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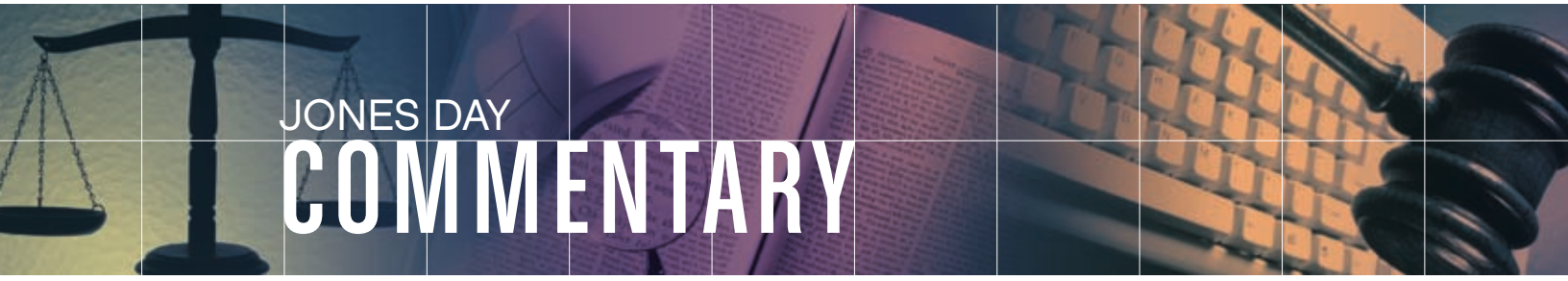

ENERGY

FERC INTERLOCKING DIRECTOR RULES– A GUIDE TO COMPLIANCE

FERC has recently stepped up enforcement of many provisions of the Federal Power Act ("FPA"), including Section 305, which imposes limitations on persons who serve as officers or directors of public utility companies. Section 305 requires *preapproval* by FERC for a person to hold an officer or director position at more than one public utility or at a public utility and certain other specified companies. In addition, public utility officers and directors must make an annual report filing with FERC that lists all relevant interlocks—that is, cases where they also serve as officer or director of specified other entities. After years of casually enforcing these rules, FERC has recently adopted new, tough requirements and no longer tolerates any late filings. FERC has also audited a number of public utilities in recent months to determine their level of compliance with these rules.

INTERLOCK WITHOUT APPROVAL IS UNLAWFUL

The FPA specifies that it is unlawful for a person to hold the position of officer or director of a public utility and also hold an officer or director position with certain other entities unless FERC has given its approval *prior to* the time such interlock arises.

The interlocks that require approval are those where an officer or director of a "public utility" seeks to *also* be an officer or director of:

- Any other public utility;
- Any "underwriter" (unless certain "safeguards" described below are in place); or
- Any "electrical equipment supplier" to his or her utility.

Importantly, the person's request for approval will be denied if he or she has begun to "hold" the interlock prior to seeking approval. To "hold" means acting as, serving as, voting as, or otherwise performing or assuming the duties and responsibilities of officer or director. It is improper for a person to "do the job" even if he or she has not been "officially" or "formally" elected or appointed to the position giving rise to the interlock. Further, the formal election or appointment cannot be made without, or must be expressly conditioned for its effectiveness on, the prior FERC approval being obtained.

Until recently, FERC rules suggested that an application for approval would be timely if made up to 30 days *after* the interlock arose. And, in practice, many applications were filed—and duly approved—months or even years late. In October 2005, however, FERC adopted new rules making it clear that no late filing would be acceptable. A filing that indicates the person has already begun to "hold" the position will be denied. In such a case, the person will have no choice but to resign from one of the positions to eliminate the interlock. Violations of Section 305 can subject the person to criminal penalties, but FERC's power to impose civil penalties of up to $1 million per day, granted in the Energy Policy Act of 2005, do not apply to Section 305 violations.

DEFINITIONS

For these rules, "public utility" means any public utility as defined in the FPA, *i.e.,* a person that owns facilities for the transmission of, or makes sales of, electricity in interstate commerce. Thus, traditional vertically integrated electric utilities as well as exempt wholesale generators and other independent generators, transmission companies, regional transmission organizations, power marketers, and others are generally public utilities. Some public utilities that have been granted authority to sell power at market-based rates may have waivers that relieve them of compliance with the interlock rules. As noted below, however, FERC is not granting new waivers in this area.

An important distinction is that the interlock-approval requirement does not apply if a person is only an officer or director of a holding company for a public utility. Some holding company systems include outside directors only at the holding company level, and these persons do not serve as directors of any public utility subsidiary. In such cases, those directors' other officer and director positions will not give rise to an interlock that requires preapproval. If these directors also serve as directors of the public utility subsidiaries, however, all the interlocks described in this *Commentary* will be relevant. In any multi-utility holding company system, it is likely that there will be officer or director interlocks at the utility level. The requirements for these are discussed below.

The persons subject to the rule include any director and any officer. "Officer" includes any president, vice president, secretary, treasurer, general manager, comptroller, chief purchasing agent, director, or partner, or a person who performs any other similar executive duties or functions. This is a broader definition than the term "executive officer," which is used by the SEC to determine who is subject to restrictions and reporting requirements of federal securities laws.

Utility to Utility. Since the 1930s, FERC has sought to first break up and then prevent the reformation of large multi-utility holding companies and other combinations by refusing to approve requests to hold interlocking positions between unaffiliated public utility companies. FERC continues that policy today. For example, recently FERC denied the request of the CEO of a northeastern U.S. utility holding company and its utility subsidiaries to also serve on the board of Southwest Power Pool, a regional transmission organization. FERC held that it could not find that "neither public nor private interests will be adversely affected" through the interlock. The applicant's suggestion that his expertise in the field of electric transmission, generation planning, and operation would aid SPP was not sufficient to overcome FERC's view that there is potential for abuse when unaffiliated utilities are interlocked.

By contrast, FERC has a process for automatic approval to hold interlocking positions among affiliated public utilities—such as being an officer of several public utilities in a single holding company system. Even here, however, the person must make a notice filing to FERC *before* beginning to hold the multiple positions. Approval is deemed granted immediately upon making this filing. In this notice filing, the person must represent that he or she has "not yet performed or assumed the duties or responsibilities" of the position. Generally, once this initial informational filing is made, the person can thereafter assume different titles or positions in the same holding company system without needing further preapproval. As

described below, the person would report his or her current positions in the required annual update report.

Utility to Underwriter. An "underwriter" is any person that is "authorized by law" to underwrite or participate in the marketing of the securities of a public utility. The underwriter does not have to actually engage in these practices; it is sufficient to be authorized to do so. The interlock does not have to be directly with the entity that is itself authorized to underwrite. If the utility officer or director is an officer or director of any entity in a holding company family that has an affiliate authorized to underwrite, the interlock is jurisdictional and the entity will be deemed to be an "underwriter."

One of the purposes of regulating interlocks between public utilities and firms that could underwrite public utility securities was to eliminate abusive transactions, such as inflated underwriting fees or provisions in securities that were unfavorable to the issuing utility, which were often imposed during the 1930s when underwriting houses dominated public utility organizations. Persons authorized to underwrite include "investment banks"—firms such as Goldman Sachs or Lehman Brothers that help companies place securities with the public. However, another law from the 1930s, the Glass-Steagall Act, prohibited commercial banks—those that take deposits and engage in lending—from engaging in securities underwriting. Because commercial banks were not authorized to underwrite, an interlock between a public utility and a commercial bank did not require approval by FERC.

In the 1980s and 1990s, restrictions were eased on commercial banks' engaging in underwriting activities. When a commercial bank became authorized to underwrite, an interlock between that bank and a public utility needed FERC approval. FERC routinely granted approval but frequently imposed conditions. Where the person involved was an "insider" at the bank or public utility (*i.e.,* an officer as opposed to an outside director), FERC usually provided that the bank was prohibited from acting as an underwriter for any of the public utility's securities. In 1999, the Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act, repealed the Glass-Steagall Act and allowed all banks—both commercial and investment—to underwrite, and consequently virtually all interlocks between a bank or an investment bank and a public utility would have required approval under the FPA.

The Gramm-Leach-Bliley Act also amended the FPA, however, and significantly eased the requirements for FERC approval in the case of interlocks between utilities and commercial and investment banks. The revised FPA provides that all interlocks between a commercial or investment bank and a utility are jurisdictional and will require FERC approval *unless* the utility institutes one of the four statutorily provided safeguards against self-dealing. These four safeguards, any one of which will obviate the need for FERC approval for an interlock with a commercial or investment bank, are as follows:

- The officer or director does not participate in any deliberations or decisions of the public utility regarding the selection of an underwriter to underwrite or participate in the marketing of securities of the public utility, if such officer or director serves as an officer or director of an underwriter that is under consideration in the deliberation process.
- The underwriter of which the person is an officer or director does not engage in the underwriting of, or participate in the marketing of, securities of the public utility of which the person is an officer or director.
- The public utility for which the person is an officer or director selects underwriters by competitive procedures.
- The issuance of securities of the public utility for which the person serves as an officer or director has been approved by all federal and state regulatory agencies having jurisdiction over the issuance.

These exceptions are quite broad and easy to satisfy. With minimal actions, no FERC approval should be needed for any interlock between a public utility and an "underwriter." In most cases, a public utility must receive federal or state regulatory commission approval to issue securities. That alone is sufficient to eliminate the need for FERC approval of the interlock. In addition, if the officer or director does not participate in the selection of an underwriter, the interlocked underwriter may participate in an offering of the utility's securities. Although it is likely that in virtually every instance one of the four safeguards will be in place, if a public utility does use as an underwriter a firm with which it has an officer or director interlock, the utility should document which of the safeguards it is relying on (*e.g.,* with a notation in the minutes of the board of directors meeting approving the securities issuance).

Utility to Electrical Equipment Supplier. The third and final category of interlock that requires FERC approval is an interlock between a public utility and any entity that supplies "elec-

trical equipment" to that public utility. The purpose of this section was to eliminate the type of conflict of interest that existed in the 1930s where utilities would pay inflated prices for electrical equipment from suppliers because of the influence of the interlocked person. If the electrical equipment supplier does no business with the utility involved—that is, it sells only to other public utilities—then no approval is needed. If there are transactions between the interlocked companies, FERC approval is needed before the interlock arises.

FERC approves these interlocks only if the amount of electrical equipment supplied to the utility is *de minimis*, both in terms of the total amount of equipment purchased by the utility from all vendors and the percentage of the supplier's total sales represented by its sales to the utility. The percentage for both figures must be very small—in the range of 1 to 2 percent or less. FERC will impose a condition that the interlocked person make an annual filing with FERC showing that the amount of the transactions between the supplier and the utility for each fiscal year remains a *de minimis* amount.

"Electrical equipment" means any apparatus, device, integral component, or integral part used in an activity that is electrically, electronically, mechanically, or by legal prescription necessary to the process of generation, transmission, or distribution of electric energy. Guidance in applying the definition of "electrical equipment" may be obtained by examining the items within the accounts described in the FERC Uniform System of Accounts as specified in FERC Rule 46.2 (18 CFR § 46.2). Excepted from these accounts are vehicles, structures, foundations, settings, and services.

Public utilities must take care when reviewing the qualifications of new directors, or when allowing officers to become directors of other companies, that the company is not an electrical equipment supplier. It may not be immediately apparent from publicly available information whether or not the entity is in the business of supplying any of the categories of goods that constitute electrical equipment.

ANNUAL REPORT TO FERC – FORM 561

Every officer and director of a public utility who holds an interlocking position with another utility (including multiple utilities within a single holding company system), or with an underwriter or an electrical equipment supplier to his or her utility, must file, prior to April 30 each year, an annual report on FERC Form 561 listing the interlocks. In addition to the three types of interlock that require preapproval, Form 561 also must be filed by any person who has an interlock between a public utility and any of the following types of entity:

- Bank, investment bank, bank holding company, foreign bank, insurance company, financial services or credit provider, mutual savings bank, or savings and loan association.
- Underwriter (as described above).
- Electrical equipment supplier (to any utility).
- Fuel supplier.
- 20 largest purchasers.
- Any entity controlled by any of the above.

There is some overlap in these categories. An entity may be a "bank" and also be an "underwriter." Note, however, that the "bank" category is broader and also includes insurance companies and other types of financial entities. These other interlocks do not require FERC approval, but if a person held such an interlock at any time during a calendar year, he or she must report it on the Form 561 filed by April of the following year. In addition, if the "officer" or "director" of the public utility serves as an "officer," "director," "partner," "appointee," or "representative" of the other entity, there is a reportable interlock. The purpose of this expanded list of relevant titles or positions is to capture situations where there is a less formal relationship between the person and the other entity that could nevertheless give rise to a conflict of interest.

A "fuel supplier" is any entity that produces or supplies coal, natural gas, oil, nuclear fuel, or other fuel for the use of *any* public utility.

The "20 largest purchasers" category relates to another requirement of Section 305 of the FPA. Under Section 305(c), every public utility subject to FERC jurisdiction must, by January 31 of each year, compile a list of its 20 largest purchasers of electricity. This is a list of each purchaser that, during any of the three preceding calendar years, purchased (for purposes other than resale) one of the 20 largest amounts of electric energy (by KWH) sold (for purposes other than resale) by the utility (or by any public utility in the same

holding company system) during such year. The list must include the name of the purchaser and its principal business address. This list is filed with FERC on Form 566 and must be made publicly available in the utility's principal business office. In addition, the utility must notify each of its 20 largest purchasers that they are included on the list.

As noted above, any officer or director interlock with a company that is on the list of the utility's 20 largest purchasers must be reported to FERC. Finally, as also noted above, no approval is needed for an interlock between a public utility holding company and any of the other entities described in Section 305. Some companies nevertheless report on Form 561 an interlock between a person who is a director or officer of the public utility holding company (but not any public utility subsidiary) and other entities such as banks, insurance companies, electrical equipment suppliers, and so on. While such a report arguably would not be required, FERC frequently "attributes" the activities of subsidiaries to other entities in the holding company family and has specified that companies which "control" or are "controlled by" the types of entities listed in Section 305 must also be treated as if they were themselves jurisdictional entities.

CHANGED CIRCUMSTANCES

In cases where an interlock must be approved by FERC, any major change in position or circumstances (such as if an officer later becomes director) requires the filing of a supplemental application with FERC and receipt of approval prior to the change taking effect. However, routine reelection to an approved position does not require any action. The termination of an interlock and other changes must be reported to FERC within 30 days of the event.

In the case of those interlocks among multiple utilities in a holding company system, no preapproval or filing is required (after the first filing of this type) for a person to hold additional positions that are also eligible for the automatic approval. However, changes in position (*e.g.,* assuming a new title; becoming officer or director of an additional company or utility; terminating a position) should be reported to FERC within 30 days of the change.

FILING FOR APPROVAL; AUTOMATIC APPROVALS

While the interlocking-director rules technically apply individually to the officers or directors involved and do not impose a duty on the public utility, as a practical matter, each public utility must take steps to ensure that its personnel comply with the law. When a utility is considering adding a new director to its board or filling officer positions, it will be imperative to find out the person's other affiliations well in advance. If the new person is affiliated with another public utility, with a firm authorized to underwrite utility securities, or with an entity that supplies electrical equipment to the utility, FERC approval will have to be sought and obtained *before* the person can assume the new positions. (Or, for an interlock with an underwriter, steps will have to be taken to observe one of the four safeguards noted above.) There will be considerable embarrassment if the person involved begins to "hold" the interlocking position without approval and then has to resign. The person also may be subject to criminal penalties.

Before any person is selected to serve as a director of the public utility, someone knowledgeable with the requirements should ascertain whether preapproval will be required. If approval is required, it will be necessary to prepare a filing containing the information required by Part 45 of FERC's regulations (18 CFR Part 45). A filing will be deemed approved automatically on the 60th day following the filing unless FERC has taken action to the contrary before that time. It is critical to a utility's planning that it build in sufficient time to prepare an application and let the 60 days elapse *before* the date the new director is to assume his or her duties.

Advance planning is required in connection with the election of new officers as well. In a multi-utility holding company system, *before* a person can be elected for the first time as an officer or director of multiple utilities, a filing must be made with FERC under Rule 45.9. This filing is deemed to be effective immediately upon filing. Accordingly, with some planning, a newly elected officer can assume his or her duties with minimal delay but must wait until the Rule 45.9 filing is made to begin to hold the position. As noted above, an officer or director who has initially made a filing under Rule 45.9 may assume additional positions of the same type without preapproval.

In 2005, FERC changed its policy regarding waivers that FERC had typically granted to public utilities authorized to make wholesale sales of electricity at market-based rates. FERC often included in its orders authorizing use of market-based rates a partial waiver of the requirement to seek approval for interlocking positions involving that utility. Similar to the automatic approvals for affiliated utilities, these orders authorized a simple notice filing, after the interlock arose, merely stating the facts of the interlock. Beginning October 24, 2005, FERC will no longer include such a waiver in market-based rate orders. Such interlocks will now require a full advance filing seeking authorization under Part 45.

PROCEDURES TO ENSURE COMPLIANCE

The person in the public utility responsible for ensuring compliance with Section 305 of the FPA must coordinate efforts with those responsible for identifying and vetting potential candidates to serve on the board or act as officers of the utility so that necessary advance filings can be prepared and filed in a timely manner. More importantly, perhaps, an advance review of the FERC requirement can avoid the embarrassment of having to ask a previously selected candidate to step aside. For example, it could be embarrassing to invite a person to be a director of a public utility only to discover later that he or she is an officer or director of an electrical equipment supplier that provides more than a *de minimis* amount of equipment to the utility. FERC probably would not approve such an interlock, and the utility would have to ask the person to step aside. It may be necessary to elect or appoint officers and directors to their positions expressly conditioned so that they are not authorized to begin service (and in fact do not begin to "hold" the position) until FERC approval is in hand. It is also important that current officers and directors of public utilities be reminded periodically that there are certain other officer and director positions that they cannot accept until they have received advance approval from FERC.

CONCLUSION

The FERC rules surrounding interlocking officer and director approval and reporting are technical and detailed. Compliance can be ensured only if the public utility imposes careful procedures to identify potential interlocks early and assigns personnel to monitor all interlocks and make the necessary filings in a timely manner.

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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