

# Commercial Paper Market: Evolution and Development Experiences across Globe

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## Introduction

Commercial Paper is an unsecured money market instrument sold by corporate to meet their short term funding requirements. The financial instrument has been used across the globe in many developed and developing countries. This paper is an attempt to understand the history, evolution, development and growth of commercial paper as money market instrument across globe.

## History and Evolution of Commercial Paper:

Commercial paper evolved first in US, later it is introduced by many other countries across the globe. Canada and Australia are the countries introduced the commercial paper in the early decades of 1960s and 1970s, followed by Spain in 1982, Sweden in 1983, Norway in 1984, France in 1985 United Kingdom and Finland in 1986. In 1987 it was introduced in Japan, which currently stands second largest market for the issuance of domestic commercial paper, next to US. Belgium and India have witnessed the instrument in the money market in 1990 followed by Germany in 1991.

TABLE – 3.1  
THE RANK ACCORDING TO OPENING OF MARKET FOR CP

S. No.	Name of the Country	Market Opening year	Rank
1.	United States	Pre 1960s	1
2.	Canada	PRE 1960s	2
3.	Australia	Mid 1970s	3
4.	Spain	1982	4
5.	Sweden	1983	5
6.	Norway	1984	6
7.	Netherlands	1984	6
8.	France	1985	8
9.	UNITED KINGDOM	1986	9
10.	Finland	1986	9
11.	Japan	1987	11
12.	Belgium	1990	12
13.	India	1990	12
14.	Germany	1991	14

**Source:** Commercial paper: Markets and survey, Bank for International settlements, p. 12

In India, this money market instrument is allowed to be issued by blue-chip corporate for funding their working capital needs in year 1990, following positive recommendations by the Vaghul Working Group.

When ranked the top 15 countries on the basis of opening of markets for commercial paper, then the first one will be assigned to US, followed by Canada and Australia, Germany falls in the last after Japan, Belgium and India (for more details see table I above). From the above discussion we can infer that commercial paper is a money market instrument picking up its importance in the late 1960s and slowly adopted and used by different countries. Over the years it evolved as a short-term financing instrument in different countries.

## General Features of Commercial Paper:

In this section an attempt is made to present the features found across the countries in which the instrument is used to fund working capital needs by the firms. The common features of commercial paper in all the countries over the world under discussion are:

- ✓ In general, the commercial paper is sold by firms under a preannounced program. Once a program has been announced the issuer is free to raise funds from the market as and when required, with considerable gains in terms of flexibility.
- ✓ It is issued in a bearer form as a negotiable instrument;
- ✓ It is issued at a discount on its face value;
- ✓ Ownership of the security is evidenced by the possession of the document of certificate;
- ✓ It is freely transferable to provide liquidity to the investor;
- ✓ The feature of Continuous tap method in placing the instrument is observed in many countries.

**COMMERCIAL PAPER IN US: (\$ US DOLLAR)**

Commercial paper evolved in US first somewhere in the early 20th century. It is observed that the commercial paper is issued rarely in the registered form. The ownership is recorded in the books of the issuer or issuer's agent known as registrar. The regulators allow the paper to be issued with a maturity of one week to nine months. Though the regulations allow the corporate to access the market with one to nine weeks' paper, the corporate prefer the commercial paper maturity to be within two and six weeks. The companies are allowed to float the instrument for a minimum of one lakh and the firms prefer to issue with a minimum size of one million. US is the first country, where the commercial paper is floated and is the senior most in all the countries' markets. The rare feature that is found in US is that generally paper's maturity is around three months. In the North American markets virtually all commercial paper issues are backed by bank credit lines. In the United States 100% coverage of the amount outstanding at any given time is the rule, although borrowers of high quality or with alternative sources of liquidity may negotiate less stringent conditions. Asset backed commercial paper too has originated in the early 1980s in US.

**COMMERCIAL PAPER IN CANADA: (CANADIAN DOLLAR)**

Apart from the general feature of issue, it is noticed that, in some cases, the issuing firm may maintain register of the investors. The features of the commercial paper issuance in Canada are in similarity to that of United States. The denomination of the instrument may be of 100,000 Canadian dollars and maturity may range from 1 day to 12 months. It is observed that, the firms typically issue for a period of less than or three months. When it comes to participants in the issue of commercial paper in the market, bankers were given a clear authority to act as principals from 1987 onwards, which was earlier in question. The security is issued both through dealers and also through direct placement. Blue-chip firms adopt direct placement route disintermediating the banks, and, also there are dealers involved to place the paper in the market.

**COMMERCIAL PAPER IN AUSTRALIA: (AUSTRALIAN DOLLAR)**

In Australia the commercial paper evolved as a security in the mid-1970s. The regulators allow the commercial paper to mature generally from 7 days to 2 years. Typically, the companies float the instrument with the maturity ranging between one month and three months. Coming to the denomination of the paper, the companies prefer to issue for \$ 5 lakhs, even the regulators also allow the companies to go for a minimum of \$5 lakh. When we see, the issuing procedure adopted, in Australia there are firms who go directly to the investors and some firms use dealers to place their paper in the market directly. Even the tender panel system is common in Australia. And in some issues, it is also observed that commercial paper is underwritten. Excepting underwriting of commercial paper, almost all the features of US are similar, in the Australian commercial paper market. In the post financial crisis period Australia's central bank had started accepting commercial paper as collateral for loans, the latest in a string of measures to add liquidity to money markets amid a global credit squeeze. According to source, "The Reserve Bank of Australia said that the move was aimed at easing a logjam in the commercial paper (CP) market, where companies do much of their short-term borrowing. The market has been all, but shut in many countries around the world as investors shun all types of risk. The US Federal Reserve has even taken the extraordinary step of buying CP directly, picking up more than \$US40 billion a day on average. The RBA is not going that far, rather it will accept commercial paper as collateral for loans in its daily money market operation. The central bank said it would accept Australian dollar commercial paper rated P-1 or equivalent, Australian dollar asset-backed commercial paper (ABCP) rated P-1 or equivalent and Australian dollar debt securities rated AAA or equivalent, excluding highly structured products. For CP and asset-backed securities, the RBA would charge a margin of 10% for loans. For other AAA-rated securities, the margin would vary from 2% to 8%, depending on maturity.

**COMMERCIAL PAPER IN SPAIN: (PESETA)**

The distinction that we find in this country, when compared with other countries like Japan, France, etc., the issuing firms maintain a register of the investors in the commercial paper. The smallest denomination of the issuance of the commercial paper is Spanish peseta 2.5 lakh, whereas in many cases, the typical smallest denomination that Spanish companies' issue is in between 5 lakhs and 10 lakhs. Coming to maturity, it can range from one month to eighteen months, but in general the firms prefer issuing the paper for 3 months. There are two types of markets for commercial paper, namely organized and un-organized. In organized market the paper may mature for less than three months also. Issuing procedure adopted in Spain reveals that, direct placement route is used, but for only a marginal portion of the total issued. Spanish companies to place the commercial paper in the market also adopt tender panel system.

**COMMERCIAL PAPER IN SWEDEN: (KRONE)**

Commercial paper has evolved in Sweden in the year 1983. The issuing firms do not maintain any registers for the list of the investors like that of Spain. The minimum denomination and typical amount of issue of commercial paper is of one million Crone and 20 to 50 million respectively. When it comes to the period of maturity allowed and generally preferred by the firms is one day to two years and three months to one year respectively. In the process of placement dealers are used as intermediaries and continuous tap method is adopted in Sweden.

**COMMERCIAL PAPER IN NORWAY: (NORWEGIAN KRONER)**

The minimum denomination allowed is 1 million by regulators. The firms prefer to issue with the same size. The maturity may range from one day to one year, whereas the companies typically issue with a maturity of 3 months or less than that. In Norway, the issuing procedure doesn't differ to that of France, Spain, Belgium and the Great Britain. There are cases, where the instrument is direct placed; as well we observe that, the dealers act as intermediaries to place the paper in the market. Companies in other countries adopt continuous tap system, whereas in Norway this feature is not present. When tender panel system is considered, a

distinct feature can be observed that, the dealer bids for whole amount of issue. This feature is specific for Norway and not observed in many other countries.

#### **COMMERCIAL PAPER IN NETHERLANDS: (DUTCH GUILDER)**

In Netherlands the issuance of commercial paper evolved in the year 1984. The smallest denomination permitted is 1 million and the firms generally prefer to issue for the same denomination. The maturity of the commercial paper may range from 15 days to 2 years and generally the firms prefer issuing it for less than or equivalent to 3 months. When we observe the market for the instrument in the country, it is floated with the help of dealers acting as intermediaries. The tender panel system and direct placement method are not found. The continuous tap system is found in this country.

#### **COMMERCIAL PAPER IN FRANCE: (FRANC)**

In France, the firms first floated the commercial paper in 1985 to meet their short-term requirements. Coming to the size of the issue, the smallest denomination that they could issue stands at Franc 100,000s, but in general, the firms prefer issuing the paper with denominations ranging from 10 million to 50 million. The regulators fixed the maturity with minimum of 10 days and maximum of 12 months, whereas the firms prefer issuing for three months and of less than three months. Coming to placement, it may be sold to investors either directly or indirectly via intermediaries like dealers, agents, etc. Direct placements are very common only in United States and to some extent it is a feature observed in Canada and Australia. It plays a marginal role in France, including Norway, Spain, the United Kingdom and Belgium. In France, it is observed that the procedure of continuous tap is used to place the paper in the market extensively. This is also a feature in many other countries including India.

#### **COMMERCIAL PAPER – UNITED KINGDOM: (POUND STERLING)**

Commercial paper has evolved as an instrument in 1986 in United Kingdom. Corporate are allowed by the regulators to issue the paper generally with a smallest denomination of 100,000-pound sterling and firms typically issue with the same. The maturity may range with the lowest of 7 days and to the maximum of 12 months. The companies choose to issue the paper maturing in between one month and one quarter. To issue the commercial paper, dealers play major role and also many firms to avoid dealer cost utilize their goodwill to place it directly. While placing the paper, continuous tap method is used. Some firms use tender panel system to place it in the market.

#### **COMMERCIAL PAPER IN FINLAND: (FINNISH MARRKA)**

In Finland, we find a distinct procedure of issuing commercial paper but rarely apart from the general method observed in many other countries (of issuing at a discount to the face value, and in the bearer form). The minimum denomination is that of one million (Finland Marrka), whereas typically that ranges between 10 million and 20 million. The paper may mature according to the regulations from one day to one year. Commonly the paper is issued with the maturity period ranging from one month to three months. The dealers play a substantial role in placing the commercial paper in the market; firms also prefer this route. The continuous tap system is also found in the process, while the tender panel system is adopted.

#### **COMMERCIAL PAPER IN JAPAN: (YEN)**

In Japan commercial paper is considered as a bill, rather than a security since its inception into the market in 1987. The issuing firm doesn't hold the register for the list of the investors. The minimum denomination of the commercial paper, which may be, issued Yen 100,000 but in general the issues are of the size of Yen 1 billion to Yen 10 billion. In case of maturity the paper may mature any time in between 15 days to 9 months, whereas common feature observed is that of companies issuing it for maturity of 15 days and 3 months. In case of placement the paper is issued through dealers and continuous tap is a feature, which is used in the process.

The reforms in the form of deregulation and liberalization in Japan's financial markets were significant in the 1980s. The Yen/Dollar Committee report in 1984 prompted the Japan's financial system to witness measures to expand the Euroyen markets and liberalize domestic markets (see Frankel (1984) and Bank of Japan (1995)). The Commercial Paper market is established in November 1987. Interest rates on large denomination time deposits were gradually deregulated over the period 1985 – 89.

The Tokyo Offshore market was established in 1986. It is against this background that a domestic CP market was established in November 1987. At the same time, the prohibition on non-residents issuing Euro-yen CPs was also lifted (see McKenzie, C R, 1996). Bank of Japan while issuing the guidelines to allow the companies access finances through the CP also have laid down certain conditions. Such that the companies after issuing do not default and as well the instrument stays fit in the market. The eligibility criterion was that the firms with net worth  $\geq 110$  billion yen in addition to meeting the net worth requirement (A) must meet at least 4 out of the other 5 conditions (from B to F); Firms with net worth less than 110 billion yen in addition to meeting the net worth and the shareholders' equity/total assets condition (A and B) must meet at least 3 out of 4 conditions (C to F):

A	Net Worth	$\geq 300$ billion	$\geq 100$ billion	$\geq 55$ billion
B	Shareholders Equity/Total Assets	$\geq 30\%$	$\geq 40\%$	$\geq 50\%$
C	Net Worth to paid-in capital ratio	$\geq 3$	$\geq 4$	$\geq 5$
D	Working income to total assets ratio	$\geq 8\%$	$\geq 10\%$	$\geq 12\%$
E	Interest Coverage Ratio	$\geq 3$	$\geq 4$	$\geq 5$
F	Dividend paid in last 5 years (continuously)	$\geq 6$ yen	$\geq 6$ yen	$\geq 6$ yen

2. The Firms that can issue straight bonds without collateral with:
  - A. An AA ranking; or
  - B. An A ranking and a net worth  $\geq$  billion yen.
3. The firms that can issue straight bonds with collateral;
4. Trading companies that satisfy A, B and E and at least one of C and D (of the given below):
  - A. Net Worth  $\geq$  150 billion yen
  - B. Shareholders Equity to total Assets ratio  $\geq$  3% (plus liquidity ratio  $\geq$  100%)
  - C. Net worth to total paid in capital  $\geq$  1.5 times
  - D. Working Income to total assets ratio  $\geq$  5%
  - E. Dividends paid in last 5 years (continuously) and  $\geq$  5 yen paid in last 3 years.
5. Firms that can issue straight bonds with firm collateral and have a net worth of  $>$  150 billion yen.

From December 1988, firms eligible to issue Commercial Paper are limited to listed (or unlisted firms that have fulfilled the disclosure rules specified by the Securities and Exchange Law for at least three successive years) and either:

1. are firms that
  - a) obtain and publish ratings for their Commercial Paper from at least two ratings institutions with at least one of these ratings being an A—1 rating or an A—2 rating and the firm has a net worth exceeding 55 billion; and
  - b) Are not finance related (with the exception of Securities Finance Companies from December 1988; Securities Companies from January 1990; Lenders, Lease and Credit Companies from June 1993; and insurance companies from April 1994).
2. Are firms that were eligible to issue Commercial Paper under the previous rules and have not obtained a rating for their Commercial Paper;

Inoue, T (1998) observes lending to the corporate from the banking system has become restrictive towards extending loans to the corporate as the banks wanted to reduce the proportion of risk assets i.e. corporate loans. The banks have also become keen to meet the capital adequacy targets and the fear that the financial institutions would likely to suffer from evaluation losses and real estate holdings due to weakening economy. In the beginning the maturity for the CP was a month and less than six months limited to few eligible issuers. Then the system was reviewed and the maturity was extended to be less than one year abolished the minimum maturity of one month. The firms accessing should issue for an amount more than 100 million yen and was not disturbed with the form being negotiable instrument and sold at discount. In the early years when the CP was allowed there were only 170 eligible firms to issue CP excluding financial companies, later in the review the requirement of rating was reduced to A-3 increasing the eligible firms. On the other hand, the guidelines were modified allowing the financial companies (securities, loan brokers, leases and consumer credit companies, and insurance companies) with a prohibition that the firms will not reinvest for lending using the proceeds. In the initial stages the backup lines of guarantee were required for the firms issuing CP from financial firms, later this norm also been modified and made that the firms need not require such back-up line.

In the process of liberalizing and improving the usage of CP as a source for the corporate the stamp duty which was earlier class-wise flat is reduced to 5000 yen making the usage of instrument attractive for issuers and investors remained constant that the financial institutions with an understanding about the instrument and market only remained as investors. Securities holding tax and interest withholding tax were exempted by the regulators from the beginning of issue allowance. The total issuances of CP was around 1% in the case of Japan in 1997, whereas in the case of US it has touched 5%, revealing that the market in US is much bigger for CP as a proportion of debt market. The study in the Japanese market revealed to the question that as to why the market for CP is not growing, and found that “the companies are not using CP because of lack of demand in the market by the investors”, investors being financial institutions in the market, when they are questioned they expressed that “for the case of liquidity risk and the market being very small”.

Overview of Commercial Paper in Japan

Particulars	1987 when Started	1997 (10 years Hence)
Legal Nature	Promissory Note	Promissory Note
Maturity	1 to 6 Months	Less than one year
Interest Rate	Sold at Discount	Sold at Discount
Book Value	100 million Yen or more	100 Million Yen or more
Eligible Issuers	Eligible Issues of Straight bond (some 170 firms) Financial companies excluded	Similar to A-3 rating or above (some 800 firms), Securities, Loan Brokers, Lease and consumer credit companies, and insurance companies included (issues for the purpose of re-investing the proceedings to lending is prohibited).
Backup Line/ Guarantee	Backup line or guarantee of financial institutions required, except the firms that meet a certain criteria (trading house, electric power, etc.)	Not required when rating agency determines so.
Issuing method	Issue via dealer (dealer paper system)	Issue via dealer (dealer paper system)



Dealer	Financial Institutions, securities, call loan brokers	Financial Institutions, securities, call loan brokers
Purchaser	Institutional investors familiar with financial markets	Institutional investors familiar with financial markets
Stamp duty	Class wise flat rate	5000 yen per issue uniformly
Securities transaction tax	Exempted	Exempted
Interest withholding tax	Exempted	Exempted

The experiences recorded in the Japanese market reveal that there was a malfunction of dealers and improper communication between the fund raisers and investors; hence the market for CP issuance did not grow as that much as that it should have. Inoue 1998 further observes that despite a tremendous increase in number of eligible issuers for CP only supreme rated i.e. A-1 rated companies issued CP in the market. Banks on the other hand have also extended support to these firms to continue with good relations from their side and invested in such paper, pricing too favoured issuers and zero underwriting fee issues were not unusual with the support from the banks. CP has become a substitute for bank lending. CP issues and transactions require decent infrastructure to support the growth including lifting of stamp duty.

#### **COMMERCIAL PAPER IN BELGIUM: (BELGIAN FRANC)**

The commercial paper as a security evolved in the year 1990 in Belgium. The smallest denomination of the commercial paper may be franc 10 million according to the regulatory authorities. The corporate in Belgium prefer to issue for a minimum amount of 25 million. The maturity of the commercial paper issue may range from one month to one year. Typically, companies float for maturity ranging for two months or less than that of two months. To place the paper in the market dealers, play a dominant role. In some cases, it is directly placed. The continuous tap system is adopted to tap the market at different time intervals of one day to one week. In some cases, the tender panel system is noticed in this market.

#### **COMMERCIAL PAPER IN GERMANY: (DEUTSHE MARK)**

Commercial paper has evolved in Germany in 1991 later than that of Belgium and India. It ranks 13<sup>th</sup> when they are ranked on the basis of adoption of commercial paper in their financial markets. The smallest denomination a firm can issue commercial paper is 500,000 Mark and typically firms also issue of the same size. The minimum maturity for the paper can be of seven days with the maximum maturity period limit going to two years. The enterprises prefer to issue a commercial paper with maturity of around one month and one quarter.

#### **SUMMARY AND CONCLUSION:**

The commercial paper is a money market instrument used for funding working capital by the corporate in United States in the early 1960s followed by Canada and Australia in the early 1970s. The trend of allowing commercial paper as a money market instrument is later followed by the countries across the globe and spread in countries such as Spain, Sweden, Norway, France, United Kingdom and Finland in the 1980s. The first Asian country following the suit was Japan in 1987 and followed by India in the year 1990. The issuance of commercial paper generally takes place under a pre-announced program across the countries. After the announcement of the program, the issuing company is free to mobilise funds from the market as and when required, with considerable gains in terms of flexibility;

Commercial Paper is issued generally in a bearer form as negotiable instrument in almost all the countries. It is issued at a discount on its face value; i.e. the commercial paper is sold at a discount of interest for the period of holding for the investor to redeem at par. In some countries, commercial paper is sole as an interest bearing certificate and such feature is observed very rarely in US, Canada, Finland and Norway. Ownership of the security is evidenced by the possession of the document of certificate when it was issued in the physical format; currently all countries have shifted to Dematerialized format for the investors to hold in electronic format and transfer with all the ease.

It is freely transferable to provide liquidity to the investor and Dematerialised format enables the investors to sell or buy in the market without hassles. The feature of Continuous tap method in placing the instrument is observed in all the countries that are using commercial paper to fund working capital. The task force recommended that the information and reporting should be standardized and presented in English enabling more participants and to also improve the transparency a primary index on short term paper issues be prepared. Further the recommendations include the paper to be of quality rating eligibility with duration of less than one year i.e. a firm should have a minimum rating of A2 or equivalent and allowed the investments to be allowed as is for the other debt securities;

To increase the liquidity and attract investments the settlement was advised to be immediate i.e. T+0 settlement even for the international or foreign investors along with a domestic legislation in the Euro-zone to adopt a common format for the entire euro-market. The Japanese commercial paper market is older by over three years compared to Indian commercial paper, but has expanded and grown much faster. Liquidity in the market and quality of the seller in terms of rating are prominent issues of the commercial paper markets the regulators have been seriously concerned and mandated. In US, the unrated commercial paper is also sold, which

the task force for the development of short term debt securities has not allowed in the euro-market. In Belgium, the maturity for the commercial paper is not regulated and is allowed to be issued with any maturity;

In all, the countries where commercial paper is used as money market instrument by the corporate and later the market is explored by banking and finance companies followed by asset backed commercial paper market development with both non-banking non-finance companies, non-banking finance companies and in some markets banking companies issuing commercial paper and securitized commercial paper in the market.

#### FEATURES OF COMMERCIAL PAPER IN DIFFERENT COUNTRIES

Particulars	US	Canada	Australia	Spain	Sweden	Norway	Netherlands
Bearer	Y	Y	Y	Y	Y	Y	Y
Registered	Rare	Rare	N	Rare	N	N	N
Discount Basis	Y	Y	Y	Y	Y	Y	Y
Interest Bearing	Rare	Rare	N	N	N	Rare	N
Denomination: Smallest Typical	100T 1M	100T 1M	100T ½-1M	250T ½-1M	1M 20-50M	1M 1M	1M 1M
Maturity Range (Months) Typical (mon)	¼ - 1 ½ - 1 ½	1/30 - 12 < 3	1 - 6 < 3	1 - 18 3	1 1/30 - 24 3 - 12	<-12 <_3	½ - 24 <_3
Placement a) Direct b) Dealers c) Contin. Tap d) Tender panel	Y Y Y -	Y Y Y -	Y Y Y Common	Marg. Y Y Most	- Y Y -	Marg. Y Y Dealers	- Y Y -

Particulars	France	UK	Finland	Japan	Belgium	India	Germany
Bearer	Y	Y	Y	Y	Y	Y	Y
Registered	N	N	N	N	N	N	N
Discount Basis	Y	Y	Y	Y	Y	Y	Y
Interest Bearing	N	N	Rare	N	N	N	N
Denomination: Smallest Typical	1M 10-50M	100T 1M	1M 10-20M	100T 8-80M	10M 25M	500T	500T 500T
Maturity Range (Months) Typical (mon)	1/30-12 < 3	¼ - 12 1 - 3	1/30 - 12 1 - 3	½ - 9 ½ - 3	1 - 12 <_2	¼-12m 3m	¼ - 24 1 - 3
Placement e) Direct f) Dealers g) Cont Tap h) TP	Marg. Y Y -	Marg. Y Y Rare	- Y Y -	Y Y Y -	Marg. Y Y -	Marg. Y Y Rare	- Y Y -

**Source:** Compiled from Working Paper of BIS: No. 37, J. S. Alworth and C. E. V. Borio: Commercial paper markets: a survey, ISBN 92-9131-035-2

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- [9] The European Union's fourth directive on undertakings for collective investment in transferable securities (UCITS) is an important step towards the single market in financial services. It is likely to transform the asset management industry in the same way MiFID did for broker-dealers and investment banks. MiFID is the Markets in Financial Instruments Directive (Directive 2004/39/EC). It replaced the Investment Services Directive (ISD) which was adopted in 1993. It has been in force since 2008. It is a cornerstone of the EU's regulation of financial markets.

