Local Government Investment Pool
Educational Series
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Commercial Paper

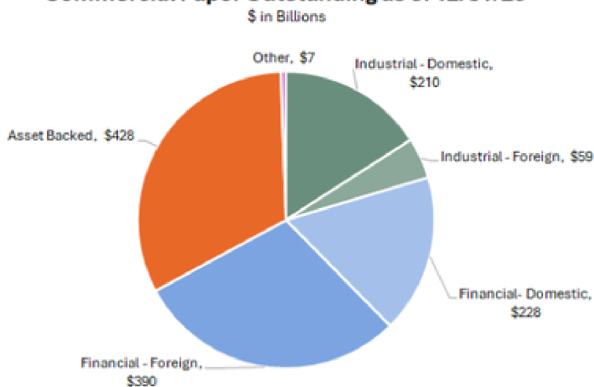
A Value Added and Diversifying Investment

Introduction

Commercial paper (CP) is a high-quality, short-term credit instrument used in money market funds and local government investment pools (LGIP) to enhance portfolio yield, maintain liquidity and diversify holdings. This paper provides an overview of the commercial paper market, examines the different types of commercial paper and describes the role it plays in the portfolio structure of an LGIP.

What is Commercial Paper?

Commercial paper is an unsecured, short-term debt instrument issued as a discount or floating rate security. Most CP programs typically offer securities with maturities of less than 270 days (some commercial paper is available with maturities up to 397 days). Commercial paper serves as a convenient financing method for companies that have short-term financing and operational needs. Companies typically establish a commercial paper program to cover their short-term liabilities such as accounts payable, inventories and payrolls.



The U.S. commercial paper market is one of the largest non-government debt markets, with large corporations and financial institutions acting as the main issuers of commercial paper. As of the end of 2025, there was $1.34 trillion of commercial paper outstanding in the United States. In terms of categories, commercial paper is issued by financial institutions (domestic and foreign), industrial organizations (foreign and domestic) and asset backed programs. The chart to the left shows the amount outstanding by category as of December 31, 2025.

Types of Commercial Paper

The Securities and Exchange Commission (SEC) provides registration exemptions for commercial paper because Congress recognizes that certain short-term financing transactions pose less risk and are used differently from public investment offerings. There are two primary exemptions under the Securities Act of 1933 govern the issuance of commercial paper: Section 3(a)(3) (public-style CP) and Section 4(a)(2) (private placement CP). These structures differ materially in liquidity, distribution, transparency, and risk profile. Moreover, registered debt offerings and private placements under Rule 144A allow for maturities greater than 270 days. In addition, certain bank obligations rely on different exemptions under section 3(a)(2).

Section 3(a)(3) CP is a broadly distributed, highly standardized form of short-term debt. It must be of prime quality, have a maturity of 270 days or less, and be used to finance current transactions. It is typically issued through dealers and is actively traded in secondary markets, supporting high liquidity.

In contrast, Section 4(a)(2) CP is issued through private placements and sold only to accredited or sophisticated investors. It does not require proceeds to fund current transactions and can exhibit more flexible structuring. However, it has restricted resale and lower liquidity compared to 3(a)(3) CP. This structure is common in asset-backed and bank-sponsored programs. Some 4(a)(2) CP is issued with maturities greater than 270 days.

Key distinctions include: 3(a)(3) is broadly distributed and highly liquid, while 4(a)(2) is privately placed with limited liquidity. 3(a)(3) requires use of proceeds for working capital and has a maturity cap, while 4(a)(2) has fewer statutory constraints but relies on market convention.

Both structures are typically eligible for high-quality portfolios such as money market funds and LGIPs. However, 3(a)(3) CP is generally used for liquidity management, while 4(a)(2) CP is used selectively to enhance yield and diversify credit exposure.

Commercial Paper Structure Comparison

Feature	Section 3(a)(3)	Section 4(a)(2)
Exemption Type	Security-based	Transaction-based (private placement)
Offering Style	Broad / dealer market	Private placement
Use of Proceeds	Must fund current transactions	No restriction
Maturity Limit	≤ 270 days	No statutory limit (market-driven)
Investor Base	Broad institutional	Accredited / sophisticated only
Liquidity	High	Somewhat Limited
Resale	Freely tradable	Restricted
Market Transparency	High	Lower
Typical Issuers	Corporates, banks	Financials, ABCP conduits

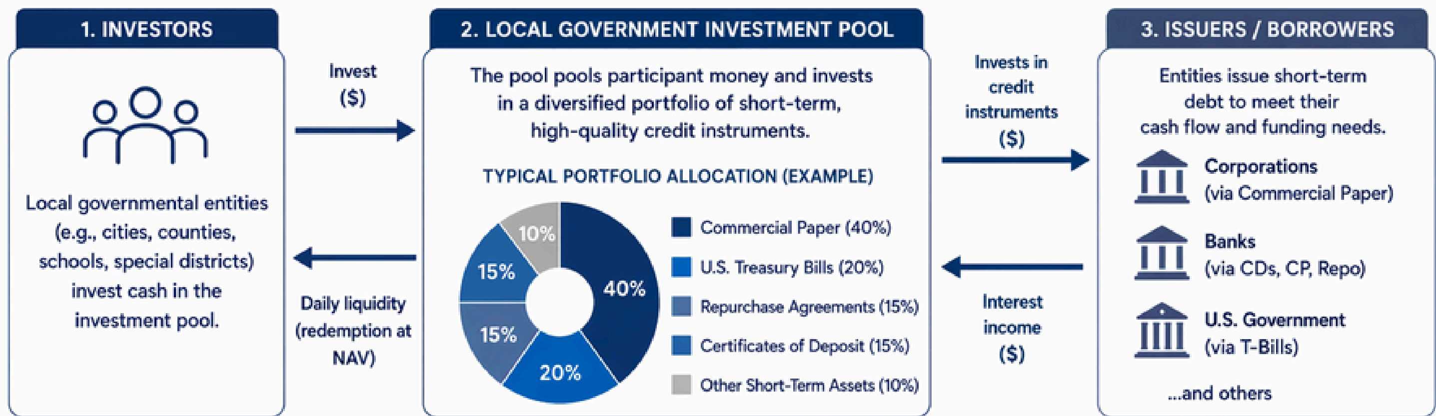
Commercial paper is considered short-term debt by the rating agencies. Thus, the credit rating metrics differ than for long term debt. The highest ratings for commercial paper is as follows: Moody's Ratings (A1), S&P Global (P1) and Fitch Ratings (P1). Definitionally these ratings indicate strong creditworthiness and low default risk.

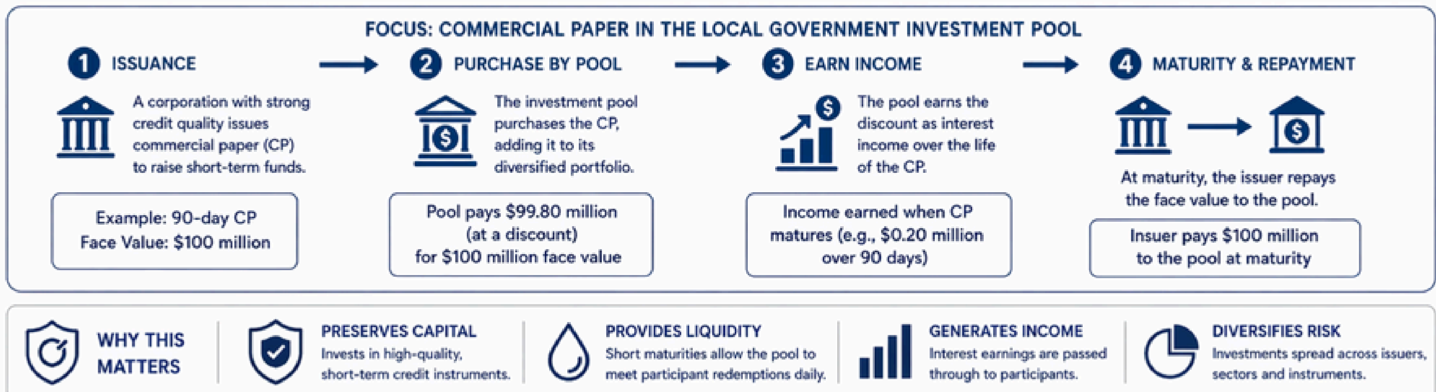
The Function of Commercial Paper in an LGIP

Many LGIPs invest in credit instruments to add yield such as negotiable certificates of deposit, corporate notes and commercial paper. Commercial paper not only provides added yield to a portfolio, but it also allows for diversification into high-quality nonfinancial issuers. The graphic below shows the relationship between investors (participants), an LGIP and issuers of commercial paper.

How Credit Instruments are used in a LGIP

LGIPS invest in short-term, high-quality credit instruments to provide liquidity, preserve capital and earn competitive income.





Conclusions

Commercial paper is a foundational instrument in short-term funding markets, and its use within institutional portfolios requires a disciplined understanding of both structure and regulation. The distinction between Section 3(a)(3) and Section 4(a)(2) commercial paper is critical, as it directly affects liquidity, transparency, and portfolio risk. For liquidity-focused investors—particularly LGIPs—high-quality, broadly distributed commercial paper serves as a core liquidity tool. Ultimately, effective use of commercial paper depends on aligning instrument characteristics with liquidity needs, credit standards, and regulatory requirements, ensuring that yield enhancement does not come at the expense of stability, liquidity, or compliance with GASB 79 and rating agency frameworks.

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