it is appropriate to limit the applicability of §3(a)(3) and §3(a)(10) to specific commercial paper. Further, if §3(a)(3) and §3(a)(10) were interpreted literally to apply to all notes maturing in less than nine months, the opportunities for fraud would be rampant. Any fraudulent instrument that qualified as a note but matured in less than nine months would be exempt. Such an interpretation would contravene

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[51]*Hearing on S. 875 before the Senate Banking and Currency Committee*, 73rd Cong. 98.

[52]15 U.S.C.A. §79f(b).

[53]15 U.S.C.A. §80a-2(a)(38).

[54]*Sanders*, 463 F.2d at 1079.

the purpose of the federal securities laws, "ensuring that investments of all designations be regulated to prevent fraud and abuse."[55]

V. What are the Elements of the Specific Commercial Paper To Which §3(A)(3) and §3(A)(10) Apply?

In Release No. 33–4412, the SEC promulgated the following test to determine whether a note is "commercial paper":

(1) prime quality negotiable commercial paper;
(2) of a type not ordinarily purchased by the general public;
(3) paper issued to facilitate well recognized types of current operational business requirements;
(4) of a type eligible for discounting by Federal Reserve banks.[56]

Although these elements have been widely cited by the courts, the courts frequently apply these elements conclusively and without precise analysis.[57] The SEC staff has issued many no-action letters relating to §3(a)(3), however. Study of these no-action letters together with the few cases that have truly applied the SEC's test reveals the emergence of a consistent interpretation of the four parts of the SEC's test.

A. "Of a Type Not Ordinarily Purchased by the General Public"

1. Interpretation By SEC and Courts

Upon review of SEC no-action letters relating to the §3(a)(3) exemption, several inferences about the SEC's interpretation of the non-public requirement emerge.

First, with a few exceptions,[58] the minimum denomination of

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[55] *Reves*, 494 U.S. at 73.

[56] *Sanders*, 463 F.2d at 1079.

[57] *See, e.g., Nat'l Bank of Yugoslavia v. Drexel Burnham Lambert, Inc.*, 768 F. Supp. 1010, 1017 (S.D.N.Y 1991); *Holloway v. Peat, Marwick, Mitchell & Co.*, 900 F.2d 1485 (10th Cir. 1990).

[58] In the 1970's, the SEC staff issued several no-action letters regarding notes with a minimum denomination of $10,000. Allied Bancshares, Inc., SEC No-Action Letter, 1978 WL 12259, at *4 (Dec. 14, 1978); Jostens, Inc., SEC No-Action Letter, 1976 WL 12532, at *3 (June 14, 1976).

commercial paper found to be exempt is $25,000.[59] If the minimum denomination of the proposed notes is less than $25,000, the SEC staff usually refuses to issue the requested no-action letter[60] because the "staff evidently feels that notes of large denomination are not ordinarily purchased by the general public."[61] For example, the SEC staff refused to issue a no-action letter to Rowe Corporation because the notes' denominations were too low: "The fact that Rowe's proposed notes would have denominations that could be as low as $100 indicate that such notes would be easily accessible to a part of the general public . . . ."[62] Texas American Bancshares, Inc. requested a no-action letter for $10,000 notes but stated: "[I]f such amount is currently felt to be too low, TAB would propose in the alternative a minimum denomination of $25,000."[63] In response, the SEC staff issued a no-action letter regarding only the $25,000 notes.[64] Similarly, after rejecting Spokane Mortgage Company's no-

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[59]*See, e.g.*, Southeast Banking Corp., SEC No-Action Letter, 1989 WL 26486 (Nov. 21, 1989) (minimum denomination of $25,000); Lyondell Petrochemical Co., SEC No-Action Letter, 1989 WL 246100 (July 19, 1989) (same); Bank of Boston Corp., SEC No-Action Letter, 1989 WL 246327 (Aug. 28, 1989) (same). *See also* J. William Hicks, *Commercial Paper: An Exempted Security Under Section 3(a)(3) of the Securities Act of 1933*, 24 UCLA L.R. 227, 295 (1976) (recognizing an informal SEC staff requirement of $25,000 minimum denomination for short-term notes).

[60]*See, e.g.*, FBT Bancorp Inc., SEC No-Action Letter, 1979 WL 14539, at *2 (July 7, 1979) (refusing a no-action request for $5,000 notes); Spokane Mortgage Co., SEC No-Action Letter, 1975 WL 11233, at *3 (Oct. 3, 1975) (refusing a no-action letter for $10,000 notes partly because of "the relatively low minimum denomination of the notes"); Del. Valley Realty & Mortgage Investors, SEC No-Action Letter, 1971 WL 6497, at *3 (1971) (refusing to issue a no-action letter where the notes were of a minimum denomination of $500); U.S. Bancorp, SEC No-Action Letter, 1971 WL 8536, at *3 (Dec. 1, 1971) (revising the original request for no action in response to an SEC telephone request by raising the minimum denomination to $50,000).

[61]J. William Hicks, *Commercial Paper: An Exempted Security Under Section 3(a)(3) of the Securities Act of 1933*, 24 UCLA L.R. 227, 239 (1976).

[62]Rowe Corp., SEC No-Action Letter, 1974 WL 9966, at *4 (Nov. 20, 1974).

[63]Texas Am. Bancshares, Inc., Request for SEC No-Action Letter, 1974 WL 9965, at *3 (Nov. 11, 1974).

[64]Texas Am. Bancshares, Inc., SEC No-Action Letter, 1974 WL 9965, at *5 (Nov. 11, 1974).

action request for $10,000 notes,[65] the SEC staff approved Spokane Mortgage Company's no-action request for $25,000 notes.[66]

Second, according to SEC no-action letters thus far, exempt paper cannot be marketed to the general public.[67] Recently, the meaning of this prohibition was fleshed out in several no-action letters so that it resembles a hybrid of the limitations on activity during the ''waiting period'' of a public offering and Rule 502(c)'s prohibition on ''general solicitation.''

In the SEC's no-action letter addressed to General Electric Capital Corp., the staff explicitly found that the §3(a)(3) exemption would continue to be available if the issuer ''publish[es] limited advertisements from time to time relating to the companies' commercial paper programs as generally described in your letter.''[68] General Electric described the following advertising scheme in its letter:

> Advertisements may be a tombstone or other similar form of advertisement and will appear from time to time only in publications such as The Wall Street Journal, Institutional Investor, Investment Dealers' Digest, Corporate Finance, Pensions & Investment, Treasury Management and similar Publications.
>
> Each advertisement will state that the commercial paper has not been and will not be registered under the Securities Act, will be offered only to sophisticated institutional investors pursuant to the exemption afforded by Section 3(a)(3) of the Securities Act and may not be reoffered or resold in the United States absent

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[65]Spokane Mortgage Co., SEC No-Action Letter, 1975 WL 11233, at *3 (Oct.. 3, 1975).

[66]Spokane Mortgage Co., SEC No-Action Letter, 1975 WL 11235, at *1 (Nov. 3, 1975).

[67]See, e.g., General Electric, SEC No-Action Letter, 1994 WL 369848 (July 13, 1994); Nat'l Westminster Bancorp Inc., SEC No-Action Letter, 1989 WL 246387 (Sept. 29, 1989); Southeast Banking Corp., SEC No-Action Letter, 1989 WL 246486 (Nov. 21, 1989); MNC Fin'l, Inc., SEC No-Action Letter, 1988 WL 235074 (Sept. 8, 1988); Lyondell Corp., SEC No-Action Letter, 1989 WL 246100 (July 19, 1989); Bank of Boston Corp., SEC No-Action Letter, 1989 WL 246327 (Aug. 28, 1989).

[68]General Elec. Capital Corp., SEC No-Action Letter, 1994 WL 369848, at *10 (July 13, 1994).

registration under the Securities Act or pursuant to an exemption therefrom.[69]

In arguing that this type of advertisement did not preclude an exemption under §3(a)(3), General Electric's counsel argued that the limitation on advertising, although often treated as a prerequisite to obtaining the §3(a)(3) exemption, is merely of evidentiary importance because it tends to show that the paper is not of a type usually purchased by the general public. Therefore, according to General Electric's counsel, "commercial paper advertising that is not directed at the general public will not render the Section 3(a)(3) exemption unavailable so long as the issuer can still demonstrate that its commercial paper is not of a type generally purchased by the general public and is not intended to be sold to the general public."[70] Although it is not clear whether the SEC staff agreed with the reasoning of General Electric's counsel, the staff did approve the proposed advertising. Since the recipients of the proposed advertising were neither limited to those with whom the issuer had a preexisting relationship nor limited to sophisticated or accredited investors, the proposed advertising would probably qualify as "general solicitation" under Rule 502(c).[71] This suggests that the limitation on marketing commercial paper to the public is less stringent than Rule 502(c)'s prohibition of general solicitation. Rather, the proposed use of a "tombstone or other similar form of advertisement" suggests that the limitation on marketing to the general public is similar to the limitation imposed on issuers during the "waiting period" of a registered offering.[72] This conclusion is not definitive, however, because the SEC staff did not detail why the §3(a)(3) exemption was available in this situation. It is likely that the SEC staff was influenced by General Electric's intent to sell its

[69]General Elec. Capital Corp., SEC No-Action Letter, 1994 WL 369848, at *6–7 (July 13, 1994).

[70]General Elec. Capital Corp., SEC No-Action Letter, 1994 WL 369848, at *5 (July 13, 1994).

[71]THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION §4.20 (4th ed. 2002) (recognizing that "[o]ne of the benchmarks of a general solicitation is contacting potential investors with no previous relationship to the issuer or persons promoting the offering" and that "assuring that only accredited investors will receive offering materials will preclude a finding that a general solicitation has taken place").

[72]17 C.F.R. §230.134.

commercial paper only to sophisticated institutional investors.[73] If an issuer intended to sell its commercial paper to sophisticated individual investors as well as institutional investors, it is not clear whether the SEC staff would view tombstone advertisements as acceptable.

If, however, an issuer satisfies the more stringent requirement of refraining from "general solicitation," the issuer has probably not marketed the commercial paper to the general public and would thus satisfy the §3(a)(3) exemption. Professor J. William Hicks suggests: "The safest approach for an issuer with little experience in the commercial paper market might be to structure the offering as though it were a private placement under section 4(2) of the 1933 Act."[74] This advice seems to have been followed by Prescient Markets, Inc.'s counsel. In its request for a no-action letter, Prescient proposed to operate an "Internet-based, electronic execution platform for commercial paper," where potential investors must complete an online questionnaire and be deemed an institutional "accredited investor" before receiving access to screens that display rates and other offering materials, thus complying with the SEC's interpretation of "general solicitation" in the context of the internet.[75] The SEC staff did not express a view as to whether the §3(a)(3) exemption or the §4(2) exemption were satisfied in this context. Prescient's counsel, however, presumed that compliance with the SEC's interpretation of "general solicitation" would necessarily satisfy §3(a)(3)'s restriction on marketing to the general public.

Third, it appears that unsophisticated or unaccredited individuals may not purchase the paper. Some issuers whose proposals were approved by the SEC staff only planned to sell the paper to institutional investors.[76] Other issuers' proposals were approved despite expanding their potential purchasers to include sophisticated individual purchasers, presumably to be interpreted consistently with the §4(2)

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[73]General Elec. Capital Corp., SEC No-Action Letter, 1994 WL 369848, at *6 (July 13, 1994).

[74]Hicks, William J., *Commercial Paper: An Exempted Security Under Section 3(a)(3) of the Securities Act of 1933*, 24 UCLA L. REV. 227 (1976).

[75]Prescient Markets, Inc., SEC No-Action Letter, 2001 WL 328060 (Apr. 2, 2001).

[76]*E.g.*, Prescient Markets, Inc., SEC No-Action Letter, 2001 WL 328060 (Apr. 2, 2001); General Elec. Capital Corp., 1994 WL 369848 (July 13, 1994).

sophistication requirement.[77] For example, the counsel of MNC Financial, Inc. described these sophisticated individual purchasers as "experienced in the commercial paper market and [...] capable of evaluating the merits and risks of investing in the Notes."[78] Finally, a few issuers satisfied the exemption while expanding their potential purchasers to include individuals who satisfy the status of "accredited investors" under Rule 501(a).[79] The sale to "accredited investors" is arguably more expansive than the sale to "sophisticated investors" because an individual need not be sophisticated in order to qualify as an accredited investor. For example, a natural person whose individual net worth at the time of purchase exceeds $1,000,000 qualifies as an accredited investor, regardless of sophistication level.[80]

In *Sanders v. John Nuveen & Co.*, the paper was placed through a broker-dealer and sold to 42 purchasers, included the plaintiff, an individual.[81] The court did not consider whether the individual purchaser was sophisticated or accredited.[82] The paper had an aggregate face amount of $1,661,500.[83] Although the court did not mention the denominations of the notes, they clearly had a maximum denomination of $1,661,500/42, or $39,559.52. Based on these facts, the court found that the paper was "obviously offered and sold to the general public."[84] Assuming that the individual purchasers were neither sophisticated nor accredited, this interpretation is consistent with that of the SEC staff.

Similarly, in *SEC v. M. A. Lundy Associates*, the notes were of a minimum purchase price of $5,000, the issuer advertised in newspapers throughout Rhode Island for a one-year period, and the purchas-

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[77]Turner Broadcasting, SEC No-Action Letter, 1989 WL 246469 (Nov. 7, 1989); Southeast Banking Corp., SEC No-Action Letter, 1989 WL 246486 (Nov. 21, 1989); MNC Fin'l, Inc., SEC No-Action Letter, 1988 WL 235074 (Sept. 9, 1988); Bank of Boston, SEC No-Action Letter, 1989 WL 246327 (Aug. 28, 1989).

[78]MNC Fin'l, Inc., SEC No-Action Letter, 1988 WL 235074 (Sept. 9, 1988)

[79]E.g., Mid-Citco, SEC No-Action Letter, 1989 WL 245920 (Mar. 21, 1989).

[80]Rule 501(a)(5), Regulation D.

[81]*Sanders*, 463 F.2d at 1079.

[82]Id.

[83]Id.

[84]Id.

ers were not screened for sophistication or accreditation.[85] Consistently with the interpretations of the SEC staff, the court found that the non-public requirement was not satisfied because the notes were advertised and sold to the general public.

Further, consistent with the SEC staff's interpretation, the court in *Franklin Savings Bank v. Levy* found the non-public requirement satisfied where the notes were of a minimum denomination of $500,000 and all of the purchasers except a few were banks or corporations.[86] Finally, in *In re NBW Commercial Paper Litigation*, because the notes were offered and sold "to members of the general public, sophisticated or not, so long as they had $25,000 to invest," the non-public requirement was not satisfied.[87]

2. Appropriateness of a Non-Public Requirement

The House committee's intent that the paper be of a type not ordinarily purchased by the general public is clearly enunciated in H. Report No. 85. This expression of the committee's intent, however, is tempered somewhat by the absence of any language in House Bill 5480 or in §3(a)(3) that alludes to a non-public requirement. This expression of the committee's intent is further tempered by the contradictory testimony that the committee heard on whether short-term paper is offered or sold to the public.

For example, Mr. Breed baldly stated: "Now, commercial paper and promissory notes are not sold to the public. You and I are never going to lose any money nor is any of the public going to lose any money if that man should happen to default in those notes."[88] Yet, a few minutes later, Mr. Breed seemed to contradict this statement: "It might be that a great big rich man would say, 'Well, I will take some of this short-term paper,' and he might buy it from his bank, but the ordinary public would have nothing whatever to do with it."[89] In response, Representative Edward A. Kenney suggested: "Well now, in making this exemption, if we specify something of

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[85]*SEC v. M.A. Lundy Assocs.*, 362 F. Supp. 226, 232 (D.R.I. 1973).

[86]*Franklin Savings Bank v. Levy*, 406 F. Supp. 40, 43 (S.D.N.Y. 1975), *rev'd on other grounds*, 551 F.2d 521 (2d Cir. 1977).

[87]*In re NBW Commercial Paper Litig.*, 813 F. Supp. at 18–19.

[88]*Hearing on H.R. 4314 before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 179 (1933).

[89]*Hearing on H.R. 4314 before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 181 (1933).

that character, that is, paper not to be sold to the public so as to eliminate that feature, would there be any objection to it?"[90] To this suggestion, Mr. Breed responded:

> Well, if you felt it was necessary. When you use 'the public,' it is a broad term. You would have to begin to modify and exclude banks, or bankers, and then, why on earth should you not, if you know an industry in your own home town that is good, you might rather have their $5,000 note, due in 4 months, than to have some security on the stock exchange. Why should you be prohibited from buying it?[91]

In light of Mr. Breed's contradictory testimony and Representative Kenney's proposal to explicitly limit the application of the exclusion to commercial paper not publicly sold, the House committee' s failure to add such exclusionary language casts some doubt on whether the non-public requirement was reflected in House Bill 5480, despite the House Report's statement otherwise.

Similarly, the Senate Banking and Currency Committee heard testimony indicating that short-term paper is sometimes offered or sold to the public, as exemplified by the following exchange among Senator William Gibbs McAdoo, Mr. Thomas Creigh (general attorney of the Cudahy Packing Company), and Senator Alva B. Adams:

> Senator McAdoo: Well, the public does not get any of your short-term notes, I take it.
>
> Mr. Creigh: Well, I do not come in intimate contact with that matter, but I have seen many cases where the ordinary public is willing to take our 90-day paper. And I hope they will continue. . . .
>
> Senator Adams: I had some of that paper, not in your company, but in another one.[92]

In response to this testimony, the Senate Committee explicitly limited the application of the proposed exclusion to instances "when such paper is not offered or intended to be offered for sale to the

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[90] *Hearing on H.R. 4314 before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 182 (1933).

[91] *Hearing on H.R. 4314 before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 182 (1933).

[92] *Hearing on S. 875 before the Senate Banking and Currency Committee*, 73rd Cong. 237 (1933).

public.''[93] This limitation was struck during Senate debate, however. Senator Adams, who moved for this amendment, explained his motion as follows:

> [I]t is intended to protect from the operation of the act certain paper which should not be included along with commercial paper, since it merely circulates among banks, instead of the general public.[94]

According to Kenneth V. Handal, Senator Adams thought that, since commercial paper was circulated only among banks, the limitation was unnecessary to limit the exemption to bank-held commercial paper.[95] Senator Adams struck the limitation in order to ensure that bankers' acceptances were included within the exemption. Handal's interpretation is consistent with Senator Adams' remarks on the floor. Senator Adams' remarks are curious, however, in light of Senator Adams' personal knowledge that short-term paper is sometimes held by individual investors. Since the Senate was under the impression from Senator Adams' remarks, however, that commercial paper ''merely circulates among banks,'' the striking of the limitation should not be interpreted as a purposeful extension of the exemption to commercial paper held by the ordinary public.

Although the historical underpinnings for the SEC's requirement that the paper be of a type not ordinarily purchased by the general public are somewhat shaky, there is support for a general non-public requirement.

3. Appropriate Interpretation of Non-Public Requirement

An analysis of SEC no-action letters relating to the non-public requirement shows that three elements have emerged: (1) a minimum denomination of $25,000; (2) a prohibition on marketing to the general public; and (3) a prohibition on selling to unsophisticated or unaccredited individuals. The legislative history of the non-public requirement suggests that these are proper elements on which to concentrate and sheds light on how each of these elements should be applied.

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[93] S. 875, 73rd Cong. §2(a) (1933).

[94] 77 Cong. Rec. 2987 (1933).

[95] Kenneth V. Handal, Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L.R. 362 (1971–72).

First, Mr. Breed, during the Hearings before the House Interstate and Foreign Commerce Committee, made the only reference to actual denominations of commercial paper. He answered, in response to Representative Kenney's suggestion that the bill be amended to explicitly prohibit the paper from being sold to the public: "[W]hy on earth should you not, if you know an industry in your own home town that is good, you might rather have their $5,000 note, due in 4 months, than to have some security on the stock exchange. Why should you be prohibited from buying it?"[96] As discussed above, the House Committee did not incorporate Representative Kenney's suggested prohibition into House Bill 5480. While this could be interpreted as an outright rejection of the non-public requirement, it could also be interpreted merely as a willingness to allow commercial paper to be distributed in circumstances such as those described by Mr. Breed. Thus, the Committee could have intended to allow individuals to purchase the exempted notes as long as they were of such large denominations that they would not be purchased by an ordinary investor. $5,000 in 1933 would be worth approximately $69,400 today.[97] As a result, the $25,000 benchmark currently reflected in no-action requests to the SEC staff could probably be increased and remain in line with the legislative history.

Second, as outlined above, the no-action requests that the SEC has granted prohibit the marketing of their paper to the general public. This usually means that the issuer will not engage in "general solicitation," although an occasional issuer has been allowed the exemption despite proposing to act similarly to an issuer during the "waiting period" of a public offering. The prohibition on marketing the paper to the general public was not emphasized during the Committee hearings, although it was included in S. Report No. 47, accompanying Senate Bill 875, which included an explicit non-public requirement. Since a non-public requirement has been implied into §3(a)(3) despite the striking of the explicit non-public requirement, the Senate report's reference to a prohibition on

[96] *Hearing on H.R. 4314 before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 182 (1933).

[97] See the Columbia Journalism Review Dollar Conversion Calculator, at http://www.cjr.org/resources/inflater.asp ($5,000 in 1933 was worth $69,444.44 in 2002); the Economic History Services Conversion Calculator, at http://eh.net.hmit.ppowerusd/dollar__answer.php ($5,000 in 1933 was worth $69, 406.58 in 2002).

marketing is nonetheless relevant. The Senate report states: "It is not intended under the bill to require the registration of short-time commercial paper which . . . ordinarily is not advertised for sale to the general public."[98] First, the word "ordinarily" adds some flexibility to the limitation on advertising. Second, as argued by the counsel of General Electric in its no-action request, the Senate Report's reference to advertising does not appear to have been intended as a separate element that must be satisfied. Rather, it merely describes the type of paper that usually would be of a "type not generally purchased by the general public." As a result, a less restrictive interpretation of the prohibition on marketing to the general public, similar to the type of restrictions placed on an issuer during the "waiting period" of a public offering, is appropriate.

Third, as noted above, the no-action requests that the SEC staff has granted usually limit their prospective individual purchasers to sophisticated individuals, although a few have expanded their prospective individual purchasers to include accredited investors. The few references to this issue in the legislative history tend to support the latter interpretation because the legislators seem more concerned with protecting less wealthy investors than unsophisticated investors. For example, while arguing against an explicit non-public requirement, Mr. Breed testified: "There is probably not one case in one hundred thousand of the sale of that paper to an individual. It might be that a great rich man would . . . but the ordinary public would have nothing whatever to do with it."[99]

B. "Prime Quality"

1. Interpretation by SEC and Courts

The SEC's interpretation of the "prime quality" requirement has been inconsistent. On January 25, 1989, the SEC staff issued no-action letters in response to requests by Southern National Corporation and Southtrust Corporation. Neither applicant detailed any evidence that their paper would be of "prime quality," thus suggesting that the requirement was no longer enforced or had been subsumed by another aspect of the analysis. Presumably in reliance on these

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[98]S. Rep. No. 47, at 3 (1933).

[99]*Hearing on H.R. 4314 before the House Interstate and Foreign Commerce Committee*, 73rd Cong 181 (1933).

no-action letters, Bank of Boston Corporation[100] did not include evidence of "prime quality" in its no-action request on July 13, 1989, and Southeast Banking Corporation[101] did not include evidence of "prime quality" in its no-action request on August 25, 1989. In response, the SEC requested information from both issuers that would indicate that the proposed commercial paper would be of "prime quality." Then, in 1992, the staff "imposed a moratorium on the issuance of no-action letters with respect to Section 3(a)(3) pending reexamination by the staff of the 'prime quality' criterion of the exemption."[102] More than a decade later, the staff has not yet released the results of its reexamination of the requirement.

Based on the no-action letters issued prior to the moratorium, however, it appears that there are several ways for an issuer to establish that its proposed paper is of "prime quality."

First, an issuer can show prime quality with evidence that the proposed commercial paper is rated in one of the two highest categories by a nationally recognized investment rating service.[103] The following five organizations currently rate commercial paper with the following ratings: Duff and Phelps, Inc.: Duff 1+, Duff 1, Duff 1-, Duff 2, and Duff 3. Fitch Investor Services Corp.: F-1 to F-4. McCarthy, Crisanti, Naffei, Inc.: MCM-1 to MCM-6. Moody's Investors Services: P-1, P-2, or P-3. Standard and Poor's, Inc.: A-1, A-2, or A-3.[104]

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[100]Bank of Boston, SEC No-Action Letter, 1989 WL 246327 (Aug. 28, 1989).

[101]Southeast Banking Corp., SEC No-Action Letter, 1989 WL 246486 (Nov. 21, 1989).

[102]General Elec. Capital Corp., SEC No-Action Letter, 1994 WL 369848 (July 13, 1994).

[103]Peoples Gas Light & Coke Co., SEC No-Action Letter, 1989 WL 246386 (Sept. 28, 1989) (F-1+ by Fitch, A-1- by Standard & Poor's, P-1 by Moody's, and D-1 by Duff & Phelps); Southeast Banking Corp., SEC No-Action Letter, 1989 WL 246486 (Nov. 21, 1989) (A-2 by Standard & Poor's, S-1 by Duff & Phelp's); Bank of Boston, SEC No-Action Letter, 1989 WL 246327 (Aug. 28, 1989) (A-1+ by Standard & Poor's, D-1 by Duff & Phelps); Security Pacific, SEC No-Action Letter, 1988 WL 234397 (May 23, 1988) ("rated in one of the two highest categories by a nationally recognized investment rating service").

[104]Federal Reserve Bank of New York, Fedpoint 29: Commercial Paper, *at* http://www.ny.frb.org/pihome/fedpoint/fed29.html (last visited Feb. 28, 2003).

These ratings are based on the "issuer's financial condition, bank lines of credit and timeliness of repayment."[105]

Second, an issuer can establish prime quality by backing the notes with unused bank lines of credit adequate to redeem all of the notes outstanding at any given time.[106]

Third, an issuer can show prime quality by presenting evidence of "the nature of the issuer and the extent of government regulation to which such issuer is subjected."[107] For example, Imperial Corporation's paper was neither rated by a nationally recognized investment rating service nor backed by lines of credit.[108] Rather, Imperial Corporation submitted copies of its most recently filed Form 10K and Form 10Q to show that it had "substantial assets to support the commercial paper it would issue and that such paper would be issued within an extensively regulated and supervised environment."[109]

In analyzing the "prime quality" requirement, most courts seem to focus on the "nature of the issuer" rather than the paper's rating or the issuer's line of credit. For example, in *United States v. Hill*, the court rejected the defendant's claim that the notes were of prime quality because they were "highly speculative and bore no resemblance to the high grade paper issued or accepted by finance houses."[110] The court continued: "The 3(a)(3) exemption was not intended, and does not extend, to cover financing by an insolvent company in its speculative attempt to launch an enterprise."[111] Similarly, in *Sanders v. John Nuveen & Co.*, the court found it

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[105]Federal Reserve Bank of New York, Fedpoint 29: Commercial Paper, *at* http://www.ny.frb.org/pihome/fedpoint/fed29.html (last visited Feb. 28, 2003).

[106]Turner Broadcasting, SEC No-Action Letter, 1989 WL 246469 (Nov. 7, 1989); Lyondell Petrochemical, SEC No-Action Letter, 1989 WL 246100 (July 19, 1989); Black & Decker, SEC No-Action Letter, 1989 WL 246118 (July 12, 1989); Russell Corp., SEC No-Action Letter, 1988 WL 234922 (Sept. 22, 1988).

[107]Southeast Banking Corp., SEC No-Action Letter, 1989 WL 246486, at *9 (Nov. 21, 1989).

[108]Imperial Corp., SEC No-Action Letter, 1988 WL 235017, at *8 (Sept. 21, 1988).

[109]Imperial Corp., SEC No-Action Letter, 1988 WL 235017, at *9 (Sept. 21, 1988).

[110]United States v. Hill, 298 F. Supp. 1221, 1227 (D. Conn. 1969).

[111]Id.

"unlikely that the paper purchased by the plaintiff and members of his class is . . . prime quality" because, within a few weeks after selling the paper, the issuer "had assets of $12.5 million and liabilities of more than $36 million."[112] Additionally, in *UBS Asset Management (New York) Inc. v. Wood Gundy Corp.*, the court explicitly recognized that, although the SEC views a prime quality rating as conclusive evidence of "prime quality," courts are more reluctant to so find in the face of evidence that the paper was not in fact of prime quality at the time it was sold:

> "The Division [of Corporation Finance of the SEC] has relied on several factors to determine that commercial paper is of 'prime quality,' including the financial strength of the issuer, support of the commercial paper by a form of credit enhancement, or rating of the commercial paper by a national rating agency." However, courts have declined to find commercial paper prime where it was issued to cover financing for an insolvent company.[113]

Despite other courts' refusal to find "prime quality" based solely on a prime rating, in *Montcalm County Board of Commissioners v. McDonald & Co. Securities*, the court, albeit in dicta, appeared to regard the paper's Standard & Poor rating of A-2 and Fitch rating of F-2 as conclusive evidence of the paper's prime quality.[114]

Further, in *Franklin Savings Bank v. Levy*,[115] the court seemed to blend the "prime quality" requirement with the scienter requirement, treating the defendants' knowledge of the paper's quality at the time it was sold as relevant to whether the paper was exempt from the 1934 Act. Plaintiff Franklin Savings Bank alleged that the general partners of Goldman, Sachs & Company engaged in violations of §10(b) of the Securities Exchange Act in connection with the sale of Penn Central Transportation Company (PCTC) commercial paper.[116] Defendants argued that, because the paper was issued a prime rating by the National Credit Office, a subsidiary of Dun & Bradstreet, Inc., the paper was "prime quality" at the time it

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[112] *Sanders*, 463 F.2d at 1079.

[113] *UBS Asset Management (New York) Inc. v. Wood Gundy Corp.*, 914 F. Supp. 66, 69 (S.D.N.Y. 1996) (quoting Mercury Fin. Co., SEC No-Action Letter, 1989 WL 245554, at *5 (Jan. 20, 1989)).

[114] *Montcalm County Bd. of Commissioners v. McDonald & Co. Securities*, 833 F. Supp. 1225, 1227, 1235 (W.D. Mich. 1993).

[115] *Franklins Savings Bank v. Levy*, 406 F. Supp. 40 (S.D.N.Y. 1975), *rev'd on other grounds*, 551 F.2d 521 (2d Cir. 1977).

[116] *Id.* at 41.

was sold, despite PCTC's filing for reorganization under the Bankruptcy Act three and a half months later.[117] While analyzing whether this rating proves that the paper was of prime quality when it was sold, the court twice commented on the defendants' state of mind. First, the court stated:

> Franklin could only buy notes rated high by NCO, but such rating does not absolve Goldman, Sachs of its duty of disclosure. The question is whether Goldman, Sachs' decision under all the circumstances was proper in view of the protections afforded investors by the securities laws.[118]

Then, later in the opinion, the court again intermingled the defendants' state of mind with the applicability of the 1934 Act:

> It is an inescapable conclusion that starting with February 4, Goldman, Sachs just did not have faith in this paper any more and was lightening its load and reducing its exposure. At this point, I find that the paper could no longer be considered prime paper and qualify for exemption from the provisions of Section 10(b).[119]

Rather than treating "prime quality" as an objective standard, the court seemed to look at the defendants' opinion of the paper's quality in determining whether the 1934 Act provisions apply, which in this context essentially writes the exclusion for commercial paper out of the Act. For example, if a plaintiff were able to establish scienter in his §10(b) claim, then it is likely that the plaintiff would similarly be able to show that the defendant thought that the paper was not of prime quality at the time of sale.

2. Appropriateness of a Prime Quality Requirement

It clearly was important to the legislators of the 1933 Act that the exempted commercial paper be of prime quality. For example, in support of excluding commercial paper from the coverage of the Act, McCluney & Co. stated: "During the present depression commercial paper has again proven to be the safest investment a bank can buy with the exception of Government obligations."[120] Similarly, Senator Glass described the scope of the exemption as fol-

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[117] *Id.* at 41, 43.

[118] *Id.* at 44.

[119] *Id.* at 46.

[120] *Hearing on S. 875 Before the Senate Banking and Currency Committee*, 73rd Cong. 95 (1933).

lows: "Well, I do not think it would cover any securities that have gone into default."[121]

Although the legislators did not explicitly outline how the prime quality requirement should be interpreted, the courts' analysis, which treats a prime rating as merely evidentiary, seems most consistent with the Acts' goal of "ensuring that investments of all descriptions be regulated to prevent fraud and abuse."[122]

C. "Of a Type Eligible for Discounting by Federal Reserve Banks"

The requirement that the paper be of a type eligible for discounting by Federal Reserve banks[123] is no longer relevant because the Federal Reserve has stopped discounting commercial paper.[124] Further, when enforced, this requirement overlapped with the "current operations" requirement: "As to the requirement that the note be of a type eligible for discount by the Federal Reserve banks, 12 C.F.R. §201.4(a) adopts the current transactions standard. That standard is

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[121] *Hearing on S. 875 Before the Senate Banking and Currency Committee*, 73rd Cong. 98 (1933).

[122] *Reves*, 494 U.S. at 73.

[123] The Supreme Court has explained the criteria for this eligibility as follows:

> In order for commercial paper to be eligible for discount at Federal Reserve banks, its proceeds may not "be used for permanent or fixed investments of any kind, such as land, buildings, or machinery, or for any other fixed capital purpose" or "for transactions of a purely speculative character" or "for . . . trading in . . . investment securities except direct obligations of the United States." Consistent with the short maturity of commercial paper, the proceeds must be used "in producing, purchasing, carrying, or marketing goods," "meeting current operating expenses," or "carrying or trading in direct obligations of the United States."

Sec. Indus. Ass'n v. Bd. of Governors, 468 U.S. 137, 170 n.10 (1984) (citing G. Munn & F. Garcia, Encyclopedia of Banking & Finance 196 (8th ed. 1983)).

[124] Prescient Markets, Inc., SEC No-Action Letter, 2001 WL 328060 (Apr. 2, 2001) ("We understand that the SEC has discarded this requirement because it is no longer relevant in light of market practice."); General Elec. Capital Corp., SEC No-Action Letter, 1994 WL 369848 (July 13, 1994) ("Release 4412 imposes a fourth requirement—that the paper be of a type eligible for discounting by a Federal Reserve bank. The Fed has stopped discounting commercial paper, rendering this requirement moot.").

met so long as the initial use of proceeds was for proper purposes.''[125]

D. "Issued to Facilitate Well Recognized Types of Current Operational Business Requirements"

1. Interpretation by SEC and Courts

The requirement that the paper be ''issued to facilitate well recognized types of current operational business requirements'' is explicitly included in §3(a)(3). Section 3(a)(3) applies to ''[a]ny 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.'' The SEC interprets this requirement as follows:

> A type of security which usually has been considered to fall within the terms of Section 3(a)(3) is short-term paper issued by finance companies to carry their installment loans. Securities Act Release No. 401 recognized that current transactions by such companies may properly include: '(a) the making of loans upon or purchasing of . . . notes, installment contracts, as other evidences of indebtedness in the usual course of business, or (b) the payment of outstanding notes under Section 3(a)(3).' The items covered by the release are composed of assets easily convertible into cash and are comparable to liquid inventories of an industrial or mercantile company. *What is a current transaction is, of course, a question which must be considered in the light of the particular facts and business practice surrounding individual cases.*[126]

As recognized by the SEC, the classification of a transaction as a ''current transaction'' is necessarily fact-specific. Professor J. William Hicks analyzed a series of these fact-specific determinations and formulated the following list of transactions that, if certain criteria are met, qualify as ''current transactions'':

(1) Commercial Financing
(2) Consumer Credit Loans
(3) Mortgage Warehousing Loans
(4) Factoring

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[125] *Franklin Savings Bank*, 406 F. Supp. at 43.

[126] Securities Act of 1933 Release No. 33–4412, 1961 WL 61632 (Sept. 20, 1961).

(5) Preconstruction Loans
(6) Construction Loans
(7) Land Acquisition and Development Loans
(8) Standing Mortgage Loans
(9) Short-Term Remaining Portions of Long-Term Loans
(10) Ordinary Operating Expenses
(11) Temporary Investments
(12) Discharge of Certain Existing Indebtedness[127]

Apparently, once an issuer establishes that the proposed transactions qualify as "current transactions," the issuer need not trace the funds if the issuer can show that, at all times, the amount of money spent on "current transactions" exceeds the amount of outstanding short-term debt. In response to a 1974 no-action request, the SEC staff stated:

> You indicate that it is your understanding that, "so long as the aggregate amount of Commercial Paper outstanding at any time does not exceed the amount of proceeds invested in current transactions there is no necessity of tracing dollars to establish that funds actually received were invested in specific current transaction." . . . We are not in a position at this time to pass on the correctness of . . . the above understanding[], in light of a re-evaluation which is currently being undertaken by the staff as to the scope of the term, current transactions in Section 3(a)(3).[128]

However, despite the staff's cryptic comment about re-evaluation, issuers have continued to request and receive no-action letters in reliance on the showing that the aggregate amount of commercial paper outstanding at any time does not exceed the amount of proceeds invested in current transactions.[129] In its request for a no-action letter, Lyondell Petrochemical Co. summarized the SEC staff's treatment of this issue: "[T]he Division customarily issues 'no-action' letters under Section 3(a)(3) of the Act on the basis of a commitment to limit the amount of outstanding commercial paper in accordance with a formula that appropriately reflects well recognized categories of 'current transactions' contemplated by

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[127] J. William Hicks, *Commercial Paper: An Exempted Security Under Section 3(a)(3) of the Securities Act of 1933*, 24 UCLA L.R. 255–72 (1976).

[128] Capital Mortgage Inv., SEC No-Action Letter, 1974 WL 6749 (Mar. 25, 1974).

[129] E.g., Am Crystal Sugar Co., SEC No-Action Letter, 1987 WL 108666, at *2 (Nov. 13, 1987); Nichols Hills Bancocorporation, SEC No-Action Letter, 1983 WL 28548 (Aug. 12, 1983).

Section 3(a)(3).''[130] Further, in a 1997 non-binding response to a telephone inquiry, the Division of Corporate Finance stated: ''Tracing of commercial paper proceeds to actual 'current transactions' is not necessary under Section 3(a)(3) where the proceeds will be commingled with the issuer's general funds and such funds will be applied in part to current transactions equal in amount to the commercial paper proceeds.''[131]

2. Appropriate Interpretation of Current Operations Requirement

The current operations requirement as currently interpreted is consistent with the current operations requirement for the discounting of commercial paper by the Federal Reserve.[132] The legislative history of §3(a)(3) supports this interpretation of the current operations requirement. For example, H. Report No. 85 clearly indicates the House's intent that the current operations requirement be interpreted consistently with the discounting rules: ''Paragraph (3) exempts short-term paper of the type available for discount at a Federal Reserve bank. . . .''[133] Similarly, the Senate Banking and Finance Committee recognized the relationship between paper eligible for discount and paper to be exempt under the Federal Reserve Board's proposed amendment, whose language §3(a)(3) closely tracks:

> Ollie M. Butler: ''In connection with short-term commercial paper, the Federal Reserve Board proposes an amendment to the definition of securities which will exempt commercial paper maturing within 9 months that is eligible for discount with Federal Reserve Banks.''
>
> Senator Adams: ''Their definition was practically that of the

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[130] Lyondell Petrochemical Co., SEC No-Action Letter, 1989 WL 246100 (July 19, 1989).

[131] Division of Corporate Finance Manual of Publicly Available Telephone Interpretations, Compiled by the Office of Chief Counsel, at http://www.sec.gov/interps/telephone/1997manual.txt (last visited Mar. 3, 2003). Note that this informal response is ''not binding due to [its] highly informal nature'' and is ''intended as general guidance and should not be relied on as definitive.'' Id.

[132] Amicus Curiae Brief of the Securities and Exchange Commission, *In re NBW Commercial Paper Litig.*, Civil Action No. 91-0626 (D.D.C.), at 42 n.23.

[133] H.R. Rep. No. 85, at 15 (1933).

statutes in reference to paper eligible for discount in Federal Reserve Banks.''[134]

Thus, the current operations requirement appropriately focuses on whether the funds are used for ''assets easily convertible into cash and are comparable to liquid inventories of an industrial or mercantile company.''[135]

VI. Reconciliation of "Virtually Identical" Language with §3(a)(3)'s Status as an Exemption from Registration and §3(a)(10)'s Status as an Exclusion from the Definition of Security

Under the literal language of the 1933 Act, the exempt notes are exempt only from the registration provisions of the Act and thus private §12(a)(2) and SEC and United States Attorney §17(a) actions are still available. In fact, both §12(a)(2) and §17(a) explicitly recognize their applicability to securities exempt from registration under §3.[136] In addition, several courts have recognized the applicability of §12(a)(2) and §17 to notes exempt from registration under §3(a)(3).[137] Under the literal language of the 1934 Act, the excluded notes are excluded from the definition of ''security'' and thus §10(b) and Rule 10b-5 enforcement are literally unavailable. Further, the Supreme Court in *Tcherepnin* stated that the definitions of ''security'' in the 1933 Act and 1934 Act are ''virtually identical.''[138]

Under a literal interpretation of the provisions, the definitions of ''security'' would not be ''virtually identical'' because notes exempt from registration under the 1933 Act would still be ''securi-

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[134]*Hearing on S. 875 Before the Senate Banking and Currency Committee*, 73rd Cong. 241 (1933).

[135]Amicus Curiae Brief of the Securities and Exchange Commission, *In re NBW Commercial Paper Litig.*, Civil Action No. 91–0626 (D.D.C.), at 42 n.23.

[136]15 U.S.C.A. §77l(a)(2) (''[W]hether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section. . . .''); 15 U.S.C.A. §77q (c) (''The exemptions provided in section 77c of this title shall not apply to the provisions of this section.'').

[137]*E.g.*, *Nat'l Bank of Yugoslavia*, 768 F. Supp. at 1014.

[138]*Tcherepnin*, 389 U.S. at 335–36.

ties'' under the 1933 Act while they would not be ''securities'' under the 1934 Act. This literal interpretation seems antithetical to the ''virtually identical'' language. However, the ''virtually identical'' language can be reconciled with the Acts' treatment of commercial notes by reading the ''unless the context otherwise requires'' language that precedes each definition as tempering the definitions' ''virtually identical'' meanings.

Under this literal interpretation, notes exempt from registration under the 1933 Act would be subject to the antifraud provisions of the 1933 Act but not the 1934 Act. This discrepant treatment appears illogical and without a meaningful basis in the legislative history. In fact, the congressional committees drafting the commercial paper exemption did not comment on the distinction between excluding certain commercial paper from the definition of security and exempting that paper from the registration provisions.

The Federal Reserve Board proposed to the House Committee that notes maturing in less than nine months be excluded from the 1933 Act's definition of security.[139] This proposed amendment was read into the record in the midst of a discussion about exempting these notes from the registration provisions of the 1933 Act. No one commented on the differing ramifications of exempting these notes from the registration provisions and of excluding them from the definition of security.

When the Senate Committee examined how to treat commercial paper, Senator Adams appeared to recognize the distinction between exempting certain commercial paper from the registration provisions and excluding it from the definition of security:

> Senator Adams: You would recognize the propriety, would you not, of the fraud sections being made applicable even to commercial paper? . . . And if one of those note brokers, some intermediary, should misuse these things, misuse the mails, I take it you would concede that it would be proper to provide for prosecution of them, even though you do not think he should be required to make a registration of those securities.''[140]

Yet, despite this apparent recognition of the distinction between exemption from registration exclusion from the definition of secu-

[139] *Hearing on H.R. 4314 Before the House Interstate and Foreign Commerce Committee*, 73rd Cong. 180–81 (1933).

[140] *Hearing on S. 875 Before the Senate Banking and Currency Committee*, 73rd Cong. 234 (1933).

rity, the Senate Committee's Report proposed that certain commercial paper be excluded from the definition of security.[141] The Conference Committee resolved the discrepancy between the House's exemption from registration and the Senate's exclusion from the definition of security in favor of an exemption from registration.

In light of the apparent failure to recognize the full import of the distinction between exemption from registration and exclusion from the definition of security, Congress's choice to exclude notes maturing in less than nine months from the 1934 Act's definition of security was perhaps not a calculated decision.

Further, under this interpretation, injured investors in commercial paper would likely be precluded from relying on any of the antifraud provisions of the federal securities acts, reserving to the SEC the exclusive right of enforcement. First, §17(a) has been consistently interpreted as not providing a private right of action.[142] Second, the Supreme Court has interpreted §12(a)(2) as only applying to public offerings.[143] In order to qualify as ''commercial paper'' under §3(a)(3), notes may not be offered or sold to the public. As a result, an investor in a §3(a)(3) note appears to be functionally precluded from using §12(a)(2). This interpretation seems to contravene the purpose of the federal securities laws, ''to prevent fraud and abuse.''[144]

Rather than interpreting these provisions literally, there are two plausible alternative interpretations that use the Supreme Court's ''virtually identical'' language to rewrite the Acts' literal terms. Especially in light of the above concerns with a literal interpretation, these alternatives demand a closer analysis.

First, it is plausible to interpret the 1933 Act literally so that ''commercial paper'' is exempt from registration under the 1933 Act but still a ''security'' under the 1933 Act. Then, rather than interpreting the 1934 Act literally, the Supreme Court's ''virtually identical'' language would write the ''commercial paper'' exclu-

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[141] S. 875 as reported to the Senate from the Committee on Banking and Currency.

[142] *Finkel v. Stratton Corp.*, 962 F.2d 169, 175 (2d Cir. 1992) (''Courts of Appeals construing §17(a) after *Aaron* have uniformly concluded that there is no private right of action.'').

[143] *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995).

[144] *Reves*, 494 U.S. at 73.

sion entirely out of the 1934 Act. Therefore, "commercial paper" would be a "security" under both Acts and the definitions of "security" under both Acts would be "virtually identical." Additionally, "commercial paper" would be subject to the antifraud provisions of both Acts, disposing of the literal interpretation's discrepant treatment and furthering the Acts' purpose of protecting investors.

This interpretation is supported by the treatment of notes in the companion enactments to the Securities Acts. As recognized by the Seventh Circuit: "[A]ll notes are subject to the antifraud provisions of the other acts."[145]

In support of this interpretation, commentator Edward Sonnenschein, Jr., cited SEC Release No. 33–4412.[146] The last paragraph of the release states: "It should be emphasized that section 3(a)(3), if available, affords an exemption only from the registration and prospectus requirements of section 5 of the Act and that civil liabilities of section 17 are still available."[147] Mr. Sonnenschein argued that, by recognizing that the antifraud provision of the 1933 Act were still applicable, the SEC was suggesting "a similar result with respect to the coverage of the antifraud provisions of the 1934 Act."[148] Mr. Sonnenschein recognized that this interpretation "comports with the differing policies underlying the 1933 Act registration scheme, on the one hand, and the antifraud scheme of both Acts, on the other."[149]

Despite the policy justifications for application of the 1934 Act's antifraud provisions to commercial paper exempt under §3(a)(3), reliance on SEC Release No. 33–4412 as support for this interpretation is unsound. Because Release No. 33–4412 is a Securities Act interpretative release, the SEC did not address, explicitly or impliedly, whether the 1934 Act antifraud provisions apply to exempt commercial paper. Further, despite the murky legislative history supporting the exclusion of commercial paper from the 1934 Act's definition of security and despite the companion enactment's

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[145]*Sanders*, 463 F.2d at 1078.

[146]Edward Sonnenschein, Jr., *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1575 (1980).

[147]Securities Act of 1933 Release No. 3304412, 1961 WL 61632 (Sept. 20, 1061).

[148]Edward Sonnenschein, Jr., *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1575 (1980).

[149]Id.

treatment of commercial paper, §3(a)(10) of the 1934 Act purports to exclude these notes from the definition of security. This exclusion, absent a more compelling argument, should not be ignored.

Second, it is plausible to interpret the 1934 Act literally so that "commercial paper" is excluded from the definition of "security" under the 1934 Act. Then, rather than interpreting the 1933 Act literally, the 1933 Act definition of "security" would be interpreted consistently with the 1934 Act definition. Therefore, both definitions would be "virtually identical," and neither Act's antifraud provisions would apply to "commercial paper."

Apparently by accident, several courts have stated that notes maturing in less than nine months are not "notes" under the 1933 Act. For example, the Ninth Circuit in dicta stated that the 1933 Act "defines security as including 'any note. . . .', exempting only those which arise 'out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which (have) a maturity at the time of issuance of not exceeding nine months. . . . '"[150]

The defendants in *Floyd v. First Penn Corp.* represented to the court, without outlining their reasoning, that commercial notes are not securities under the 1933 Act.[151] The defendants could have argued in good faith that, because commercial notes are not securities under the 1934 Act and because the definitions of "security" in the 1933 Act and the 1934 Act are interpreted as identical, commercial notes are not securities under the 1933 Act. Rather than outline this argument, however, the defendants merely replaced "Securities Act of 1934" with "Securities Act of 1933" in a quote from a Fifth Circuit decision holding that commercial paper is not a security under the 1934 Act.[152] The court rebuked the defendants' sleight of hand: "The defendants' papers reveal either a fundamental misunderstanding of the federal securities laws or an unconscionable attempt to mislead the court. . . . This court cannot and will not countenance this sort of lawyering."[153]

Further, the court rejected the defendants' reasoning: "[T]he

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[150]*Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1255 (9th Cir. 1976).

[151]*Floyd v. First Penn. Corp.*, 1983 WL 1290, at *1 (W.D. Okla. Feb. 4, 1983).

[152]*Id.* at *1 n.1.

[153]*Id.* at *1, *1 n.1.

defendants read too much into the courts' conclusion that the definition of 'security' in the 1933 and 1934 Acts is 'virtually identical.' "[154] In an attempt to reconcile the Supreme Court's statement that the definitions "security" in the 1933 and 1934 Acts are "virtually identical" with the Acts' treatment of commercial notes, the court stated that the "virtually identical" language only applies to the first facet of the definition of "security."[155] According to the court, the first facet of the definition outlines what *is* a security, while the second facet outlines what *is not* a security.[156] The court's attempt at reconciliation is valiant but unconvincing because the so-called second facet actually operates to limit the so-called first facet. Rather than merely operating as facets, these two parts of the definition are interconnected.

These two alternative interpretations that use the Supreme Court's "virtually identical" language to rewrite the Acts' literal terms are less convincing than a literal interpretation where the "unless the context otherwise requires" language that precedes each definition tempers the definitions' "virtually identical" meanings. Under this literal interpretation, commercial paper satisfying §3(a)(3) is an instrument that, because of the context, is within the definition of security under the 1933 Act but excluded from the definition of security under the 1934 Act. This solution is preferable to the alternatives analyzed above, which would require not merely liberal interpretation of the text of the Acts but blatant rejection of the text of the Acts.

VII. Which Party Has the Burden of Proving the Applicability or Inapplicability of §3(a)(3) and §3(a)(10)?

The court in *Floyd* also highlighted an interesting difference in the treatment of commercial notes under the 1933 Act and under the 1934 Act.[157] In the 1933 Act, since the commercial paper provision is an exemption from registration, the party attempting to show that a note is exempt from the registration provisions of the Act has the

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[154] *Id.* at *2 (referring to *Tcherepnin*, 389 U.S. at 335–36).

[155] Id.

[156] Id.

[157] *Id.* at *3.

burden of proving the exemption by a preponderance of the evidence.[158] In the 1934 Act, since the commercial paper provision is part of the definition of "security," the party attempting to show that a note is subject to the 1934 Act has the burden of proving the inapplicability of the commercial paper provision by a preponderance of the evidence.[159] For example, in *Franklin Savings Bank* the court recognized that the plaintiff, who was asserting a §10(b) claim, had the burden of showing that the commercial paper exclusion was not met: "Plaintiff has failed to show that the original use of the PCTC commercial paper was not for the current operating purposes required by the SEC test."[160] Therefore, under the 1933 Act, the party attempting to show that the securities laws do not apply has the burden of proving that the note is commercial paper; and, under the 1934 Act, the party attempting to show that the securities laws apply has the burden of proving that the note is not commercial paper.

Several courts have added a further twist to this complex analysis by interpreted §3(a)(3) and §3(a)(10) as creating a rebuttable presumption that a note maturing in less than nine months is exempt commercial paper. For example, in *In re NBW Commercial Paper Litigation*, the court interpreted §3(a)(3) as creating a presumption that a note maturing in less than nine months is exempt from registration, capable of rebutting with evidence that the paper is not "prime quality commercial paper, which is not generally available to the public."[161] This presumption would shift the burden of proof under §3(a)(3) to the party seeking application of the registration provisions to a note maturing in less than nine months and would

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[158] Id. (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953)).

[159] Id.

[160] *Franklin Savings Bank*, 406 F. Supp. at 43.

[161] *In re NBW Commercial Paper Litigation*, 813 F. Supp. at 18. Oddly, the court explained the showing necessary to rebut the presumption as follows: "[A]s with the presumption that a note is a security created by the Supreme Court in *Reves*, this presumption is rebuttable with evidence that sales are made to the public (or other unsophisticated investors) *and* that the investments are of less-than-prime quality. In keeping with the purposes of the statute, the presumption is successfully rebutted only if both elements are met." *Id.* at 18, 18 n.15 (footnote moved to text). This articulation is curious because the court had on the previous page adopted the SEC's interpretation that §3(a)(3) only exempts "prime quality commercial paper which is not generally available to the public." *Id.* at 17. The effect of the court's articulation, however, is to exempt paper that is (1) not offered to the public but not prime

shift the burden of proof under §3(a)(10) to the party seeking to avoid 1934 Act coverage of a note maturing in less than nine months.

In *Abbell Credit Corp. v. Bank of Am. Corp.*, however, the court refused to shift the burden of proof to the party seeking coverage of the federal securities laws to prove that a note maturing in less than nine months is not exempt commercial paper.[162] Rather, the court reaffirmed: "The burden of establishing an exemption is on the party that claims it."[163]

Since the *In re NBW* presumption reverses the usual burden of proving an exemption from registration or of proving that an instrument is a security, *In re NBW*'s interpretation is not convincing absent an explicit statutory intention to alter the usual burden of proof.

VIII. Which of the Plausible Interpretations of §3(a)(3) and §3(a)(10) Is Best?

As determined above, §3(a)(3) and §3(a)(10) should be interpreted as applying to prime quality commercial paper that is not of a type ordinarily purchased by the general public and is issued to facilitate well recognized types of current operational business requirements. Commercial paper satisfying the requirements of §3(a)(3) is exempt from registration, and the party seeking to establish the exemption has the burden of proving that the instrument qualifies as exempt commercial paper. Commercial paper satisfying the requirements of §3(a)(10) is excluded from the 1934 Act, and the party seeking coverage of the 1934 Act has the burden of proving that the instrument does not qualify as exempt commercial paper. In sum, the majority interpretation, discussed *supra* part II.B. as the first of seven plausible interpretations, is the best interpretation.

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quality, or (2) prime quality but offered to the public, in addition to paper that is (3) prime quality and not offered to the public.

[162] *Abbell Credit Corp. v. Bank of Am. Corp.*, 2002 WL 335320, at *6 (N.D. Ill. Mar. 1, 2002) (not reported).

[163] Id.

IX. Interaction of the *Reves* "Family Resemblance" Test and the §3(a)(3) and §3(a)(10) Analyses

When this interpretation of §3(a)(3) and §3(a)(10) is analyzed in light of the Supreme Court's *Reves* "family resemblance" test, the *Reves* test appears to subsume §3(a)(3) and §3(a)(10). The prime quality commercial paper that would be exempt under §3(a)(3) and §3(a)(10) does not seem to even qualify as a note under *Reves* because it bears a family resemblance to "notes evidencing loans by commercial banks for current operations."[164] Therefore, commercial paper satisfying §3(a)(3) and §3(a)(10) appears to be merely a specialized type of non-note under *Reves*, and §3(a)(3) and §3(a)(10) are essentially written out of the Securities Acts.

In order to demonstrate that *Reves* subsumes §3(a)(3) and §3(a)(10), it is necessary first to look more closely at the *Reves* analysis. The "family resemblance" test begins with the presumption that every note maturing in more than nine months is a security.[165] The Supreme Court did not address whether this presumption similarly applies to notes maturing in less than nine months.[166] The Second Circuit's original formulation of the family resemblance test had applied no presumption to notes maturing in less than nine months.[167] Subsequent to *Reves*' adoption of the family resemblance test, however, most courts addressing the issue have extended the *Reves* presumption to all notes.[168] Similarly, the SEC applies the *Reves* presumption to all notes under the 1933 Act, regardless of maturity.[169]

The presumption that a note is a security can be rebutted by showing that the note bears a strong resemblance to one of the enumer-

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[164]*Reves*, 494 U.S. at 65.

[165]*Id.* at 65.

[166]*Id.* at 65 n.3.

[167]Id. (citing *Chem. Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 954 (2d Cir. 1984)).

[168]*Holloway*, 900 F.2d at 1494 (applying the *Reves* presumption to notes maturing in less than nine months); *SEC v. R.G. Reynolds Enters., Inc.*, 952 F.2d 1125, 1131 (9th Cir. 1991) (same); *SEC v. Better Life Club of Am., Inc.*, 203 F.3d 54 (D.C. Cir. 1999) (unpublished opinion) (same); *Roer v. Oxbridge, Inc.*, 198 F. Supp. 2d 212, 223 (E.D.N.Y. 2001) (same).

[169]Amicus Curiae Brief of the Securities and Exchange Commission, *In re NBW Commercial Paper Litig.*, Civil Action No. 91–0626 (D.D.C.), at 13.

ated categories of non-notes. This showing is accomplished by using the following four factors as points of comparison: (1) "the motivations that would prompt a reasonable seller and buyer to enter into it," (2) "the 'plan of distribution' of the instrument," (3) "the reasonable expectations of the investing public, and (4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."[170] Further, even if a note does not bear a strong resemblance to one of the enumerated categories, "the decision whether another category should be added is to be made by examining the same factors."[171]

Caselaw has developed the meaning of each *Reves* factors. Once this meaning is compared with the showing required to satisfy §3(a)(3) and §3(a)(10), the two analyses appear to overlap. If an instrument satisfies §3(a)(3) and §3(a)(10), then the instrument appears to not qualify as a "note" under *Reves*.

A. Comparison of the *Reves* Elements and the §3(a)(3) and §3(a)(10) Analyses

1. Motivations that Would Prompt a Reasonable Seller and Buyer to Enter into the Transaction

—a. Caselaw Interpretation

In *Reves*, the court explained that, if the seller's motivation is "to raise money for the general use of a business enterprise or to finance substantial investments," then the instrument resembles a security.[172] On the other hand, if the note is "exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, . . . the instrument is less sensibly described as a 'security.' "[173] Because the seller sold the notes "in an effort to raise capital for its general business operations," the court characterized the transaction as "an investment in a business

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[170] *Reves*, 494 U.S. at 66–67.

[171] *Id.* at 67.

[172] *Id.* at 66.

[173] Id.

enterprise rather than as a purely commercial or consumer transaction.''[174]

In *Holloway v. Peat, Marwick, Mitchell & Co.*, the Tenth Circuit, when analyzing the seller's motivation, similarly looked at whether the proceeds were used ''to buy specific assets or services,'' resembling a non-security, or for ''general financing,'' resembling a security.[175] In *Guidry v. Bank of LaPlace*, the defendant raised funds to purchase blocks of airline tickets to be re-sold at a profit and gave investors post-dated checks reflecting interest.[176] The court found that, because the raised funds ''facilitated the purchase of alleged airline tickets as well as corrected [defendant's] cash flow difficulties,'' the checks did not appear to be ''notes'' under the first prong of the *Reves* test.[177]

In *Banco Espagnol de Credito v. Security Pacific National Bank*, Security Pacific sold loan participations on Integrated's debt to plaintiffs.[178] The Second Circuit found that, because ''Integrated was motivated by a need for short-term credit at competitive rates to finance its current operations,'' ' 'the overall motivation of the parties was the promotion of commercial purposes' rather than an investment in a business enterprise.''[179]

In *Stoiber v. SEC*, the District of Columbia Circuit court attempted to clarify further the *Reves* distinction between commercial and investment uses of raised funds: ''Although the line between commercial and investment uses may not always be sharp, *Reves*' examples appear to distinguish between funding the enterprise generally and funding a discrete component or department of the enterprise.''[180]

Further, in *Stoiber*, the court examined how the motivations of an issuer of a note could bear a ''family resemblance'' specifically to the motivations of a borrower in a bank loan for commercial opera-

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[174]*Id.* at 67–68.

[175]*Holloway*, 900 F.2d at 1488 n.1.

[176]*Guidry v. Bank of LaPlace*, 740 F. Supp. 1208, 1210 (E.D. La. 1990, *aff'd in part, modified in part*, 954 F.2d 278 (5th Cir. 1992) (agreeing with the district court that the post-dated checks were not ''notes'' under *Reves*).

[177]*Id.* at 1214.

[178]*Banco Espagnol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51, 53 (2d Cir. 1992).

[179]*Id.* at 55.

[180]*Stoiber v. SEC*, 161 F.3d 745, 750 (D.C. Cir., 1998).

tions: "There is a substantial difference between the goals of the parties in this case and those involved when banks provide . . . commercial loans for current operations. . . . A loan for current operations allows the borrower to achieve the commercial goal of continuing to operate a business smoothly during a period when cash inflows and outflows do not match up. . . . Unlike with a loan for current operations, Stoiber was funding his entire endeavor, not just getting past a cash crunch."[181]

In *Reves*, the court additionally explained that, if the buyer is interested "primarily in the profit the note is expected to generate," then the instrument resembles a security.[182] Since "one of the primary inducements offered purchasers was an interest rate constantly revised to keep it slightly above the rate paid by local banks and savings and loans," the *Reves* court found that the purchasers' motivations resembled those of securities purchasers.[183]

A split in authority exists about whether a buyer of a note with a fixed rate of interest is motivated by "profit." Soon after *Reves*, two district courts found that a fixed rate of interest could not qualify as profit, noting that in *Reves* the interest rate was constantly revised.[184]

Since 1990, however, three circuit courts have discounted the argument that a fixed interest rate does not qualify as profit. In *Stoiber v. SEC*, the District of Columbia Circuit stated: "[T]he Supreme Court [in *Reves*] has said a favorable interest rate indicates that profit was the primary goal of the lender. The fact that the rates were fixed and not variable does not suggest otherwise."[185] In *SEC v. Wallenbrock*, the Ninth Circuit similarly rejected the contention that customers of notes with a fixed interest rate are not motivated by profit: "The fact that Wallenbrock's promised interest rate was stable . . . is not sufficient to make the notes a non-security. Indeed, the promise of a high, stable 20% interest rate likely attracted investors looking for significant profits."[186] Further, in *Pollack v. Laidlaw Holdings, Inc.*, the Second Circuit found that the

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[181]Id.

[182]*Reves*, 494 U.S. at 66.

[183]*Id.* at 67–68.

[184]*Reeder v. Succession of Palmer*, 736 F. Supp. 128, 130 (E.D. La. 1990), *aff'd*, 917 F.2d 560 (5th Cir. 1990) (TABLE); *Guidry*, 740 F. Supp. at 1214.

[185]*Stoiber*, 161 F.3d at 750.

[186]*SEC v. Wallenbrock*, 313 F.3d 532, 538 (9th Cir. 2002).

"district court erred in finding that the fixed rate of return cut against the presumption that the notes are securities."[187]

—b. Overlap with §3(a)(3) and §3(a)(10)

The current operations requirement of §3(a)(3) and §3(a)(10) requires the proceeds of commercial paper "to be used for interim financing, not permanent investment."[188] As noted by Kenneth V. Handal, "[f]unds received from the issuance of commercial paper have traditionally been used to finance current operational business expenditures of a well-defined seasonal or periodic nature."[189] In other words, the issuer of paper that satisfies the current operations requirement is motivated "to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose."[190] Therefore, the motivations of an issuer of commercial paper bear a family resemblance to the motivations of a business that borrows money in a bank loan for commercial operations; thus, commercial paper bears a family resemblance to notes evidencing loans by commercial banks for current operations, which are not securities.

When analyzing the buyer of commercial paper's motivations, it is apparently not dispositive that the rate of return is fixed. Further, it is difficult to argue that the buyer is not motivated by profit. Therefore, despite the seller's motivations resembling those of an issuer of a non-security, the buyer's motivations resemble those of a purchaser of a security.

2. Plan of Distribution of the Instrument

—a. Caselaw Interpretation

In *Reves*, the court stated that, if "it is an instrument in which there is 'common trading for speculation or investment,' " then it is

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[187]*Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808, 813 (2d Cir. 1994).

[188]J. William Hicks, *Commercial Paper: An Exempted Security Under Section 3(a)(3) of the Securities Act of 1933*, 24 UCLA L.R. 227, 272 (1976).

[189]Kenneth V. Handal, Comment, The Commercial Paper Market and the Securities Acts, 39 U. Chi. L.R. 362, 364 (1971–72).

[190]*Reves*, 494 U.S. at 66.

more likely to be a "note."[191] In analyzing whether the requisite "common trading" existed, the court looked at whether the notes were "offered and sold to a broad segment of the public."[192] Following this reasoning, the Second Circuit in *Banco Espagnol* found that the instruments did not resemble notes because the plan of distribution was "a limited solicitation to sophisticated financial or commercial institutions and not to the general public."[193]

—b. Overlap with §3(a)(3) and §3(a)(10)

In order to satisfy the non-public requirement of §3(a)(3) and §3(a)(10), the paper must have a minimum denomination of at least $25,000. Further, the paper cannot be marketed to the general public. This requirement has been interpreted generally as banning general solicitation, although one issuer was permitted to advertise in a limited fashion to sophisticated institutional investors. Finally, unaccredited investors, and perhaps even unsophisticated investors, may not purchase the paper.[194] In light of these requirements, paper satisfying §3(a)(3) and §3(a)(10) is not "offered and sold to a broad segment of the public" and thus bears a family resemblance to non-securities for which there is not "common trading for speculation or investment."[195]

3. Reasonable Expectations of the Investing Public

—a. Caselaw Interpretation

In *Reves*, the court stated that it would consider "instruments to be securities on the basis of ... public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not 'securities' as used in that transaction."[196] In *Reves*, "[t]he advertisements for the notes . . . characterized them as 'investments,' there were no countervailing

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[191]Id.

[192]*Id.* at 68.

[193]*Banco Espagnol de Credito*, 973 F.2d at 55.

[194]See *supra* text accompanying notes 95–99.

[195]*Reves*, 494 U.S. at 66, 68.

[196]*Id.* at 66.

factors that would have led a reasonable person to question this characterization."[197]

In *Stoiber*, the court characterized this factor as a "one-way ratchet" because, although this factor "allows notes that would not be deemed to be securities under the other three factors nonetheless to be treated as securities if the public has been led to believe they are," this factor does not "allow notes which would under the other factors would be deemed securities to escape the reach of the securities laws."[198]

—b. Overlap with §3(a)(3) and §3(a)(10)

The expectations of the public would appear to be a self-fulfilling prophesy in this context. If courts were to recognize that paper satisfying §3(a)(3) and §3(a)(10) is not a note under *Reves*, then the public would accordingly not expect commercial paper to be a security. Although commercial paper is currently perceived by the public as a security, the public's expectations would probably not be betrayed by a holding that the paper is a non-security because, under current law, commercial paper is already exempt from registration under the 1933 Act and excluded entirely from the 1934 Act. Therefore, the public would not lose any substantive rights as a result of the paper's unexpected classification as a non-security.

4. Risk Reducing Factors that Make Application of the Securities Laws Unnecessary

—a. Caselaw Interpretation

With this factor, the court analyzes "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."[199] In *Reves*, the court cited insurance by the Federal Deposit Insurance Corporation and regulation under the Employee Retirement Income Security Act of 1974 as examples of regulatory schemes that would render application of the Securities

[197] *Id.* at 68–89.

[198] *Stoiber*, 161 F.3d at 201.

[199] *Reves*, 494 U.S. at 67.

Act unnecessary.[200] In addition to looking at the existence of other regulatory schemes, the *Reves* court also noted that the notes were "uncollateralized and uninsured," suggesting that the riskiness of the note itself is relevant.[201] Accordingly, the Tenth Circuit in *Holloway* examined the "risk to the initial investment."[202]

In analyzing the riskiness of an instrument, the court in *Nat'l Bank of Yugoslavia v. Drexel Burnham Lambert, Inc.* recognized that an instrument's short maturity is relevant to its riskiness, but the court explicitly stated that "[t]he short maturities of the time deposits do not, by themselves, satisfy this factor, since notes of certain new or financially unstable enterprises, though of short maturities, may entail substantial risk."[203]

—b. Overlap with §3(a)(3) and §3(a)(10)

In order to satisfy §3(a)(3) and §3(a)(10), commercial paper must be of prime quality. Although the SEC staff treats a prime rating as conclusive evidence of prime quality, most courts have adopted a better-reasoned analysis that treats the prime rating as merely evidentiary. The SEC staff additionally examines whether the paper is backed by unused lines of credit or whether the nature of the issuer is such that the paper can be viewed as prime quality. The courts have focused on the nature of the issuer in determining whether the paper is of prime quality, requiring the issuer to show that it was solvent at the time of issuance.[204] Commercial paper satisfying §3(a)(3) and §3(a)(10) is not risky because its issuer must be a financially stable enterprise and because the paper matures in less than nine months. Since the "risk to the initial investment" is a key component of the analysis of whether any risk-reducing factors make application of the securities law unnecessary, paper satisfying §3(a)(3) and §3(a)(10) bears a family resemblance to a non-security.

5. Conclusion

Therefore, application of the *Reves* factors to commercial paper

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[200] *Id.* at 69.

[201] Id.

[202] *Holloway*, 900 F.2d at 1488 n.1.

[203] *Nat'l Bank of Yugoslavia*, 768 F. Supp. at 1015.

[204] See *supra* text accompanying notes 103–14.

satisfying §3(a)(3) and §3(a)(10) shows that all of the *Reves* factors except the buyer's motivation for entering into the transaction support a finding that commercial paper bears a family resemblance to a non-security under *Reves*. Of the types of non-security recognized in *Reves*, notes evidencing loans by commercial banks for current operations seem most similar to commercial paper.

B. Support for Argument that §3(a)(3) and §3(a)(10) are Subsumed by *Reves*

In one of the first published articles analyzing the Supreme Court's decision in *Reves*, Professor Marc I. Steinberg seemed to recognize that commercial paper satisfying the requirements of §3(a)(3) and §3(a)(10) would similarly not be a security under the family resemblance test:

> [T]he law is as it should be: short-term high quality commercial paper marketed to sophisticated purchasers for facilitating current operations is exempt from securities law coverage. This standard comports with the "family resemblance" test: application of the four factors in this setting connotes exclusion from the reach of the securities laws. On the other hand, where an instrument is called commercial paper but is in reality an investment security, the "family resemblance" test mandates that the instrument be deemed a "security."[205]

The Second Circuit's decision in *Banco Espagnol v. Security Pacific National Bank* also lends support for the proposition that commercial paper under §3(a)(3) and §3(a)(10) is not a "note" under *Reves* because it bears a strong family resemblance to "loans issued by banks for commercial purposes," which are not notes. The court analyzed whether the loan participations on Integrated's debt that Security Pacific had sold privately to institutional investors were notes under *Reves*.[206] Integrated used the funds to finance its current operations.[207] The court found that the loan participations had a "family resemblance" to "loans issued by banks for com-

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[205]Marc I. Steinberg, *Notes as Securities: Reves and Its Implications*, 51 OHIO ST. L.J. 675, 684 (1990).

[206]*Banco Espagnol de Credito*, 973 F.2d at 55.

[207]Id.

mercial purposes.''[208] As recognized by Chief Judge Oakes in dissent, the loan participations closely resembled commercial paper: ''The bottom line is that the market closely resembles the commercial paper market. . . .''[209] Chief Judge Oakes argued that, because commercial paper is a security, the loan participations that resembled commercial paper were similarly securities.[210] The dissent's comparison between the loan participations and commercial paper can be recast, however, to argue that, because the loan participations that closely resembled commercial paper were not notes, commercial paper is similarly not a note.

The idea that the ''commercial paper'' exemption and exclusion are subsumed into the ''note'' analysis is not novel. Pre-*Reves*, several courts that used the ''family resemblance'' test to analyze whether an instrument was within the definition of ''note'' under the Securities Acts began to merge this analysis into the analysis of whether the §3(a)(3) or §3(a)(10) exclusions were met. For example, *in State Mutual Life Insurance Co. v. Arthur Andersen & Co.*, the court cited the SEC's characterization of commercial paper as helpful to a ''fuller understanding of the nature of this 'family.' ''[211]

Further, multiple courts that used the ''investment versus commercial'' test to determine whether an instrument was within the definition of ''note'' under the Securities Acts recognized the merging of the commercial paper analysis and the note analysis. Although the Supreme Court in *Reves* chose to adopt the ''family resemblance'' test rather the ''investment versus commercial'' test to determine whether an instrument is a ''note'' within the coverage of the Securities Acts, the pre-*Reves* courts' recognition of the merging of the ''investment versus commercial'' analysis and the commercial paper exemption analysis is nonetheless relevant because ''the 'family resemblance' and 'investment versus commercial' tests . . . are really two ways of formulating the same general approach.''[212]

For example, *in SEC v. Continental Commodities*, the Fifth

[208] *Id.* at 56.

[209] *Id.* at 60 (Oakes, J., dissenting).

[210] *Id.* at 56.

[211] *State Mutual Life Assurance Co.*, 1977 WL 929 (S.D.N.Y Mar. 3, 1977).

[212] *Reves*, 494 U.S. at 64. The Tenth Circuit detailed the similarity between the ''investment versus commercial'' test and the ''family resemblance'' test in *Holloway*, 900 F.2d 1485. Prior to the Supreme Court's decision in *Reves*,

Circuit identified those cases where a commercial-investment distinction was read into the definition of "note" as underpinning its application of a commercial-investment distinction to §3(a)(3) and §3(a)(10):

> Additional testimony to its approval is supplied by courts which deem the commercial-investment dichotomy as implicit within the 'unless the context otherwise requires' prefatory language . . . and those courts which read the dichotomy into the definitional sections without positing a precise derivational source. And it was this impressive line of cases which led this court to hold that the exemption for short-term notes under the Securities Exchange Act of 1934 applied only to commercial paper and not investment paper... Accordingly, it is the character of the note, not its maturity date, which determines coverage under both the registration provisions of the Securities Act of 1933, and the Securities Exchange Act of 1934.[213]

Similarly, in *McClure v. First National Bank of Lubbock*, the court recognized that, by interpreting the Acts to only apply to investment notes and by interpreting §3(a)(3) and §3(a)(10) to only apply to commercial notes, §3(a)(3) and §3(a)(10) were being subsumed into the definition of "note":

> We realize that our holding today that the Act does not apply to commercial notes of a longer duration than nine months, taken with the decisions voiding the short-term exemption as to investment paper, virtually writes that exemption out of the law. . . . [T]he investment or commercial nature of a note entirely controls the applicability of the Act, depriving of all utility the exemption based on maturity-length.[214]

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the Tenth Circuit had analyzed the instruments under the "investment versus commercial" test, applying the factors cited in *Zabriskie v. Lewis*. *Holloway v. Peat, Marwick, Mitchell & Co.*, 879 F.2d 772 (10th Cir.) (applying the factors from *Zabriskie*, 507 F.2d 546, 551 n.9 (10th Cir. 1974)), *vacated by* 494 U.S. 1014 (1990). The Supreme Court vacated the judgment and remanded the case to the Tenth Circuit for further consideration in light of *Reves*. 494 U.S. 1014. The Tenth Circuit reanalyzed the instruments and reaffirmed the judgment from the original *Holloway*. *Holloway*, 900 F.2d at 1489. While reanalyzing the instruments, the court noted: "[M]ost, though not all, of the facts we analyzed under the *Zabriskie* factors are incorporated into the *Reves* factors." *Id.* at 1488.

[213] *Continental Commodities*, 497 F.2d at 524–25.

[214] *McClure v. First Nat'l Bank of Lubbock*, 497 F.2d 490, 494–95 (5th Cir. 1974).

In *SEC v. Univest*,[215] the court similarly recognized the overlap in analyses. The court cited SEC Release No. 33–4412 (which interprets §3(a)(3) of the Securities Act) as helpful in determining whether the notes were within the 1933 Act definition of "security."[216] The court relied on the SEC's factors to determine whether the notes were securities under the "investment versus commercial" test, without mentioning whether the notes matured in less than nine months and without mentioning the §3(a)(3) exclusion. Similarly, in *Great Western Bank & Trust*, while analyzing whether a note with a ten month maturity was a "note" under the Exchange Act, the Ninth Circuit de-emphasized the significance of a note's maturity: "While courts now consider the Exchange Act's nine-month exemption as nondispositive of the commercial-investment issue, it is true that the longer one's funds are to be used by another, the greater the risk of loss."[217] Like the court in *Univest*, the Ninth Circuit used factors from SEC Release No. 33–4412 to determine whether the note was "note" under the "commercial versus investment" test. For example, the court looked at whether "the obligations were issued to a single party or to a large class of investors,"[218] which is similar to the SEC's non-public requirement. The court also looked at "the relationship between the amount borrowed and the size of the borrower's business,"[219] which is similar to the SEC's prime quality requirement. Finally, the court looked at the whether the proceeds would be used for current transactions or for capital expenditure,[220] which is similar to the SEC's current transactions requirement.

The District of Columbia Circuit also merged these analyses into one inquiry: "We, too, find persuasive the reasoning that Congress intended to include investment notes of whatever duration within coverage of both Securities Acts and to exclude only commercial notes."[221]

Several courts have separately analyzed (1) whether an instru-

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[215]*SEC v. Univest*, 405 F. Supp. 1057 (N.D. Ill. 1976).

[216]*Id.* at 1060.

[217]*Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976).

[218]*Id.* at 1258.

[219]Id.

[220]Id.

[221]*Bauer v. Planning Group, Inc.*, 669 F.2d 770, 776 (D.C. Cir. 1981).

ment is a security under *Reves*, and (2) whether the instrument is commercial paper under §3(a)(3) and §3(a)(10). These courts have all found that (1) the instrument in question is a security under *Reves*, and (2) the instrument is not commercial paper under §3(a)(3) and §3(a)(10).[222] These holdings are consistent with the proposition that an instrument cannot simultaneously be commercial paper under §3(a)(3) and §3(a)(10) and a security under *Reves*.

In several of these cases, the court concluded without any analysis that the instrument was not §3(a)(3) and §3(a)(10) commercial paper, suggesting that the court may have recognized the duplication in analysis.[223] Similarly, in *SEC v. R.G. Reynolds*, the Ninth Circuit recognized the applicability of §3(a)(3) to "short term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors."[224] Rather than analyzing whether the notes in question satisfied this test, however, the court appeared to incorporate the §3(a)(3) analysis into its "family resemblance" test, stating: "[T]ime is simply one factor to be assessed in looking at the economic realities of the investment."[225] The court concluded that the instruments were "notes" under both Acts. In contrast to these conclusory statements that §3(a)(3) and §3(a)(10) do not apply, the court in *In re NBW Commercial Paper Litigation* performed an intricate analysis of whether the instruments in question were notes under *Reves* and whether they were exempt from registration under §3(a)(3), concluding that they were notes and that they were not exempt.[226] Interestingly, the court seemed to recognize the duplicative nature of the analyses because, rather than describing in detail how the notes were offered to the public and thus not exempt under §3(a)(3), the court cross-referenced the *Reves* analysis.[227] These cases suggest that courts may be recognizing the duplicative nature of the *Reves* analysis and the commercial paper analysis.

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[222] *Wallenbrock*, 313 F.3d at 540 (finding that the instruments were notes and not commercial paper); *In re NBW Commercial Paper Litig.*, 813 F. Supp. at 12–15, 16–20 (same); *Nat'l Bank of Yugoslavia*, 768 F. Supp. 1010 (same); *Holloway*, 900 F.2d 1485 (same).

[223] *Nat'l Bank of Yugoslavia*, 768 F. Supp. 1010; *Holloway*, 900 F.2d 1485.

[224] *R.G. Reynolds*, 952 F.2d at 1132.

[225] *Id.* at 1133.

[226] *In re NBW Commercial Paper Litig.*, 813 F. Supp. at 12–15, 16–20.

[227] *Id.* at 18.

X. Impact of Conclusion That §3(a)(3) and §3(a)(10) are Subsumed By *Reves*

A. Reconciliation of "Virtually Identical" Language and the Acts' Treatment of "Commercial Paper"

If the commercial note exclusion from the definition of "security" were subsumed within the definition of "note," then the definitions of "security" in the 1933 and 1934 Acts would in reality be "virtually identical," rendering reliance on the "unless the context otherwise requires" language unnecessary.

B. Burden of Proof

Under *Reves*, a note is presumptively a note under the 1933 Act and the 1934 Act, and the party seeking to avoid application of the Acts has the burden of showing that the instrument bears a family resemblance to a non-security.[228] As noted above, although *Reves* does not address whether this presumption applies to a note that matures in less than nine months, post-*Reves* courts have applied this presumption to notes maturing in less than nine months as well as notes maturing in more than nine months.

If the *Reves* presumption applies to all notes regardless of maturity and if, as posited by the court in *In re NBW Commercial Paper Litigation*,[229] §3(a)(3) and §3(a)(10) create a rebuttable presumption that a note maturing in less than nine months is exempt commercial paper, then a flaw exists in the argument that §3(a)(3) and §3(a)(10) are subsumed by *Reves*. In a case where virtually no evidence is presented regarding the circumstances of the issuance of a note maturing in less than nine months, the *Reves* presumption would operate to classify the note as a security. Then, the §3(a)(3) and §3(a)(10) presumption would operate to exempt the note from the registration provisions of the 1933 Act and from the 1934 Act altogether. Therefore, the conflicting presumptions would operate to distinguish the commercial paper analysis from the *Reves* note analysis.

However, most courts have declined to interpret §3(a)(3) and

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[228] *Reves*, 494 U.S. at 67 ("A note is presumed to be a 'security,' and that presumption may be rebutted only by a showing that the notes bears a strong resemblance . . . to one of the enumerated categories of instrument.").

[229] *In re NBW Commercial Paper Litig.*, 813 F. Supp. at 7, 18.

§3(a)(10) as creating a presumption that a note maturing in less than nine months is exempt commercial paper. For example, the court in *Abbell Credit Corp.* reaffirmed that, even in the context of §3(a)(3), "[t]he burden of establishing an exemption is on the party that claims it."[230] Therefore, if the *In re NBW* presumption is rejected, the flaw in the argument that §3(a)(3) and §3(a)(10) are subsumed by *Reves* disappears.

Then, because the §3(a)(3) and §3(a)(10) analyses are subsumed by the *Reves* analysis, the party using the family resemblance test to show that an instrument is not a note under the securities laws would similarly have the burden of proving that an instrument is "commercial paper," regardless of whether the cause of action arises from the 1933 Act or the 1934 Act. Therefore, if the *Reves* presumption applies to all notes and if §3(a)(3) and §3(a)(3) do not create a presumption of non-coverage, the seemingly senseless distinction recognized by the court in *Floyd* would be eradicated. No longer would the burden of proving that a note is subject to the 1933 Act's registration provisions and the burden of proving that a note is subject to the 1934 Act be on opposite parties. Rather, the party seeking to avoid coverage of the Securities Acts would always have the burden of proving that the commercial paper is not a security under *Reves*.

C. Recognition that §17 Enforcement is No Longer Available for Commercial Paper

If §3(a)(3) is subsumed by the family resemblance test, §17(a) enforcement is not longer available to commercial paper satisfying the requirements of §3(a)(3). Because §17(a) is universally regarded as not providing for a private right of action, the unavailability does not deprive the private litigant of any rights.

XI. CONCLUSION

Therefore, the enigma of §3(a)(3) and §3(a)(10) has a workable solution. The 1933 Act exemption from registration and the 1934 Act exclusion from the definition of "security" apply only to prime quality commercial paper of a type not ordinarily purchased by the general public and issued to facilitate current operations. When this

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[230] *Abbell Credit Corp.*, 2002 WL 335320, at *6.

interpretation of §3(a)(3) and §3(a)(10) is analyzed in light of the Supreme Court's *Reves* "family resemblance" test, the *Reves* test appears to subsume §3(a)(3) and §3(a)(10). In other words, if a note satisfies the elements of "commercial paper," then it also has a strong "family resemblance" to an instrument that is not a "note" under the Securities Acts. This interpretation is appealing because it prevents cunning issuers from avoiding the antifraud provisions of the Securities Acts, renders the 1933 Act and 1934 Act definitions of "security" identical, and simplifies the note analysis.