

## ENERGY REGULATORY ALERT

### INCREASED FEDERAL ENERGY REGULATORY COMMISSION SCRUTINY OF INVESTMENT ADVISERS AND PUBLIC UTILITY HOLDING COMPANIES

On November 20, 2008, the Federal Energy Regulatory Commission (FERC or “Commission”) issued two orders that will increase the FERC’s scrutiny over investment advisers and the acts of public utility holding companies that currently may not be subject to FERC oversight.

The first of the two orders<sup>1</sup> clarifies that an investment adviser that is a “public utility holding company,” i.e., holds the voting rights of 10 percent or more of securities in a public utility<sup>2</sup> or public utility holding company<sup>3</sup>, must obtain FERC authorization under section 203(a)(2) of the Federal Power Act (“FPA”)<sup>4</sup> prior to directing, on behalf of its client and for its client’s benefit, the acquisition of 10 percent or more of the voting securities valued in excess of \$10 million of a public utility or public utility holding company. However, the FERC has granted public utility holding companies blanket authorization to acquire up to 9.9 percent of the voting securities in public utilities or public utility holding companies.

The FERC recognized that the applicability of FPA section 203(a)(2) to investment advisers that have directed such securities acquisitions on behalf of their clients was not clear prior to the issuance of its Investment Adviser Order. Therefore, it is allowing investment advisers that are public utility holding companies and that acquired 10 percent or more of the voting securities in a public utility or public utility holding company valued in excess of \$10 million without prior FERC authorization to file with the Commission within 90 days of the date of the publication of its Order in the *Federal Register* an application requesting such

<sup>1</sup> *Horizon Asset Mgmt., Inc.*, 125 FERC ¶ 61,209 (2008) (“Investment Adviser Order”).

<sup>2</sup> A public utility is a transmitting utility or an electric utility company.

<sup>3</sup> A public utility holding company is a holding company in a holding company system that includes a transmitting utility or an electric utility company.

<sup>4</sup> 16 U.S.C. § 824b(a)(2) (2006). In order to obtain the requisite prior authorization under FPA section 203(a)(2), a public utility holding company must file an application with the FERC that complies with the filing requirements provided in 18 C.F.R. § 33.2 *et seq.* (2008).

authorization. Investment advisers failing to make the requisite FPA section 203(a)(2) filings could become subject to FERC sanctions, including monetary penalties.<sup>5</sup>

In the second order,<sup>6</sup> the FERC clarified when a public utility holding company that has received an exemption or waiver of the regulatory requirements under the Public Utility Holding Company Act of 2005 (PUHCA 2005)<sup>7</sup> must provide notification of material changes in the facts on which the exemption or waiver were based. Specifically, a public utility holding company that has received an exemption or waiver must notify the FERC each time it acquires 10 percent or more of any additional public utility or public utility holding company. All companies that already have acquired 10 percent or more of the voting securities in a public utility or public utility holding company since they were granted exemptions or waivers from requirements under PUHCA 2005 must file with the FERC, within 45 days of the date of the Order's publication in the *Federal Register*, a notification of change in material facts that provides updates on any such investments.

## I. INVESTMENT ADVISER ORDER

The FERC issued its Investment Adviser Order in response to the May 19, 2008, (as amended on September 25, 2008) Horizon Asset Management, Inc. filing ("Application") requesting (a) a disclaimer of FERC jurisdiction that otherwise would require Horizon to obtain prior Commission authorization under FPA section 203<sup>8</sup> for acquisitions of the securities of certain public utility holding companies or certain electric utility operating companies; or, in the alternative, (b) blanket authorizations under sections 203(a)(1) and 203(a)(2) for Horizon to instruct or advise on the acquisition on behalf of account holders of securities of public utilities or public utility holding companies, and for public utilities or public utility holding companies to sell securities to Horizon on behalf of the account holders.

Horizon is an investment adviser registered with the Securities and Exchange Commission (SEC) and its primary business is the management and direction of separately managed accounts that are owned by individuals and entities ("Account Holders") and are "in the hands of" account custodians, which typically are large banking institutions. The vast majority of the accounts are "discretionary accounts," so Horizon has the exclusive authority to manage the accounts and instruct the custodian to add or reduce positions in the accounts, including positions in public utilities or public utility holding companies. Each Account Holder has delegated to Horizon the responsibility for supervising and managing the securities portfolio of that account, which responsibility includes both the purchase and sale of the securities, as well as the right to vote the shares. Therefore, Horizon believes that the Account Holders are passive investors with respect to ownership interests in utilities and are unable to exercise control over the utilities.

<sup>5</sup> The FERC has the authority to assess civil penalties in the amount of \$1,000,000 per day per violation of the FPA, the Commission's orders or its regulations. 16 U.S.C. § 825o-1.

<sup>6</sup> *Material Changes in Facts that Require Notifications Under the Pub. Util. Holding Co. Act of 2005*, 125 FERC ¶ 61,208 (2008) ("PUHCA Clarification Order").

<sup>7</sup> 42 U.S.C. § 16451, *et seq.*

<sup>8</sup> *Id.* § 824b.

### A. Request for Disclaimer of Jurisdiction

In its Application, Horizon argued that the Commission should grant its request for a disclaimer of jurisdiction because its activities as an investment adviser that directs acquisitions of stock for its Account Holders does not bring it within the Commission's jurisdiction under FPA section 203. Horizon argued that section 203(a)(2), which generally requires public utility holding companies that will "purchase, acquire, or take" public utility or public utility holding company securities valued in excess of \$10 million to first obtain Commission authorization,<sup>9</sup> does not apply to Horizon's activities because Horizon merely directs stock trading companies to buy or obtain securities for its Account Holders. In other words, Horizon does not obtain or buy the securities for or in the accounts it manages.

The FERC rejected Horizon's request to disclaim jurisdiction over Horizon pursuant to FPA section 203 for two reasons. First, it held that Horizon is a holding company as defined by the FPA, which adopts the definition of that term provided in PUHCA 2005: a company that "directly or indirectly owns, controls, or holds, with power to vote" 10 percent or more of the outstanding voting securities of a public utility company or of a holding company of any public utility company.<sup>10</sup> The Commission held that, because Horizon's Account Holders delegate the power to vote their securities to Horizon, Horizon, which already holds more than 10 percent of the voting securities in three public utilities<sup>11</sup> "directly . . . holds with the power to vote" those securities, and, thus, squarely fits into the definition of a public utility holding company.

Second, the FERC considered whether, as Horizon claimed, its activities do not constitute "the purchase, acquisition, or taking" of securities within the meaning of FPA section 203(a)(2), and, therefore, should not subject Horizon to the requirement to obtain Commission authorization pursuant to section 203. The Commission stated that, although the terms "purchase, acquire, or take" are not defined in either the FPA or PUHCA 2005, the terms must be given meaning in light of the statutory context and purposes of section 203(a)(2), which was the simultaneous repeal of PUHCA 1935 and enactment of additional corporate review authority in the FPA, specifically through the addition of section 203(a)(2), which pertains to certain public utility holding company investments. The Commission concluded that, in that context, it is reasonable to read the terms "purchase, acquire, or take" sufficiently broadly to permit it

to ensure adequate federal oversight of certain holding company transactions involving public-utility companies and transmitting utilities. Were the Commission to interpret new section 203(a)(2) to exclude the types of investment activities engaged in by Horizon or by similar investment advisers that, like Horizon, are holding companies, it is possible that such holding companies could exercise control over public-utility companies or transmitting utilities in a way that harms energy customers.<sup>12</sup>

<sup>9</sup> *Id.* § 824b(a)(2).

<sup>10</sup> Investment Adviser Order at n.28 (citing 42 U.S.C. § 16451(8)).

<sup>11</sup> The three public utilities are Reliant Energy, Inc., Sierra Pacific Power Company, and Aquila, Inc.

<sup>12</sup> Investment Adviser Order at P 31.

The FERC did “not see how Horizon could hold securities with the power to vote them if it did not gain possession or control of them, i.e., if it did not ‘acquire’ or ‘take’ them.”<sup>13</sup> The Commission also held that, although Horizon does not acquire all of the rights inherent in owning securities when it directs the acquisition of such securities on behalf of its Account Holders, the fact that Horizon acquires the voting rights associated with those securities is sufficient to make Horizon’s activities fall within the definition of “purchase, acquire, or take,” and, therefore, subjects Horizon to the requirements of FPA section 203(a)(2) to the extent it acquires the voting rights in a public utility or public utility holding company’s securities that are valued in excess of \$10 million. The Commission concluded that, because Horizon is a public utility holding company, and because it “purchases, acquires or takes” securities in other public utilities or public utility holding companies, the Commission has jurisdiction over such transactions, and it rejected Horizon’s request for a disclaimer of jurisdiction.

#### **B. Request in the Alternative for Blanket Authorization under Section 203**

As an alternative to its request for a disclaimer of jurisdiction under FPA section 203, Horizon requested blanket authority under section 203(a)(1)<sup>14</sup> for utilities or holders of utility voting securities to sell such securities to Horizon or, on behalf of the Account Holders, to entities acting on the basis of Horizon’s instructions or advice subject to certain conditions. The FERC dismissed this request for authorization under FPA section 203(a)(1) as unnecessary because, with the conditions it imposed in granting Horizon’s request for section 203(a)(2) authorization, such sales would not result in the change in control of a public utility or jurisdictional facilities, or the sale, lease or merger of a public utility or jurisdictional facilities. However, the FERC granted Horizon’s request for blanket authorization under section 203(a)(2) for three years.

FPA section 203(a)(2) requires public utility holding companies to obtain FERC authorization before acquiring securities in a public utility or public utility holding company valued in excess of \$10 million. However, public utility holding companies are granted a blanket authorization to purchase, acquire or take any voting security in a public utility, or a holding company in a holding company system that includes a public utility if, after the acquisition, the holding company will own less than 10 percent of the outstanding voting securities.<sup>15</sup> Prior FERC authorization is required under section 203(a)(2) when, in such circumstances, a public utility holding company acquires 10 percent or more of the voting securities valued in excess of \$10 million.

In granting Horizon’s request for blanket authorization to acquire up to 19.99 percent of the voting securities in a transmitting utility, an electric utility or a public utility holding company, the FERC analyzed the effect the transactions would have on competition, rates and regulation, and whether they would result in cross-subsidization. The Commission held that Horizon demonstrated that the

---

<sup>13</sup> *Id.* at P 32.

<sup>14</sup> That section provides that “No public utility shall, without first having secured an order of the Commission authorizing it to do so – (A) sell, lease, or otherwise dispose of the whole of its facilities subject to the jurisdiction of the Commission, or any part thereof of a value in excess of \$10,000,000.” 16 U.S.C. § 824b(a)(1)(A).

<sup>15</sup> 18 C.F.R. § 33.1(c)(2)(ii).

transactions subject to the blanket authorization would not affect competition. In reaching that conclusion, the Commission relied upon a number of commitments Horizon made in its Application, including the commitment to continue filing Schedule 13G, which, along with the associated regulatory and enforcement regime administered by the SEC, will ensure that Horizon will not exercise control over public utilities or public utility holding companies. The Commission also relied on Horizon's proposal to include language in its Form ADV<sup>16</sup>, its Policies and Procedures Manual, its annual letter to Account Holders and all future Account Holder Agreements that will state that Horizon will not exercise the shareholder voting rights delegated by Account Holders to exercise control over any public utility or any public utility holding company. The Commission reasoned that these proposals, when implemented, would subject Horizon to potential legal action by both the SEC and the Account Holders, as well as appropriate action by the Commission, if it violated its proposals.

The FERC also relied on Horizon's commitment to restrict the holdings of the voting securities of any public utility or public utility holding company to less than 10 percent in any individual Horizon account and to no more than 19.99 percent for Horizon or any affiliated entity having voting power, since these conditions are similar to limits on ownership that the Commission has placed on holdings of public utilities or public utility holding companies by firms that are investment advisers or engage in similar activities.<sup>17</sup> The Commission also accepted Horizon's commitments to (a) exercise its voting power in a way that is consistent with its fiduciary duties to its Account Holders and maintain readily auditable records of the voting of the shares; (b) file contemporaneously with the Commission a copy of relevant Schedule 13G filings made to the SEC and file with the Commission any comment or deficiency letters received from the SEC; (c) provide the Commission with quarterly reports of security holdings of public utilities and public utility holding companies; and (d) reflect any changes in the information provided on the initial Schedule 13G in an annual amended filing due within 45 days of the end of each calendar year. The Commission found that, with implementation of the above-described conditions, Horizon will be unable to exercise control over the public utilities and public utility holding companies whose securities are acquired under the blanket authorization requested under FPA section 203(a)(2), so the transactions under that blanket authorization will have no adverse effect on competition.

The FERC found that the transactions under the blanket authorization requested by Horizon under FPA section 203(a)(2) will not have an adverse effect on rates because Horizon will not acquire or exercise control over any public utility, so it will have no role in the setting of rates by such entities, and the acquisition of securities will not affect the market-based or cost-based rates of the public utilities in which the Account Holders will be investing. The Commission held that the transactions under the blanket authorization will not have an adverse effect on regulation because the acquisition will not result in any change in the activities, corporate structure or control of a public utility that might affect its jurisdictional status under either federal or state law. Finally, the Commission held that the transactions under the blanket authorization will not result in cross-subsidization or the pledge or

---

<sup>16</sup> A Form ADV is a SEC form used to register an investment adviser under the Investment Advisers Act of 1940. 15 U.S.C. 80b-1 *et seq.*

<sup>17</sup> Investment Adviser Order at P 47.

encumbrance of utility assets for the benefit of an associate company because Horizon and the Account Holders will be non-controlling investors in public utilities with no ability improperly to cause or direct the utilities in which they have an interest to cross-subsidize their non-utility associate companies or to pledge or encumber their assets.

The FERC denied Horizon's request for a permanent blanket authorization and, instead, granted Horizon's blanket authorization for a three-year period, which the Commission found will balance Horizon's need to operate under the requested authorizations with the Commission's duty to provide adequate regulatory oversight under FPA section 203, particularly as the Commission continues to gain experience with section 203(a)(2) authorizations.

The FERC held that, if a public utility holding company acquires securities in a public utility or another public utility holding company without prior Commission authorization, it is acting in violation of statutory requirements. Therefore, the Commission denied the request for retroactive approval under FPA section 203(a)(2) of Horizon's holdings in excess of 10 percent of the voting shares of Reliant, Sierra Pacific and Aquila. However, because the Commission recognized that, prior to its issuance of the Investment Adviser Order, it had not directly or clearly addressed the scope and meaning of "purchase, acquire, or take any security" clause of section 203(a)(2), the Commission declined to impose sanctions on Horizon for failing to obtain advance Commission approval.

However, the FERC warned that, now that it has clarified its jurisdiction, any similar companies that acquire or hold securities on behalf of account holders are on notice that the Commission considers the types of transactions described in Horizon's Application to be jurisdictional under FPA section 203(a)(2), thus requiring prior authorization. Importantly, the Commission provided all investment companies and advisers the opportunity to file within 90 days of the date of the publication of the Investment Adviser Order in the *Federal Register* an application requesting such authorization. After that time, the failure to make a timely filing may result in subjecting the entity in question to sanctions.

## II. PUHCA CLARIFICATION ORDER

In its PUHCA Clarification Order, the FERC clarifies and provides guidance on certain filings that need to be made pursuant to the Commission's regulations under PUHCA 2005,<sup>18</sup> which currently require persons meeting the definition of a public utility holding company set forth at 18 C.F.R. § 366.1 (2008)<sup>19</sup> to notify the Commission of their status no later than 30 days after they become a holding company.<sup>20</sup> PUHCA 2005 also provides exemptions from, or waivers of requirements applying to, holding companies, and companies receiving these exemptions and waivers are required to notify the Commission of material changes in facts that may affect the exemption or waiver.<sup>21</sup>

---

<sup>18</sup> 42 U.S.C. § 16451, *et seq.*

<sup>19</sup> The FERC's regulations generally describe a public utility holding company as "[a]ny company that directly or indirectly owns, controls, or holds, with power to vote, 10 percent or more of the outstanding voting securities of a public-utility company or of a holding company of any public-utility company . . . ." 18 C.F.R. § 366.1.

<sup>20</sup> *Id.* § 366.4(a)(1).

<sup>21</sup> *Id.* §§ 366.3, 366.4(d).



The PUHCA Clarification Order explains that there are a number of entities that qualify for exemptions to PUHCA 2005's regulations, including certain passive investors and utility operating companies, as well as certain classes of transactions.<sup>22</sup> These entities are exempt from the FERC's books and records regulations, as well as the Commission's accounting, record-retention and reporting requirements.<sup>23</sup> To receive an exemption, a person must file an exemption notification, *i.e.*, FERC-65A, and the exemption is deemed granted if the Commission does not act within 60 days.<sup>24</sup> Persons that do not qualify for an exemption under the regulations may petition for a declaratory order granting one. The PUHCA Clarification Order also explains that the waivers provided under PUHCA 2005 "apply to holding companies that have single-state holding company systems, as defined in section 366.3(c)(1) of the Commission's regulations, as well as investors in independent transmission-only companies and holding companies with 100 MW of generation or less that is used for their own load or sales to affiliated end users."<sup>25</sup> To receive a waiver, qualifying holding companies must file a waiver notification, *i.e.*, FERC-65B.<sup>26</sup>

The FERC further explains that, if there are any material changes in facts that may affect the exemption or waiver, the Commission must be notified within 30 days of the material change. At that time, the person or entity must (a) submit a new FERC-65A, FERC-65B or petition for declaratory order; (b) file a written explanation of why the material change in facts does not affect the exemption or waiver; or (c) notify the Commission that it no longer seeks to maintain the exemption or waiver.<sup>27</sup> These regulations do not specifically state when a notification is required other than for an exemption or waiver.

In its order, the FERC clarifies one type of change in facts that should *in all cases* be subject to a notification:

If a holding company that has previously filed an exemption or waiver notification, *i.e.*, FERC 65A or FERC 65B, or that has received an exemption or waiver through a declaratory order, becomes a holding company with respect to an *additional* public-utility company or holding company of any public-utility company (*i.e.*, obtains the power to vote 10 percent or greater of the voting securities of an *additional* company), that holding company should file with the Commission a notification of material change in facts that describes the additional public utility company or holding company of any public-utility company and otherwise comply with the requirements of section 366.4(d)(1) of the Commission's regulations by selecting one of the three possible courses of action set forth in that section. This filing should be made *whether or not* a change has occurred with respect to the basis on which the exemption or waiver was granted.<sup>28</sup>

<sup>22</sup> PUHCA Clarification Order at P 2.

<sup>23</sup> 18 C.F.R. § 366.3.

<sup>24</sup> *Id.* § 366.4(b).

<sup>25</sup> PUHCA Clarification Order at P 3.

<sup>26</sup> 18 C.F.R. § 366.4(c).

<sup>27</sup> PUHCA Clarification Order at P 4.

<sup>28</sup> *Id.* at P 5.

The PUHCA Clarification Order allows all holding companies subject to this clarification to file within 45 days of publication in the *Federal Register* a notification of change in material facts updating the Commission on “any investments of 10 percent or more of the voting securities of a public-utility company or holding company of a public-utility company since the time the exemption or waiver was granted.”<sup>29</sup>

## CONTACT INFORMATION

If you have any questions concerning this alert, please contact—

G. Philip Nowak .....	202.887.4533 .....	pnowak@akingump.com .....	Washington, D.C.
Nadine A. Moustafa .....	202.887.4153 .....	nmoustafa@akingump.com .....	Washington, D.C.

---

<sup>29</sup> *Id.* at P 6.