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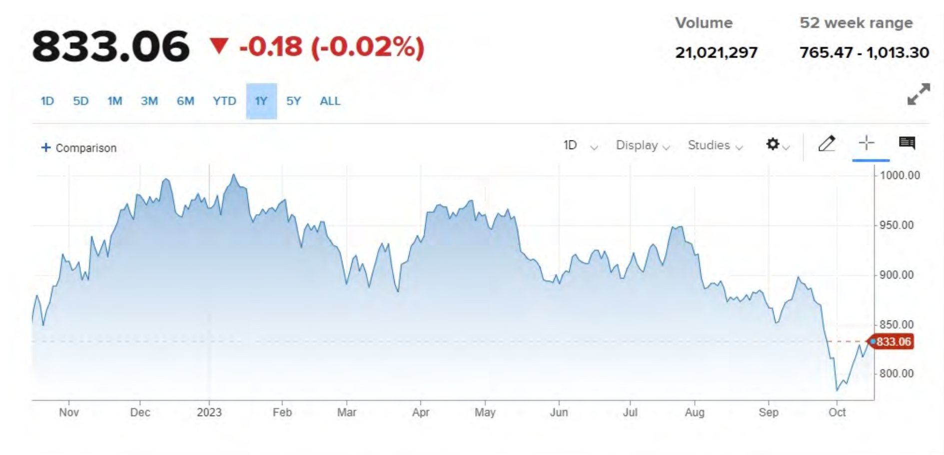
SHARE PRICES UNDER PRESSURE, UTILITY EXECS HEAD TO EEI

The chart[1] below shows the performance of the Dow Jones Utility Average, which tracks the performance of 15 prominent utility companies[2] traded in the United States, for 2023 to date. As indicated below, the index is down by approximately 17% since the index's high in January 2023.[3]



1 Courtesy https://www.cnbc.com/quotes/.DJU.

2 The DJU is comprised of 15 publicly traded utility companies in the United States: The AES Corporation, American Electric Power Company, Inc., American Water Works Company, Inc., Atmos Energy Corporation, Consolidated Edison, Inc., Dominion Energy, Inc., Duke Energy Corporation, Edison International, Exelon Corporation, FirstEnergy Corp., Public Service Enterprise Group Incorporated, Sempra Energy and Xcel Energy Inc.

3 Good, Allison, *US utilities, renewables stock selloff underscores concern over spending plans*, Energy Finance Daily (Oct. 9, 2023).

Depressed stock prices have had a meaningful impact on capital markets activity—and strategic plans—for many in the industry. First and foremost, the drop in share price has put pressure on many utilities' balance sheets.[4] The low stock price makes it more expensive to add equity to the balance sheet by selling shares into the market. At the same time, from a credit metrics perspective, a significant share price decline will also gain the attention of the ratings agencies. One important question, then, for many issuers, will be how to "manage the balance sheet" going forward.

Selling Equity

With depressed share prices, utility issuers are going to be reticent to execute large equity deals in this market. With a few notable exceptions—including a ONE Gas, Inc. forward in September 2023 and a Spire Inc. forward under its ATM in June 2023—the equity markets in the electric and gas utility space have (not surprisingly) been very quiet in 2023.

While most industry participants have existing ATMs, the question is whether such issuers will use them when stock prices are so low. Below is a chart of electric and gas utility issuers which have filed ATMs since October 1, 2020.

Issuer	Most Recent Filing Date	Amount Registered	Forward Component
Ameren Corporation	**November 10, 2022**	**$1,000,199,028**	**Yes**
American Electric Power Company, Inc.	**November 6, 2020**	**$1,000,000,000**	**Yes**
Alliant Energy Corporation	**December 14, 2022**	**$225,000,000**	**No**
Atmos Energy Corporation	**March 31, 2023**	**$1,000,000,000**	**Yes**
Avista Corporation	**August 2, 2023**	**4,844,787 shares**	**No**
Black Hills Corporation	**June 16, 2023**	**$400,000,000**	**Yes**
Duke Energy Corporation	**November 10, 2022**	**$1,500,000,000**	**Yes**
Edison International	**August 4, 2022**	**$500,000,000**	**Yes**
Entergy Corporation	**August 9, 2022**	**$1,116,396,318**	**Yes**
Eversource Energy	**May 11, 2022**	**$1,200,000,000**	**No**
Exelon Corporation	**August 4, 2022**	**$1,000,000,000**	**Yes**
NextEra Energy Partners, LP	**April 26, 2022**	**$300,000,000**	**No**
NiSource Inc.	**February 22, 2021**	**$750,000,000**	**Yes**
Northwest Natural Holding Company	**August 13, 2021**	**$200,000,000**	**No**
NorthWestern Corporation	**April 23, 2021**	**$200,000,000**	**Yes**
PNM Resources, Inc.	**November 10, 2022**	**$200,000,000**	**Yes**
PG&E Corporation	**April 30, 2021**	**$400,000,000**	**Yes**
Portland General Electric Company	**April 28, 2023**	**$300,000,000**	**Yes**
Spire Inc.	**May 9, 2022**	**$200,000,000**	**Yes**
The Southern Company	**November 5, 2021**	**50,000,000 shares**	**No**
Xcel Energy Inc.	**November 5, 2021**	**$800,000,000**	**No**

4 While the drop in share price alone does not immediately impact an issuer's balance sheet, the decline in stock price will pressure the balance sheet going forward nonetheless.

With respect to the ratings agencies, one way to get "equity credit" without selling equity is to issue "hybrid" securities with equity-like features. The below chart provides examples of certain hybrid securities. The examples on the left side of the chart are more "debt like". And on the right side of the chart, the securities are more "equity like".

	Convertible Debt	Junior Subordinated Debt	Perpetual Convertible Preferred	Mandatory Units	Mandatory Equity (Tangible) Units	Mandatory Convertible Preferred
Description	• Debt security with investor option to convert into a fixed number of shares in the future	• Long dated subordinated debt with Company option to defer interest payments	• Preferred stock that the Company can force into a fixed number of shares in the future	• Debt security plus a forward purchase contract to issue a variable number of shares in the future (typically 3 years or less)	• Amortizing note plus a pre-paid forward purchase contract to issue a variable number of shares in the future (typically 3 years or less)	• Preferred stock that will mandatorily convert into a variable number of shares in the future (typically 3 years or less)
Rating Agency Equity Treatment [1]	• 100% debt	• Moody's: 25% **Likely increases to 50% as Basket M** • S&P: Up to 50% • Fitch: Up to 50%	• Moody's: IG - Basket C (50%) **Likely stays 50% as Basket L** Non-IG - Basket E (100%) • S&P: Up to 50% • Fitch: Up to 50%	• Moody's: IG - up to Basket B (25%) **Likely increased to 50% as Basket M if debt host has at least a 30 year maturity, otherwise drops to 0% as Basket L** Non-IG: 0% • S&P: Up to 100% (must convert within 1-2 years for Non-IG) • Fitch: 0%	• Moody's: 80% **Likely reduced under new Moody's methodology** • S&P: 80% • Fitch: 80%	• Moody's: Up to Basket E (100%) **Likely unchanged under new Moody's methodology** • S&P: Up to 100% (must convert within 1-2 years for Non-IG) • Fitch: Up to 100%

1. Issuer rating could impact the amount of equity credit received. S&P's methodology also requires a maximum of 2 years to conversion for BB rated issuers and 1 year to conversion for B rated issuers. This represents the agencies' stated methodologies, but there can be variability depending on several factors, including the analyst, etc.

One trend from earlier this year was convertible debt. See "Traffic in Convertibles: New Trend in Utility Capital Markets" in the August 2023 issue of Baseload. With the recent runup in interest rates, the coupon rates on converts are lower than on plain vanilla debt because investors in the convert have exposure to equity upside. But, as indicated in the chart above, the rating agencies typically ***do not award any equity credit at the time of a convertible debt issuance***.

Also, as noted in the table above, Moody's has proposed an update to its hybrid methodology for investment-grade issuers in September 2023. Moody's previously maintained a "five basket" scale, attributing equity content in 25% increments from 0% to 100%. The proposed methodology at Moody's would shift to a three basket scale: Basket L (0% equity credit), Basket M (50% equity credit) and Basket H (100% equity credit). (High yield issuers will remain on a binary scale at Moody's, with only Basket L and Basket H.)

One item to note among the changes at Moody's is that junior subordinated debt would likely receive 50% equity credit at Moody's, rather than 25% previously. This would bring Moody's in line with the other two agencies with respect to junior subordinated debt. That said, even with higher equity credit expectations from Moody's, issuers will need to also consider the higher coupons of subordinated debt (versus senior debt).

Asset Sales

One trend in this volatile environment has been to raise proceeds through sales of minority interests as a substitute for accessing the capital markets. As mentioned in "Traffic in Convertibles: New Trend in Utility Capital Markets" in the August 2023 issue of Baseload, several in the industry have recently explored the sale of minority interests:

- **Duke Energy Corp.** agreed to sell a 19.9% interest in its Duke Energy Indiana subsidiary to an affiliate of GIC Private Limited, Singapore's sovereign wealth fund;
- **FirstEnergy Corp.** sold a 19.9% stake in FirstEnergy Transmission, LLC (FET), the holding company for FirstEnergy's three regulated transmission subsidiaries, to Brookfield Super-Core Infrastructure Partners (Brookfield) for $2.4 billion; and in February 2023, FirstEnergy Corp. announced that it entered into an agreement to sell an additional 30% ownership interest in FET to Brookfield;
- **NiSource Inc.** announced it would sell a 19.9% interest in Northern Indiana Public Service Co. to a Blackstone Infrastructure Partners affiliate; and
- **Sempra Energy** sold a 10% non-controlling interest in Sempra Infrastructure Partners for $1.73 billion in cash to a subsidiary of the Abu Dhabi Investment Authority.

But the pace of these minority interest sales has slowed. Outside of the sale of "minority interests", some utilities have turned to selling certain assets in order to raise proceeds. See, for example, the recent news regarding American Electric Power Company, Inc.'s strategic review of (1) AEP Energy retail business, (2) AEP OnSite Partners, which is AEP's unregulated distributed resources business; and (3) certain non-core transmission joint ventures. In March 2023, RWE, a German energy company, announced that it had closed its $6.8 billion acquisition of Con Edison's clean energy businesses. Last month, NextEra Energy, Inc. announced Florida Power & Light Company entered into a definitive agreement to sell Florida City Gas to Chesapeake Utilities Corporation. On September 5, 2023, Dominion Energy announced that it had concluded a sale process and executed three separate definitive agreements to sell Dominion's three natural gas distribution companies to Enbridge.[5] The transactions are valued at $14.0 billion—all cash consideration of $9.4 billion plus the assumption of debt.[6] And on October 4, Duke Energy Corporation announced it had completed the sale of its commercial distributed generation portfolio to an investment fund managed by ArcLight Capital Partners, LLC. But the above activity aside, and despite consolidation in the energy space more broadly, M&A activity in the electric and gas utilities sector may be muted given the current state of share prices.

Reduce Capex

Many utilities will be providing updated capex numbers at the upcoming EEI Financial conference in Phoenix. Investor-owned North America regulated utilities (electric, gas, and water) have increased their spending exponentially over the past two decades at a compounded annual growth rate of about 9%.[7] And S&P Global Ratings expects that the industry's capital spending for 2023 will reach a record at about $200 billion.[8]

According to S&P Global, over half of medium-term spending from electric utilities is expected to be focused on transmission and distribution (T&D) infrastructure.[9] Outside of T&D, spending in the renewable generation and storage segments collectively accounts for approximately 15% of expected capital investment. Some companies have indicated increased appetite for spending in this segment following last year's passage of the Inflation Reduction Act (IRA).

Recent share price pressure may be, in part, a concern about companies' abilities to attractively raise the capital needed to finance spending.[10] But while one "lever" to manage the balance sheet is presumably a reduction in planned capex—for a regulated utility, capital expenditures are central to the business. A utility's rate base is essentially the company's "prudent" capital investment, as determined by the applicable regulatory authority net of accumulated depreciation.[11] Stated differently, it is the net asset base from which the utility provides electric, gas or water service, and upon which the utility is allowed to earn a rate of return. Thus, the rate base value is a key variable in the determination of a utility's revenue requirement. For vertically integrated electric utilities, rate base generally includes generation, transmission and distribution infrastructure. Given the importance of future capex to a regulated utility—especially with the ongoing transition from fossil fuels to clean energy—we expect issuers will be hard pressed to downsize existing plans to any great extent.

5 Dominion Energy, Inc., *Dominion Energy Advances Business Review; Announces Agreements to Sell Gas Distribution Companies to Enbridge* (Sept. 5, 2023).

6 *Id.*

7 Gosberg, Gabe, *The Outlook For North American Regulated Utilities Turns Stable*, S&P Global Ratings (May 15, 2023). The S&P report notes several risks confronting regulated utilities including, among others, (1) inflation risk, (2) record levels of capital spending, and (3) physical risks such as exposure to wildfires, storms, extreme temperature events and hurricanes.

8 *Id.*

9 DeLucia, Chris, *North American power: Electric utility capex growth is expected to remain robust, but where is the investment going?*, S&P Global Commodity Insights (July 17, 2023).

10 Good, Allison, *US utilities, renewables stock selloff underscores concern over spending plans*, Energy Finance Daily (Oct. 9, 2023).

11 Ernst, Russell, *Rate Base: Understanding A Frequently Misunderstood Concept*, S&P Global Market Intelligence (Mar. 3, 2017).

Reduce Dividend Growth

Electric utilities tend to have high dividend payout ratios—often 65% or more.[12] And historically, US regulated utility dividend cuts have been infrequent, only occurring during times of significant distress.[13] [14] While any reduction in dividend levels or dividend growth estimates is bound to be unpopular with investors, in some scenarios, conserving cash may be necessary to manage credit metrics at a particular level.

Take the Downgrade?

While a reduction in share price may not necessarily affect certain of the standard credit metrics used by the rating agencies in order to rate the issuer and its debt securities, any significant pressure on share price is nonetheless going to gain the attention of the rating agencies. After all, the share price presumably captures the market's expectations of the issuer's expected future earnings prospects.

To the extent a company's credit metrics remain under pressure, one (likely unpopular) option would be to accept that a downgrade from the ratings agencies may be in the cards. While this will surely increase a utility's borrowing costs going forward, some utilities may decide that a potential downgrade is a more palatable option than (1) selling equity at depressed prices, (2) selling off assets, (3) reducing planning capital spending, or (4) reducing future dividend growth.

Conclusion

The first nine months have been challenging for utility share prices. A historical runup in interest rates has created challenges throughout the business model, among others: (1) refinancing risk and expense, (2) the additional costs of capital spending, and (3) working with regulators to approve such higher expenses. Likely, some difficult decisions lie ahead. And in some cases, the decision may be to choose among a series of unappealing options.

12 Bary, Andrew, *Utility Stocks Have Been Big Winners This Year. Why It's Time to Lighten Up*, Barron's (Sept. 21, 2022).

13 Cox, Charlotte, *US utility dividends stay the course despite pandemic*, S&P Global Market Intelligence (Sept. 9, 2020).

14 Singh, Arshreet, *Hawaiian Electric suspends dividend after Maui wildfires, shares fall*, Reuters (Aug. 24, 2023); Kilgore, Tomi, *Algonquin Power to cut dividend by 40%, provides downbeat profit outlook*, MarketWatch (Jan. 12, 2023); *NextEra Energy Partners (NEP) Cuts Distribution Rate, Units Drop*, Yahoo Finance (Sept. 28, 2023).

STILL DAMN GOOD: 4(A)(2) MARKET SHOWS CONTINUED STRENGTH

Issuer	First Closing	Security	Total Principal Amount	Tenor
Southern Indiana Gas and Electric Company	**March 15, 2023**	**Secured**	**$180,000,000**	**5-yr, 10-yr**
Hawaiian Electric Industries, Inc.	**March 16, 2023**	**Unsecured**	**$100,000,000**	**5-yr, 10-yr**
Oncor Electric Delivery Company LLC	**March 29, 2023**	**Secured**	**$400,000,000**	**3-yr, 8-yr, 13-yr**
Elizabethtown Gas Company	**April 27, 2023**	**Secured**	**$125,000,000**	**5-yr**
South Jersey Gas Company	**April 27, 2023**	**Secured**	**$250,000,000**	**5-yr**
Public Service Company of New Mexico	**April 28, 2023**	**Unsecured**	**$200,000,000**	**12-yr, 30-yr**
Texas-New Mexico Power Company	**April 28, 2023**	**Secured**	**$185,000,000**	**10-yr, 20-yr**
Northern States Power Company (Wisconsin)	**June 8, 2023**	**Secured**	**$125,000,000**	**30-yr**
Mississippi Power Company	**June 28, 2023**	**Unsecured**	**$100,000,000**	**3-yr, 10-yr**
South Jersey Industries Inc.	**July 21, 2023**	**Unsecured**	**$150,000,000**	**5-yr**
Northern Illinois Gas Company	**July 31, 2023**	**Secured**	**$275,000,000**	**7-yr, 12-yr, 30-yr, 40-yr**
Potomac Edison Company	**August 25, 2023**	**Secured**	**$100,000,000**	**5-yr**
Portland General Electric	**August 29, 2023**	**Secured**	**$500,000,000**	**7-yr, 10-yr, 15-yr, 30-yr, 36-yr**
Southwestern Public Service Company	**September 8, 2023**	**Secured**	**$100,000,000**	**30-yr**
Madison Gas and Electric Company	**September 13, 2023**	**Unsecured**	**$70,000,000**	**11-yr, 30-yr**
Southern Indiana Gas and Electric Company	**October 13, 2023**	**Secured**	**$470,000,000**	**6-yr, 7-yr, 11-yr**

2023 has been a strong year for 4(a)(2) debt private placements (debt 4(a)(2)) in the power and utility space. In addition to a survey of deals which have gone to market this year (see chart above), we thought it might be helpful to review some of the primary characteristics of a debt 4(a)(2) by a utility issuer.

First of all, why tap the 4(a)(2) market, especially if the issuer already has an effective registration statement on file with the Securities and Exchange Commission? As illustrated by the chart above, many of the deals done in this market are less than "index eligible" in size.[1] Second, more flexibility exists with respect to the timing of closing (or multiple closings). While registered offerings sometimes close as long as on a T+5 or T+10 basis, a 4(a)(2) can schedule different series to close months down the road.

The Basics

Most debt deals done on a 4(a)(2) basis will use a Model Form Note Purchase Agreement (Model Form) as the agreement between the issuer and the purchasers. This agreement will also serve, in many cases, as the document pursuant to which the debt is issued (as discussed further below). These Model Forms are available on the website of the American College of Investment Counsel (See aciclaw.org/forms). Model Form No. 1 is for issues of a credit quality equivalent of A- or better for domestic issuers. Model Form No. 2 is for issues of a credit quality equivalent of BBB- or better for domestic issuers. And important to note, the purchasers in the deal—typically large insurance companies—will always want to stick very closely to the language and terms set forth in the relevant Model Form.[2] In fact, purchasers' counsel will likely be tasked with creating an "issues memo" (to be shared by purchasers' counsel with potential investors only) describing the differences between the draft note purchase agreement distributed to potential investors and the relevant Model Form.

Note also, the investment banks on the transaction will not be acting in the capacity as "underwriters", but rather will be serving as "agents" of the issuer.[3] This distinction drives significant differences in the documentation versus a registered or 144A offering. The banks, as "agents", will not receive disclosure opinions from counsel or a comfort letter from the issuer's outside accountants.

1 In January 2017, Bloomberg announced that the Barclays Benchmark Fixed Income Index would, effective April 1, 2017, raise its minimum tranche size from $250 million to $300 million. Press Release, Bloomberg, *Bloomberg Announces Changes to Bloomberg Barclays Fixed Income Indices* (Jan. 24, 2017), available at https://www.bloomberg.com/company/announcements/bloomberg-announces-changes-bloombergbarclays-fixed-income-indices.

2 One issuer-specific item that may drive differences between the draft Note Purchase Agreement for the deal and the Model Form is the existing set of covenants present in any existing credit facility of the issuer.

3 In most cases, the first action item on a utility debt 4(a)(2) will be the negotiation of an engagement letter between the agents and the issuer.

Note Purchase Agreement or Indenture/Mortgage

The Model Form is drafted so as to constitute the document by which the notes will be issued (i.e. without the need for a separate trust indenture or similar). But some issuers have preferred to use their existing indentures for the issuance of the 4(a)(2) debt. This is particularly true in cases where the offering will be of mortgage bonds pursuant to the issuer's existing mortgage. In either case, whether using the issuer's existing senior note indenture or its mortgage, certain terms of the existing mortgage/indenture will likely be incorporated into the note purchase agreement (e.g. affirmative covenants, negative covenants).

If the issuer uses the note purchase agreement for the issuance of the debt (as opposed to a standalone indenture or mortgage), the issuer could end up acting as registrar and transfer agent for the notes. This can be a significant task from time to time. The notes or bonds in a 4(a)(2) will most likely be issued in "certificated" form, with each purchaser receiving individual, executed notes. (rather than book-entry notes held at DTC)[4] From time to time, an issuer will receive re-registration requests from holders (often in connection with a transfer of ownership).

What About Those Delayed Closings?

The Model Form contains several footnotes for additional language that should be included if an issuer seeks to have a delay between "closing" (which, in 4(a)(2) world, means the date the note purchase agreement is executed) and funding (i.e. financial closing).[5] In many cases, the note purchase agreement will be executed concurrently with funding/financial close. That said, an issuer will also need to understand exactly how the issuer will be required to bring down reps in the case of a transaction where there is a significant delay between execution of the note purchase agreement ("closing") and financial close ("funding").

Section 5.3 of the Model Form provides a representation from the issuer with respect to the "disclosure package", including that such disclosure package does not "omit to state any material fact necessary to make the statements therein not misleading in light of the circumstances under which they were made". Section 5.3 of the Model Form also contains a representation from the issuer that "…there has been no change in the financial condition, operations, business or properties of the Company or any Subsidiary except changes that would not, individually or in the aggregate, reasonably be expected to have a Material Adverse Effect." There is a natural tension created by these reps, among others, when a funding/closing is scheduled for many months in the future. In our experience, however, the burden/risk will be on the issuer to bring down those representations at the later funding/closing. To the extent the issuer feels the need to update its disclosures or representations at the time of the subsequent closing (and is not able to make such representations "cleanly"), it would likely give rise to the ability (at least as a technical matter) of the purchasers to opt out of the scheduled closing.

Diligence

The diligence process will be wholly different from a registered debt deal. The investment banks, acting as "agents" will likely conduct their own due diligence prior to reaching out to potential investors. But such "agent due diligence call" will likely not involve outside counsel or the outside accountants. Later, during marketing, the agents will likely schedule a "Management conference call" for potential investors. But again, outside counsel and outside accountants will not be involved. (And, in our experience, there will be no associated "bringdown" diligence calls for the deal). Finally, in some cases, post-circle, the agents may schedule an onsite investor due diligence meeting (again, without outside counsel or outside accountants). But in our experience, these onsite investor meetings are relatively rare.

4 Individual notes will often be registered in a "nominee name" for each purchaser.

5 Many of the terms to refer to steps in the process can be unfamiliar. The "circle date" refers to the date when investors formally agree to participate in the transaction at agreed-upon terms.

The Securities Law Framework[6]

In our experience, most utility debt 4(a)(2)s are structured as "traditional private placement transactions".[7] They are not structured to fit within the conditions of Regulation D under the Securities Act of 1933 (1933 Act).[8] Transactions that rely on the 1933 Act Section 4(a)(2) exemption for "transactions by an issuer not involving any public offering" without relying on a specific Regulation D safe harbor rely on practices that have evolved through case law.[9]

The following elements are typically present in Section 4(a)(2) offerings:

- **avoidance of any general solicitation**; whether by or on behalf of the issuer;[10]
- **limitation on the number of offerees**; at closing, the agents will traditionally deliver an "offeree letter" detailing the number of offerees (including purchasers) in the offering;
- **representations by purchasers as to their "investment intent"**; i.e. that the purchasers are not buying with a view to a distribution; a rep from the purchasers to this effect is included as Section 6.1 of the Model Form;
- **representations as to the sophistication of the investors**; the offeree letter described above will also state that immediately prior to making any offer of securities, the agent(s) had reasonable grounds to believe, and did believe, that each such offeree (including each purchaser) was an "accredited investor" (as defined in the 1933 Act); and
- **the provision of extensive information**; the practice varies in exactly what materials will be provided to offerees. In some cases, a "private placement memorandum" (PPM) will be prepared, in addition to the issuer's financial statements.

Issuers should also be aware that Section 7 of the Model Form contains significant reporting obligations on the part of the company going forward. These can include, among others, the obligation to deliver (1) annual and quarterly financial statements, and (2) certificates with respect to covenant compliance (See Section 7.2 of the Model Form).[11] Section 7.3. "Visitation" goes so far as to permit representatives of noteholders, under certain circumstances, to visit and inspect the offices and properties of the company or any subsidiary, including to examine their respective books of account.

FINRA and Blue Sky

A FINRA filing for the offering under FINRA Rule 5110 will not be necessary. See the definition of "Public Offering" in FINRA Rule 5110(j)(18).

Similarly, a debt 4(a)(2) by a utility issuer will rarely require extensive blue sky analysis. While the states where the offering is conducted will have authority to investigate and bring enforcement actions for fraud, most states have blue sky statutes which provide for exemptions from state registration and notice requirements for offerings to certain sophisticated investors—an "institutional exemption".

Conclusion

The 4(a)(2) market has remained a popular option for utility issuers in 2023. This is especially true for (1) smaller deals and (2) where issuers are not in need of the proceeds immediately. But if contemplating this route, issuers should also be aware that there are significant differences in the timeline and structure of these transactions via-a-vis a registered or 144A transaction.

6 While outside the scope of this article, another consideration for the offering is whether or not the offering may be "integrated" with another offering. "Integration" refers to the possibility that (1) two or more private transactions will be considered as a single transaction, or (2) one or more private transactions will be considered to be part of a contemporaneous public offering. See Johnson, Jr., Charles and McLaughlin, Joseph, (Sixth Edition), *Corporate Finance and the Securities Laws*, Wolters Kluwer. The SEC adopted new Rule 152 in 2020 in order to simplify the rules for determining when an issuer's private and public offerings might be "integrated," or considered part of the same offering. New Rule 152 offers safe harbors from integration and, where no safe harbor is available, a principles-based approach to determine whether an exemption from registration is available for a particular offering.

7 Securities sold under Section 4(a)(2) are deemed to be "restricted securities" and are subject to transfer or resale restrictions.

8 Rule 503 requires a company selling securities in reliance on Regulation D to file with the SEC an informational notice—a "Form D" —not later than 15 calendar days after the first sale of the securities. In our experience, because most debt private placements by utilities are structured as true private placements under Section 4(a)(2) rather than relying on the Regulation D safe harbors, most utilities do not file a Form D in connection with the offering.

9 See, e.g., *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

10 Rule 502(c) provides some guidance by listing examples of communications that may be viewed as general solicitation and general advertising, including (1) "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio" and (2) "any seminar or meetings whose attendees have been invited by any general solicitation or general advertising.

11 Section 7.4 "Electronic Delivery" provides relief, among others, for issuers who file periodic reports via the SEC's EDGAR system.

REGULATION M WRENCH IN THE WORKS: THE INVESTMENT GRADE EXCEPTION GOES AWAY

In June 2023, the US Securities and Exchange Commission (SEC) voted to remove and replace references to credit ratings from exceptions provided in Rule 101 and Rule 102 of Regulation M (Reg. M or the Rule), with such amendments becoming effective August 21, 2023.

Reg. M, which went into effect on March 4, 1997 is intended to prevent manipulative practices by issuers and underwriters in securities offerings. Reg. M is a "prophylactic" rule, which means that it prohibits certain conduct whether or not that conduct actually violates the securities laws. The operative provisions of Reg. M generally prohibit underwriters (Rule 101 of Reg. M) and issuers (Rule 102 of Reg. M) from bidding for, purchasing or attempting to induce others to bid for or purchase securities during a restricted period while such securities are "in distribution."

Prior to the SEC's June 2023 amendments, a blanket exception to compliance for nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities that were in each case rated investment grade by at least one nationally recognized statistical rating organization (commonly referred to as the "investment grade exceptions") meant that investment grade debt issuers and underwriters generally need not read any further.

The June 2023 amendments were a long awaited change stemming from the 2008 financial crisis and a mandate imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). Dodd-Frank required the removal of any reference to or requirement of reliance on credit ratings. Investment grade exceptions were to be replaced with new exceptions based on alternative standards of creditworthiness. Specifically, for nonconvertible debt securities and nonconvertible preferred securities, the SEC introduced a probability of default threshold for determining whether the exception to Reg. M applies and introduced a blanket exception for asset-backed securities offered pursuant to an effective shelf registration statement on Form SF-3.

Probability of Default Determination

Rules 101 and 102 were amended such that nonconvertible securities of issuers for which the probability of default, estimated as of the sixth business day immediately preceding pricing and over the horizon of 12 full calendar months from such day, is 0.055% or less. Such determination should be made by "the distribution participant acting as the lead manager (or in a similar capacity of a distribution),"[1] which would typically fall to the billing and delivering underwriter for a typical investment grade shelf takedown. Importantly, such determination should be derived from a "structural credit risk model," which the SEC defined to mean any commercially or publicly available model that calculates, based on an issuer's balance sheet, the probability that the value of the issuer will fall below the threshold at which the issuer would fail to make scheduled debt payments, at or by the expiration of a defined period."[2]

1 Release No. 34-97657; File No. S7-11-22, 17 C.F.R. Parts 240 and 242, The Securities and Exchange Commission, June 7, 2023, *available at* https://www.sec.gov/rules/final/2023/34-97657.pdf, at 9.

2 *Id.* at 118.

We understand that Bloomberg has become the default provider for this calculation for most of the investment banks. Unfortunately, it is unlikely there will be 100% continuity between those securities previously exempted under the investment grade exceptions and those securities that pass the probability of default threshold. As the SEC noted, as of March 2023, the probability of default threshold captured approximately 76% of the investment grade securities during a sample period.[3] We understand from certain underwriters this problem is particularly acute for operating company issuers using Bloomberg's probability of default analysis, as numerous operating company issuers with investment grade ratings fail the test (while their holding company parent passes).

Form SF-3 Exception

Previously, investment grade asset-backed securities benefited from the same exception as discussed above. The SEC replaced such exception in Rules 101 and 102 with an exception exempting asset-backed securities offered pursuant to an effective shelf registration statement on Form SF-3 from compliance with Reg. M. The SEC's rationale for the bright line test was based at least in part on the observation that "an exception for asset-backed securities that is based on a structural credit risk model…would be unfeasible because distribution participants…may not be able to collect all of the information required to calculate the probability of default, such as the value and volatility of the equity."[4] This new exception leaves those issuers which rely on Form SF-1 without an available exception from compliance with Reg. M. Notably, Form SF-1 is primarily used in connection with dedicated utility rate securitization transactions, since most issuances in this space involve a single issuance of securities by a unique special purpose entity formed for such purpose. This is more akin to an initial public offering on Form S-1 than a shelf takedown on Form S-3. Absent amended guidance from the SEC allowing reliance for users of Form SF-1, SEC-registered issuances of utility securitization bonds going forward may need to comply with Reg. M.

"Reopeners" and "Sticky Offerings"

As was the case when the investment grade exceptions applied, Reg. M's reach is limited because bids for and purchases of outstanding nonconvertible securities are not restricted unless the existing security is identical in all of its terms to the security being distributed. As the SEC noted in its adopting release, a single basis point difference in coupon or single day's difference in maturity is a separate security.[5] As such, Reg. M generally does not restrict trading in an issuer's already outstanding debt securities during the distribution of its newly issued debt securities.

One scenario that may prove problematic with the new amendments is a reopening of an issuer's already existing nonconvertible debt securities. In a reopener, an issuer offers additional securities of an existing series of debt rather than offer a new series with different terms. The "reopened" securities must have the same terms (maturity, coupon, interest payment dates, exchange listing, redemption provisions, etc.) as the originally issued securities. Additional securities issued pursuant to a reopener should ultimately trade fungibly with the originally issued securities. See *Debt Reopeners: A Restated Utility Quick Reference* in the November 2021 issue of Baseload. As such, the security subject to the distribution is identical to the existing security that already trades. Absent reliance on an exception to Reg M., underwriters and issuers will need to comply with Reg. M with respect to activities involving the existing security to be reopened prior to the pricing of the reopening and until the distribution of the securities is complete. Said another way, Reg. M's restrictions could begin to apply as early as five business days prior to pricing of the reopener. This may create compliance headaches for the underwriters which may (or their affiliates may) trade in such security and would be restricted from doing so under Reg. M. See the discussion below regarding the start of Reg. M's prohibitions.

3 *Id.* at 73.

4 *Id.* at 41.

5 *Id.* at 10.

The other instance in which Reg. M may now apply is a "sticky offering". A "sticky offering" results when the underwriters are unable to sell all of the securities in a distribution and one or more of the underwriters holds a long position in the securities after pricing. While we understand this to be rare in the context of an investment grade debt offering, the possibility of a "sticky offering" without the Reg. M exception can be problematic as the securities begin to trade before the distribution is complete.

Revised Playbook for Underwriters

Step 1: Determine if an Exception Applies

The first step underwriters should take for any offering of nonconvertible debt securities is to determine whether an exception to Reg. M applies for the offering. There are two potential exceptions: (1) the probability of default exception discussed above (i.e., the issuer is below 0.055%) and (2) the "actively traded" exception (securities that have an "average daily trading value"[6] of at least $1 million and are issued by an issuer whose common equity securities have a public float value of at least $150 million; provided, however, that such securities are not issued by the distribution participant or an affiliate of the distribution participant).

The lead underwriter should make this determination six business days prior to pricing. If an exception can be satisfied, nothing else is needed as Reg. M will not apply. If an exception is not available, Reg. M will apply to the offering.

Step 2: Determine if Filing FINRA Form 5190 is Necessary

As of the date of this publication, FINRA has not revised its guidance for filing of Form 5190. But by its terms, filing of this form may be required if a distribution is subject to Reg. M. Pursuant to Section (c)(1) of FINRA Rule 5190, a member should make the filing for "a distribution of any security that is a covered security subject to a restricted period under Rule 101 of SEC Regulation M." Given the guidance from FINRA is outdated and does not contemplate the new probability of default exception, we understand certain underwriters are still contemplating whether filing the Form 5190 with FINRA is necessary.

Step 3: For Reopeners, Determine the Start of the Restricted Period

If the contemplated offering is a reopener, the next step is to determine when the restricted period under Reg. M begins:

- For securities with an average daily trading value of at least $100,000 or more of an issuer whose common equity securities have a public float value of $25 million or more, the restricted period begins on the later of one business day prior to pricing or such time that an underwriter becomes a distribution participant.
- For securities that do not satisfy the above test, the later of five business days prior to pricing or such time that an underwriter becomes a distribution participant.

The playbook for a "sticky" offering is also challenging. Assuming the "sticky" offering does not also contemplate a reopener, in the event one or more underwriters of the offering held a long-position in the security after pricing (i.e., was unable to sell 100% of the issuance to investors), underwriters will need to determine the end of Reg. M's restricted period. We are not aware of any SEC guidance specifically on point for how long an underwriter would need to hold an unsold security in order to demonstrate investment intent or firm guidance on when a distribution is complete, so each underwriter will need to assess the facts and circumstances at the time to determine the best course of action.

6 Reg. M defines "Active Daily Trading Value" as "the worldwide average daily trading volume during the two full calendar months immediately preceding, or any 60 consecutive calendar days ending within the 10 calendar days preceding, the filing of the registration statement; or, if there is no registration statement or if the distribution involves the sale of securities on a delayed basis pursuant to [Rule 415], two full calendar months immediately preceding, or any consecutive 60 calendar days ending within the 10 calendar days preceding, the determination of the offering price."

RECENT CLIENT ALERTS AND PUBLICATIONS

Over the past year, Hunton lawyers have authored client alerts and blog posts covering a range of topics relevant to the power and utilities capital markets industry:

First-in-the-Nation Climate Disclosure Bills Become Law in California, October 17, 2023

The Nascent Hydrogen Economy is One Step Closer to Liftoff; DOE Selects Hydrogen Hubs, October 17, 2023

Second Circuit Rules Syndicated Term Loan in Kirschner is Not a Security, August 30, 2023

SEC Issues New Guidance on Rule 10b5-1 Plan Amended Rules, August 20, 2023

FERC'S Order No. 2023 Aims at Improving and Expediting the Generator Interconnection Process, August 4, 2023

SEC Adopts Final Public Company Cybersecurity Disclosure Rules, July 27, 2003

Treasury Guidance on Tax Credit Transfers, June 16, 2023

Department of Energy Loan Guarantee Program Update: Loan Programs Office Issues Updated Title 17 Clean Energy Financing..., June 12, 2023

Department of Energy Establishes Clean Hydrogen Roadmap, June 9, 2023

SEC Approves New Rules Expanding Disclosure Requirements for Issuer Share Repurchases, June 6, 2023

Are Syndicated Term Loans Really Securities?, March 9, 2023

DOE Issues FOA for Carbon Capture Large-Scale Pilots and Carbon Capture Demonstration Projects Program, March 2, 2023

DOE Publishes Notice of Intent to Fund Clean Hydrogen Projects, January 17, 2023

SEC Unanimously Approves New 10b5-1 Plan Conditions and Expands Required Disclosures, January 11, 2023

BASELOAD is prepared from time to time to provide general information about selected power and utilities capital markets developments and issues for attorneys at Hunton Andrews Kurth LLP, and is provided to clients and friends of Hunton Andrews Kurth LLP. It is not intended to provide legal advice or legal opinions and must not be relied on as such. If you have questions related to any of the articles in this issue, please contact any of the below members of the Power and Utilities Capital Markets group at Hunton Andrews Kurth LLP:

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