THE FEDERAL RESERVE'S FIGHT AGAINST COVID-19: A STUDY OF THE CORPORATE BOND INTERVENTION

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ABSTRACT

In response to the COVID-19 pandemic, the Federal Reserve (Fed) embarked on an unprecedented mission to stabilize the U.S. economy as businesses shut down. One emergency Fed facility, the Secondary Market Corporate Credit Facility (SMCCF), was used to purchase corporate bonds and corporate bond exchange-traded funds (ETFs) in the secondary market. This extraordinary measure, which injected liquidity into the corporate bond market, aimed to mitigate economic fallout for large companies. Purchasing corporate bonds marked a departure from previous Federal Reserve interventions, but the statutory authority was the same as had been used in past crises: Section 13(3) of the Federal Reserve Act (FRA). Additionally, the SMCCF was supported by the new Coronavirus Aid, Relief, and Economic Security Act (CARES).

This Note examines the legal bases for the SMCCF, highlighting where the Federal Reserve exceeded its statutory authority. Specifically, this Note examines statutory provisions that require security, a liquidity purpose, a penalty rate, and that the borrower be a U.S.-centric business. This Note proceeds to propose alternative facilities for future crises that solve the same problem, but that are within statutory bounds. This Note also reevaluates the Federal Reserve's emergency lending framework, suggesting an amendment to modernize Section 13(3).

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INTRODUCTION

Few financial crises have sparked as swift and broad a government response as did the crisis triggered by the COVID-19 pandemic. As the government shut down the U.S. economy in hopes of controlling

COVID-19's spread,[1] it risked an economic catastrophe reminiscent of the Great Depression.[2] Amidst this turmoil, the Fed embarked on uncharted waters by launching the Secondary Market Corporate Credit Facility (SMCCF), through which it purchased corporate bonds.[3] The Fed aimed to use this program to provide credit to corporations, enabling corporations to maintain operations during an economic shutdown.[4] The SMCCF was a clear success, with the corporate primary bond market's reopening after a period of closure, thus allowing many U.S. corporations to issue new bonds.[5]

Section 13(3) of the Federal Reserve Act (FRA) authorized the SMCCF,[6] with additional support provided by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act).[7] Section 13(3) grants the Federal Reserve the power to "discount" in "unusual and exigent circumstances."[8] This language has been interpreted to mean that the Federal Reserve can make emergency loans, or, more controversially,

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1. *See* Harriet Torry & Sarah Nassauer, *Coronavirus Closures Froze Swaths of U.S. Economy in March*, WALL ST. J., Apr. 16, 2020, https://www.wsj.com/articles/march-retail-sales-plunged-8-7-as-coronavirus-shutdowns-took-hold-11586954353.

2. *See* David C. Wheelock, *Comparing the COVID-19 Recession with the Great Depression*, FED. RSRV. BANK ST. LOUIS (Aug. 12, 2020), https://research.stlouisfed.org/publications/economic-synopses/2020/08/12/comparing-the-covid-19-recession-with-the-great-depression. The decline in GDP during the second quarter of 2020 was greater than the decline in GNP in any single quarter during the Great Depression. GDP was not measured during the Great Depression; hence the comparison to GNP.

3. *See* Steven Sharpe & Alex Zhou, *The Corporate Bond Market Crises and the Government Response*, BD. GOVERNORS FED. RSRV. SYS. (Oct. 7, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/the-corporate-bond-market-crises-and-the-government-response-20201007.html.

4. *See* COMM. FIN. SERVS., OVERSIGHT OF THE TREASURY DEPARTMENT'S AND THE FEDERAL RESERVE'S PANDEMIC RESPONSE, H.R. Doc. No. 116-99, at 51, 53 (2020) (statement of Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System and Jim Nussie, President and CEO, Credit Union National Association).

5. *See* Robert McCauley, *The Fed in the Corporate Bond Market in 2020* 3, 16 (Bos. Univ. Glob. Econ. Governance Initiative, GEGI Working Paper No. 041, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3676193. *See also infra* Part I.B.2.

6. Press Release, Bd. Governors Fed. Rsrv. Sys., Federal Reserve announces extensive new measures to support the economy (Mar. 23, 2020, 8:00 AM), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm.

7. *See* Coronavirus Aid, Relief, and Economic Security Act, H.R. 748, 116th Cong. §4003(b)(4)(A)-4003(b)(4)(B) (2020) (enacted).

8. *See* 12 U.S.C. § 343(3)(A).

purchase debt securities.[9] Following Section 13(3)'s use during the Global Financial Crisis of 2008 ("2008 Crisis"), Congress amended Section 13(3) to refine its use.[10] The COVID-19 crisis marked the first application of the amended Section 13(3). This Note argues that the SMCCF exceeded the authority granted to the Federal Reserve in both Section 13(3) and the CARES Act.

I. CORPORATE FINANCE, COVID-19 DISRUPTION, AND THE FEDERAL RESERVE'S RESPONSE

A. CAPITAL-RAISING ACTIVITIES IN CORPORATE FINANCE

Companies require capital not just to survive but also to develop and grow.[11] They can use capital for a range of needs, from making acquisitions and meeting payroll to maintaining adequate equity cushions. Companies can obtain capital through retained earnings or by issuing debt or equity securities.[12] However, they do not issue debt and equity in the same amounts. S&P Global estimates that global corporate equity issuances[13] totaled $426 billion in 2023,[14] while global bond issuances that year were more than 18 times that amount, at $7.7 trillion.[15] Companies raise capital by issuing debt and equity securities

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9. *See* Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. PA. J. BUS. L. 221, 224-26 (2010); *see* Telephone Interview by Steven Kelly with Scott G. Alvarez, Esq., Former Gen. Couns. to Bd. Governors, U.S. Fed. Rsrv. Sys., YALE SCH. MGMT.: PROGRAM ON FIN. STABILITY 7-10 (Apr. 14, 2022), https://ypfsresourcelibrary.blob.core.windows.net/fcic/YPFS/Web_Ready_Trasncript_Alvarez-final_2.pdf.

10. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010) (enacted).

11. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1 (Aspen Publ'g, 10th ed. 2022).

12. *See* The Investopedia Team, *What Are the Sources of Funding Available for Companies?*, INVESTOPEDIA (June 27, 2023), https://www.investopedia.com/ask/answers/03/062003.asp.

13. Issuance refers to new equity and new debt sold publicly.

14. *See* Ken Shimokawa, *Equity Issuance Finishes 2023 Flat Year over Year; Long-Term IPO Performance Improves*, S&P GLOB. MKT. INTEL. (Jan. 26, 2024), https://www.spglobal.com/marketintelligence/en/news-insights/blog/equity-issuance-finishes-2023-flat-year-over-year-long-term-ipo-performance-improves.

15. *See* NICK W KRAEMER ET AL., CREDIT TRENDS: GLOBAL FINANCING CONDITIONS: CAUTIOUS OPTIMISM AFTER PEAK RATES (S&P Global Ratings, 2024), https://www.spglobal.com/ratings/en/research/articles/240125-credit-trends-global-financing-conditions-cautious-optimism-after-peak-rates-12978845#ContactInfo.

into the "primary" market;[16] investors can then trade these securities in the "secondary" market.[17] Prices in the secondary market indicate the value of a company's securities and thus the cost of capital that the company would likely achieve by issuing new securities of a similar type.[18]

1. Corporate Bond Market Overview

Corporate debt instruments, namely bonds,[19] vary by rating and instrument type.[20] Rating agencies categorize bonds by default risk.[21] There are two broad tiers of ratings: investment-grade, which have a low default risk, and speculative-grade, which have a high default risk.[22] "Instrument type" refers to various differences in a debt instrument's attributes, such as initial purchaser,[23] seniority in the event of default, and structural differences.[24] Senior unsecured investment-grade bonds

16. *See* James Chen, *Primary Market: Definition, Types, Examples, and Secondary*, INVESTOPEDIA (May 28, 2022), https://www.investopedia.com/terms/p/primarymarket.asp.

17. *See* Will Kenton, *What Is the Secondary Market? How It Works and Pricing*, INVESTOPEDIA (June 7, 2023), https://www.investopedia.com/terms/s/secondarymarket.asp.

18. If a company has debt maturing in ten years trading at 5.00% in the secondary market, a subsequent primary market 10-year issuance should yield close to 5.00%. *See infra* Part I.A.2.

19. While the technical term for the securities referred to as "bonds" would be "debentures" or "notes," this Note adopts the commonly understood convention of referring to these senior unsecured debt securities as "bonds."

20. *See, e.g.*, SARAH LIMBACH & EVAN M. GUNTER, CREDIT TRENDS: GLOBAL STATE OF PLAY: DEBT GROWTH DIVERGING BY CREDIT QUALITY Table 7 (S&P Global Ratings, 2023), https://www.spglobal.com/ratings/en/research/articles/230906-credit-trends-global-state-of-play-debt-growth-diverging-by-credit-quality-12835732.

21. *See* James Chen, *Investment Grade Credit Rating Details: What Does It Mean?*, INVESTOPEDIA (Aug. 16, 2023), https://www.investopedia.com/terms/i/investmentgrade.asp.

22. *See id.* Investment-grade ratings comprise Baa3 to Aaa from Moody's and BBB- to AAA from S&P. Anything lower (beginning with Ba1 and BB+) is considered speculative-grade. Speculative-grade debt is also called "junk" or high yield.

23. With a loan, the borrower typically contracts with a bank. With a publicly issued bond, the bond is made available to the investing public.

24. *See* LIMBACH & GUNTER, *supra* note 20, at Table 7. Examples of different types of debt securities include revolvers, term loans, secured bonds, unsecured bonds, and subordinated bonds.

comprise the largest segment of the rated U.S. corporate debt market, accounting for 60% of the nearly $12 trillion rated U.S. corporate debt as of July 2023.[25] The senior unsecured market includes significant portions of the capital structure of America's largest, most established businesses,[26] such as Apple,[27] Home Depot,[28] and McDonald's.[29]

2. The Bond Issuance Process

When a corporation decides to issue bonds, it hires investment banks[30] to solicit investors.[31] Over a single day,[32] these banks market the deal, assessing an issue spread that balances the needs of both the issuer and the investors.[33] Many issuers access the market frequently, with some having over one hundred series of bonds outstanding.[34] Investors and banks can refer to existing bonds trading in the secondary market to determine the appropriate spreads for new issues. Thus, an increase in the yield of a bond in the secondary market suggests a corresponding

25. *See id.* Based on debt rated by S&P Global.

26. *See* DIANE VAZZA ET AL., U.S. CORPORATE DEBT MARKET: THE STATE OF PLAY IN 2019 (S&P Global Ratings, 2023), https://www.spglobal.com/en/research-insights/articles/u-s-corporate-debt-market-the-state-of-play-in-2019.

27. Apple's most recent unsecured bond issuance was rated Aaa at Moody's and AA+ at S&P. *See* Apple Inc., Final Pricing Term Sheet (Filed Pursuant to Rule 433) (May 8, 2023), https://www.sec.gov/Archives/edgar/data/320193/000114036123023544/ny20007635x2_fwp.htm.

28. Home Depot's most recent unsecured bond issuance was rated A2 at Moody's, A at S&P, and A at Fitch. *See* The Home Depot, Inc., Final Term Sheet (Filed Pursuant to Rule 433) (Nov. 27, 2023), https://www.sec.gov/Archives/edgar/data/354950/000035495023000246/hdnovember2023fwp.htm.

29. McDonald's most recent unsecured bond issuance was rated Baa1 at Moody's and BBB+ at S&P. *See* McDonald's Corporation, Summary of Terms (Filed Pursuant to Rule 433) (Aug. 9, 2023), https://www.sec.gov/Archives/edgar/data/63908/000110465923089430/tm2323206d3_fwp.htm.

30. When acting on behalf of a company to issue bonds, banks are also known as bookrunners or underwriters.

31. *See* Hendrik Bessembinder et al., *Overallocation and secondary market outcomes in corporate bond offerings*, 146 J. FIN. ECON. 444, 447 (2022).

32. *See id.* The public issuance process is very fast because investors are familiar with investment-grade companies, and companies want to reduce intraday Treasury rate risk.

33. *See* Kerry Siani, Raising Bond Capital in Segmented Markets 2-9 (unpublished manuscript, Oct. 6, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4239841. Issue spread is the difference between a bond's yield at issuance and the yield on an on-the-run United States Treasury bond with a similar duration.

34. *See* Bessembinder et al., *supra* note 31, at 447.

increase for a primary market issuance with a similar maturity. Notably, the volume of trading in the secondary market directly influences primary market pricing.[35]

B. ECONOMIC AND FINANCIAL IMPACT OF COVID-19 AND THE FEDERAL RESERVE'S RESPONSE

1. *Impact of COVID-19 on the Economy and Financial Markets*

The United States reported its first case of COVID-19 on January 20, 2020.[36] By March 3, the country had 60 cases, and by March 15, states began economic shutdowns.[37] As the shutdowns intensified, the U.S. economy slumped.[38] For example, spending at clothing stores plummeted by 50%, and manufacturing output fell by 6.3% month-over-month, which was the largest decline since World War II.[39] Between March and August of 2020, 56 million Americans filed for unemployment benefits.[40]

The pandemic strained the ability of U.S. corporations' cash reserves to meet routine expenses like payroll.[41] Because the pandemic appeared to be a short-term disruption in March 2020, companies seemed only to need short-term emergency funds as a bridge to the other side of the economic shutdown. These needs could normally be met by issuing securities. However, this time, capital markets were unavailable.

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35. *See* Michael A. Goldstein, Edith S. Hotchkiss, & David J. Pedersen, *Secondary Market Liquidity and Primary Market Pricing of Corporate Bonds*, J. RISK FIN. MGMT. 2019 at 10 (finding that a 10% increase in liquidity decreases the issuance spread by 8% to 14%).

36. *See* Savannah Bergquist, Thomas Otten, & Nick Sarich, *COVID-19 pandemic in the United States*, 9 HEALTH POL'Y AND TECH. 623, 626 (2020).

37. *See CDC Museum COVID-19 Timeline*, CENTERS FOR DISEASE CONTROL AND PREVENTION, https://www.cdc.gov/museum/timeline/covid19.html (last visited Jan. 14, 2025).

38. *See* Torry & Nassauer, *supra* note 1.

39. *See id.*

40. *See* JAMES K. JACKSON ET AL., CONG. RSCH. SERV., R46270, GLOBAL ECONOMIC EFFECTS OF COVID-19 7 (2020).

41. *See* Emily Flitter & Peter Eavis, *Some Companies Seeking Bailouts Had Piles of Cash, Then Spent It*, N.Y. TIMES (Apr. 24, 2020), https://www.nytimes.com/2020/04/24/business/coronavirus-bailouts-buybacks-cash.html.

The primary market for corporate bonds was inaccessible[42] in early March,[43] along with the loan,[44] equity,[45] and commercial-paper markets.[46]

With markets closed, revolving credit facilities became Corporate America's primary source of liquidity. While these facilities can remain untapped for years, they provide companies with the immediate option to access liquidity.[47] Between March 5 and March 31, 2020, American companies drew $161 billion in cash from revolving credit facilities, with the consumer discretionary industry's drawing the most.[48] Nevertheless, given their limited size and high cost, revolving credit facilities offered only a partial and limited solution.[49]

2. *The Federal Reserve's Market Intervention Strategies*

In response to the market disruption, on March 23, 2020, the Fed announced the Primary Market Corporate Credit Facility (PMCCF) and

42. Liquidity in the secondary market vanished and investors questioned business fundamentals amid COVID-19, causing spreads to widen and a misunderstanding of bond values to emerge. *See, e.g.*, SIRIO ARAMONTE & FERNANDO AVALOS, CORPORATE CREDIT MARKETS AFTER THE INITIAL PANDEMIC SHOCK 2 (Bank for Int'l Settlements 2020), https://www.bis.org/publ/bisbull26.pdf.

43. *See* BD. INT'L ORG. SEC. COMMISSIONS, CORPORATE BOND MARKETS – DRIVERS OF LIQUIDITY DURING COVID-19 INDUCED MARKET STRESSES 12 (2022), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD700.pdf.

44. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-21-167, FINANCIAL STABILITY: AGENCIES HAVE NOT FOUND LEVERAGED LENDING TO SIGNIFICANTLY THREATEN STABILITY BUT REMAIN CAUTIOUS AMID PANDEMIC 30 (2020).

45. *See* Maggie Fitzgerald, *Coronavirus and market volatility shuts down the IPO market for potential listings like Airbnb*, CNBC (Mar. 14, 2020, 10:34 AM), https://www.cnbc.com/2020/03/14/coronavirus-and-market-volatility-shuts-down-the-ipo-market-for-potential-listings-like-airbnb.html.

46. *See* S.P. KOTHARI ET AL., U.S. CREDIT MARKETS: INTERCONNECTEDNESS AND THE EFFECTS OF THE COVID-19 ECONOMIC SHOCK 6 (U.S. Sec. Exch. Comm'n 2020), https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf.

47. *See* Julie Kagan, *Revolving Loan Facility Explained: How Does It Work?*, INVESTOPEDIA (Nov. 3, 2023), https://www.investopedia.com/terms/r/revolving-loan-facility.asp.

48. *See* LCD News, *Another $5.7B of RC drawdowns as US companies eye coronavirus, liquidity*, S&P GLOB. MKT. INTEL. (Mar. 31, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/another-5-7b-of-rc-drawdowns-as-us-companies-eye-coronavirus-liquidity-57826825.

49. *See* Kagan, *supra* note 47.

the SMCCF.[50] These measures marked the first time in its history that the Federal Reserve committed to purchasing corporate bonds.[51] The goal of these facilities was, according to a congressional report, "to support the flow of credit to large investment-grade U.S. companies so that they [could] maintain business operations and capacity during the period of dislocation related to COVID-19."[52]

Through the PMCCF, the Federal Reserve intended to buy bonds directly from issuers as either the sole buyer or as a part of a syndicate.[53] The Federal Reserve intended to charge the issuer an additional 100 basis-point fee.[54] However, the PMCCF posed problems. Former Minneapolis Federal Reserve President Narayana Kocherlakota strongly criticized the PMCCF, arguing that it was "a direct taxpayer subsidy to corporate shareholders."[55] Others similarly argued that serving as the sole investor in a transaction is akin to direct lending, which would subject the borrower to restrictions on stock buybacks and executive compensation pursuant to the CARES Act.[56] The Federal Reserve ultimately never purchased a bond nor a loan via the PMCCF, and the

50. *See* Jeanna Smialek, *The Fed Goes All In With Unlimited Bond-Buying Plan*, N.Y. TIMES (Mar. 23, 2020), https://www.nytimes.com/2020/03/23/business/economy/coronavirus-fed-bond-buying.html.

51. *See* Sharpe & Zhou, *supra* note 3.

52. *See The Quarterly CARES Act Report to Congress: Hearing Before the S. Comm. on Banking, Hous., and Urb. Affs.*, 116th Cong. 51 (2020) (statement of Jerome H. Powell, Chair, Bd. of Fed. Rsrv. Sys.).

53. *See Term Sheet - Primary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a9.pdf.

54. *See id.*

55. *See* Eric Levitz, *The Fed's Response to COVID-19 Is Impressive — and Alarming*, N.Y. MAG.: INTELLIGENCER (Mar. 27, 2020), https://nymag.com/intelligencer/2020/03/federal-reserve-coronavirus-economic-crisis-democracy.html. While the PMCCF technically bought bonds from issuers, Kocherlakota refers to the PMCCF as purchasing "loans." Because the Fed could be the sole purchaser in a primary market issuance, the bond would be indistinguishable from purchasing a loan.

56. *See* Jeremy Kress (@Jeremy_Kress), X (Apr. 28, 2020, 12:59 PM), https://twitter.com/Jeremy_Kress/status/1255179918843019266. Under the CARES Act, Congress placed limitations on borrowers receiving loans from section 4003(b), including limitations on buybacks, dividends, and layoffs. *See* CARES Act § 4003(c)(2)(E)-(G).

facility's authorization expired at the end of 2020.[57] As a result, this Note focuses on the SMCCF.

Unlike the PMCCF, which authorized primary-market purchases,[58] the SMCCF aimed to enhance market liquidity through purchases of corporate bonds and corporate bond exchange-traded funds (ETFs) in the secondary market.[59] Initially, bonds eligible for purchase by the Federal Reserve had to be issued by businesses with "material operations in the United States," had to have credit ratings of at least Baa3/BBB-, and had to have maturities of under five years.[60] For an ETF to be eligible for purchase, it needed to have an investment objective of "broad exposure to the market for U.S. investment grade corporate bonds."[61]

i. SMCCF's Impact on the Market

The SMCCF announcement achieved the Federal Reserve's goals by restoring liquidity and reviving the primary market.[62] Even before the Federal Reserve purchased any corporate bonds,[63] its announcement bolstered investor confidence, prompting investors to begin purchasing primary-market corporate bonds again.[64] A study revealed that,

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57. *See* Natalie Leonard, *United States: Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility*, 4 J. FIN. CRISES 1797, 1798 (2022). Federal Reserve Chair Powell later admitted that he expected the PMCCF would see greater demand than the SMCCF. *See Semiannual Monetary Policy Report to Congress: Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*, 116th Cong. 16 (2020).

58. *See Term Sheet - Primary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a9.pdf.

59. *See Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/smccf.htm (Oct. 13, 2021).

60. *See Term Sheet – Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (Mar. 23, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200323b2.pdf.

61. *See id.*

62. *See* McCauley, *supra* note 5, at 3.

63. The Federal Reserve did not begin purchases until May 12, 2020. *See* Press Release, Fed. Rsrv. Bank of N.Y., New York Fed Announces Start of Certain Secondary Market Corporate Credit Facility Purchases on May 12 (May 11, 2020), https://www.newyorkfed.org/newsevents/news/markets/2020/20200511.

64. *See* Jeanna Smialek, *The Fed announces plans to sell off its corporate bond holdings.*, N.Y. TIMES (June 2, 2021), https://www.nytimes.com/2021/06/02/business/fed-sells-corporate-bond-holdings.html.

immediately after the Federal Reserve's SMCCF announcement, eligible companies were three times more likely to issue new debt,[65] and eligible companies' bonds traded at a yield that was 20 basis-points lower relative to their ineligible counterparts.[66]

After the SMCCF was announced, the primary market for investment-grade corporate bonds surged. March, April, and May of 2020 remain the three months with the greatest investment-grade corporate bond issuance, with companies' issuing over $800 billion in new debt during the period.[67] In the initial weeks, only the highest quality, blue-chip issuers had access to the primary market, and they used the proceeds from new issuances to refinance commercial paper.[68] As market accessibility expanded to lower rated investment-grade issuers, these entities issued debt for operational needs,[69] liquidity enhancement,[70] and debt refinancing.[71]

ii. Case Study – Sysco Corporation

Sysco Corporation shows how companies adeptly navigated the challenges of this period.[72] Sysco describes itself as the "[l]argest global distributor of food and related products primarily to the foodservice or

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65. *See* Nina Boyarchenko, Anna Kovner & Or Shachar, *It's what you say and what you buy: A holistic evaluation of the corporate credit facilities*, 144 J. FIN. ECON. 695, 701-02 (2022).

66. *See* Simon Gilchrist et al., *The Fed Takes On Corporate Credit Risk: An Analysis of the Efficacy of the SMCCF* 31 (Fed. Rsrv. Bank of Atlanta, Working Paper No. 2020-18, 2020), https://www.atlantafed.org/-/media/documents/research/publications/wp/2020/09/15/18-analysis-of-efficacy-of-smccf.pdf. Trading at a lower yield corresponds to a higher price.

67. *See Largest Monthly Volume All-Time*, CREDIT FLOW RSCH. (on file with author) (database updated Apr. 2024).

68. *See* Fitch Wire, *Flurry of US IG Bond Issuance Replaces CP at Higher Cost*, FITCH RATINGS (Apr. 8, 2020, 4:24 PM), https://www.fitchratings.com/research/corporate-finance/flurry-of-us-ig-bond-issuance-replaces-cp-at-higher-cost-08-04-2020.

69. *See* TIRUPAM GOEL & JOSÉ MARÍA SERENA, BONDS AND SYNDICATED LOANS DURING THE COVID-19 CRISIS: DECOUPLED AGAIN? 5-6 (Bank for Int'l Settlements 2020), https://www.bis.org/publ/bisbull29.pdf.

70. *See id.*

71. U.S. GOV'T ACCOUNTABILITY OFF., GAO-21-180, FEDERAL RESERVE LENDING PROGRAMS: USE OF CARES ACT-SUPPORTED PROGRAMS HAS BEEN LIMITED AND FLOW OF CREDIT HAS GENERALLY IMPROVED 31 (2020).

72. In full disclosure, the author worked on the Sysco transactions mentioned in this section.

food-away-from-home industry."[73] The reaction to COVID-19 forced many of Sysco's clients, such as restaurants and hotels, to close, significantly reducing demand for Sysco's offerings.[74] Moody's and S&P consequently downgraded Sysco's credit rating from A3 to Baa1 and from BBB+ to BBB-, respectively.[75] Additionally, Sysco drew $1.63 billion from its two revolving credit facilities.[76] Then, just seven days following the SMCCF announcement, on March 30, 2020, Sysco issued $4 billion in new bonds.[77]

iii. Overview of SMCCF Eligibility and Structure

After its announcing the SMCCF, the Federal Reserve refined the scope of the facility through two amended Term Sheets.[78] The final Term Sheet identified three asset categories eligible for purchase through the SMCCF: individual corporate bonds, ETFs, and bonds based on a broad-market index.[79] Eligibility criteria for individual bonds included a maturity of fewer than five years, issuance by an American business with the majority of its workforce in the United States, a minimum credit rating of BBB-/Baa3 as of March 22, 2020, and that the bond not be issued by a depository institution.[80] The date for the credit rating allowed the Federal Reserve to purchase speculative-grade bonds downgraded after March 22, 2020, thus accommodating companies hurt

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73. *See* Sysco Corp., Prospectus Supplement to Prospectus dated Aug. 27, 2018 S-1 (Form 424B3), at S-1 (Mar. 30, 2020), available at https://www.sec.gov/Archives/edgar/data/1541916/000119312520094278/d899357d424b3.htm.

74. *See id.* at S-8.

75. *See id.* at S-10.

76. *See id.* at S-3.

77. *See id.* at cover page. Sysco issued a four-tranche deal, including 10 and 30-year bonds with coupons of 5.95% and 6.60%. One month prior, Sysco had issued different series of 10- and 30-year bonds with coupons of 2.40% and 3.30%, respectively. *See* Sysco Corp., Prospectus Supplement to Prospectus dated Aug. 27, 2018, at cover page (Form 424(b)(3)) (Feb. 11, 2020), available at https://www.sec.gov/Archives/edgar/data/1541916/000119312520094278/d899357d424b3.htm.

78. *See Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS., (Oct. 13, 2021), https://www.federalreserve.gov/monetarypolicy/smccf.htm.

79. *See Term Sheet – Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf. *See infra* Part II.D.3 for an explanation of the broad market index.

80. *See id.*

by the pandemic.[81] To be eligible for purchase by the SMCCF, ETFs also needed to have a primary objective of investing in either United States investment-grade or speculative-grade corporate bond markets.[82] Further, all SMCCF purchases had to be made at fair market value.[83] Additionally, the Term Sheets specified that the Federal Reserve would cease purchasing assets on December 31, 2020.[84]

The Term Sheets also clarified the SMCCF's operational framework. To facilitate purchases, the Federal Reserve organized a special purpose vehicle (SPV)[85] that it would finance through a loan secured by the corporate bonds and ETFs the SPV purchased.[86] The SPV was also funded by a $25 billion investment from the Treasury, as designated by the CARES Act, which could be leveraged by up to ten to one, thereby setting the SMCCF's maximum holdings at $250 billion.[87] However, the Federal Reserve's leveraging of the Treasury investment depended on the risk profile of assets purchased.[88] Speculative-grade purchases could only be leveraged at seven to one, while investment-

81. *See id.* The Federal Reserve still set a credit rating floor of BB-/Ba3 for those purchases beneath investment grade.

82. *See id.*

83. *See id.*

84. *See id.*

85. *See id.*

86. *See id.*

87. *See id.* Before the CARES Act was passed, the SMCCF received a $10 billion "equity investment" from the Department of Treasury using the Exchange Stabilization Fund (ESF). *See also Term Sheet – Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (Mar. 23, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200323b2.pdf. The ESF was created in 1934 to stabilize currencies, and the Secretary of the Treasury has broad discretion in its use. It was used in the 1990s to lend $20 billion to Mexico to stabilize the Peso, but it somewhat deviated from its original intent in 2008 when it was used to stabilize money market funds. *See* Sage Belz & David Wessel, *What is the Exchange Stabilization Fund? And how is it being used in the coronavirus (COVID-19) crisis?*, BROOKINGS INSTITUTION (Mar. 24, 2020), https://www.brookings.edu/articles/what-is-the-exchange-stabilization-fund-and-how-is-it-being-used-in-the-coronavirus-covid-19-crisis/. Immediately preceding COVID-19, the ESF had assets of $94.7 billion. *See Exchange Stabilization Fund Statement of Financial Position*, U.S. DEPT. OF TREASURY (Feb. 29, 2020), https://home.treasury.gov/system/files/206/February_FY20_Financial_Statements.pdf.

88. *See Term Sheet – Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

grade purchases could be leveraged at ten to one.[89] In other words, for every $1 investment by the Treasury, the Federal Reserve could purchase $10 of investment-grade assets, but only $7 of speculative-grade assets.

The Federal Reserve began ETF purchases on May 11, 2020,[90] and it began buying individual corporate bonds on June 16, 2020.[91] By June 2020, the Federal Reserve had become the third-largest holder of the largest corporate investment-grade ETF.[92] By the end of 2020, it had purchased individual bonds from over 500 issuers, including $91.6 million in bonds from AT&T, $89.8 million in bonds from Volkswagen, and $82.5 million in bonds from Apple.[93]

iv. Public Scrutiny of the SMCCF

The SMCCF's bond purchases have drawn public and legislative scrutiny, particularly concerning government support for companies with questionable tax and employment practices. For example, research from the Project on Government Oversight (POGO) revealed that the SMCCF had purchased $585.9 million bonds from 44 Fortune 500 companies that did not pay federal income taxes in 2018.[94] Among these companies, 32 had incurred penalties for corporate misconduct during

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89. *See id.*

90. *See* Press Release, Fed. Rsrv. Bank of N.Y., New York Fed Announces Start of Certain Secondary Market Corporate Credit Facility Purchases on May 12 (May 11, 2020), https://www.newyorkfed.org/newsevents/news/markets/2020/20200511.

91. *See FAQs: Secondary Market Corporate Credit Facility*, FED. RSRV. BANK OF N.Y. (July 8, 2021), https://www.newyorkfed.org/markets/primary-and-secondary-market-faq/corporate-credit-facility-faq.

92. *See* Katherine Greifeld, *Fed Becomes No. 3 Holder of World's Biggest Corporate-Bond ETF*, BLOOMBERG (June 29, 2020, 4:56 PM), https://www.bloomberg.com/news/articles/2020-06-29/fed-becomes-no-3-holder-of-world-s-biggest-corporate-bond-etf.

93. *See SMCCF Transaction Specific Disclosures 12-11-20*, BD. OF GOVERNORS OF FED. RSRV. SYS. (June 3, 2021), https://www.federalreserve.gov/publications/2020-reports-to-congress-in-response-to-covid-19.htm.

94. *See* Brandon Brockmyer & Ryan Summers, *Freeloaders and the Fed: Scrutinizing the Federal Reserve's Secondary Market Bond Purchases Under the CARES Act*, PROJECT ON GOV'T OVERSIGHT (Feb. 3, 2021), https://www.pogo.org/analysis/freeloaders-and-the-fed-scrutinizing-the-federal-reserves-secondary-market-bond-purchases-under-the-cares-act

the preceding three years.[95] Furthermore, the Federal Reserve purchased bonds from companies named on Bloomberg's list of "tax inverters."[96]

A report from the House Select Subcommittee on the Coronavirus Crisis echoed POGO's report, finding that more than one million workers from 140 companies whose bonds the SMCCF had purchased were laid off during the COVID-19 crisis.[97] The report criticized 383 companies for distributing dividends during the pandemic and highlighted Sysco's decision to lay off about a third of its workforce shortly before paying dividends to shareholders.[98] The report criticized the composition of the Federal Reserve's bond portfolio, noting an overrepresentation of fossil-fuel producers.[99]

Additionally, analysts have criticized the SMCCF's impact on free markets.[100] Professor James A. Dorn argued that the Federal Reserve "undermine[d] corrective forces" of the market by buying corporate bonds, suggesting that the SMCCF represented a move towards "market socialism."[101] Financial markets commentator Jim Bianco feared that the SMCCF was a gateway to future Federal Reserve equity purchases, which would permit the government to directly influence American companies.[102]

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95. *See id.*

96. *See id.* "Tax inverters" are defined as "companies that took advantage of tax code loopholes and moved their business operations abroad without changing majority ownership, headquarters, or management leaders . . . ." *See id.*

97. *See* STAFF OF SELECT SUBCOMM. ON THE CORONAVIRUS CRISIS, 116TH CONG., PRIORITIZING WALL STREET: THE FED'S CORPORATE BOND PURCHASES DURING THE CORONAVIRUS PANDEMIC 1-2 (2020), https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=13134&context=ypfs-documents.

98. *See id.* at 2.

99. *See id.* at 1-3.

100. *See* James A. Dorn, *The Fed's Corporate Lending Facilities: A Case of Pseudo Markets*, CATO INST. (May 26, 2020, 8:40 AM), https://www.cato.org/blog/feds-corporate-lending-facilities-case-pseudo-markets.

101. *See id.*

102. *See* Jim Bianco (@biancoresearch), X (June 15, 2020, 3:35 PM), https://twitter.com/biancoresearch/status/1272613721475616769.

C. The Legal Foundation of the SMCCF: The Interplay Between Section 13(3) and the CARES Act

The Federal Reserve cited Section 13(3) as its authority for creating the SMCCF.[103] Central to this section of the FRA is its provision that "[i]n unusual and exigent circumstances, the Board of Governors of the Federal Reserve System . . . may authorize any Federal reserve bank . . . to discount . . . notes, drafts, and bills of exchange."[104]

1. Development of Section 13(3)

i. The Genesis of Federal Reserve Act Section 13(3)

Section 13(3), added to the FRA in 1932 during the Great Depression, aimed to mitigate banking crises through direct lending.[105] Banks reduced lending during the Great Depression to conserve capital, leading to concerns that businesses would be unable to obtain financing.[106] In the four years after Section 13(3) was enacted, the Federal Reserve lent approximately $1.5 million to American businesses.[107] Later, in 1966 and again in 1969, the Federal Reserve considered using Section 13(3) to lend to banks, but ultimately no loans were made.[108]

ii. Deploying Section 13(3) in the 2008 Crisis

The 2008 Crisis, primarily triggered by a collapse in the housing market,[109] was the most severe economic downturn in American history

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103. *See* Press Release, Bd. Governors Fed. Rsrv. Sys., Federal Reserve announces extensive new measures to support the economy (Mar. 23, 2020, 8:00 AM), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm.

104. 12 U.S.C. § 343(3)(A).

105. *See* Parinitha Sastry, *The Political Origins of Section 13(3) of the Federal Reserve Act*, FRBNY ECON. POL'Y REV., Sept. 2018 at 1, 15.

106. *See* David C. Wheelock, *Emergency Lending to Nonbank Borrowers*, FED. RSRV. HIST. (May 10, 2022), https://www.federalreservehistory.org/essays/emergency-lending-13-3.

107. *See* Sastry, *supra* note 105, at 27.

108. *See* Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 496 (2011).

109. *See* Vincent Reinhart, *A Year of Living Dangerously: The Management of the Financial Crisis in 2008*, 25 J. ECON. PERSPS. 71, 73 (2011).

since the Great Depression.[110] Distress at Bear Stearns, an investment bank that securitized mortgages, signaled early trouble.[111] Bear Stearns amassed a portfolio of high-risk, illiquid mortgage-backed securities.[112] The portfolio was leveraged at 35 to one, and the leverage was predominantly financed through short-term commercial paper.[113] However, as credit conditions tightened and concerns over Bear Stearns's financial stability grew, the bank faced imminent collapse.[114]

On March 14, 2008, the Federal Reserve lent to JPMorgan Chase through its discount window to finance a loan to Bear Stearns.[115] However, this effort proved insufficient for Bear Stearns to survive on its own. Two days later, JPMorgan Chase agreed to acquire Bear Stearns, conditioned upon excluding $30 billion of Bear Stearns's troubled assets from the purchase.[116] To facilitate this acquisition, the Federal Reserve created an SPV under Section 13(3) and loaned it $29 billion.[117] This LLC then acquired the troubled assets from Bear Stearns's balance sheet, clearing the path for JPMorgan Chase's purchase of the rest of Bear Stearns.[118] Later that year, the Federal

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110. *See* Gautam Mukunda, *The Social and Political Costs of the Financial Crisis, 10 Years Later*, HARV. BUS. REV. (Sept. 25, 2018), https://hbr.org/2018/09/the-social-and-political-costs-of-the-financial-crisis-10-years-later.

111. *See* Reinhart, *supra* note 109, at 76.

112. *See id.*

113. *See id.*

114. *See id.* at 76-78; Thomas O. Porter II, *The Federal Reserve's Catch-22: A Legal Analysis of the Federal Reserve's Emergency Powers*, 13 N.C. BANKING INST. 483, 493-95 (2009).

115. *See* Porter II, *supra* note 114, at 494-95 (quoting testimony from New York Federal Reserve Bank President Timothy Geithner). Bear Stearns could not access the discount window on its own because the discount window is only available to depository institutions like JP Morgan Chase, so the Federal Reserve made a loan to JP Morgan Chase to subsequently loan to Bear Stearns. *See* Reinhart, *supra* note 109, at 78 (2011). The discount window is a liquidity facility available to depository institutions to ensure the smooth functioning of credit markets. *See Discount Window Lending*, BD. GOVERNORS FED. RSRV. SYS. (Sept. 30, 2024), https://www.federalreserve.gov/regreform/discount-window.htm.

116. *See* Reinhart, *supra* note 109, at 78.

117. *See* Porter II, *supra* note 114, at 496. JPMorgan Chase also loaned $1 billion to this LLC. *See id.*

118. *See id.* at 496-97.

Reserve launched two more SPVs to purchase high-risk assets from insurance company AIG.[119]

iii. Broad-Based Section 13(3) Facilities During the 2008 Crisis: The Commercial Paper Funding Facility

After rescuing Bear Stearns, the Federal Reserve broadened its crisis response by establishing facilities designed to support entire financial markets rather than individual firms.[120] By the conclusion of the 2008 Crisis, the Federal Reserve had established six such facilities.[121] Two were the Term-Asset-Backed Securities Loan Facility, which provided loans for the purchase of asset-backed securities, and the Money Market Investor Funding Facility, designed to support money market investors.[122]

A notable precursor to the SMCCF during the 2008 Crisis was the Commercial Paper Funding Facility (CPFF).[123] Commercial paper, a short-term debt instrument that matures after 30 days, on average, is bought by institutional investors and issued in order to finance corporations' immediate operational needs.[124] Before the 2008 Crisis, the size of the commercial paper market was approximately $1.97 trillion, with asset-backed securities constituting 56.8% of this market.[125]

Market turmoil erupted in September 2008 when Lehman Brothers declared bankruptcy and a major money-market fund revealed that it held $785 million in Lehman Brothers commercial paper.[126] These events triggered a run on money markets and drove up interest rates on

119. *See* Daniel J. Hunt, *Just Grin and Bear It: Why Consistent Use of Individual Bailouts under Section 13(3) of the Federal Reserve Act Is a Necessary Evil to Combat Economic Mass Destruction*, 6 GEO. MASON J. INT'L COM. L. 59, 75-76 (2014).

120. *See id.* at 76-77.

121. *See* OFF. OF INSPECTOR GEN., THE FEDERAL RESERVE'S SECTION 13(3) LENDING FACILITIES TO SUPPORT OVERALL MARKET LIQUIDITY: FUNCTION, STATUS, AND RISK MANAGEMENT 3-4 (2010).

122. *See id.* at 4.

123. The CPFF was also revived as a response to COVID-19. *See Commercial Paper Funding Facility*, BD. GOVERNORS FED. RSRV. SYS., (June 11, 2021), https://www.federalreserve.gov/monetarypolicy/cpff.htm.

124. *See* Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007–2009*, 24 J. ECON. PERSPS. 29, 30-32 (2010). Current assets normally include receivables and inventory.

125. *See id.* at 32.

126. *See id.* at 40.

commercial paper.[127] To stabilize the commercial paper market, the Federal Reserve launched the CPFF.[128] The Federal Reserve established an SPV to purchase highly rated commercial paper with a maturity of three months or less.[129] While the CPFF accepted both secured and unsecured commercial paper, it imposed a 100 basis-point "credit enhancement surcharge" on the latter.[130] In addition, the CPFF charged a 10 basis-point facility fee on the maximum amount the issuer could issue to the CPFF.[131]

Following the 2008 Crisis, a now-frequently-cited article by Alexander Mehra critiqued several of the Federal Reserve's emergency measures, including the CPFF, as exceeding the Federal Reserve's Section 13(3) authority.[132] He specifically argued that the CPFF violated Section 13(3)'s requirement that loans purchased by the Federal Reserve be "indorsed or otherwise secured to the satisfaction of the Federal [R]eserve bank."[133] This provision, he argued, is intended to protect the Federal Reserve by requiring that debt be secured or that a third party guarantee it.[134] Because the CPFF purchased unsecured commercial paper, there was no security, nor was their evidence of endorsement.[135] However, Mehra acknowledged that the Federal Reserve could justify buying unsecured commercial paper by characterizing the CPFF surcharge on unsecured paper as a form of security, although he viewed this protection as minimal relative to the size of the CPFF.[136]

iv. Revising Section 13(3): The Dodd-Frank Amendments

In response to the 2008 Crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), whose ostensible goals were to stabilize the financial system and obviate future

127. *See id.* at 40-41.
128. *See Commercial Paper Funding Facility (CPFF)*, BD. GOVERNORS FED. RSRV. SYS. (Mar. 18, 2020) https://www.federalreserve.gov/regreform/reform-cpff.htm.
129. *See id.*
130. *See id.*
131. *See id.* This created proceeds of $849 million for the Federal Reserve.
132. *See generally* Mehra, *supra* note 9.
133. *See id.* at 243, 223.
134. *See id.* at 228-29.
135. *See id.* at 243.
136. *See id.*

bailouts.[137] This legislation significantly amended Section 13(3),[138] with the intent of preventing repetitions of the Bear Stearns and AIG bailouts while still allowing the Federal Reserve to offer broad-based emergency lending in crises.[139]

The Dodd-Frank amendments introduced both substantive and procedural changes to Section 13(3). Substantively, a key addition required that emergency lending facilities be "broad-based" so that bailouts of individual firms like Bear Stearns and AIG would no longer be possible.[140] Further, the amendments required that emergency lending aim to "provid[e] liquidity to the financial system," ensure that "security for emergency loans [be] sufficient to protect taxpayers from losses," and exclude participation by insolvent borrowers.[141]

Procedurally, Dodd-Frank also required the Federal Reserve to establish policies and procedures for emergency lending.[142] Moreover, it conditioned the use of Section 13(3) on the Secretary of the Treasury's approval and mandated the timely and orderly termination of any emergency lending programs.[143]

v. Enacting Dodd-Frank Amendments via Federal Reserve Rulemaking: Regulation A

In November 2015, the Federal Reserve promulgated Regulation A, which details policies and procedures meant to align the Federal Reserve's use of Section 13(3) with Dodd-Frank's mandates.[144] Issuing this regulation provided the Federal Reserve with a platform to explain and operationalize its interpretation of the Dodd-Frank amendments.

Regulation A defines a program or facility as being "broad-based" if it "is designed to provide liquidity to an identifiable market or sector of the financial system."[145] Conversely, a facility is not "broad-based" if

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137. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

138. *See id.* at § 1101.

139. *See* MARC LABONTE, CONG. RSCH. SERV., R44185, FEDERAL RESERVE: EMERGENCY LENDING 10 (2020).

140. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1101(a).

141. *See id.* § 1101(a)(6).

142. *Id.*

143. *Id.*

144. *See* MARC LABONTE & M. MAUREEN MURPHY, CONG. RSCH. SERV. INSIGHT, IN10426, FEDERAL RESERVE ISSUES FINAL RULE ON EMERGENCY LENDING (2016).

145. 12 C.F.R. § 201.4(d)(4)(ii).

it aims primarily at preventing the bankruptcy of fewer than five entities.[146] In explaining this rule, the Federal Reserve stated that facilities such as the CPFF satisfy this definition of broad-based, whereas interventions similar to those for Bear Stearns and AIG do not.[147]

Regulation A also refines the meaning of "indorsed or otherwise secured" by specifying that Section 13(3) credit must be sufficiently indorsed or secured "to the satisfaction of the lending Federal Reserve Bank."[148] To meet this "satisfaction" requirement, Federal Reserve banks must "assign a lendable value to all collateral for the program or facility, consistent with sound risk management practices and to ensure protection for the taxpayer."[149]

Additionally, Regulation A sets conditions for a "penalty rate and fees," requiring that the Federal Reserve extend credit at a premium to normal market rates[150] and in a manner that motivates timely repayment.[151] This measure encourages the prompt repayment of Federal Reserve loans once markets stabilize,[152] and it protects taxpayers by creating a small equity buffer.[153]

2. *Legislative Support for the SMCCF Through the CARES Act*

Just four days after the Federal Reserve announced the SMCCF, Congress enacted CARES.[154] Aimed at mitigating the pandemic's

146. *Id.* § 201.4(d)(4)(iii).

147. *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. 78959, 78961 (Dec. 18, 2015).

148. *See* 12 C.F.R. § 201.4(d)(6)(i). The "indorsed or secured" provision had been integral to Section 13(3) since its 1932 inception, so this marked a significant adjustment. *See* Sastry, *supra* note 105, at 20-21.

149. *See id.* § 201.4(d)(6)(ii).

150. *See id.* § 201.4(d)(7)(ii)(A).

151. *See id.* § 201.4(d)(7)(ii)(C).

152. The theory of incentivizing timely repayment is that borrowers will not want to leave outstanding securities that charge a premium, so when the issuer is able to repay a debt, they will be incentivized to repay the most expensive debt.

153. *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. 78959, 78963 (Dec. 18, 2015).

154. *See* Jacob Pramuk, *Trump signs $2 trillion coronavirus relief bill as the US tries to prevent economic devastation*, CNBC (Mar. 27, 2020, 1:28 PM), https://www.cnbc.com/2020/03/27/house-passes-2-trillion-coronavirus-stimulus-bill-sends-it-to-trump.html.

economic impact, this $2 trillion piece of legislation authorized business grants and direct payments to individuals while expanding unemployment benefits.[155] Crucially, the CARES Act authorized the Secretary of the Treasury to deploy up to $500 billion in loans, loan guarantees, and investments to support eligible businesses, states, and municipalities.[156]

Of that $500 billion, a portion was earmarked for so-called vital sectors such as airlines and businesses critical to national security.[157] Section 4003(b)(4) of the CARES Act, however, established a broader mandate by allocating the remaining $454 billion (i.e., the amount not earmarked for vital sectors) to the Federal Reserve to bolster liquidity within the financial system and support loans to eligible businesses.[158] This provision authorized the Federal Reserve to purchase debt securities either directly from issuers or on secondary markets.[159] Eligibility for section 4003(b)(4) funds was restricted to "businesses that [were] created or organized in the United States or under the laws of the United States and that ha[d] significant operations in and a majority of [their] employees based in the United States."[160]

Under this authority, the Federal Reserve established nine lending facilities, including the SMCCF, the Main Street Lending Program ($75 billion), the Municipal Liquidity Facility ($35 billion), and the Commercial Paper Funding Facility ($10 billion).[161] Allocating funds to these facilities provided an equity cushion if these emergency measures suffered losses.[162]

3. Reconciling Section 13(3) with the CARES Act

During the 2008 Crisis, Congress did not pass legislation related to some Section 13(3) facilities, including the Bear Stearns bailout and the

155. *See id.*
156. *See* Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (2020), § 4003(a).
157. *See id.* §§ 4003(b)(1)-4003(b)(3).
158. *See id.* § 4003(b)(4). An eligible business was defined as "a United States business that has not otherwise received adequate economic relief in the form of loans or loan guarantees provided under this Act." *See id.* § 4002(4)(B).
159. *See id.* §§ 4003(b)(4)(A)-4003(b)(4)(B).
160. *See id.* § 4003(c)(3)(C).
161. *See* Christopher Condon, *Fed Unbound: All the Central Bank's Virus-Linked Lending Moves*, BLOOMBERG (Sept. 10, 2020, 6:41 PM).
162. *Id.*

CPFF.[163] Left with only the text of Section 13(3) and without extra financial resources from Congress, the Federal Reserve had to navigate many of the crisis's challenges without input from Congress.[164]

Alexander Mehra underscored the challenges of interpreting Section 13(3) by noting that "discount," the term giving the Federal Reserve power in Section 13(3), traditionally implies extending loans rather than purchasing assets.[165] However, as a workaround to this limitation, the Federal Reserve creatively utilized SPVs to indirectly purchase assets,[166] a strategy that obeyed the letter of Section 13(3) but perhaps not its spirit.[167] In other words, because the Federal Reserve's powers are limited to lending, the Federal Reserve could comply with Section 13(3) by lending to an SPV, which could in turn buy assets such as commercial paper.[168]

When Congress enacted the CARES Act after facilities such as the SMCCF had been announced, it retroactively authorized asset purchases within the legislation's $454 billion allocation provision. Under

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163. *See, e.g.*, Press Release, Fed. Rsrv. Bank of N.Y., Summary of Terms and Conditions Regarding the JPMorgan Chase Facility (Mar. 24, 2008), https://www.newyorkfed.org/newsevents/news/markets/2008/rp080324b.html (citing Section 13(3) as the authority for establishing the SPV to purchase Bear Stearns's troubled assets); *Commercial Paper Funding Facility: Program Terms and Conditions*, FED. RSRV. BANK N.Y. (Oct. 7, 2008), https://www.newyorkfed.org/markets/CPFF_Terms_081007 (citing Section 13(3) as the authority for the CPFF).

164. However, later in the 2008 Crisis, Congress passed the Emergency Economic Stabilization Act of 2008, which created the $700 billion Troubled Asset Relief Program (TARP). Included in this program was an investment in AIG to save the insurer and funding the Term Asset-Backed Loan Facility (TALF), a joint program with the Federal Reserve. Nonetheless, TARP was not involved in Bear Stearns nor the CPFF. *See About TARP*, U.S. DEP'T TREASURY, https://home.treasury.gov/data/troubled-assets-relief-program/about-tarp.

165. *See* Mehra, *supra* note 9, at 225-26.

166. *See id.* at 235.

167. *See id.*

168. This view is controversial. Former General Counsel to the Federal Reserve Board of Governors Scott G. Alvarez has directly disputed this explanation for SPVs, arguing instead that they serve to safeguard SPVs from losses by other SPVs and for transparency. Because the CARES Act directly authorized secondary market purchases, the distinction is not important for this Note. *See* Interview with Scott G. Alvarez, Esq., Former Gen. Couns. to Bd. Governors, U.S. Fed. Rsrv. Sys., YALE SCH. MGMT.: PROGRAM ON FIN. STABILITY (Apr. 14, 2022), https://ypfsresourcelibrary.blob.core.windows.net/fcic/YPFS/Web_Ready_Trasncript_Alvarez-final_2.pdf.

statutory interpretation principles such as the General/Specific Canon,[169] the CARES Act can be used to inform the interpretation of Section 13(3)'s scope regarding the pandemic response. In other words, while Mehra interpreted "discount" to mean "lend," the CARES Act explicitly authorized purchases, and the Act's implicit interpretation of Section 13(3) should control.[170]

Moreover, the CARES Act clarifies its relationship to Section 13(3), stating its intent to act in concert with existing requirements.[171] CARES emphasizes its complementary role to Section 13(3), stating: "For the avoidance of doubt, any applicable requirements under Section 13(3) . . ., including requirements relating to loan collateralization, taxpayer protection, and borrower solvency, shall apply with respect to any program or facility described in subsection (b)(4)."[172]

II. ANALYZING THE FEDERAL RESERVE'S AUTHORITY FOR THE SMCCF

Even though Congress supported the Federal Reserve's Section 13(3) facilities during the COVID crisis, it did not specify what form the Federal Reserve's response should take.[173] This Part analyzes specific provisions of Section 13(3) and the CARES Act and argues that the Federal Reserve exceeded the authority granted by those statutes. Additionally, Part II.E explains why it is important that the Federal Reserve acts within the bounds of its authority.

A. APPLYING SECTION 13(3)'S SECURITY REQUIREMENT TO THE SMCCF

Section 13(3) requires "discount[s]" (i.e., loans) to be "indorsed or otherwise secured to the satisfaction of the Federal reserve bank."[174] Dodd-Frank expands on this by mandating that "security for emergency

169. *See* VALERIE C. BRANNON, CONG. RSCH. SERV., R45153 STATUTORY INTERPRETATION: THEORIES, TOOLS, AND TRENDS 52 (2023), https://crsreports.congress.gov/product/pdf/R/R45153 (citing ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS 183 (2012)).

170. *See* H.R. 748, 116th Cong. §§ 4003(b)(4)(A)-4003(b)(4)(B) (2020) (enacted).

171. *See id.* § 4003(c)(3)(B).

172. *See id.* (noting the authorizing provision § (b)(4) in the CARES Act allowed money to be used for the SMCCF).

173. *See id.* § 4003(b)(4) (allocating $454 million for Federal Reserve use so long as the money is used for primary/secondary market purchases or loans).

174. *See* 12 U.S.C. § 343(3)(A).

loans [be] sufficient to prevent taxpayers from losses" and that the Federal Reserve assign lendable value to collateral on Section 13(3) loans.[175]

1. *Interpreting the "Indorsed or Otherwise Secured" Provision in Section 13(3)*

"Indorsed" refers to a third-party guaranteeing debt,[176] indicating that, in case of a borrower's default, the Federal Reserve would have recourse to the guarantor.[177] Additionally, endorsements are rare for investment-grade corporate bonds, as they would offer only marginal pricing improvements.[178] Dodd-Frank also seemingly disregards the "indorsed" component of this provision by focusing on "security for emergency loans," and requiring the assignment of "a lendable value to collateral," thus only addressing the security aspect and overlooking the need for indorsement.[179] This Note therefore focuses on the "otherwise secured" requirement of Section 13(3).

Broadly, the term "secured" refers to having "any 'ground for regarding something as secure, safe, or certain,'"[180] often involving collateral like a mortgage to back debt. Yet the requirement to be "indorsed or otherwise secured" is qualified by the phrase that it be to "the satisfaction of the Federal Reserve bank."[181] Mehra notes that while this provision offers the Federal Reserve considerable discretion, it would be meaningless if it did not require at least some degree of security.[182]

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175. *See id.* § 343(3)(B)(i); Dodd-Frank Wall Street Reform and Consumer Protection Act § 1101(a)(6).

176. *See* Memorandum from Scott G. Alvarez et al. on Authority of the Federal Reserve to Provide Extensions of Credit in Connection with a Commercial Paper Funding Facility (CPFF) 4 (Mar. 9, 2009), https://ypfsresourcelibrary.blob.core.windows.net/fcic/YPFS/AlvarezAshtonFallonWeideAllison2009.pdf.

177. *See* Mehra, *supra* note 9, at 228-29.

178. An issuer can issue debt at a lower cost when that debt is guaranteed by a higher rated guarantor. For investment grade companies, the issuer would receive little benefit from receiving a guarantee. *See* Fang Chen et al., *Why do firms issue guaranteed bonds?*, 119 J. BANKING & FIN., Oct. 2020, at 1.

179. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 1101(a)(6) (B)(i) (2010).

180. *See* Alvarez et al., *supra* note 176, at 4.

181. *See* 12 U.S.C. § 343(3)(3)(A); *see also* Mehra, *supra* note 9, at 228.

182. *See* Mehra, *supra* note 9, at 229.

Professor Peter Conti-Brown and his co-authors have described two possible, yet conflicting, interpretations of Section 13(3)'s security requirements: one requiring comprehensive security, and the other minimal security.[183] The comprehensive security interpretation aligns with Congress's intention that the Federal Reserve, under Section 13(3), "extend credit with the expectation of full repayment."[184] This view is consistent with the Dodd-Frank amendments, which require loans to be secure enough to prevent taxpayer losses.[185] For example, in describing Regulation A, the Federal Reserve emphasized that all 2008 Crisis facilities were fully repaid with interest, thereby protecting taxpayers from losses.[186]

Conversely, the minimal security interpretation recognizes that collateral can fluctuate in value, implying that loans might not always be fully secured.[187] Further, one could argue that "secured to the satisfaction" of the Federal Reserve means that the Federal Reserve enjoys broad discretion regarding the degree of security.[188] However, because Dodd-Frank emphasizes taxpayer protection,[189] the Federal Reserve only has discretion in the security of a debt to the extent taxpayers are protected.

2. *Security Requirement During the Global Financial Crisis*

During the 2008 Crisis, the Federal Reserve purchased unsecured debt via the CPFF.[190] The Federal Reserve's legal counsel argued that this action complied with Section 13(3)'s "indorsed or otherwise secured" requirements by asserting that the 100 basis-points insurance fee on unsecured commercial paper effectively offset potential losses.[191]

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183. *See* Peter Conti-Brown, Yair Listokin, & Nicholas R. Parrillo, *Towards an Administrative Law of Central Banking*, 38 YALE J. ON REGUL. 1, 71-75 (2021).

184. *See id.* at 72 (quoting Scott G. Alvarez, Thomas C. Baxter Jr. & Robert F. Hoyt, *The Legal Authorities Framing the Government's Response to the Global Financial Crisis*, 2 J. FIN. CRISES 3, 15 (2020)).

185. *See* 12 U.S.C. § 343(3)(B)(i).

186. *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. 78959, 78962 (Dec. 18, 2015).

187. *See* Conti-Brown, Listokin & Parrillo, *supra* note 183, at 74.

188. *See* Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis*, 101 MINN. L. REV. 1529, 1553 (2017).

189. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 1101(a)(6).

190. *See supra* Part I.C.1.iii.

191. *See* Alvarez et al., *supra* note 176, at 8.

He argued that this fee established a financial buffer, allowing accumulated fees from all issuers to cover losses from any individual issuer, and thus securing the commercial paper purchases.[192]

Furthermore, the Federal Reserve asserted that its loans to an SPV, backed by high-quality commercial paper, fulfilled the security requirement.[193] This stance was predicated on the belief that the creditworthiness of the collateral—the highly rated commercial paper—sufficiently secured the loans made to the SPV. However, critics such as Professor Eric Posner point out a subtlety: functionally, this amounts to an unsecured loan to borrowers of unsecured commercial paper.[194]

3. *The SMCCF Lacked Any Security and Insufficiently Protected Taxpayers*

Echoing the CPFF strategy, the Federal Reserve extended loans to an SPV under the SMCCF, using the SPV's asset purchases as collateral.[195] Unlike the CPFF, the SMCCF did not purchase asset-backed securities, but rather solely unsecured bonds and ETFs.[196] Unsecured bonds are, by definition, not secured. ETFs, such as the iShares iBoxx US Dollar Investment Grade Corporate Bond ETF (LQD)—the SMCCF's largest holding as of December 11, 2020—offer diversified access to the corporate bond market, but do not offer collateral.[197] Despite the inherent risk mitigation offered by ETFs through diversification, these instruments lack explicit collateral backing

192. *See id.*
193. *See id.* at 3.
194. *See* Posner, *supra* note 188, at 1552.
195. *See Term Sheet – Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (Mar. 23, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200323b2.pdf.
196. *See supra* Part I.B.2.
197. *See* James Chen, *What Is an Exchange-Traded Fund (ETF)?*, INVESTOPEDIA (Feb. 22, 2024), https://www.investopedia.com/terms/e/etf.asp; *See SMCCF Transaction Specific Disclosures 12-11-20*, BD. OF GOVERNORS OF FED. RSRV. SYS. (Dec. 11, 2020), https://www.federalreserve.gov/publications/2020-reports-to-congress-in-response-to-covid-19.htm (linking to spreadsheet with ETF holdings). The market value of the LQD holding was $2.473 billion as of November 30, 2020. At this time, it accounted for ~18% of all SMCCF holdings. On March 1, 2024, LQD held 2,766 securities. *See iShares iBoxx $ Investment Grade Corporate Bond ETF*, ISHARES, https://www.ishares.com/us/products/239566/ishares-iboxx-investment-grade-corporate-bond-etf.

like that of asset-backed securities.[198] Further, unlike the CPFF, the SMCCF did not charge a premium.[199] Rather, it acquired all securities at market prices, and participants did not pay fees that might offset losses.[200]

Furthermore, SMCCF investments carried greater risk than those of the CPFF, attributable to differences in credit ratings and the maturities of the purchased assets. The Federal Reserve's December 11, 2020, report indicated that approximately 3% of SMCCF investments were in speculative grade double-B bonds, while approximately 57% were in triple-B bonds.[201] The average maturity at this time was 2.8 years.[202] This contrasted with the CPFF's exclusive investments in short-term, high-grade commercial paper,[203] demonstrating a broader acceptance of risk in the SMCCF purchases.

The Federal Reserve argued that CARES funds allocated to the SMCCF buffered the Federal Reserve against potential losses. When answering a question submitted by Congresswoman Joyce Beatty regarding the legality of the SMCCF, Fed Chair Jerome Powell conflated taxpayer protection with Federal Reserve protection: "Section 13(3) of the FRA requires facilities to be designed in a way that protects the Federal Reserve from losses."[204] As the source of this protection, Powell cited, "the equity provided by the U.S. Department of the Treasury (Treasury) in connection with the SMCCF further protects the FRBNY from loss."[205]

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198. If one security defaults, the ETF will decline based on the weight of that security in the portfolio.

199. *See Term Sheet – Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (Mar. 23, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200323b2.pdf.

200. *See id.*

201. *See SMCCF Transaction Specific Disclosures 12-11-20*, BD. OF GOVERNORS OF FED. RSRV. SYS. (Dec. 11, 2020), https://www.federalreserve.gov/publications/2020-reports-to-congress-in-response-to-covid-19.htm.

202. *See id.*

203. *See Commercial Paper Funding Facility: Program Terms and Conditions*, FED. RSRV. BANK N.Y. (Oct. 7, 2008), https://www.newyorkfed.org/markets/CPFF_Terms_081007. The rating was limited to those rated "at least A1/P1/F1 by a major NRSRO."

204. *See* COMM. FIN. SERVS., OVERSIGHT OF THE TREASURY DEPARTMENT'S AND THE FEDERAL RESERVE'S PANDEMIC RESPONSE, H.R. Doc. No. 116-99, at 111-12 (2020).

205. *See id.* at 112. The FRBNY refers to the Federal Reserve Bank of New York, which is the entity that made the loan to the SMCCF SPV. *See Term Sheet - Secondary*

Arguing that the Federal Reserve is protected from loss is not the same as arguing that taxpayers are protected from loss. The CARES Act capital structure—often described as "first-loss protection"—primarily safeguards the Federal Reserve's balance sheet, but only up to the amount allocated by the CARES Act.[206] However Treasury equity can be leveraged 10-to-1 for investment-grade bonds and 7-to-1 for speculative-grade bonds.[207] In other words, in a widespread downturn, the Federal Reserve would be only partially protected from loss by the CARES Act funds.

B. Applying Section 13(3)'s Liquidity Requirement to the SMCCF

The Dodd-Frank amendment to Section 13(3) requires that any emergency facility be "for the purpose of providing liquidity to the financial system, and not to aid a failing financial company."[208] This provision partially seeks to prevent individual firm bailouts,[209] thereby reinforcing the principle that emergency facilities must pursue broad-based objectives.[210] The meaning of "providing liquidity to the financial system" is explored in the next Part.

1. Legal and Economic Definitions of "Liquidity"

Black's Law Dictionary defines liquidity in two ways: "1. The quality, state, or condition of being readily convertible to cash. 2. . . . The characteristic of having enough units in the market that large transactions can occur without substantial price variations."[211] Alternatively, Professor Lev Menand distinguishes between two types of

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Market Corporate Credit Facility, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

206. *See* Leonard, *supra* note 56, at 1809.

207. *See Term Sheet - Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

208. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 1101(a)(6).

209. *See* Gregory J. Hudson, *Balancing Central Bank Accountability and Independence: The Case of the Federal Reserve's Emergency Powers After Dodd-Frank*, 132 BANKING L. J. 161, 179 (2015).

210. *See supra* Part I.C.1.iv.

211. *See Liquidity*, BLACK'S LAW DICTIONARY (11th ed. 2019).

liquidity as understood by economists: "funding liquidity" and "market liquidity."[212] Funding liquidity concerns the robustness of financial companies' balance sheets and the companies' access to funding.[213] Market liquidity, aligning with the Black's Law Dictionary's second definition of liquidity, pertains to the ease with which assets can be traded in secondary markets.[214]

Federal Reserve liquidity interventions traditionally aim to bolster the funding liquidity of financial companies, preventing crises triggered by abrupt funding shortfalls.[215] Such liquidity crises, historically characterized by bank runs, arise when the fear of insolvency leads depositors to withdraw funds en masse, triggering a cascading solvency crisis across financial institutions.[216]

The 2019 repurchase agreement (repo) crisis serves as an example of a modern liquidity crisis.[217] During the repo crisis, short-term borrowing rates spiked due to factors such as scheduled tax payments and large Treasury issuances.[218] In other words, the demand for short-term funding exceeded its supply. In response, the Federal Reserve launched an overnight repo program that stabilized rates by supplying banks with cash.[219] The program assuaged fears, causing rates to normalize over time.[220] The repo crisis underscores the varied origins and manifestations of liquidity crises.

While Section 13(3) does not define liquidity, its purpose has historically been thought to alleviate bank cash shortfalls.[221] However,

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212. *See* Lev Menand, *The Federal Reserve and the 2020 Economic and Financial Crisis*, 26 STAN. J. BUS. & FIN. 101, 123-24 (2021). (citing Markus K. Brunnermeier & Lasse Heje Pedersen, *Market Liquidity and Funding Liquidity*, 22 REV. FIN. STUD. 2201 (2009)).

213. *See* Markus K. Brunnermeier & Lasse Heje Pedersen, *Market Liquidity and Funding Liquidity*, 22 REV. FIN. STUD. 2201, 2201 (2009).

214. *See id.*

215. *See* Menand, *supra* note 211, at 123-24.

216. *See* Posner, *supra* note 188, at 1533, 1553-54.

217. The repo market is the financial system's method for obtaining short-term funding.

218. *See* Sam Schulhofer-Wohl, *Understanding Recent Fluctuations in Short-Term Interest Rates*, FED. RSRV. BANK CHI.: CHI. FED LETTER, NO. 423 (2019), https://www.chicagofed.org/publications/chicago-fed-letter/2019/423. These rates are anchored by the federal funds rate, which at this time, was 2%-2.25%. However, over a short period, repo rates shot up to 9% due to a reduced supply of credit.

219. *See id.*

220. *See id.*

221. *See* Menand, *supra* note 211, at 31-32.

during the 2008 Crisis, the Federal Reserve used Section 13(3) to alleviate market liquidity problems,[222] and neither Dodd-Frank nor Regulation A sought to redefine the meaning of liquidity. Thus, Congress has implicitly endorsed Section 13(3) to address either type of liquidity problem. It follows that secondary-market bond purchases that the Federal Reserve conducted through the CPFF, which served to provide market-liquidity, were arguably within the bounds of Section 13(3)'s liquidity provision.

2. *COVID-19 was a Solvency Crisis, Not a Liquidity Crisis*

The 2019 repo crisis and the financial upheaval caused by COVID-19 represent distinct phenomena: the former was marked by a temporary shortfall in bank liquidity,[223] while the latter involved widespread solvency concerns due to COVID-19.[224]

The cruise industry exemplifies this distinction. Before the pandemic disrupted markets in mid-March 2020, early signs of trouble included the Diamond Princess quarantine on February 18, 2020,[225] and the State Department's travel advisory against cruise travel on March 8, 2020.[226] The market reacted to these developments, as seen in the performance of Royal Caribbean's 3.7% Notes due in 2028. These notes, trading at a 3.23% yield (132 basis point spread to Treasuries) at the end of 2019, saw their yield rise to 3.40% (260 basis point spread to Treasuries) by March 2, and then sharply to 12.40% (1,167 basis point spread to Treasuries) by March 23, mirroring investors' growing perceptions of default risk.[227]

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222. *See supra* Part I.C.1.iii.

223. *See* Schulhofer-Wohl, *supra* note 217.

224. *See* Tobias Adrian & Fabio Natalucci, *COVID-19 Crisis Poses Threat to Financial Stability*, IMF Blog (Apr. 14, 2020), https://www.imf.org/en/Blogs/Articles/2020/04/14/blog-gfsr-covid-19-crisis-poses-threat-to-financial-stability.

225. *See CDC Museum COVID-19 Timeline*, CENTERS FOR DISEASE CONTROL AND PREVENTION, https://www.cdc.gov/museum/timeline/covid19.html (last visited Mar. 2, 2024).

226. *See* Jeanne Whalen et al., *Cruise industry, an economic engine in Florida, could be hit hard by coronavirus advisories*, WASH. POST (Mar. 9, 2020, 7:22 PM), https://www.washingtonpost.com/travel/2020/03/08/state-department-cruise-ship-travel/.

227. *See* Bloomberg Data (on file with author). Spread information is based on the bond's option-adjusted-spread to Treasuries.

Investors reacted rationally to the pandemic's impact on Royal Caribbean. They contemplated the possibility of default, and Royal Caribbean's funding costs increased as a result. The experience of Royal Caribbean underscores the contrast between the transient liquidity constraints banks experienced in 2019 and the pervasive solvency fears across industries during the COVID-19 crisis.

Section 13(3) states that lending under it should "not [be] to aid a failing financial company."[228] Regulation A Section 201.4(d)(4)(iii) expands on this intent, stating, "[a] program or facility will not be considered to have broad-based eligibility for purposes of this paragraph (d) if: (A) The program or facility is designed for the purpose of assisting one or more specific companies avoid bankruptcy . . . ."[229] Thus, Regulation A extends Section 13(3)'s restrictions against aiding troubled firms to encompass all companies in distress, not exclusively financial ones.[230] The purchase of corporate bonds during the pandemic more closely resembles an effort to prevent company bankruptcies than to provide liquidity.

3. The Liquidity Crisis Had Ended by the Time the Federal Reserve Purchased Corporate Bonds

Distinguishing between illiquidity and insolvency is crucial; Section 13(3) aims specifically to mitigate liquidity shortages, not solvency crises.[231] While the COVID-19 crisis introduced both liquidity and solvency challenges, it mainly raised solvency concerns.[232] The SMCCF's announcement initially seemed like a reaction to a market liquidity crisis. Yet, by the time it purchased ETFs in May,[233] the

228. *See* 12 U.S.C. § 343(3)(B)(i).

229. 12 C.F.R. § 201.4(d)(4)(iii).

230. Regulation A adds this limitation through its definition of "broad-based," a phrase added to Section 13(3) in Dodd-Frank.

231. The phrase in Section 13(3) "for the purpose of providing liquidity to the financial system" is immediately followed by, "and not to aid a failing financial company." *See* 12 U.S.C. § 343(3)(B)(i). The comments to Regulation A reinforce the view that Section 13(3) should address liquidity, not solvency: "these restrictions would not permit emergency lending to . . . provide credit to prevent a firm from entering bankruptcy . . ." *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. 78959, 78961 (Dec. 18, 2015).

232. *See supra* Part II.B.3.

233. *See* Press Release, Fed. Rsrv. Bank of N.Y., New York Fed Announces Start of Certain Secondary Market Corporate Credit Facility Purchases on May 12 (May 11, 2020), https://www.newyorkfed.org/newsevents/news/markets/2020/20200511.

corporate bond market had stabilized and was even flourishing.[234] In other words, by the time the Federal Reserve began buying bonds, there was no liquidity problem.

This situation prompted an exchange between Federal Reserve Chair Powell and Senator Pat Toomey during Powell's June 2020 semiannual monetary policy testimony to Congress.[235] Toomey questioned the continued need for the SMCCF in light of the market's recovery.[236] Powell defended the continued operation, stating, "we feel that we need to follow through and do what we said we were going to do . . . ."[237] Put differently, because the Federal Reserve had said earlier that it would buy corporate bonds, it needed to continue buying bonds two months later when there was no liquidity problem. Although Powell's stance might support Federal Reserve credibility,[238] there is no statutory basis for its continuing to operate a liquidity facility in the absence of a liquidity problem.

C. APPLYING REGULATION A'S PENALTY RATE REQUIREMENT TO THE SMCCF

Regulation A mandates that any lending facility operating under Section 13(3) charge borrowers a penalty rate.[239] While the PMCCF complied with this requirement,[240] the SMCCF did not.[241]

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234. *See* CREDIT FLOW RSCH, *supra* note 66 (highlighting that March, April, and May 2020 remain the top three months for most corporate debt issued).

235. *See Semiannual Monetary Policy Report to Congress: Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*, 116th Cong. 15-16 (2020).

236. *See id.* Senator Toomey lays out two reasons for Congress funding the SMCCF: market functioning and providing liquidity to "fundamentally solvent" companies.

237. *See id.* at 16. While Powell prefaces the answer by saying the prior commitment is not the "main reason" for continuing to buy corporate bonds and bond ETFs in a strong market, he provides no other reason in this exchange.

238. *See infra* Part II.E.2 (emphasizing the importance of Federal Reserve credibility for the Federal Reserve to exercise its power).

239. *See* 12 C.F.R. § 201.4(d)(7).

240. *See Term Sheet - Primary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a9.pdf (describing the 100 basis-points fee for the PMCCF).

1. Historical Basis and Rationale for Penalty Rates

Professor Eric Posner explains that penalty rates, a concept stemming from Walter Bagehot's 1873 liquidity crisis framework, aim to insure lenders against losses, counteract moral hazard, and encourage borrowers to return to the primary market after a crisis to refinance at a lower rate.[242] Penalty rates should be at some premium such that the all-in price[243] is higher than the pre-crisis price, but lower than the market price during the crisis.[244]

In adopting Regulation A, the Federal Reserve codified the use of penalty rates as a limitation on its Section 13(3) authority.[245] Regulation A mandates that the penalty rate should offer the benefits Posner describes: providing liquidity during emergencies, promoting timely repayment, and compensating taxpayers for risks.[246] Although Regulation A allows the Federal Reserve significant discretion in setting rates, it must consider the market impact, historical precedents, and repayment risks.[247] Further, Regulation A makes clear that the rate applied must ensure that "the taxpayer is appropriately compensated for the risks associated with the credit extended under the program or facility."[248]

Prior to Regulation A, Section 13(3) facilities charged penalty rates, as exemplified by the CPFF's 10 basis-point fee on unsecured commercial paper.[249] The Term Asset-Backed Securities Loan Facility (TALF), another 2008 Crisis facility, offered secured loans to asset-backed securities (ABS) investors, aiming to inject liquidity into the

241. *See Term Sheet - Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

242. *See* Posner, *supra* note 188, at 1533-34, 1538 (citing WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (1873)).

243. "All-in" price refers to the asset's price plus the penalty.

244. *See* Posner, *supra* note 188, at 1538. If the borrowing cost were higher than the prevailing market cost, then the liquidity facility would not see participation from borrowers, so the lender must strike a healthy medium.

245. *See* 12 C.F.R. § 201.4(d)(7).

246. *See id.* § 201.4(d)(7)(ii).

247. *See id.* § 201.4(d)(7)(iii).

248. *See id.*

249. *See Commercial Paper Funding Facility (CPFF)*, Bd. Governors Fed. Rsrv. Sys. (Mar. 18, 2020), https://www.federalreserve.gov/regreform/reform-cpff.htm.

ABS market.[250] Loans were made at a rate that was higher than the current market rate, but lower than the normal market rate.[251] Additionally, the Federal Reserve applied collateral "haircuts"[252] and charged fees contingent on collateral type.[253]

2. *The SMCCF's Omission of Penalty Rates*

While the PMCCF applied a penalty rate, the SMCCF notably did not.[254] The absence of a penalty rate in the SMCCF may partly reflect the complexities of enforcing such rates in secondary market operations. Imposing a penalty rate on secondary market purchases would risk distorting market prices and deterring investor sales to the Federal Reserve by adding transaction costs.[255]

There is no precedent for the Federal Reserve's imposing penalty rates on secondary-market purchases. Quantitative easing measures involving Treasuries and mortgage-backed securities have been conducted at market rates.[256] This reflects a distinction between direct issuer transactions in the primary market, where penalty rates directly influence issuer behavior, and secondary market activities, where the sellers are investors.

In a COVID-19 Congressional Oversight Commission hearing, the Commissioner, Bharat Ramamurti, highlighted the absence of a penalty

250. *See* OFF. INSPECTOR GEN., THE FEDERAL RESERVE'S SECTION 13(3) LENDING FACILITIES TO SUPPORT OVERALL MARKET LIQUIDITY: FUNCTION, STATUS, AND RISK MANAGEMENT 95 (2010).

251. *See id.* at 98.

252. *See id.* A "haircut" means the Federal Reserve would undervalue the collateral securing a loan, so when the loan is initially issued, it will be oversecured.

253. *See id.* at 102.

254. *See Term Sheet - Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

255. The SMCCF, by purchasing a bond, bought it from an investor. If an investor can sell that same bond to another investor at no penalty rate, why sell to the Fed?

256. *See* MARC LABONTE, CONG. RSCH. SERV., IF11751, THE FEDERAL RESERVE'S BALANCE SHEET AND QUANTITATIVE EASING 1 (2022). Legal authority for purchasing Treasuries and MBS is found in section 14 of the FRA. *See* Daniel Thompson & Adam Kulam, *The Rescue of Fannie Mae and Freddie Mac–Module F: Federal Reserve's Large-Scale Asset Purchase (LSAP) Program*, 3 J. FIN. CRISES 402, 409 (2021). Thus, Regulation A does not apply.

rate in the SMCCF's structure.[257] The Federal Reserve's Office of General Counsel explained that the penalty rate provision in Regulation A did not apply to secondary market transactions[258]—an interpretation not supported by Regulation A's text.[259]

A more convincing argument would be that Regulation A's discretionary language for the penalty rate provision provides the Federal Reserve with the flexibility to justify the absence of a penalty rate.[260] For example, because Regulation A requires pricing at "a premium to the market rate in normal circumstances,[261] the Federal Reserve could have set a premium such that the price including the premium (the rate in normal circumstances plus the premium) was the same as the rate during the crisis. Nevertheless, the absence of any effort to implement a penalty rate means that the SMCCF's approach was not in compliance with Regulation A.

D. APPLYING CARES ACT ELIGIBILITY REQUIREMENTS TO THE SMCCF

The SMCCF was constrained not only by Section 13(3) but also by the CARES Act. This section will explore the statutory requirements under the CARES Act that influenced the operation of the SMCCF, the Federal Reserve's interpretation of these requirements in the context of foreign subsidiaries and companies with limited U.S. operations, and the implications of the broad market index eligibility loophole that allowed bond purchases from companies not meeting U.S.-centric business requirements.

257. *See Examination of the Municipal Liquidity Facility Established by the Federal Reserve Pursuant to the CARES Act: Hearing Before the Congressional Oversight Commission*, 116th Cong. 15-16 (2020).

258. *See* COMMISSION MEMBERS OF CONGRESSIONAL OVERSIGHT COMMISSION, THE FIFTH REPORT OF THE CONGRESSIONAL OVERSIGHT COMMISSION 42-43 (2020), https://coc.senate.gov/wp-content/uploads/2022/10/The-Fifth-Report-of-the-Congressional-Oversight-Commission.pdf. The Office of General Counsel provided no reasoning for this decision.

259. *See* 12 C.F.R. § 201.4(d)(7).

260. *See* Steven Kelly, *Cruel and Unusual Circumstances: The Fed's Use and Misuse of Penalty Rates*, FINREG BLOG (June 21, 2021), https://sites.duke.edu/thefinregblog/2021/06/21/cruel-and-unusual-circumstances-the-feds-use-and-misuse-of-penalty-rates/.

261. *See* 12 C.F.R. § 201.4(d)(7)(ii)(A).

1. Statutory Analysis of U.S.-Centric Business Requirements for CARES Act Programs

Section 4003(c)(3)(C) of the CARES Act mandates that SMCCF funds, as designated by section 4003(b)(4), be used primarily to benefit companies based in the United States.[262] Specifically, section 4003(c)(3)(C) mandates that facilities utilizing funds from section 4003(b)(4)

> shall only purchase obligations or other interests (other than securities that are based on an index or that are based on a diversified pool of securities) from, or make loans or other advances to, businesses that are created or organized in the United States or under the laws of the United States and that have significant operations in and a majority of its employees based in the United States.[263]

This provision ("U.S.-centric business requirements") demonstrates Congress's intention to ensure that the Federal Reserve's emergency programs benefit domestic companies and employees.

However, many issuers in the investment-grade corporate bond market do not meet the CARES Act's U.S.-centric business requirement. Consequently, the Federal Reserve provided a further interpretation of this requirement.[264] A subsidiary of a foreign company could participate in the SMCCF provided it met the U.S.-centric business requirements.[265] Furthermore, if the subsidiary is created for the sole purpose of issuing debt,[266] then the company benefiting from the issuance must meet the U.S.-centric business requirements.[267]

262. *See* CARES Act § 4003(c)(3)(C).

263. *See id.*

264. *See Oversight of Financial Regulators: Ensuring the Safety, Soundness Diversity, and Accountability of Depository Institutions During the Pandemic: Hearing Before the Committee on Financial Services, House of Representatives*, 116th Cong. 202-218 (2020).

265. *See id.* at 208.

266. A company is defined as created for the sole purpose of issuing debt if 95% or more of proceeds from an issuance are transferred to a beneficiary. *See id.*

267. *See Oversight of Financial Regulators: Ensuring the Safety, Soundness Diversity, and Accountability of Depository Institutions During the Pandemic: Hearing Before the Committee on Financial Services, House of Representatives*, 116th Cong. 208 (2020).

2. Broad Market Index Eligibility Loophole in the SMCCF Term Sheets

Although conducting a quantitative analysis of every bond purchased by the SMCCF exceeds this Note's scope, it is evident that the Federal Reserve did not fully comply with the U.S.-centric business requirements. For example, in November 2020, the SMCCF purchased a bond of Diageo Investment Corp. for $2.3 million.[268] In its latest registration statement, Diageo Investment Corp., which is a U.S. company, states that its purpose is to "lend substantially all proceeds of its borrowings to Diageo or to one or more of Diageo's operating companies."[269] In its latest annual report, Diageo had 3,115 employees in North America, representing 10% of the company's total employees.[270] In other words, neither Diageo Investment Corp. nor Diageo met the U.S.-centric business requirements.

However, the Federal Reserve was able to buy this Diageo Investment Corp. bond because in June 2020 the Federal Reserve Term Sheet modified the SMCCF's criteria to include individual bonds, ETFs, and corporate bond portfolios tracking a broad market index.[271] This third category meant that the Federal Reserve could buy individual corporate bonds alongside other individual corporate bonds that, together, track a broad market index.[272] For broad market index eligibility, the Federal Reserve applied criteria such as credit ratings and maturities.[273] However, it relaxed the U.S.-centric business requirements to remove limitations on companies with insufficient U.S. employees or

268. *See SMCCF Transaction Specific Disclosures 12-11-20*, BD. OF GOVERNORS OF FED. RSRV. SYS. (Dec. 11, 2020), https://www.federalreserve.gov/publications/2020-reports-to-congress-in-response-to-covid-19.htm.

269. *See* Diageo plc, Registration Statement (Form F-3) 12 (Feb. 23, 2023), https://www.sec.gov/Archives/edgar/data/1087911/000119312523045694/d474542df3asr.htm.

270. *See* Diageo, Annual Report 2023 40 (2023).

271. *See Term Sheet - Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (June 15, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200615a1.pdf.

272. *See Oversight of Financial Regulators: Ensuring the Safety, Soundness Diversity, and Accountability of Depository Institutions During the Pandemic: Hearing Before the Committee on Financial Services, House of Representatives*, 116th Cong. 210 (2020).

273. *See Term Sheet - Secondary Market Corporate Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (June 15, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200615a1.pdf.

U.S. operations.[274] Additionally, issuers were required to certify eligibility for individual bond purchases by the Federal Reserve, but such certification was not needed for bonds acquired as part of the broad market index.[275]

3. A Loophole Permitting Bond Purchases of Companies Excluded by the U.S.-Centric Business Requirements Opposes Congressional Intent

The broad market index exception stems from the parenthetical in the U.S.-centric business requirements in the CARES Act: purchases "that are based on an index or that are based on a diversified pool of securities" would not need to meet U.S.-centric business requirements related to employment or operations.[276] Journalist Brian Chappatta pointed out that the exception in Section 4003(c)(3)(C) was specifically designed to exempt ETFs from the U.S.-centric business requirements.[277] Given that the CARES Act's enactment followed the Federal Reserve's announcement of the SMCCF and its inclusion of ETF purchases,[278] we can infer that Congress intended to grandfather in ETF eligibility.[279]

The exemption includes two categories: "securities that are based on an index [and] that are based on a diversified pool of securities."[280] Neither of these terms is defined, but they both have meanings in finance. "Based on an index" likely refers to passive index fund ETFs, which are securities tracking a benchmark index such as the S&P 500.[281]

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274. *See id.*

275. *See Oversight of Financial Regulators: Ensuring the Safety, Soundness Diversity, and Accountability of Depository Institutions During the Pandemic: Hearing Before the Committee on Financial Services, House of Representatives*, 116th Cong. 204 (2020). *See also* Brian Chappatta, *Fed Seems to Skirt Law to Buy Corporate Bonds*, BLOOMBERG (June 18, 2020), https://www.bloomberg.com/view/articles/2020-06-18/fed-seems-to-skirt-the-law-to-buy-corporate-bonds.

276. *See* CARES Act § 4003(c)(3)(C).

277. *See* Chappatta, *supra* note 275.

278. *See* Pramuk, *supra* note 154.

279. Because ETFs own bonds from potentially thousands of companies, it would be logistically challenging to certify each ETF holding as compliant with CARES Act section 4003(c)(3)(C), hence the need for a carve-out.

280. *See* CARES Act § 4003(c)(3)(C).

281. *See* Jason Fernando, *What Are Index Funds, and How Do They Work?*, INVESTOPEDIA (Mar. 7, 2024), https://www.investopedia.com/terms/i/indexfund.asp. For example, the Vanguard Total Bond Market ETF is a bond ETF that seeks to track

Securities "based on a diversified pool of securities" likely refers to all other ETFs, such as those that are actively managed.[282] The rationale for exempting ETFs from the U.S.-centric business requirements is clear: verifying compliance for each ETF holding with the U.S.-centric business requirements would be overly burdensome and would likely prohibit the purchase of many ETFs.[283] Thus, despite not meeting the U.S.-centric business requirements, Diageo Investment Corp. would qualify for the broad market index so long as it was purchased as part of a broad market index.[284]

The U.S.-centric business requirements reflect Congress' emphasis on bolstering the domestic economy while the exemption reflects a practical carve-out. As Powell admitted regarding the PMCCF, the aim was "to promote employment and payrolls at large U.S. corporations during this challenging time."[285] This sentiment was echoed by members of Congress, who desired some strings to be attached to CARES Act funds used by the Federal Reserve.[286] While the Federal Reserve found a

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the Bloomberg U.S. Aggregate Float Adjusted Index. *See Vanguard Total Bond Market ETF*, VANGUARD, https://investor.vanguard.com/investment-products/etfs/profile/bnd.

282. For example, the Janus Henderson Sustainable Corporate Bond ETF is actively managed and seeks to invest in bonds of companies that meet sustainable criteria. *See Sustainable Corporate Bond ETF*, JANUS HENDERSON INVESTORS, https://www.janushenderson.com/en-us/advisor/product/scrd-sustainable-corporate-bond-etf/.

283. *See* Chappatta, *supra* note 275.

284. *See SMCCF Transaction Specific Disclosures 12-11-20*, BD. OF GOVERNORS OF FED. RSRV. SYS. (Dec. 11, 2020), https://www.federalreserve.gov/publications/2020-reports-to-congress-in-response-to-covid-19.htm (showing that the Federal Reserve purchased Diageo bonds).

285. *See* COMM. FIN. SERVS., OVERSIGHT OF THE TREASURY DEPARTMENT'S AND THE FEDERAL RESERVE'S PANDEMIC RESPONSE, H.R. Doc. No. 116-99, at 99-100 (2020).

286. For example, in the Senate Congressional Record, Senator Chris Van Hollen said:

> When the proposal first arrived here in the Senate from the White House, we were looking at about a $500 billion slush fund with no strings attached, no real accountability, and no real transparency. So we tried to tie that down so that we will have an inspector general with subpoena power that will ensure that there will be no stock buybacks with these emergency funds. Now, we are going to still look at the fine print, but we have come a long way from the proposed blank check to the Secretary of the Treasury, which was in the bill as it arrived here as proposed by the administration.

loophole for purchasing bonds that violated the U.S.-centric business requirements, that loophole likely violates the intent of the CARES Act.

E. EFFECT OF THE FEDERAL RESERVE EXCEEDING ITS AUTHORITY

Given the likelihood that the Federal Reserve will deploy similar facilities in future crises,[287] understanding the implications of Federal Reserve overreach is crucial. Bloomberg notes that the COVID-19 precedent could lower barriers to future activations of similar facilities,[288] underscoring the need to ensure that facilities like the SMCCF align with the Federal Reserve's statutory authority.

1. Standing to Sue the Federal Reserve for Exceeding Section 13(3)

Even if the Federal Reserve exceeded the authority granted to it under the FRA, a successful lawsuit challenging this overreach is highly unlikely.[289] Following the Federal Reserve's bailout of AIG, a shareholder lawsuit claimed that the Federal Reserve's equity stake in AIG violated Section 13(3), but the Federal Circuit ruled that the plaintiff lacked standing.[290] In light of this ruling, it is difficult to imagine a shareholder plaintiff who would satisfy standing requirement

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Senator Bernie Sanders echoed a similar sentiment, though he was less convinced that limitations on the Federal Reserve's programs were sufficient: "I am especially concerned that the administration will be able to spend $500 billion in virtually any way they want-any corporation they want-with virtually no strings attached." While both Van Hollen and Sanders were dissatisfied with the extent of the limitations, they both clearly expressed an intent for CARES Act funds to be limited. *See* 116 CONG. REC. S2021, S2052, S2059 (2020).

287. The CPFF and TALF, for example, were both created during the 2008 Crisis and revived during the COVID-19 crisis response.

288. *See* Emily Barrett, *The Weekly Fix: See You in the Next Crisis, Corporate Credit Facility*, BLOOMBERG (June 4, 2021, 5:00 AM), https://www.bloomberg.com/news/newsletters/2021-06-04/the-weekly-fix-see-you-in-the-next-crisis-corporate-credit-facility?embedded-checkout=true.

289. *See generally* Steffi Ostrowski, *Judging the Fed*, 131 YALE L. J. 726, 736 (2021).

290. *See id.* at 736-37 (referencing Starr Int'l Co., Inc. v. United States, 856 F.3d 953 (Fed. Cir. 2017)).

to sue the Federal Reserve for exceeding its authority in creating the SMCCF.[291]

2. Maintaining Federal Reserve Credibility Amid Expanding Expectations

In an article published in 2021, Professor Christina Parajon Skinner highlighted the need for the Federal Reserve to strictly adhere to its established mandates in order to preserve its credibility amidst its evolving role.[292] As calls increase for the Federal Reserve to address broader social and economic issues such as climate change, it becomes even more crucial for the Federal Reserve to clearly define its authority.[293] Parajon Skinner argued that "it is only by sticking to the boundaries of its mandates, and its informally established rules and norms for exercising power, that the Fed[eral Reserve] can maintain the credibility required for effective policy execution."[294]

Remaining credible is essential for the Federal Reserve to ensure financial stability and fulfill its dual mandate[295] of price stability and maximum employment.[296] To alleviate pressures on the Federal Reserve, Parajon Skinner advocated Congressional intervention, such as in the form of amendments to the FRA.[297] Parajon Skinner described the SMCCF as "flirt[ing] with activism."[298] If the SMCCF did exceed the Federal Reserve's Section 13(3) authority, it could undermine the institution's credibility and thus harm its ability to carry out successful monetary policy in the future.

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291. *See id.* at 736-37. While the lendee (such as AIG) is more likely to have standing to sue, they would not pursue legal action because they are the beneficiary of the bailout.

292. *See generally* Christina Parajon Skinner, *Central Bank Activism*, 71 DUKE L.J. 247, 318 (2021).

293. *See id.* at 319.

294. *See id.* at 319.

295. *See* Mohamed A. El-Erian, *The Fed's Credibility Problem*, PROJECT SYNDICATE (Apr. 3, 2023), https://www.project-syndicate.org/commentary/fed-credibility-crisis-lost-confidence-around-the-world-by-mohamed-a-el-erian-2023-04.

296. *See The Federal Reserve's Dual Mandate*, FED. RSRV. BANK CHI., https://www.chicagofed.org/research/dual-mandate/dual-mandate (Oct. 20, 2020).

297. *See* Christina Parajon Skinner, *supra* note 293, at 325-28.

298. *See id.* at 272.

III. RECOMMENDATIONS FOR COMPLYING WITH SECTION 13(3) IN FUTURE CRISES

This Note considers two broad approaches to address the issue of the SMCCF exceeding the Federal Reserve's statutory authority. First, Part III.A assumes the FRA will remain unchanged, necessitating future solutions to crises that extend credit to large corporations in compliance with the existing FRA provisions. Second, Part III.B suggests amending the FRA to modernize the security requirement. Ultimately, the most straightforward resolution would be for Congress to pass legislation that directly addresses the Federal Reserve's power to purchase corporate bonds.

A. REFASHIONING PREVIOUSLY USED SECTION 13(3) FACILITIES TO APPLY TO LARGE CORPORATIONS

The SMCCF functioned as a mechanism to indirectly provide credit to large corporations.[299] Instead of directly lending to businesses, the Federal Reserve opted to purchase corporate bonds in the secondary market, attempting to stimulate the corporate bond market. Although this approach succeeded in stimulating the primary corporate bond market,[300] it is debatable whether the SMCCF is the optimal method for providing corporations with credit. Alternative strategies were deployed during the Federal Reserve's response to COVID-19 that could more closely align with the Federal Reserve's Section 13(3) authority while achieving the same objective of lending to large corporations.

1. *Broadening the Scope of the Main Street Lending Program*

On April 9, 2020, the Federal Reserve introduced the $600 billion Main Street Lending Program (MSLP).[301] The MSLP filled a gap by targeting businesses too large for the Paycheck Protection Program (PPP) yet too small to issue bonds eligible for purchase by the

299. *See* COMM. FIN. SERVS., OVERSIGHT OF THE TREASURY DEPARTMENT'S AND THE FEDERAL RESERVE'S PANDEMIC RESPONSE, H.R. Doc. No. 116-99, at 51, 53 (2020).

300. *See supra* Part I.B.2.

301. *See* Matthew Vann, *Fed unveils details of $600B Main Street lending program for businesses hurt by pandemic*, ABC NEWS (Apr. 9, 2020, 6:00 PM), https://abcnews.go.com/Business/fed-unveils-details-600b-main-street-lending-program/story?id=70066755&cid=social_twitter_abcnp.

SMCCF.[302] Under the MSLP, lenders originated loans to businesses, and the Federal Reserve acquired 95% of each loan via an SPV, leaving the originators with a 5% share.[303] The diversity of issuers and the customizable nature of the loans necessitated the creation of several variations of the MSLP.[304]

The Main Street Priority Loan Facility, for example, purchased newly originated loans if the total issuance amount was $50 million or less and if the loan held a senior position or was on equal footing (*pari passu*) with a borrower's existing obligations.[305] These loans could be either secured or unsecured.[306] Key requirements for loans this facility purchased included a five-year maturity, a one-year deferral of interest payments, and pricing set at LIBOR plus 300 basis-points.[307] Additionally, each borrower had to pay a 100 basis-point origination fee to the lender, which in turn had to pay a 100 basis-point transaction fee to the SPV.[308] To ensure that the MSLP was targeting medium-sized businesses, participating borrowers needed to have no more than 15,000 employees or annual revenues of not more than $5 billion.[309] In addition, the Term Sheet mandated that borrowers "make commercially reasonable efforts to maintain [their] payroll and retain [their] employees."[310] Ultimately, the MSLP purchased 1,830 loans.[311]

One alternative to the SMCCF would have been for the Federal Reserve to expand the MSLP's scope by removing its employee size and revenue requirements. This modification would have allowed large

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302. *See* MARC LABONTE, CONG. RSCH. SERV., IF11632, THE FEDERAL RESERVE'S MAIN STREET LENDING PROGRAM (2020). To qualify for the Paycheck Protection Program, a company needed to have 500 or fewer employees, a net worth of $15 million or less, or a net income of $5 million or less. Corporations qualified for the MSLP if they had either 15,000 or less employees or $5 billion or less revenue.

303. *See id.*

304. *See Examination of the Main Street Lending Program: Hearing Before the Congressional Oversight Commission*, 116th Cong. 9-11 (2020).

305. *See id.* at 9-10. This excludes mortgage debt.

306. *Term Sheet - Main Street Priority Loan Facility*, BD. GOVERNORS FED. RSRV. SYS. (Dec. 29, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20201229a2.pdf.

307. *See id.*

308. *See id.*

309. *See id.*

310. *See id.*

311. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-24-106482, FEDERAL RESERVE LENDING PROGRAMS: STATUS OF MONITORING AND MAIN STREET LENDING PROGRAM 24 (2023).

businesses to participate in the MSLP, and it could have resolved various SMCCF-related issues. In particular, this structure would subject borrowers to a penalty rate and enforce the U.S.-centric business requirement.[312] Additionally, by possibly requiring loans to be secured, lenders could enforce Section 13(3)'s security requirement. However, this approach might still fall short of meeting Section 13(3)'s liquidity requirement. While the structure of the MSLP likely satisfies Section 13(3)'s liquidity requirement,[313] the MSLP encounters a similar dilemma to the SMCCF:[314] determining the juncture at which financial assistance transitions from offering liquidity support to averting insolvency.

From a policy standpoint, the MSLP was more focused than the SMCCF. It made direct loans to promote employment retention and imposed restrictions on recipient use of funds, including restrictions related to shareholder returns.[315] In contrast, no limitation was placed on the SMCCF's use of funds because the bonds were purchased in the secondary market. Moreover, the MSLP more accurately reflected Section 13(3)'s original intent as a lender to private businesses rather than an investor in private businesses' secondary market securities.[316]

2. *Expanding the Term Asset-Backed Securities Loan Facility*

Initially established during the 2008 Crisis and reactivated during the COVID-19 pandemic, the Term Asset-Backed Securities Loan Facility (TALF) is another of the Federal Reserve's crisis facilities.[317] Similar to other facilities, the Federal Reserve extended recourse loans to an SPV, and the SPV provided loans to private investors.[318] The

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312. The more stringent requirements include limitations on stock buybacks, dividends, and maintaining employment. *See* CARES Act §§ 4003(c)(2)(E)-4003(c)(2)(G).

313. *See supra* Part II.B.1-II.B.2 (defining liquidity for purposes of Section 13(3) to apply to either funding or market liquidity and for the benefit of financial or non-financial companies).

314. *See supra* Part II.B.3 (explaining that the SMCCF potentially assisted companies in averting insolvency).

315. *See* CARES Act § 4003(c)(3)(A)(ii).

316. *See* Mehra, *supra* note 9, at 224-26.

317. *See* Mark E. Van Der Weide & Jeffery Y. Zhang, *Tale of the Tape: Lessons from the 2008 and 2020 Financial Crisis*, 26 STAN. J. L. BUS. & FIN. 413, 433 (2021).

318. *See* MARC LABONTE, CONG. RSCH. SERV., FEDERAL RESERVE: EMERGENCY LENDING, R44185, at 9 (2020).

objective of these loans was to encourage investment in various types of ABS,[319] such as those backed by auto loans, student loans, and credit card receivables.[320] The Federal Reserve applied a fixed interest rate based on the type of underlying asset and imposed a 10 basis-points administrative fee.[321] TALF's primary objective was to stimulate ABS issuance, thus enabling consumers to continue obtaining credit.[322]

Compared to the SMCCF, TALF more closely aligns with the Federal Reserve's authority under Section 13(3). Functionally, TALF operates akin to a conventional liquidity facility,[323] offering funding liquidity to financial intermediaries to benefit the market broadly.[324] Specifically, the collateralization of TALF loans depends on the type of underlying ABS. For instance, auto loans are typically secured by the underlying car,[325] while student loans are not secured.[326]

Expanding TALF to assist large corporations would involve the Federal Reserve's lending to corporate bond investors, thus enhancing market liquidity in the corporate bond market.[327] Charging a penalty rate on TALF loans would also be straightforward: the Federal Reserve would charge a premium over the rate the investor could borrow at in a normal market. While a broadened MSLP might enable collateral negotiations with the corporate borrower, expanding TALF to include unsecured bond purchases would pose challenges under Section 13(3)'s

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319. *See id.* at 12.

320. *See Term Sheet - Term Asset-Backed Securities Loan Facility*, BD. GOVERNORS FED. RSRV. SYS. (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a6.pdf.

321. *See id.*

322. *See* Press Release, Bd. Governors Fed. Rsrv. Sys., Federal Reserve announces extensive new measures to support the economy (Mar. 23, 2020, 8:00 AM), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm.

323. *See supra* Part II.B.1. (describing conventional liquidity facilities).

324. *See* Press Release, Bd. Governors Fed. Rsrv. Sys., Federal Reserve announces extensive new measures to support the economy (Mar. 23, 2020, 8:00 AM), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm.

325. *See* JENNIFER JOHNSON, AUTO ASSET-BACKED SECURITIES (AUTO ABS) PRIMER 3 (Nat'l Ass'n Ins. Comm'rs), https://content.naic.org/sites/default/files/capital-markets-primer-auto-abs.pdf.

326. *See* Susan M. Dynarski, *The RNC Wants to Make Student Loans Competitive Again. They Never Were*, BROOKINGS (July 21, 2016), https://www.brookings.edu/articles/the-rnc-wants-to-make-student-loans-competitive-again-they-never-were/.

327. TALF for corporations would not need to be exclusive to the bond market. For example, these same principles could apply for corporate commercial paper, corporate loans, or other sources of funding for corporations. This Note, however, assumes investors would purchase corporate bonds given the opportunity.

security requirements.[328] The Federal Reserve would be making loans to investors whose majority of assets would be unsecured corporate bonds. Therefore, while the loan recipient would be the investor, if that investor defaulted, the Federal Reserve would still be exposed to unsecured corporate bonds.

Similar to the MSLP, TALF offers a more focused mechanism for achieving its objectives. An expanded TALF would directly generate market liquidity by financing investors who are ready to engage in securities trading. In contrast, the market liquidity created by SMCCF was a second-order effect. In times of market dislocation, loans to investors under an expanded TALF might be more effective than the Federal Reserve's direct corporate bond purchases.

B. AMEND SECTION 13(3) TO PRIORITIZE RISK ASSESSMENT OVER COLLATERAL

As with many other Federal Reserve facilities, the SMCCF required a minimum credit rating, resulting in 97% of its acquired bonds being investment grade.[329] A credit rating requirement, however, marks a shift away from the Section 13(3) requirement that emergency facilities must be "indorsed or otherwise secured." Yet, the Federal Reserve's argument that the SMCCF satisfied this requirement through the equity cushion provided by the Treasury lacks any legal basis.[330] Given the evolution of Section 13(3) programs and the changing nature of debt products, the Federal Reserve should consider removing the "indorsed or otherwise secured" requirement and related provisions necessitating security.[331] Instead, Section 13(3) should emphasize the need for emergency programs to "protect taxpayers from losses."

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328. *See supra* Part II.A.2. (defining the security requirement).

329. *See* REPORTS TO CONGRESS PURSUANT TO SECTION 13(3) OF THE FEDERAL RESERVE ACT IN RESPONSE TO COVID-19: SECONDARY MARKET CORPORATE CREDIT FACILITY TRANSACTION-SPECIFIC DISCLOSURES, BD. OF GOVERNORS OF FED. RSRV. SYS. (Dec. 11, 2020), https://www.federalreserve.gov/publications/2020-reports-to-congress-in-response-to-covid-19.htm.

330. *See supra* Part II.A.3. The intent of the security requirement was to safeguard investments, not to transfer potential losses from the Federal Reserve to the Treasury.

331. Other provisions necessitating security are the Dodd-Frank provisions requiring that "security for emergency loans is sufficient to protect taxpayers from losses" and that the Federal Reserve assign "a lendable value to all collateral for a Loan." *See*

Historically, secured debt constituted a larger share of corporate capital structures than it does now.[332] The terms "indorsed" and "secured" were integral to the initial drafting of Section 13(3) in 1932.[333] However, at the time those terms were introduced, 78.7% of the corporate bonds in the market were secured, down from 98.5% in 1900.[334] By 2017, only 8.8% of the corporate bond market comprised secured bonds.[335] This decline in secured debt is attributable to advancements in accounting practices, improvements in the Bankruptcy Code, and a reduction in corporations' tangible assets.[336] Consequently, the Section 13(3) requirement for loans to be "indorsed or otherwise secured" has become obsolete in a market in which much less debt is secured.

An amendment to Section 13(3) that prioritizes prevention of taxpayer losses would align with the current market reality of predominantly unsecured corporate debt. Upon adopting these changes, the Federal Reserve must continue to prioritize creditworthiness, ensuring that Section 13(3) is not used to support insolvent borrowers.

CONCLUSION

In its response to the COVID-19 crisis, the Federal Reserve took an unprecedented step by creating the SMCCF to purchase corporate

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Dodd-Frank Wall Street Reform and Consumer Protection Act § 1101(a)(6), 12 U.S.C. § 343 (2018); *see also supra* Part II.A.1.

332. *See generally* Efraim Benmelech, Nitish Kumar, & Raghuram Rajan, *The Decline of Secured Debt* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26637, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3518250.

333. *See* Sastry, *supra* note 105, at 20-21. The original text used the conjunctive "indorsed and otherwise secured" rather than "indorsed or otherwise secured." The amendment to the disjunctive "or" was made after the stock market crash of 1987 to give the Federal Reserve more discretion in using Section 13(3). *See* Sastry, *supra* note 105, at 28-29.

334. *See* Benmelech, Kumar, & Rajan, *supra* note 333, at 4. The share of secured debt fluctuated with market sentiment. In 1929, the share of secured debt was 40.5%, but secured debt rebounded with the Great Depression.

335. *See id.* at 7.

336. *See id.* at 19-27. While the study by Benmelech, Kumar, & Rajan was focused on bonds, the principles hold true for all types of corporate debt and, thus, would apply to many forms of Section 13(3) discounting. For example, the decline in tangible assets held by corporations in the U.S. would diminish security potential of any sort, not just bonds.

bonds.[337] This move sought to channel credit to corporations through Federal Reserve-funded purchases of secondary market debt.[338] The SMCCF, authorized by Section 13(3) and the CARES Act,[339] succeeded in rescuing the corporate bond market,[340] although it raised questions regarding the scope of the Federal Reserve's authority.[341]

Section 13(3) grants the Federal Reserve extraordinary powers in crises, but those powers are limited by requirements regarding security,[342] liquidity purposes,[343] and penalty rates.[344] With respect to each of these requirements, the SMCCF exceeded Section 13(3)'s grant of authority.[345] Additionally, while partially authorized by the CARES Act, the SMCCF did not comply with its U.S.-centric business requirements.[346] While the Federal Reserve is unlikely to be held legally accountable for these oversteps, they may nonetheless damage the Federal Reserve's credibility, thus limiting its ability to effectively manage future financial crises and maintain overall financial stability.[347]

The path forward requires policymakers to reassess the Federal Reserve's past response to disruptions in the corporate bond market, either by choosing different Section 13(3) facilities[348] or by amending Section 13(3).[349] Other Federal Reserve programs, such as the MSLP and TALF, could be modified to more easily conform to Section 13(3) powers and have a similar impact on corporations as the SMCCF did.[350] Alternatively, Congress can modernize Section 13(3) by eliminating the security requirement so that the Federal Reserve can more easily respond to future crises.[351]

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337. *See supra* Part I.B.2.
338. *See supra* Part I.B.2.i.
339. *See supra* Part I.C.
340. *See supra* Part I.B.2.i.
341. *See supra* Part I.B.2.iv.
342. *See supra* Part II.A.
343. *See supra* Part II.B.
344. *See supra* Part II.C.
345. *See generally supra* Part II.
346. *See supra* Part II.D.
347. *See supra* Part II.E.
348. *See supra* Part III.A.
349. *See supra* Part III.B.
350. *See supra* Part III.A.
351. *See supra* Part III.B.