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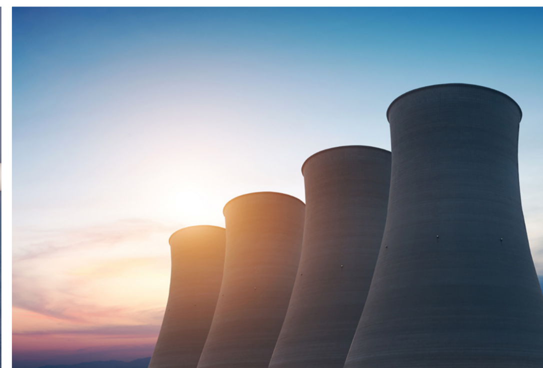
Current Topics in the Power and Utilities Capital Markets



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Utility Financing Orders: A Quick Guide to the Federal and State Framework

In utility sector financings, a common preliminary question is whether the issuer has received all necessary federal and state-level approvals for the offering. The answer to this question is often not as straightforward as one might hope. The relevant federal and state regulatory frameworks have undergone significant change since the advent of the modern electric utility over a century ago. In this article, we set aside the general considerations of the federal securities laws and attempt to outline the basic industry-specific framework applicable to the offering of securities by electric utilities and their holding companies.[1]

Federal Power Act Section 204

The Federal Energy Regulatory Commission (FERC) has jurisdiction under the Federal Power Act[2] (FPA) over the issuance of securities[3] by public utility companies subject to FERC's jurisdiction. FERC also mandates that public utilities file with FERC documentation regarding "cash management" or "money pool" arrangements.

A "public utility" for these purposes is any entity that "owns or operates facilities subject to the jurisdiction of FERC."[4] Jurisdictional facilities are those involving the "transmission of electric energy in interstate commerce and to the sale of electric energy at wholesale in interstate commerce."[5]

1 This article is limited to certain considerations with respect to the "issuance" of securities by public utility companies. We do not cover the "assumption" of securities by public utility companies or the "acquisition" by a public utility company or a holding company of securities issued by a public utility company.

2 16 U.S.C. § 791a et seq.

3 "Security" in this instance means any note, stock, treasury stock, bond, debenture, or other evidence of interest in or indebtedness of a corporation subject to the provisions of the Federal Power Act. 16 U.S.C. § 796(16). A discussion of either (1) the historical interpretation by FERC of certain defined terms in the Federal Power Act as well as (2) the potential conflict of terms used in both the Federal Power Act and state law are beyond the scope of this article.

4 16 U.S.C. § 824(e).

5 16 U.S.C. § 824(b)(1).

Exemptions

There are two exceptions to the general rule that all securities issuances by public utilities must be approved by FERC. First, small amounts of short-term debt can be issued without approval. This is a limited exemption. The aggregate amount of such short-term debt cannot be more than five percent of the par value[6] of the other securities of the public utility then outstanding.

The second exemption is more broad. A public utility need not receive FERC approval if a state utility commission has jurisdiction to approve the issuance and has done so.[7] One limitation on this second exemption, however, is that the utility must be organized under the law of the state that provides the securities issuance approval.[8] [9]

Applicants for a financing order from FERC generally seek FERC approval to issue identified types of securities, up to a specified maximum amount and for a period of two years. While an applicant is permitted to seek approval of a particular transaction, FERC will approve these "shelf" applications that give the public utility the authority to issue the identified securities from time to time over the two year period.[10]

Although repealed by the Energy Policy Act of 2005, the Public Utility Holding Company Act of 1935 (1935 Act) for many decades had required "competitive bidding" when public utility subsidiaries of holding companies registered under the 1935 Act issued securities.[11] Today, applicants for long-term debt authorizations from FERC usually request waiver of FERC's competitive bidding and negotiated placement requirements.[12] These waiver requests are routinely granted. The FERC requirements are designed to prevent excessive fees or self-dealing.

6 In the case of securities having no par value, the par value for the purpose of this calculation is the fair market value as of the date of issue. See 16 U.S.C. § 824c(e).

7 16 U.S.C. § 824c(f)

8 *Id.*

9 Query whether FERC's jurisdiction under the FPA extends to a public utility that is organized and operating in a state that regulates its securities issuance and also operates in other states that do not regulate its securities issuances. While the plain language of the statute suggests that FERC would not have jurisdiction in such instance, see also Southwest Power Pool, Inc., Docket No. ES07-40-000, addressing this issue in the RTO context.

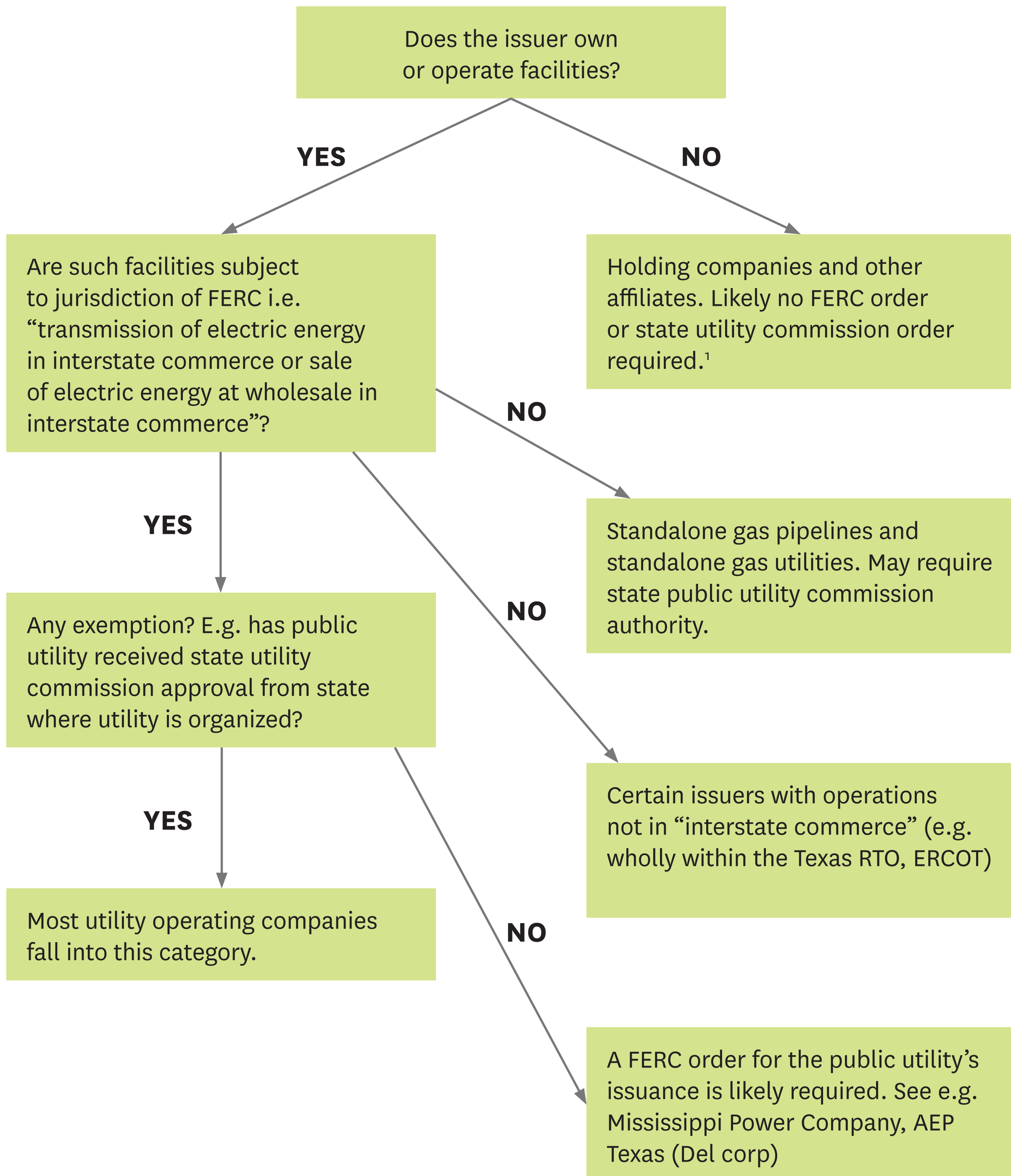
10 Since 2003, FERC has included in every authorization order to securities issuance a set of conditions, known as the "Westar" conditions, designed to address potential risks to public utility ratepayers. See 102 FERC ¶ 61,186 (2003). These conditions are designed to ensure that indebtedness related to non-utility activities does not impair a utility's ability to provide its utility service. The conditions are as follows:

- Public utilities seeking authorization to issue debt secured by utility assets must use the proceeds of such debt for utility purposes only;
- If any utility assets that are used to secure debt issuance are divested or "spun-off," the debt must follow the asset and be divested or "spun-off" as well;
- If any of the proceeds from unsecured debt are used for non-utility purposes, the debt must follow the non-utility assets;
- If the non-utility assets are divested or "spun-off," then a proportionate share of the debt must follow the divested or "spun-off" non-utility assets; and
- If utility assets financed by unsecured debt are divested or "spun-off" to another entity, then a proportionate share of the debt must also be divested or "spun-off".

11 The impact of the 1935 Act-mandated competitive bidding process continues to this day. Certain utility holding companies have adopted the competitive bid—mainly in "bought" equity and equity-linked transactions. This is due to a perceived benefit in pricing. Furthermore, the underwriting documents for many utility systems are derived directly from the competitive bid papers from the 1980s and 1990s. During that time, the bid papers were given to the underwriters on a take-it-or-leave-it basis. There was little, if any, negotiation. As a result, the bid papers were issuer-friendly agreements. For certain utility systems, their modern underwriting agreements have not moved much since the days of competitive bidding.

12 18 C.F.R. § 34.2.

Is either a FERC order or state public utility commission order required for the financing?



1. Note that while most public utility holding companies are not subject to FERC jurisdiction for securities issuances, there are a few instances of US holding companies which require state utility commission authorization for securities issuances.

Short-Term Debt

One complicating factor to the above flow chart is the issuance of short-term debt. The state utility commissions of most states regulate the issuance of equity securities and long-term debt. Fewer states regulate the issuance of short-term debt. In the case of states that do not regulate short-term debt, electric utilities routinely seek FERC approval of short-term debt programs. For example, a public utility that participates in a cash management or money pool agreement that includes issuance by it of securities (i.e. borrowing under the agreement) will usually seek FERC approval for these short-term borrowings in a shelf application (unless, of course, it is required to get state commission approval for these short-term borrowings, which would then be exempt from FERC approval).

State Commission Applications and Orders

When public utility operating companies apply to a state public utility commission for financing authorization, the application will generally set forth the types of securities to be offered, parameters for the interest rate or rates to be used and any limitation thereon, tenor, permitted underwriting discounts and the intended use of proceeds of the financings. At the outset of a new transaction, counsel will need to review the conditions set forth in any such order to make sure that the securities to be offered are contemplated by the financing order and application. Given the speed with which the most modern "technology" for an offering can change, any limitations in the financing order can be a trap for the unwary. For example, does the order permit rates to be set by LIBOR or SOFR? Does the financing order permit hybrid securities in addition to senior debt? In addition, the working group will need to ensure that the pricing terms in the offering are within the parameters set forth in the financing order (often with respect to interest rate caps, tenor, underwriting fee caps, etc).

Another wrinkle is provided by those states which require post-issuance filings/compliance reporting with the public utility commission. In most cases, deficiencies in such reporting will not call into question the validity of the securities. The practice point, however, is that these different state public utility commissions each have their own nuances with respect to approval, of which counsel and, in certain cases, the working group will need to be aware.

How about (1) holding companies of public utilities and (2) affiliates of public utilities?

As noted in the flow chart above, it's important to note that issuances of securities by ***holding companies*** and also by ***affiliates*** of public utilities do not require section 204 authorization, unless those companies also happen to also be "public utilities" (i.e. any entity that owns or operates facilities subject to the jurisdiction of FERC, which are those involving the "transmission of electric energy in interstate commerce and to the sale of electric energy at wholesale in interstate commerce.") As such, a gas distribution business that is also part of an electric utility will be subject to the Section 204 analysis described above.

How about gas pipelines and gas distribution companies?

Issuances of securities by standalone gas pipelines and standalone gas utilities are generally not subject to FERC's oversight with respect to financing orders. See the flow chart above. Such gas companies may, however, require state public utility commission authority for securities issuances. That being said, to the extent that an individual issuer's operations include both gas operations and power operations, FERC may very well have jurisdiction under FPA Section 204 as discussed above.

Are there any Blue Sky implications with respect to this analysis?

It is also important to note that the state-level utility commission authorizations with respect to the issuance of securities can also have consequences under the blue sky statutes of various states. State blue sky laws can impose registration or notice requirements for a securities offering unless the offering qualifies for an exemption. In the power sector, many offerings rely upon the "public utility" exemption contained in many state blue sky statutes. A standard formulation (in this case, from the Uniform Securities Act of 2002[13]) is provided below:

5. A security issued or guaranteed by a railroad, other common carrier, public utility, or public utility holding company that is any of the following:
    a. Regulated in respect to its rates and charges by the United States or a state.
    b. Regulated in respect to the issuance or guarantee of the security by the United States, a state, Canada, or a Canadian province or territory.
    c. A public utility holding company registered under the Public Utility Holding Company Act of 1935 or a subsidiary of such a registered holding company within the meaning of that act.

As is clear from the model statute, the fact that the securities issuance of the public utility is regulated by the United States or a state can qualify the offering for an exemption under a state blue sky statute.

Conclusion

The federal and state framework for financing orders in the power sector continues to evolve. On any power sector issuance, the working group is well advised to identify, early in the process, which approvals are required both for the particular issuer and the particular security and any relevant limitations in those approvals.

13 Even in states that have adopted the Uniform Securities Act, it is important to review each state's blue sky laws as there may be variations that are state specific.

Debt Reopeners: A Restated Utility Quick Reference

As discussed in our June 2012, June 2013 and April 2017 issues, "reopeners" of debt securities remain a popular financing tool for many issuers. In this financing technique, an issuer offers additional securities of an existing series of debt rather than offer a new series with different terms. This financing technique is known by several different names, including "reopener," "reopening," "add-on," "tack-on" or "tap." Regardless of the name, the procedure is the same. The "reopened" securities must have the same terms (maturity, coupon, interest payment dates, exchange listing, redemption provisions, etc.) as the originally issued securities. With the interest rate already fixed, a discount or premium in the selling price is needed to produce a yield reflecting the current market. Finally, if the issuance of the additional securities occurs after the first interest payment date on the outstanding securities, the initial interest payment date will differ. Additional securities issued pursuant to a reopener should trade fungibly with the originally issued securities. Reopeners are attractive to issuers looking to capitalize on debt securities that are trading strongly in the market and to take advantage of set pricing in a more volatile environment.

Why Reopen?

There are several reasons why issuers often want to reopen a series of debt securities, as opposed to issuing a new series. Unlike equity issuances, debt offerings do not typically include an option permitting underwriters to purchase additional securities within a specified period of time (a "green shoe"). A reopening, however, can satisfy additional investor interest in an issuer's debt offering. Unexpected investor demand may be a motivation for an immediate reopening of a recently issued series of securities, but reopenings are not limited to the typical 30-day green shoe option exercise period. For an issuer requiring new funds, but less than $300 million principal amount, liquidity is another driving force behind the popularity of reopeners. Debt securities that are "index eligible" have more market information readily available to investors and are more liquid. In order to be "index eligible" (i.e., eligible to be included in the Barclays Capital US Aggregate Bond Index) a debt issue must aggregate at least $300 million principal amount. A series of securities that is "index eligible" will likely receive more favorable pricing terms than a non-"index eligible" series of securities. So, if an issuer seeks to issue less than $300 million principal amount or if an original issuance was less than $300 million principal amount, a reopener may result in a combined series greater than $300 million and therefore cause the series to be "index eligible."

Process and Items to Consider

An issuer interested in pursuing a "reopener" will need to review the legal documentation underlying the initial issue of securities to ensure that the indenture (or other operative document pursuant to which the debt was issued) permits the issuance of reopened debt without the consent of the holders of the original series. The offering document for the original issuance should also disclose the issuer's ability to increase the principal amount and issue additional securities of such series.

A reopener that is registered under the Securities Act of 1933 is basically a routine takedown from the shelf registration statement.[1] The reopener prospectus should be near-identical to that from the original issuance, but any reopening needs up-to-date disclosure (risk factors, issuer developments, financial data, etc.). The reopener prospectus should also include a description of the reopening on the cover page, set out the details of the previously sold securities and note the formation of a fully fungible single series.

1 Reopenings of Rule 144A transactions can present a tricky issues. If an issuer reopens an original series of securities that were offered under Rule 144A under the Securities Act, the "restricted period" for the original securities will be restarted, as it will be impossible to distinguish between the originally issued and newly issued securities.

Investors who purchase reopened debt are required to pay, as part of the purchase price, accrued interest. The amount of the accrued interest depends on the date of the reopening issuance. In the case where the reopened debt will be issued prior to the first interest payment date following the original issuance, the purchasers will need to pay accrued interest for the period beginning on the date of the issuance of the original securities to, but not including, the date of issuance of the reopened debt. Alternatively, if the reopened debt is issued after an interest payment date on the original issuance of debt, purchasers of the reopened debt will need to pay accrued interest for the period beginning from the most recent interest payment date to, but not including, the date of issuance of the reopener.

Check the Record Dates

A record date is the date on which the holder of a debt security must be the "record holder" in order to receive interest payments. The record date in most instances is roughly two weeks before the interest payment date and is memorialized in the indenture (as well as disclosed in the offering document).

A potential record date issue may arise with respect to the payment of accrued interest on reopeners if the reopened debt securities are issued after a record date, but prior to the next interest payment date. In such instance, purchasers of the reopened debt securities (despite being issued and outstanding) will not be entitled to receive payment on the first interest payment because they were not holders of record on the record date.

The problem posed by this scenario is this: how does the trustee know who is entitled to interest payments on that first interest payment date. The holders of the reopened debt securities are not entitled to interest on that first interest payment date because they were not holders of record on the record date (the reopened bonds had not been issued yet). But the holders of the original bonds who owned the original debt securities on the record date are entitled to interest on that interest payment date. Given that the reopened debt securities and the original debt securities have identical terms (including CUSIPs), there are few practical ways that the trustee or DTC can discern as to which holders are entitled to interest and which holders are not on that interest payment date.

The easiest way to plan around this issue is to avoid reopeners that close between a record date and an interest payment date. So, whenever considering a reopener, check the record date of the original bonds immediately.

If the issuer cannot wait and needs to access the market at a time that is after the record date and before the next interest payment date, the problem can be avoided by scheduling the closing after the interest payment date. By doing so, the reopened debt securities will not be outstanding as of the interest payment date and, thus, will not be entitled to be paid interest on that day. If this route is chosen, the closing may need to extend beyond the normal T+2 to ensure that the issue closes after the interest payment date.

Other more complicated methods may be employed to avoid the record date issue (e.g. setting a special record date or establishing a separate temporary CUSIP for the reopened bonds). Our experience has been, however, that a more complicated fix requires more complicated disclosure. This may become a marketing issue as it potentially leads to more questions and concerns from investors.

Get the Date Count Right

In order for the reopened bonds to be fungible with the original bonds, investors purchasing the reopened bonds are required to pay, as part of the purchase price, any accrued interest on the reopened bonds. This accrued interest is the amount of interest that has accrued from the last interest payment date to, but excluding, the issuance date of the reopened bonds. (This payment is necessary (assuming the reopened bonds are holders of record for the next interest payment) because such days of accrued interest will nonetheless be paid as part of the full interest payment on the next interest payment date, but will not be owing to the holders of the reopened bonds).

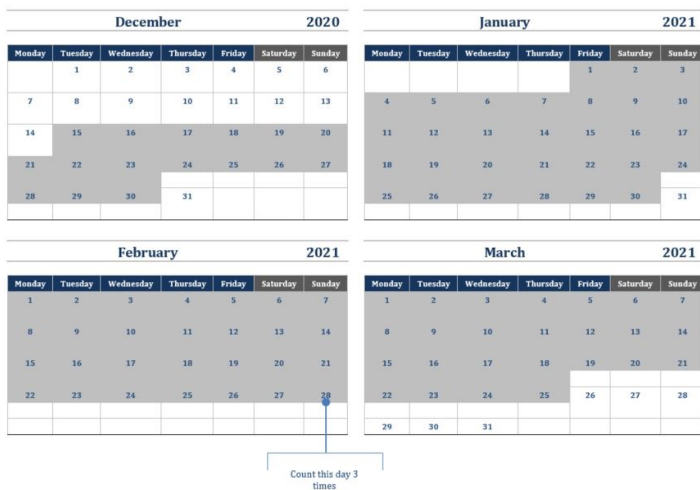
The indenture governing the debt securities typically contains terms outlining the manner in which interest accrues over time and how it is calculated. For fixed rate debt securities, accrued interest is computed on the basis of a 360-day year consisting of twelve 30-day months. So, when counting the number of days for a full month period in which interest was accruing, the number of days will always be 30, whether it is February (28/29 days) or March (31 days).

It gets a little more interesting for partial months. For a partial month that starts on the first day of the month, the accrued interest day count is calculated based on the actual number of days that has elapsed during that month to, but excluding, the issuance date of the reopened debt securities. For a partial month that includes the last day of the month, the accrued interest day count is calculated by subtracting (i) the actual number of days that have passed during that month to, but excluding, the last interest payment date from

(ii) 30 days. If there are more days in the calendar month period than 30 days, the extra days do not earn interest.

If there are less days in the calendar month period than 30 days, then the last day counts as many times as necessary in order to get to 30 days of interest.

Using the accrued interest day count formulation above, let's assume that an offering of the reopened bonds closed on March 26, 2021 and the last interest payment date was December 15, 2020. The total number of days that elapsed since the last interest payment date are, for interest calculation purposes, 101 days. This means that investors who purchase the reopened bonds will need to pay 101 days of accrued interest on the reopened bonds. For the partial month of December, 14 days (the actual number of days that has passed since the last interest payment date) will be subtracted from 30 days, resulting in 16 days of accrued interest. For each month of January and February, 30 days of interest will have accrued. For the partial month of March, interest will have accrued for 25 days, the actual number of days that have elapsed to (but not including) the issuance date. See the calendar below for an illustration of the hypothetical day count calculations.



Special Circumstances

Below we discuss reopening concerns with respect to (1) 144A transactions, (2) Environmental, social and corporate governance ("ESG")/ green bonds and (3) debt securities where the interest rate is pegged to the Secured Overnight Financing Rate ("SOFR") as a replacement to LIBOR.

144A

The question arose whether it was possible to reopen a series in a private transaction where the original issuance had already been registered through an Exxon Capital A/B exchange offer. An Exxon Capital A/B exchange offering is a procedure under which securities are privately placed pursuant to Rule 144A and then promptly exchanged for similar securities that have been registered under the Securities Act. The SEC staff's positions in this area come from a series of no-action letters: Exxon Capital Holding Corp. (available May 13, 1988); Morgan Stanley & Co. Incorporated (available June 5, 1991); K-III Communications Corporation (available May 14, 1993); and Shearman & Sterling (available July 2, 1993).

Assuming the documents that established the securities permit the reopening and absent any tax issues (as discussed later), the answer is yes.

One question is whether, in such a case, the issuer should establish a new 144A CUSIP and Regulation S CUSIP for the second offering. The concern is that adding the reopening securities to an existing private CUSIP could obfuscate the holding periods of any existing holders under Rule 144. If none of the original issuance was still held in the 144A or Regulation S CUSIP, the issue is moot. A related suggestion, however, is to involve the trustee for the series of notes, and the trustee's counsel, early in the offering process. The working group should have a clear vision of how the reopening will be mechanically structured and, post-exchange, what procedures the trustee will take in order to add the reopened debt to the existing registered CUSIP. Another consideration is an integration of the public offering, the A/B exchange, with the subsequent private offering of the same series. However, new Rule 152 should, in most cases, provide a safe harbor for the reopener.

Although this scenario does not arise very often, after jumping through the appropriate hoops, little should prevent an issuer from effecting a 144A reopening after the original issuance has been exchanged for registered securities.

Green/ESG Bonds

There have been several reopeners of green bonds that were issued to fund specific green /sustainability projects. A number of green reopenings have also funded additional green projects that have been developed since the time of the original green issuance. In each of these cases, we believe there would be a conversation about the Use of Proceeds of the reopener to ensure that the additional projects were in line with the original offering. However, under the new "framework" method of issuing ESG bonds, it would seem abundantly clear that (absent any non-ESG hurdles) the particular series could be reopened. But a similar analysis

would still be advisable—making sure that the "Eligible Projects" in the reopener were consistent with the "Eligible Projects" of the original series.

SOFR

Recently, issuers and underwriters have become more comfortable using compounded SOFR to issue debt securities. In the context of reopenings, "compounded SOFR" (i.e. whereby the daily SOFR rate is compounded over the course of the just-completed interest period and then added to a transaction-specific applicable spread to determine the interest payment due) may present new challenges. SOFR is based on observable transactions and accordingly is necessarily a backward-looking rate. With SOFR, the issuer would look at the SOFR rates over the course of the interest period in order to determine the payment due at the end of that period. Since the interest due for the current three month period is not known until the end of such period, calculating accrued interest due upon the closing of a reopener is bound to present challenges.

Tax Considerations

For the reopened securities to be fungible with the original issuance, they must have the same tax characteristics. If both the original issuance and the reopened securities are issued with no more than a *de minimis* amount of original issue discount, as long as the securities otherwise have identical terms, they should have the same tax characteristics, even if they technically are not part of the same "issue" for tax purposes. What is a *de minimis* amount of original issue discount (OID)? In general, OID is treated as *de minimis* if it is less than **(not equal to)** ¼ of 1 percent (25 basis points, or 0.25%) of the stated redemption price at maturity (which presumably is par), multiplied by the number of complete years to maturity.[2]

To illustrate this point, let's assume that bonds to be reopened in December 2021 mature on June 15, 2051, and the original bonds were issued on June 1, 2021. The bonds have 29 complete years before the maturity date. Using the OID formulation above, 29 is multiplied by 0.25%, resulting in 7.25%. The OID must be less than (but not equal to) 7.25%. On a recent reopener (in a volatile bond market), one basis point in the floor price mattered.

The tax considerations for a reopening are more complicated if either the original issuance was issued with OID or the reopened bonds will be sold with more than a *de minimis* amount of OID. At the end of September 2012, the Internal Revenue Service (IRS) issued final regulations (the Final Regulations) that make it easier to issue fungible tack-on debt instruments in situations where either the original debt instruments or the tack-on debt instruments are issued with OID for tax purposes.

First, if the securities are issued within twelve (12) days of each other they would fall under the "same issue" safe harbor if the two issues (i) have the same credit and payment terms; (ii) are sold either pursuant to a common plan or as a part of a single transaction or a series of related transactions; and (iii) the additional debt instruments are issued within a period of thirteen (13) days beginning with the issue date of the original debt instruments.

Second, if the securities do not fall under the 12-day safe harbor, an additional debt security issued with the same terms as an original debt security will generally be treated as a "qualified reopening"[3] of the original debt security if any of the following three tests is satisfied:

1. The additional debt is issued without OID (or with less than *de minimis* OID), and either (i) the original debt is publicly traded for tax purposes; or (ii) the additional debt is issued for cash to unrelated parties for an arm's-length price.

2. The additional debt is issued within six months of the issue date of the original debt, and either (i) the original debt is publicly traded for tax purposes and the yield on the original debt (based on its fair market value) does not exceed 110% of the yield on the original debt on the issue date of the original debt (or coupon rate, if it was issued without OID); or (ii) the additional debt is issued for cash to unrelated parties for an arm's-length price and the yield on the additional debt (based on its cash purchase price) does not exceed 110% of the yield on the original debt on the issue date of the original debt.

2 U.S. Code Section 1273(a)(3).

3 If both the original debt instruments and the additional debt instruments are issued with identical terms under the same indenture but without OID (or with less than a de minimis amount of OID), the issuer's reporting of income on the debt instruments to the holders, as well as the holder's accrual of interest income on the debt instrument, will be the same regardless of whether the additional debt is issued in a qualified reopening. In such a case, there is generally no reason to distinguish between the original debt instrument and the additional debt instrument for purposes of reporting or accrual of OID. As a result, when both the original debt instruments and the additional debt instruments are issued under the same indenture but without OID (or with less than a de minimis amount of OID), they should be treated as fungible for tax purposes in the market and given the same CUSIP, whether or not the additional debt instruments are issued in a qualified reopening. This "practical" fungibility has been relied on by many issuers when issuing additional debt instruments that did not technically meet the definition of a "qualified reopening."

3. The additional debt is issued more than six months after the issue date of the original debt, and either (i) the original debt is publicly traded for tax purposes and the yield on the original debt (based on its fair market value) does not exceed 100% of the yield on the original debt on the issue date of the original debt (or coupon rate, if it was issued without OID); or (ii) the additional debt is issued for cash to unrelated parties for an arm's-length price and the yield on the additional debt (based on its cash purchase price) does not exceed 100% of the yield on the original debt on the issue date of the original debt (or coupon rate, if it was issued without OID).

A debt instrument is generally treated as "publicly traded" under the Final Regulations if there is a price quote, including an indicative quote, from at least one broker, dealer or pricing service during the 31-day period ending 15 days after the measurement date (unless, at the time of the determination, the outstanding stated principal amount does not exceed $100 million, in which case, such debt instrument is considered not to be "publicly traded").

Under the Final Regulations, given the expanded definition of the term "publicly traded" and the alternative cash issuance requirement, additional debt instruments issued with no OID would normally satisfy conditions for a qualified reopening of the original debt instruments. As a result, when neither the original debt nor the additional debt is issued with OID, the issuers should generally be able to treat the additional debt as a qualified reopening of the original debt, rather than relying on the "practical" fungibility, in order to achieve fungibility for tax purposes.

Flying As They Run: Split Emerges Between Banks and Corporates on Compound SOFR

As the future of LIBOR became less and less certain, some financial issuers began to issue floating rate bonds based on SOFR in 2020. Most floating rate SOFR debt deals use a daily SOFR rate in order the make interest calculations. As such, issuers needed to wait until the end of a quarterly interest period before calculating SOFR based on the daily rates of the prior three months.

The "backward looking" nature of the SOFR rate prompted several different formulations in order to both (1) calculate the rate and (2) make the interest payment on time at the end of the quarter. "Payment delay" involved just that—delaying the interest payment until the rate from the past quarter could be calculated. "Suspension period" used the rate in effect several business days before the end of the quarter as the relevant rate for the final days in the quarter. But among both banks and corporates, the most common formulation quickly became the "Observation Shift". "Observation Shift" involves looking at an earlier period of daily SOFR rates (for both averaging of the rate and weighting of that rate) such that the interest calculations may be made in time for the upcoming interest payment date.

One of the first corporate issuers to issue floating rate bonds with a compound SOFR rate was Verizon Communications Inc. (Verizon) on March 11, 2021. As part of a $25 billion notes offering, Verizon priced two different series of floating rate debt based on SOFR. As stated in the Verizon prospectus:

> As further described herein, on each Interest Payment Determination Date relating to the applicable Floating Rate Interest Payment Date, the calculation agent will calculate the amount of accrued interest payable on the applicable floating rate notes for each interest period by multiplying (i) the outstanding principal amount of the applicable floating rate notes by (ii) the product of (a) the interest rate for the relevant interest period multiplied by (b) the quotient of ***the actual number of calendar days*** in such Observation Period divided by 360. [emphasis added]

Of interest is that, in Verizon, (and unlike day counts in "traditional" floating rate bonds) the day count for the relevant interest period keys off of the number of calendar days in the Observation Period. Moreover, the "date rolling" convention in Verizon may be described as "Modified Following Unadjusted".

> If any Floating Rate Interest Payment Date falls on a day that is not a business day, as defined below, we will make the interest payment on the next succeeding business day unless that business day is in the next succeeding calendar month, in which case (other than in the case of a maturity date) we will make the interest payment on the immediately preceding business day. If an interest payment is made on the next succeeding business day, no interest will accrue as a result of the delay in payment.

This is in contrast to the "date rolling" formulation in most traditional floating rate bonds (which are often described as issued on a "Modified Following Adjusted" basis.)[1]

Many bank and financial issuers over the past year have used a different formulation which follows more closely the day counts and "date rolling" of traditional floating rate bonds. In the SOFR calculation in these bank/financial issuers, the SOFR rate is still based on the days in the relevant "Observation

1 In many debt products, "date rolling" occurs when a payment day or date used to calculate accrued interest falls on a weekend or holiday. Common formulations are provided below:

> **"Following"**, any payment due on such date shall be postponed to the next day that is a Business Day;
> **"Modified Following"**, any payment due on such date shall be postponed to the next day that is a Business Day; provided that if such next succeeding Business Day falls in the next calendar month, then such date shall be advanced to the immediately preceding Business Day;
> **"Following Unadjusted"**, any payment due on such date shall be postponed to the next day that is a Business Day; provided that interest due with respect to such Interest Payment Date shall not accrue from and including such Interest Payment Date to and including the date of payment of such interest as so postponed; provided further that the Interest Periods shall not be adjusted for non-Business Days; ***(very common in fixed rate corporate bonds)***
> **"Modified Following Unadjusted"**, any payment due on such date shall be postponed to the next day that is a Business Day; provided that interest due with respect to such Interest Payment Date shall not accrue from and including such Interest Payment Date to and including the date of payment of such interest as so postponed; and provided further that, if such day would fall in the next succeeding calendar month, the date of payment with respect to such Interest Payment Date shall be advanced to the Business Day immediately preceding such Interest Payment Date; and provided further that the Interest Periods shall not be adjusted for non-Business Days.
> **"Following Adjusted"**, any payment due on such date shall be postponed to the next day that is a Business Day and the coupon period end date is adjusted to include the next Business Day, and the owner of the security is compensated for the extra day(s) of interest.
> **"Modified Following Adjusted"**, the coupon period end date is adjusted to include the next Business Day, unless the next Business Day falls in the next calendar month; in such a case, the coupon end date are adjusted back to the first Business Day preceding the non-Business Day. The owner of the bond is compensated for the extra day(s) of interest accrued if the bond is paid on the next Business Day, or not compensated in the event that the bond is paid earlier. ***(very common in floating rate corporate bonds)***

Period," but the days in the relevant interest period are calculated much like any other floating rate bond. This may be referred to as "Modified Following Adjusted".

Interestingly, the Alternative Reference Rates Committee (ARRC), a group of private-market participants convened by the Federal Reserve Board and the New York Fed to help ensure a successful transition from LIBOR, contemplated this difference in structure/calculation in 2019. In the "Appendix to SOFR Floating Rate Notes Conventions Matrix" (Appendix) in November 2019, the ARRC included a section "Key Provisions for Compounded SOFR FRN with Observation Period Shift". The ARRC Appendix calculated interest for floating rate notes with Observation Period Shift as follows:

Interest Amount: The amount of interest accrued and payable on the notes for each Interest Period will be equal to the product of (i) the outstanding principal amount of the notes multiplied by (ii) the product of (a) the Rate of Interest for the relevant Interest Period multiplied by (b) the quotient of the actual number of calendar days in such Interest Period divided by 360.

However, footnote 12 to the ARRC Appendix provides as follows:

> As an alternative, the Rate of Interest could be multiplied by the number of days in the relevant Observation Period dividend by 360 (i.e. "(b) the quotient of the actual number of calendar days in such Observation Period divided by 360"). This would result in a calculation of interest payable for the Interest Period being equal to the value of a swap calculated over the Observation Period. Note that additional changes to the term sheet may be needed to accommodate this alternative.

It does appear that the two different formulations considered by the ARRC in 2019 have indeed found their way into a number of SOFR floating rate deals. What remains to be seen, however, is if either formulation becomes the "market standard" in the debt capital markets at some point in the future.

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