UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

June 29, 2004

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
U.S. House of Representatives
2322 Rayburn House Office Building
Washington, DC 20515

The Honorable Edward J. Markey
Member
Subcommittee on Energy and Air Quality
U.S. House of Representatives
2108 Rayburn House Office Building
Washington, DC 20515

Dear Congressmen Dingell and Markey:

Thank you for your April 21st letter concerning the Commission's administration of the Public Utility Holding Company Act of 1935. You raise a number of follow-up questions to the staff analysis dated March 4, 2002 that was provided to you in response to your letter of February 11, 2004.

At my request, Paul Roye, the Director of the Division of Investment Management, and his staff have prepared the enclosed memorandum that provides the information and analysis requested in your letter. I hope that the Division's memorandum is helpful to you and your colleagues.

If you have additional questions or comments, please do not hesitate to telephone me at 202/942-0100 or to telephone Paul directly at 202/942-0720.

Sincerely,

William H. Donaldson

Enclosure

cc: The Honorable Joe Barton, Chairman
Committee on Energy and Commerce

The Honorable Ralph Hall, Chairman
Subcommittee on Energy and Air Quality

The Honorable Rick Boucher, Ranking Member
Subcommittee on Energy and Air Quality

The Honorable, Michael G. Oxley, Chairman
Committee on Financial Services

The Honorable Barney Frank, Ranking Member
Committee on Financial Services

The Honorable Richard C. Shelby, Chairman
Committee on Banking, Housing, and Urban Affairs

The Honorable Paul S. Sarbanes, Ranking Member
Committee on Banking, Housing, and Urban Affairs

MEMORANDUM

To: Chairman William H. Donaldson

From: Paul Roye
Director, Division of Investment Management

Re: Letter of April 21, 2004 From Congressmen Dingell and Markey Regarding the Commission's Administration of the Public Utility Holding Company Act of 1935

Date: June 28, 2004

On April 21, 2004, Congressmen John Dingell and Edward Markey sent you a letter asking a series of questions regarding the staff's and the Commission's administration of the Public Utility Holding Company Act of 1935 (the "Act"). The questions were a follow-up to your previous response to the Congressmen on similar issues. Staff in the Division of Investment Management have prepared this memorandum setting forth responses to their questions. Because of the wide variety of topics covered in their letter, we have addressed each of the Congressmen's questions individually. The bolded sections below repeat the Congressmen's questions; our responses follow.

I. The Enron Decision and the SEC's Administration of Section 3(a)(1)

1. Section 3(a)(1) of the Public Utility Holding Company Act (PUHCA or the Act) requires the Commission, "unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers" to exempt any holding company if the holding company, and every subsidiary company thereof from which the holding company derives, directly or indirectly any material part of its income, "are predominantly intrastate in character and carry on their business substantially in a single state in which such holding company and every such subsidiary company are organized." Rule 2 (exemption of holding companies which are intrastate or predominantly operating companies) provides that any such holding company, and every subsidiary thereof, shall be exempt upon the filing of an exemption statement on Form U-3A-2. Rule 6 (termination of exemptions) provides that, if it appears to the Commission (on the basis of statements claiming exemption or otherwise) that a substantial question of law or fact exists as to whether the holding company is entitled to the exemption, or if it appears that any question exists as to whether the self-certified exemption may be detrimental to the public interest or the protection of investors or consumers, the Commission may notify such holding company and the exemption will terminate 30 days after that notification.

Does the SEC believe that the current system, which allowed Enron to operate under a claim of exempt status under PUHCA that was only revoked after the company collapsed in scandal, is consistent with the public interest and the

protection of investors and consumers? If so, how were Enron and Portland General Electric (PGE) benefited by the SEC's failure to take any action to revoke Enron's exempt status until after the company was in bankruptcy?

The staff does not believe that the current system under the Act and rules is inconsistent with the public interest or the interests of investors and consumers (the "protected interests" under the Act). The system is rooted in the general framework of the Act. As was noted in the 1995 SEC staff study of the administration of the Act:

> Congress determined in 1935 that direct federal regulation was necessary to control the operations of multistate public-utility holding companies. Thus, holding companies that are confined to a given state or area, and therefore presumed to be susceptible to effective state regulation, are largely exempted from federal regulation under the Act. In contrast, holding companies with multistate operations must register with the SEC and comply with a comprehensive federal framework of regulation under the Holding Company Act.[1]

In section 3 of the Act, Congress made exemptions from registration available in situations where holding companies were either susceptible to effective state regulation or were otherwise not the type of holding company at which the Act is directed.[2] As a

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[1] *The Regulation of Public Utility Holding Companies*, Division of Investment Management (June 1995) ("1995 Report") at vii.

[2] *See* S. Rep. No. 621, 74th Cong., 1st Sess. (1935) (Report of Senator Wheeler from the Committee on Interstate Commerce) ("Senate Report") at 6; H.R. Rep. No. 1318, 74th Cong., 1st Sess. (1935) ("House Report") at 10. Congress subjected multistate holding companies to the requirements of the Act because meaningful state regulation of their abuses was often obstructed by their control of subsidiaries in several states and by the constitutional doctrines limiting state economic regulation. 1995 Report, *supra note* 1, at 2.

Section 3 of the Act establishes five classes of holding company exemptions. The most commonly used exemptions are those provided in section 3(a)(1) for an intrastate holding company and in section 3(a)(2) for a holding company that is "predominantly a public-utility company." Section 3(a)(3) provides an exemption for a holding company that is "only incidentally a holding company," being primarily engaged in another business. Section 3(a)(4) establishes an exemption for a holding company that is "temporarily a holding company" solely because it has acquired securities "for purposes of liquidation or distribution in connection with a bona fide debt previously contracted or in connection with a bona fide arrangement for the underwriting or distribution of securities." Finally, section 3(a)(5) provides an exemption for a holding company that "is not, and derives no material part of its income, directly or indirectly, from any one or more subsidiary companies which are, a company or companies the principal business of which within the United States is that of a public-utility company."

final backstop against the types of abuses that led to passage of the Act, the "unless and except" clause of section 3(a) "was designed to prevent the exemption of any holding company which, although it might meet the formal conditions under section 3(a), is essentially the type of company 'at which the purposes of the [Act] were directed.'"[3]

Rule 2, as noted in the Congressmen's letter, permits some holding companies to claim exemptions under section 3(a)(1) or 3(a)(2) rather than seek a formal Commission grant of the exemption. This ability is subject, however, to the requirement that a holding company claiming exemption under rule 2 make an annual filing on Form U-3A-2. This filing is designed to permit the staff and the Commission to monitor companies claiming exemption and, in appropriate situations, to seek further information about the facts underlying the claim of exemption or, as outlined in rule 6, to challenge the exemption.

We believe that this system strikes an appropriate balance by permitting a holding company that clearly qualifies for an exemption to claim it without going through a formal process, thereby saving both company and Commission resources, while effectively requiring that more doubtful claims of exemption be reviewed by the staff and/or the Commission through a formal process of order upon application or, if necessary, by challenging improperly claimed exemptions. Moreover, as outlined below, to further improve this system, the staff is currently preparing to recommend to the Commission that it update Form U-3A-2 so that we can more efficiently review claims of exemptions under rule 2.

As noted in the staff's previous memorandum dated March 4, 2004 ("Previous Staff Memorandum"), Enron became a public-utility holding company when it merged with the parent company of PGE in 1997. For a variety of reasons, between 1997 and 2003 Enron was not required to register under the Act. First, at the time of its merger with PGE, Enron reincorporated itself in Oregon and began to claim exemption under section 3(a)(1) of the Act pursuant to rule 2 by making annual filings on Form U-3A-2. In 2000, without withdrawing its claim of exemption under rule 2, Enron filed applications for an order of exemption under section 3(a)(3) or 3(a)(5) of the Act. Finally, in 2002, after it became unable to file the financial statements required by Form U-3A-2, Enron also filed an application for an order of exemption under section 3(a)(1) and began relying on the good faith filing provision of section 3(c) of the Act.

The benefits that Enron and PGE obtained through Enron's not registering could be characterized in a several different ways. An exempt company, for example, avoids

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[3] *Cities Service Co.*, 8 S.E.C. 318, 335-36 (1940). The Commission cited the Senate Report: "By thus imposing a mandatory duty upon the Commission to exempt companies falling within defined categories except where such exemption is definitely detrimental to the basic purposes of the statute, the Committee has felt free to broaden the exemptions beyond what would be justified if the exemptions had been made unqualified and self-operative and beyond the power of the Commission to correct when abuses are used to circumvent the purposes of the title." *Id.* at 336, note 36, citing Senate Report, *supra* note 2, at 24; House Report, *supra* note 2, at 11.

the costs associated with complying with the Act and the costs of making required filings and applications under the Act. The company also presumably benefits by not being subject to the Act's regulatory requirements, including the Act's restrictions on a registered holding company's ability to engage in other businesses, its restrictions on affiliate transactions, and the requirements regarding capital and corporate structures. Enron, like any other exempt holding company, likely obtained these benefits during the period that it was not registered under the Act. Enron also presumably benefited from its ownership of PGE, including the effect that ownership of PGE had on its income, profit and assets during this period. We also note, as we have described elsewhere, that although Enron did not obtain any benefits specific to the Act through the filing of the sections 3(a)(3) and 3(a)(5) application (because it continued to claim exemption as an intrastate holding company under rule 2 until 2002 and then filed an application for exemption under section 3(a)(1)), the filing of that application permitted it to continue to own qualifying facilities ("QFs") pursuant to the Federal Energy Regulatory Commission's regulations under PURPA.

Whether any of those benefits could be considered inappropriate depends upon whether Enron's exempt status was wrongly obtained or, with respect to its formal applications for exemption, whether any of those applications was not made in good faith.[4] In this context, we note that because (as of 1997) Enron was a holding company solely by reason of its ownership of PGE, Enron was a likely candidate for a section 3(a)(1) intrastate exemption. The company's annual filings on Form U-3A-2 did not provide any information that suggested that it could not qualify for the section 3(a)(1) exemption. With respect to Enron's formal applications under the Act, we note that although the staff vigorously opposed the granting of any of those exemptions in the hearing conducted before the Commission, the question of whether the applications were filed in good faith was not addressed in the administrative proceeding.

2. In light of the Enron experience, why hasn't the SEC revised Rule 2 so that companies can no longer claim exempt holding company status under PUHCA without some type of formal process which requires the Commission and its staff to actually evaluate whether the claim is warranted based on the facts and circumstances? In the absence of reforms to the Commission's administration of Section 3 of PUHCA and Rule 2 promulgated thereunder, what is to prevent another Enron situation from occurring?

The objective requirements for exemption under section 3(a)(1) focus exclusively upon the utility operations of the holding company. The staff continues to believe that it can adequately monitor exemptions claimed pursuant to rule 2 by reviewing the annual filings that companies make on Form U-3A-2. Moreover, as most of the companies that claim exemption under rule 2 clearly come within established precedent, the staff believes that leaving rule 2 in place conserves significant staff and Commission resources

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[4] Section 3(c) of the Act grants a temporary exemption pending Commission action on their applications to applicants who have filed an application for an exemption "in good faith."

that can more valuably be used elsewhere. The staff thus has not recommended that the Commission withdraw or otherwise modify rule 2. However, the staff is analyzing ways in which Form U-3A-2 can be updated. In particular, the staff is analyzing ways to clarify and improve the usefulness of the data requests. The staff hopes to recommend proposed form amendments to the Commission so that it can formally propose the amendments and seek public comment. The staff believes that these amendments will significantly improve the staff's efficiency in monitoring holding companies that claim exemption by Form U-3A-2 under sections 3(a)(1) and 3(a)(2) of the Act pursuant to rule 2.[5]

While the staff and Commission have continued to review their approach to the Act in light of Enron, the staff has no reason to believe that Enron's bankruptcy was causally related to the current administration of the exemptive provisions of the Act. Rather, it appears that Enron's downfall was directly related to unlawful activities of the company and a number of its employees and certain third parties. As you know, the Commission's staff is actively investigating possible violations of the federal securities laws by Enron and certain of its employees and third parties.

3. What is the current process at the SEC for evaluating whether exempt status claimed or previously granted to a utility holding company should be revoked as "detrimental to the public interest or the interest of investors or consumers"? Who has standing to initiate such a review? How many staff people are working on the matter and what internal deadlines do they have?

Rule 6, which specifies the process for terminating exemptions claimed pursuant to rule 2, has two parts. First, it provides for notification to a holding company if it appears to the Commission that "a substantial question of law or fact exists" as to whether the company meets the formal requirements for exemption. Second, the Commission may provide notification "if it appears that any question exists as to whether the exemption of any such company may be detrimental to the public interest or the interest of investors or consumers." The Commission articulated the standard for this determination in *Long Island Lighting Co.*, 18 S.E.C. 717, 722 (1945), in which it stated that "[t]he question of detriment to the public interest must be considered in relation to the declared policy of the Act and the provisions therein set forth by Congress for the protection of the public interest."[6]

The revocation of an exemption pursuant to rule 6 is an *ad hoc* procedure that is initiated by the staff and ultimately authorized by the Commission. A number of factors can prompt the staff to consider whether we believe taking formal action under rule 6 is

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[5] Previous Staff Memorandum at 13.

[6] *Accord, Eastern Gas and Fuel Associates*, 43 S.E.C. 524, 539 (1967) ("the concept of 'public interest' with respect to an application under the Holding Company Act must be considered in the context of the expressed standards and policies of the Act itself." (citation omitted)).

appropriate, including an exempt holding company's filings under the Act or under the other securities laws, complaints about the holding company from investors, customers, state regulators or other sources, and articles in industry publications that raise questions about the exempt holding company's activities or financial condition. In most cases, the staff contacts the exempt holding company to obtain further information as part of its analysis. If the staff concludes that formal action under rule 6 is appropriate, it would present a recommendation to the Commission.

Matters have arisen under rule 6 related to an exempt holding company's nonutility activities. This issue is discussed in the response to question 11, *infra*. In *Colonial Gas Energy System*,[7] the Commission invoked rule 6 because the reports filed with the Commission under the federal securities laws disclosed complexities in the financial structure of Colonial, a closely held gas intrastate exempt holding company, and its subsidiaries that impaired Colonial's ability to raise needed capital and adversely affected its operating subsidiaries.[8] In 1986, the Commission invoked rule 6 to terminate KN Energy's claim of exemption because it appeared that the criteria of section 3(a)(2) were not satisfied.[9]

In addition, apart from the procedures described in rule 6, the Commission itself may initiate the revocation of an exemption pursuant to section 3(c) of the Act. Section 3(c) provides, in pertinent part, that, "[w]henever the Commission on its own motion . . . finds that the circumstances which gave rise to the issuance of [an exemptive order under section 3(a)] no longer exist, the Commission shall by order revoke such order." This occurred in *Long Island Lighting Co.*,[10] after a preferred stockholders' protective committee of the utility filed with the Commission a petition requesting that a previously granted order of exemption under section 3(a)(1) of the Act be revoked, or, in the

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[7] Holding Co. Act Release No. 22144 (July 30, 1981).

[8] As explained in the *Colonial Gas* order, the issuance of senior securities by Colonial's operating subsidiaries was dependent under their bond indentures on the maintenance of a 45% equity ratio. Colonial's ability to finance was critical, because Colonial was the subsidiaries' sole source of new common equity.

Colonial had relied primarily on direct or indirect borrowing to provide equity to the operating companies. The utilities had sold long-term bonds in 1974. Thereafter, their short-term bank borrowings became the primary source of funds for the whole system. By the end of 1977, these loans had grown to 23% of consolidated system capitalization. Colonial's common equity was then only 18%, and the lending banks had indicated their unwillingness to continue on this basis. Colonial's inability to finance was compounded by disputes related to intercompany transactions and accounting and other business practices that delayed much-needed rate increases for the utilities.

[9] *See* Commission Minute, March 6,1986, 10:06 a.m.

[10] 18 S.E.C. 717 (1945).

alternative, that the order be modified so as to except therefrom the applicability of sections 5 and 11 of the Act. In response, the Commission initiated a proceeding on its own motion under section 3(c) of the Act. The Commission ultimately determined that the circumstances that gave rise to the order under section 3(a)(1) no longer existed and that the continuance of the exemption was detrimental to the protected interests under the Act.[11] It thus revoked the exemption.

Because an analysis of whether to revoke an existing exemption does not occur on a predictable basis, staff are not permanently assigned to this issue but rather are assigned to particular matters as they arise. The staff's internal deadlines, and the number of staff who would work on any given matter concerning the potential revocation under rule 6 of a claim of exemption, would both depend on a number of factors, such as, current staffing, workload, the complexity of the matter, the need to obtain information, and similar considerations.

4. In addition to the Enron proceeding, how many inquiries, investigations, or other proceedings has the SEC conducted over the last 15 years to determine whether an exemption should be revoked? What has been the result of any such inquiries? If there have been no such inquiries, how can the SEC know whether those currently claiming or otherwise operating under an exemption from PUHCA actually merit exempt status? How many staff are assigned to this task and for how long and with what results?

Reviewing the continuing validity of existing exemptions is one important part of the staff's work. Much of this work is conducted informally at the staff level rather than by the Commission directly. Apart from the review of Form U-3A-2 filings, which currently involves virtually all members of the Office of Public Utility Regulation (the "Office"), staff are assigned to matters involving the validity of specific existing exemptions on an as-needed basis. In most instances in which the staff has sought further information from a claimant in connection with its Form U-3A-2, the information provided has effectively satisfied the staff's concerns. The Commission's last formal action to revoke or deny an exemption prior to the *Enron* matter involved ALLTEL Corporation, a telecommunications holding company that sought an exemption from registration under section 3(a)(3) of the Act in connection with its acquisition of CP National Corporation, a company that was, among other things, a gas utility company. The application was set for hearing by order dated September 28, 1989.[12] The post-hearing procedures in the matter were stayed pending consummation of a proposed sale of the utility assets that had the effect of mooting the application.

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[11] Accordingly, the Commission noted that it was "immaterial, for our present purposes, that Long Island and its subsidiaries are 'predominantly intrastate in character' within the meaning of Section 3(a)(1) of the Act." *Long Island Lighting Co.*, 18 S.E.C. 717, 772-73 (1945).

[12] *ALLTEL Corp.*, Holding Co. Act Release No. 24959 (Sept. 28, 1989).

5. The SEC staff memorandum (p. 5) indicates that Enron's exemption was revoked due to its ownership of out-of-state utility assets and its participation in out-of-state electricity transactions. Are there other exempt holding companies that are also substantial participants in interstate electricity or natural gas markets? If so, has the SEC ever inquired whether these companies might also have out-of-state generation or transmission assets? If not, why?

There are other exempt holding companies that participate in these markets. Form U-3A-2 requires that an intrastate holding company claiming exemption under rule 2 disclose the quantity of electric energy and natural gas distributed and sold at wholesale by its subsidiary public-utility companies outside of the given state of organization. Form U-3A-2 also requires that these public-utility subsidiaries provide a description of their utility properties, and further requires that they specifically state the location of all utility assets located outside their state of organization. With respect to holding companies claiming an intrastate exemption under rule 2, the staff is thus able to review both these matters without making further inquiries of the companies.

6. Is it your view that Enron was more severely harmed by PGE's activities in wholesale energy markets or by Enron's far-flung non-utility activities?

As noted above, Enron was harmed by the unlawful activities in which the company and a number of its employees and certain third parties engaged rather than by the specific businesses in which it engaged. The record in the Enron administrative proceeding does not contain any evidence that either PGE or Enron was harmed by PGE's activities in wholesale energy markets. Indeed, both PGE and the Oregon Public Utility Commission submitted evidence, undisputed in the proceeding, that PGE carried out these activities to benefit its Oregon customers.

7. The most common source of financial stress to a utility is its ownership of non-utility businesses. A review of a number of recent reports issued by nationally recognized credit rating agencies (*see* attached list) indicate that the financial and operating performance of exempt holding companies is frequently worse than that of registered holding companies, and that where registered holding companies have seen downgrades, losses from unregulated business may be largely to blame. Is the Commission aware of these reports?

Don't the findings merit a re-examination of your previous holdings that confine examination of the appropriateness of a Section 3(a)(1) exemption to only utility subsidiaries and parent holding companies, especially in light of the language of Section 3(a) that permits the SEC to deny a holding company an exemption to which it is otherwise entitled if it finds that the exemption would be "detrimental to the public interest or the interest of investors or consumers?" If not, why not?

The staff is aware of these reports. The Commission's interpretation of section 3(a)(1), including the settled approach of not considering the place of organization of the nonutility subsidiaries of a holding company seeking exemption under section 3(a)(1),

goes back to the earliest days of the administration of the Act. The staff does not believe that a fundamental change to this approach is necessary. The section 3(a)(1) exemption is predicated, in large part, on the belief of the drafters of the Act that where a holding company and each of its public-utility subsidiaries are incorporated in the same state, the relevant state commission can obtain jurisdiction over both the holding company and its utility subsidiaries, and could thus take whatever actions it deemed necessary to protect utility customers, including placing limitations on the holding company's nonutility activities or otherwise taking steps to isolate the utility from any risks posed by those activities. The same might not be true in situations in which a holding company was not incorporated in the same state as its utility subsidiaries or owned utility subsidiaries in multiple states; thus, the Act subjects multistate utility holding companies to an overlay of federal regulation.

With respect to investors, whose interests are also protected by the Act, we do not believe that the Act was intended to ensure that holding companies meet specific standards of financial performance for the benefit of their investors. Instead, the Act is primarily focused on ensuring that the holding company structure is not used to abuse investors.[13] In most cases, this goal is achieved today through the holding companies' compliance with the reporting requirements imposed by the Commission pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934.

Of course, in an appropriate situation, the Commission might still, pursuant to the "unless and except" clause, revoke the exemption of a holding company otherwise clearly entitled to the intrastate exemption because of the impact of its nonutility activities on either its utility customers or investors. However, we continue to believe that problems of this type are more appropriately resolved through a case-by-case application of the "unless and except" clause rather than through a fundamental alteration of the Commission's current interpretation of section 3(a)(1).

8. The SEC staff memorandum (p. 6, fn. 17) states: "we vigorously review the non-utility activities of newly registered holding companies to ensure that they remain within the restrictions imposed by section 11(b) of the Act." How many such reviews have been conducted, by how many staff, and with what results?

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[13] Among the abuses sought to be corrected, for example, were "the issuance of securities taking varied and hybrid forms and sold to the public at prices based on inflated values, the overburdening of the operating companies with excessive debt and otherwise unsound financial structures, and draining excessive funds from them and imposing financial policies and unwarranted charges, all of which benefited the controlling groups in the top companies at the expense and to the serious detriment of investors and the securities markets generally and the utility consumers affected." *Vermont Yankee Nuclear Power Corp.*, 43 S.E.C. 693, 700 (1968), citing Senate Report at 2-4, 55-60, *remanded on other grounds*, *Municipal Electric Association of Massachusetts v. SEC*, 413 F.2d 1052 (D.C. Cir. 1969) and *American Light & Power Co. v. SEC*, 329 U.S. 90, 101-06 (1946).

Under current practice, the staff conducts such reviews with respect to each holding company at the time that it initially registers under the Act. These reviews are undertaken by the staff attorney(ies) assigned to the particular matter as well as by senior staff. In several instances, the Commission, in its order approving an acquisition that would cause a holding company to register, discussed the timing of, or required, certain divestments under section 11(b)(1) of the Act.[14]

9. We are aware of a number of companies that currently enjoy an exemption under Section 3(a)(1) and yet appear to engage in interstate wholesale electricity sales (*see* attachment). Please describe the efforts that you have made to determine whether these or other utility holding companies exempt under Section 3(a)(1) are similarly engaged in wholesale markets.

The staff is currently completing its review of this year's filings by holding companies claiming exemption under rule 2. These filings (on Form U-3A-2) were submitted to the Commission on March 31, 2004. As filed, the form indicates the volume of out-of-state sales of gas or electricity. Where appropriate, the staff will take further action. Whether out-of-state sales of electricity are at retail or wholesale is immaterial for purposes of satisfying the objective criteria for exemption under section 3(a)(1) or section 3(a)(2) of the Act.

10. A recent Standard & Poor's report found that PUHCA has played a valuable role in preventing registered holding companies from engaging in practices such as investment in noncore business industries like savings and loan, insurance, aircraft leasing, real estate, telecom, emerging market utilities, independent power, and energy marketing and trading that have been the cause of financial difficulties for non-registered holding companies. Moreover, the report found that the potential repeal of PUHCA creates the risk of highly leveraged companies purchasing utilities, leveraging them up, and using the cash to invest in higher-risk ventures. Please explain, in light of this finding, why the Commission continues to endorse a forgiving and expansive view of the exemptions available from the registration requirement, when the record clearly indicates that consumers and investors are better served by registration?

The Commission has not, in our view, endorsed a "forgiving and expansive" view of the Act's exemptive provisions. Indeed, the Commission's approach to section 3(a)(1) – by far, the most commonly invoked of the exemptive provisions – goes all the way back to the Commission's early administration of the Act. Since 1995, the Commission

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[14] *See, e.g.*, *E.ON AG*, Holding Co. Act Release No. 27539 (June 14, 2002) (addressing timing of divestment of nonutility subsidiaries by registered holding company as part of a general divestment program; activities of the subsidiaries included chemicals, real estate and oil); *see also CP&L Energy, Inc.*, Holding Co. Act Release No. 27284 (Nov. 27, 2000); *Keyspan Corp.*, Holding Co. Act Release No. 27271 (Nov. 7, 2000); *NiSource Inc.*, Holding Co. Act Release No. 27263 (Oct.30, 2000).

has revisited and reinterpreted section 3(a)(5) of the Act and has liberalized its application of section 3(a)(2).[15] The Commission has also slightly increased the percentage of out-of-state sales of gas or electricity permitted under section 3(a)(1) of the Act.[16] As a general matter, however, we believe that the Commission's approach to the exemptive provisions in recent years has been consistent with its historical approach – just as we stated in the 1995 Report, the exemptions under section 3(a) "have, for the most part, been construed and applied conservatively."[17] More importantly, in circumstances in which the Commission has liberalized its approach to the exemptive provisions, it has done so only after carefully considering whether the precedent it was establishing would negatively impact the ability of state commissions to regulate utilities in their states

We thus do not believe that the Commission's grant of exemptions in recent years has impaired the ability of state commissions effectively to regulate public utilities within their jurisdiction. More generally, the Commission is not empowered to impose registration upon a company simply because registration seems potentially preferable to exemption. Rather, as discussed in the response to question 1, *supra*, section 3(a) of the Act requires the Commission to grant an exemption if the objective criteria are satisfied and the Commission makes no adverse finding under the "unless and except" clause.

11. Given the clear link between non-regulated investment and weakened financial performance among exempt holding companies – as recognized by Wall Street credit agencies – why has the SEC not revisited its current interpretation of its enforcement role under Section 3(a)(1) and other PUHCA exemptions, which does not provide for any meaningful regulation or oversight of non-regulated investments by exempt holding companies?

It is unclear whether there is a difference between the Commission's "enforcement role under Section 3(a)(1)" and its general approach to interpreting that section – an approach discussed extensively above and in the Previous Staff Memorandum. More broadly, however, the Commission has understood the language of the "unless and except" clause of section 3(a), concerning an exemption that the Commission finds "detrimental to the public interest or the interest of investors or

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[15] *See AES Corp.*, Holding Co. Act Release No. 27063 (Aug. 20, 1999) (granting exemption under section 3(a)(5) of the Act) and *Houston Industries, Inc.*, Holding Co. Act Release No. 26744 (July 24, 1997) (granting exemption under section 3(a)(2) of the Act).

[16] *See NIPSCO Industries, Inc.*, Holding Co. Act Release No. 26975 (Feb. 10, 1999). There the Commission determined that a three-year average equal to 13.2% of the holding company's total net utility operating revenues permitted a conclusion that the holding company was carrying on its utility operations "predominantly and substantially" in Indiana, as required by section 3(a)(1) of the Act.

[17] 1995 Report, *supra* note 1, at 114.

consumers," to give it complete authority to address the abuses sought to be prevented by the Act.[18] For example, *Pacific Lighting Corporation*[19] stated "[i]t is undisputed that the Pacific system continues to meet the objective intrastate standards of Section 3(a)(1). The determination of the question whether in light of the substantial diversification by Pacific Lighting Corp., retention of its exemption would be detrimental within the meaning of the 'unless and except' clause turns on the proper interpretation of that clause."[20] We thus believe that, under its current interpretation of section 3 of the Act, the Commission has an adequate ability to address the abuses that the Act was intended to prevent.

However, the Act does not *per se* restrict the ability of exempt holding companies to engage in nonutility activities. The "other business" clauses of section 11, the central provision of the Act, require the Commission to limit the nonutility activities of a registered holding company to those that are "reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system" and to those that the Commission "shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems." In contrast, the Act does not specifically limit the nonutility activities of exempt holding companies, as Congress decided not to regulate those activities in the same way or to the same degree as the nonutility activities of registered

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[18] Section 1(c) of the Act requires the Commission to interpret all of the provisions of the Act "to meet the problems and eliminate the evils as enumerated in this section . . . ." The studies that preceded enactment documented a pattern of widespread abuses that were detrimental to both investors and consumers. The report of the Federal Trade Commission listed nineteen general categories of abuses, including: the issuance of securities to the public that were based on unsound asset values or on paper profits from intercompany transactions; the extension of holding company ownership to disparate, nonintegrated operating utilities throughout the country without regard to economic efficiency or coordination of management; the mismanagement and exploitation of operating subsidiaries of holding companies through excessive service charges, excessive common stock dividends, upstream loans and an excessive proportion of senior securities; and the use of the holding company to evade state regulation. Federal Trade Commission, *Report on Utility Corporations*, S. Doc. No. 92, 70th Cong., 1st Sess. (1928-1935) (in 101 volumes), pt. 73-A at 62.

As noted previously, the legislative history makes clear that the SEC's "unless and except" authority is the justification for any broad grant of exemption. *See supra* note 3.

[19] 45 S.E.C. 152 (1973).

[20] *Id.* at 157.

holding companies.[21] The Commission has rarely invoked its authority to challenge an exemption solely on the basis of nonutility diversification.[22]

The "unless and except" clause does provide the Commission with the necessary authority to limit or otherwise regulate the nonutility activities of an exempt holding company by limiting, on a case-by-case basis, the availability of the specific holding company's exemption. In doing so, the Commission must carefully analyze the impact of the specific holding company's activities on the interests protected by the Act. In particular, as noted in the 1995 Report, "[t]he [SEC] has given weight, in recent matters, to the state's judgment concerning the effect of diversification, as well as to the state's ability to exercise effective regulatory control. The United States Court of Appeals for the District of Columbia Circuit has held that the SEC does not abdicate its duty in an exemption determination 'by deciding to rely, watchfully, on the course of state regulation.'"[23]

12. Given that acquisitions of utilities by non-utility companies are on the rise and at least one Wall Street credit rating agency has noted the leveraged structure of one such transaction with disapproval, shouldn't the SEC be closely considering the financial impact on exempt utility holding companies and their regulated utilities that may result from such transactions?

As described in the answer to question 11, *supra*, the "unless and except" clause of section 3(a) gives the Commission the ability to deny exemptions that are contrary to the public interest or the interests of consumers. We thus are concerned about ownership structures that result in harm to the customers of regulated utilities or those utilities' other

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[21] The Commission has never defined the limits of permissible nonutility diversification by exempt holding companies. In *Pacific Lighting*, *supra note* 19, the staff unsuccessfully challenged an exemption on the basis of diversification. An evenly split 2-2 vote by the Commission rendered the outcome inconclusive. The same result occurred in a companion case, *National Utilities & Industries Corporation*, 45 S.E.C. 167 (1973), where the absence of a majority had the effect under section 3(c) of the Act of continuing the "good faith filing" exemption of the applicant. *See id.*, at 172. In *Pacific Lighting,* the absence of a majority had the effect of permitting the continuation of an exemption previously granted by order in 1936 (*Pacific Lighting Corporation* 1 S.E.C. 275 (1936), cited at 45 S.E.C. 152). *See Pacific Lighting, supra note* 19, at 166.

[22] In addition to the cases cited *supra note* 21, *see Lykes Bros., Inc.*, 46 S.E.C. 1196 (1978). In that matter, a company engaged in cattle ranching, meat packing, citrus farming and sugarcane and recreational operations acquired a gas utility company and requested an exemption under section 3(a)(1) or section 3(a)(3) of the Act. The SEC staff opposed the application. Lykes amended its application to request only a limited exemption and undertook to divest its interest in the utility under section 11(b)(1) of the Act. Upon divestiture, Lykes ceased to be a holding company.

[23] 1995 Report, *supra* note 1, at 114 (citations omitted).

investors (such as holders of a public utility's debt securities). In an appropriate situation, the staff would recommend that the Commission more formally investigate or seek to revoke an exemption, the grant or claim of which appeared to be causing harms of this type.

13. We understand that the 3(a)(1) exemption that Enron had was just one of at least three that the company had received through no-action letters from the SEC staff. Is this true? What was the basis for the other no-action letters granted to Enron? To what extent was continued compliance monitored?

A holding company cannot obtain an exemption from the Act by means of a no-action letter. Instead, the Office's no-action letters, which are generally focused on a specific transaction or activity in which an entity desires to engage, either offer the staff's interpretive guidance or offer the assurances of the staff that it will not recommend that the Commission take enforcement action based on a particular set of facts. The Office generally limits no-action letters to providing "no recommended enforcement" assurances based upon the specific facts and circumstances described in the letter. Exemptions, in contrast, are the subject of applications and orders under section 3 of the Act or are claimed pursuant to rules promulgated by the Commission.

Between 1992 and 1999, the staff issued five no-action letters to Enron and/or its subsidiaries. Those letters are described below.[24]

Each of the no-action letters issued to Enron was a no recommended enforcement letter. When the Office issues this type of no-action letter, it states that it will not recommend enforcement action to the Commission. Typically, as in Enron's no-action letters, the party requesting no-action assurance provides a detailed description and representations to the staff concerning the proposed transaction or activity in question. The party also provides a legal analysis; this analysis generally does not focus upon why it or the activity in question should be exempted from the Act, but rather generally focuses on why the activity in question is not within the scope of the Act. Such letters are thus primarily concerned with the meaning of the Act. Although the staff typically does not either agree or disagree with the legal analysis set forth by the party, the staff, in issuing the no-action letter, does base its determinations on the circumstances described in the request and the representations of the party. The staff states specifically in a no-action letter (more specifically, the assurance that the staff will not recommend an enforcement action) that any material change in the circumstances and representations on which the request was based might lead the staff to a different conclusion. When changes occur, parties typically submit a new no-action request.[25] In the absence of further no-

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[24] The application by Enron for an order of exemption under section 3(a)(3), or, in the alternative, section 3(a)(5), of the Act is discussed separately in the response to question 14, *infra*.

[25] *See generally* Thomas P. Lemke, "The SEC No-Action Letter Process," 42 *The Business Lawyer* 1019 (Aug. 1987) ("Lemke Article"). The Lemke Article offers a

action assurances, the party could be subject to enforcement action under the Act. The SEC's no-action process is discussed further *infra*.

In *Enron Power Marketing, Inc.*, SEC No-Action Letter (Jan. 5, 1994), the staff stated that it would not recommend an enforcement action under section 2(a)(3) of the Act in the event that EPMI, an indirect subsidiary of Enron Corp., entered into contracts for the purchase and resale of electric power or for transmission capacity in connection with its power marketing activities. EPMI did not own any generating plants, transmission lines or electric distributions systems. EPMI argued in its no-action request that under the Act, the contracts and books and records underlying its power marketing activities were not "facilities" used for the "generation, transmission or distribution of electric energy for sale" within the meaning of section 2(a)(3) of the Act and that its power marketing subsidiary therefore was not, for purposes of the Act, an electric utility company.[26]

Based on EPMI's representations, the staff gave the requested no-action assurance. Although the staff's response expressly stated that the staff did not necessarily agree or disagree with EPMI's legal analysis, the staff would have considered whether, in its view, EPMI was engaged in activities that the Act was intended to regulate. In deciding to issue the letter, the staff likely concluded that power marketing was not a utility activity.

In this regard, we note that, as discussed in a December 29, 1997 memorandum to Chairman Levitt that was prepared in response to an inquiry from Congressmen Markey and Dingell in a letter dated April 29, 1997 ("1997 Staff Memorandum"), the Commission has issued orders authorizing registered holding company subsidiaries to engage in power marketing activities since 1987. The Commission issued these orders under sections 9(a)(1) and 10 of the Act. Section 9(a)(1), in pertinent part, requires prior Commission approval by order under the standards of section 10 for a direct or indirect acquisition by a registered holding company of "any securities" or "any other interest in any business." The phrase "any other interest in any business" has been read comprehensively to cover any arrangement that entails the acquisition of a substantial interest in a nonutility business undertaking."[27]

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detailed discussion of the history and development of the SEC's no-action process and the mechanics of the process.

[26] The Act does not define the term "facilities." Section 2(a)(18) of the Act defines "utility assets" to mean "the facilities, in place, of any electric utility company or gas utility company for the production, transmission, transportation, or distribution of electric energy or natural or manufactured gas."

[27] *See* 1997 Staff Memorandum at 9-10, citing *Public Service Company of Oklahoma*, 45 S.E.C. 878, 882-83 (1975) (oil and gas venture).

In *Enron Corp.*, SEC No-Action Letter (Oct. 22, 1992), the staff stated that it would not recommend any enforcement action under sections 2(a)(4) and 2(a)(7) of the Act with respect to the company's proposal to engage in vehicular natural gas activities.[28]

In *Enron Power Corp.*, SEC No-Action Letter (Apr. 20, 1993), the staff stated that it would not recommend an enforcement action under section 2(a)(3) of the Act in the event that Enron Power Corp.– US provided certain operation and maintenance services to an electric power project under construction in the Philippines. The owners of the project, Batangas Power Corp. and Enron Power Philippines Corp., each a Philippine company, had provided notice to the Commission that each was a foreign utility company under section 33(a)(3) of the Act.

The *Enron Capital & Trade Resources, Corp.*, SEC No-Action Letter (Feb. 13, 1997), stated that the staff would not recommend an enforcement action under sections 2(a)(3) and 2(a)(4) of the Act in connection with activities in addition to those described in the EPMI request, described above. The additional activities were related to the consumption of energy and the means by which individual consumers can hook up to a system of distribution facilities.

The *Enron Federal Solutions, Inc.*, SEC No-Action Letter (Apr. 8, 1999), stated that the staff would not recommend enforcement action under sections 2(a)(3) and 2(a)(4) of the Act in connection with the proposal of Enron Federal Solutions, Inc. to own and operate the electric, gas, water and wastewater distribution systems located within the United States' Fort Hamilton Military Base in Brooklyn, New York, pursuant to the U.S. Department of Defense's congressionally-mandated privatization efforts. In seeking this relief, Enron Federal Solutions stated that its activities would be limited to the military base and that it would essentially be standing in the shoes of the federal government as provider of these services.

14. We also understand that Enron enjoyed exemptions under Section 3(a)(3) and 3(a)(5) of PUHCA, simply because it filed for such exemptions and the SEC did not take any final action to disapprove them. Is this true?

The Commission ultimately rejected all of Enron's exemptive requests, including the application for exemptions under sections 3(a)(3) and 3(a)(5). That application requested relief in the alternative, specifically, an exemptive order under section 3(a)(3) or, in the alternative, section 3(a)(5) of the Act. As noted in the response to question 1, *supra*, section 3(c) of the Act provides a "good faith filing" exemption pending the disposition of an application for exemption under section 3(a).

However, at the time it filed the 3(a)(3)/3(a)(5) application, Enron was separately claiming exempt status under section 3(a)(1) of the Act under rule 2 as an intrastate

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[28] The Commission has authorized gas registered holding companies under sections 9(a)(1) and 10 of the Act to engage in these activities. *See Consolidated Natural Gas Co.*, Holding Co. Act Release No. 25615 (August 27, 1992)

exempt holding company which the Commission also denied. It later filed a separate application for an order of exemption under section 3(a)(1). Because qualifying for more than one exemption under the Act does not provide a holding company with any relief over and above what it would receive by obtaining a single exemption, the Commission's rejection of the section 3(a)(3)/3(a)(5) application by itself would have had no practical effect on Enron's status under the Act.

15. Does the SEC or its staff review the totality of PUHCA exemptions and no-action letters granted to a single person or entity to evaluate the cumulative effect of the exemptions, and whether they might be undermining the purposes of the Act? If so, how is this done? If not, why not?

It is not possible to "accumulate" exemptions under the Act. An application may request exemptions in the alternative, for example, section 3(a)(3) or, in the alternative, section 3(a)(5) of the Act; or, as another example, section 3(a)(1) or, in the alternative, section 3(a)(2) of the Act. However, only one exemption, if any, will be granted. Moreover, as noted above, obtaining multiple exemptions pursuant to section 3 would not have any practical effect on, or provide any additional benefits to, an exempt holding company.

In contrast, the no-action letters described above concern a company's status as a holding company or subsidiary under the Act. As discussed previously, the staff's response indicates that it would not recommend any enforcement action to the Commission on the basis of the facts presented. In appropriate circumstances, the staff does consider the relationship between the activities described in the no-action request and any other activities of the requestor in determining whether to offer no-action assurances. As a general matter, however, a particular activity is either a jurisdictional utility activity or it is not. Absent special circumstances, the conduct of other activities by other subsidiaries of a holding company should not affect this analysis. No-action letters do not address whether any particular exemption would be available to a company that did not obtain the requested no-action relief with respect to its status.

II. Investments by Non-Utility Companies in Utilities

A. Ownership Structures

16. Section 2(a)(7) of the Act defines a holding company as "any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company or of a company which is a holding company." The SEC staff memorandum (pp. 7-10) indicates that the staff has issued a number of no-action letters during the past ten years under this section and cites the letter issued to Berkshire Hathaway in 2000 as the most prominent example. How does the SEC reconcile the analysis and conclusions reached by the SEC staff in the Berkshire Hathaway no-action letter with the Commission's earlier precedent in the H.M. Byllesby & Company and United Corporation decisions?

As discussed in detail below, those cases are distinguishable from *Berkshire Hathaway*. In *Berkshire Hathaway, Inc.* [29] and other similar letters, there were no *prima facie* holding companies under section 2(a)(7)(A) of the Act and the staff did not conclude that, based on the facts presented in the no-action request, Berkshire Hathaway and the other companies would exert the kind of control or controlling influence that would have warranted a recommendation to the Commission that they be found to be holding companies under the Act. In contrast, both *H. M. Byllesby & Company*[30] and *The United Corporation*[31] involved *prima facie* holding companies as well as a Commission finding that they exerted the kind of control or controlling influence that required them to be found to be holding companies.

Section 2(a)(7)(A) states that any company that owns 10% or more of the outstanding voting securities of a public utility (or public-utility holding company) is a *prima facie* holding company subject to the Act. In the transaction that was the subject of *Berkshire Hathaway, Inc.*, Berkshire Hathaway proposed to acquire 9.9% of the outstanding common stock of MidAmerican Energy Holding Company ("MidAmerican"), an Iowa corporation that claims exemption under section 3(a)(1) of the Act pursuant to rule 2. Because it owned less than 10% of the outstanding voting securities of MidAmerican, Berkshire Hathaway was not a *prima facie* holding company within the meaning of section 2(a)(7)(A) of the Act. This pattern has been repeated in each of the other no-action letters discussed in the Previous Staff Memorandum – in each case, the party seeking the staff's assurances would not own, control, or hold with power to vote 10% or more of the voting securities of a public utility or public-utility holding company.

Before considering the Commission's decisions in *H. M. Byllesby* and *United Corp.*, it is important to note that section 2(a)(7)(B) of the Act provides another means of determining holding company status. This section refers to "any person which the Commission determines . . . directly or indirectly to exercise (either along or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties, and liabilities imposed in this title upon holding companies." As discussed in the Previous Staff Memorandum,[32] because Berkshire Hathaway was not a *prima facie* holding company under section 2(a)(7)(A), the staff, in issuing a no-action letter to Berkshire Hathaway (as well as in the later matters), offered its assurances that, based upon "the rights attendant to Berkshire's

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[29] S.E.C. No-Action Letter (Mar. 10, 2000).

[30] 6 S.E.C. 639 (1940).

[31] 13 S.E.C. 854 (1943).

[32] Previous Staff Memorandum at 10.

ownership of the Convertible Preferred Stock, combined with its ownership of 9.9% of the voting securities of [MidAmerican] and the nature of its relationship with the company," it would not recommend that the Commission take action pursuant to section 2(a)(7)(B).[33]

The decisions in *H. M. Byllesby* and *United Corp.* involved efforts by holding companies that were *prima facie* holding companies under the Act -- that is, parties that, in contrast to those that sought no-action relief in the *Berkshire Hathaway* letter, did own 10% or more of the voting securities of a public utility or public utility holding company -- to obtain the relief necessary to cease to be holding companies under section 2(a)(7). These matters thus arose in an entirely different context from the transactions described in the *Berkshire Hathaway* line of no-action letters, and are distinguishable from them.

In *H. M. Byllesby*, that company ("Byllesby") and its parent, the Byllesby Corporation, sought a declaratory order under section 2(a)(7)(B) of the Act or, in the alternative, an order of exemption under sections 3(a)(3) and 3(a)(5). Because the Byllesby Corporation controlled Byllesby, disposition of the application turned upon whether Byllesby was a holding company within the meaning of section 2(a)(7) of the Act.[34]

Section 2(a)(7)(B) of the Act provides, in pertinent part, that:

> The Commission, upon application, shall by order declare that a company is not a holding company under clause (A) if the Commission finds that (i) the applicant does not . . . directly or indirectly control a public-utility company or holding company . . . and (ii) is not an intermediary company through which such control is exercised, and (iii) does not, directly or indirectly, exercise . . . such a controlling influence over the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that the applicant be subject to the obligations, duties, and liabilities imposed in this title upon holding companies.

The Commission determined, on the basis of the facts and circumstances broadly summarized below, that the requirements of section 2(a)(7)(B)(iii) were not satisfied.

From 1910 to 1930, Byllesby's predecessor and Byllesby, through ownership of voting securities, interlocking directors and officers, and otherwise, had completely dominated Standard Gas & Electric Company ("Standard Gas"), the dominant holding company in one of the largest U.S. electric utility systems, and its subsidiaries. Control of Standard Gas enabled Byllesby to guide the financial policies of the company and its

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[33] *Berkshire Hathaway, supra note* 29.

[34] *H. M. Byllesby & Company, supra* note 30, at 642.

subsidiaries, and to obtain primary participation in underwritings of their securities. Byllesby's investment banking functions greatly expanded during this period.[35]

Also during this period, Byllesby, by virtue of its domination of Standard Gas, caused the utility and its subsidiaries to enter into transactions involving the purchase and sale of utility properties and securities, which netted Byllesby large profits. Through affiliated management corporations, Byllesby likewise profited from charges for engineering, construction, legal, and similar services to Standard system companies.[36]

In 1929, other interests, including a number of investment bankers, had accumulated substantial quantities of the common stock of Standard Gas with the purpose of obtaining a voice in management. These interests pooled their stock in a company that they organized and began a struggle for control of Standard Gas that endangered the banking position that Byllesby had hitherto enjoyed. The result was an agreement between the conflicting interests, involving, among other things, a recapitalization of Standard Power & Light Corporation ("Standard Power") and Standard Gas and the allocation among the parties of specified percentages of future underwritings of securities in the Standard system companies. As a result of the agreement, Standard Power, which had previously been a subsidiary of Standard Gas, was transformed into its parent. Under a complex arrangement, Byllesby retained the power to elect a majority of the board of directors of Standard Gas. The bankers' agreement was reduced to a formal memorandum.

In 1936, Byllesby owned approximately 75% of the outstanding shares of common stock, series B, of Standard Power, now a registered holding company, which, in turn, held the majority of the common stock of Standard Gas, also a registered holding company. Under the circumstances, the Act required Byllesby to register.

To avoid that result, Byllesby sought to alter its relationship with the Standard system companies. Specifically, it caused officers and directors of Byllesby and Byllesby Corporation who held positions in Standard system companies to resign from their conflicting positions, and it entered into a voting trust agreement concerning the Standard Power common stock and received a voting trust certificate in return. The trustees had had a long business association with Byllesby and continued to hold common stock of the Byllesby Corporation.

The Commission found that Byllesby's ownership of voting trust certificates constituted ownership of "voting securities" within the meaning of section 2(a)(17) of the Act. The Commission appeared to believe that Byllesby controlled the voting trust, so it looked through the trust to the underlying voting securities. Accordingly, Byllesby was *prima facie* a holding company under section 2(a)(7)(A). The Commission then found that clause (iii) of section 2(a)(7)(B) could not be satisfied.

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[35] *Id.*

[36] *Id.* at 641-42.

The Commission noted, first, that disregarding the voting trust, it would be impelled to hold that Byllesby, both alone and "pursuant to an agreement or understanding" with the other investment bankers, exercised "a controlling influence" over the management and policies of Standard Power and Standard Gas:

> Among the facts in the record which would require this conclusion are: (1) The past relationships between Byllesby and the Standard companies have resulted in a personnel and tradition which make the Standard companies responsive to Byllesby's desires; (2) Byllesby alone can elect one less than a majority of the directors of Standard Power; (3) Byllesby together with the other investment bankers can elect all of the directors of Standard Power; (4) five out of the nine present directors of Standard Gas, elected since the reorganization of 1938, represent Byllesby and the other bankers; (5) Byllesby and the bankers have been able to allocate as they have pleased the underwriting of the Standard system companies' securities among themselves and other bankers of their selection.[37]

The Commission then considered whether the creation of the voting trust "ha[d] destroyed the controlling influence otherwise existing." The Commission determined that, in the circumstances, the former and current voting trustees were not sufficiently independent to insulate against a controlling influence. Finally, the Commission found that regulation as a holding company was appropriate for the benefit of the protected interests, since the Act was intended to eliminate, among other abuses, those resulting "'from an absence of arm's length bargaining'" and "'from restraint of free and independent competition,'" and "[o]ne of the manifestations of these abuses was the monopoly exercised by investment bankers over security issues of holding companies and their subsidiaries."[38] The Commission noted that:

> Arm's length bargaining concerning security issues by companies in the Standard system has been conspicuously absent ever since the organization of Standard Gas in 1910. From 1910 to 1929 Byllesby completely dominated all Standard financing. Since 1929 Byllesby has shared its monopoly with the few investment bankers who have held Standard Power common stock. At no time has any attempt been made by the Standard system companies to secure financing on a more favorable basis from investment bankers other than those in this group."[39]

In *United Corp.*, the Commission considered, among other things, a section 11(e) plan filed by The United Corporation ("United"), a registered holding company. Section 11(e) of the Act in pertinent part permits the submission to the Commission by a registered holding company of a plan for the divestment of control, securities, or other

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[37] *Id.* at 653.

[38] *Id.* at 655 (citing section 1(b)(2) of the Act).

[39] *Id.* at 656.

assets, or for other action for the purpose of enabling the holding company to comply with section 11(b)(1), which imposes economic and structural limits upon registered holding companies. In this case, United sought to transform itself from a holding company to an investment company, a step that Congress had expressly envisaged as a means to comply with section 11 of the Act.[40] The subsidiaries of United were themselves holding companies that directly or indirectly controlled more than 100 operating companies throughout the eastern United States.[41]

The section 11(e) plan proposed, among other things, that United would reduce its holdings in these holding company subsidiaries, at times advantageous to United, to less than 10% of voting stock. Pending the reduction, United would refrain from voting any of the securities, except with the express permission of the Commission. United had claimed since 1938 that it did not exercise control over the subsidiaries and that, while technically a holding company, it functioned primarily as an "investment company."[42]

The Commission rejected the proposed plan, finding that it was "replete with uncertainties" and would require further time-consuming proceedings upon its consummation; further, "it provides no assurance that it will be carried out with reasonable promptness."[43] The Commission also declined to set forth the steps that would be appropriate to cause United to cease to be a holding company.[44]

In its preliminary discussion, the Commission stated:

> In general we recognize the possibility that a holding company may comply with the statute by transforming itself into an "investment company." The question before us is whether United's plan in fact presents an appropriate method of transformation. * * *
>
> It is evident of course that ownership of 10 percent or more of the voting stock is not a necessary prerequisite to being a holding company within the Act, and the mere reduction to less than 10 percent will not necessarily transform United into an "investment company." The parent-subsidiary relationship is based upon the power to control or to wield a controlling influence by the parent company. The

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[40] *See* Senate Report, *supra* note 2, at 32-33. *See also Electric Bond and Share Co.*, 34 S.E.C. 536, 568 (1953) (noting Congress' intent and stating that the Commission, from the beginning of its administration of section 11, has recognized the availability of this method of compliance).

[41] *United Corp., supra note* 30, at 861-63.

[42] *Id.* at 883.

[43] *Id.* at 893-94.

[44] *Id.* at 899.

> reference to ownership of 10 percent or more of the voting securities in Sections 2(a)(7)(A) and 2(a)(8)(A) is merely a legislative declaration that ownership of 10 percent or more of the voting securities is likely to carry with it practical working control. Sections 2(a)(7)(B) and 2(a)(8)(B) make it equally clear, however, that ownership of less than 10 percent does not in itself resolve the parent-subsidiary question. The existence of control or controlling influence is frequently the result of complex and subtle intercorporate relationships, and may continue to persist regardless of the amount of voting stock held.[45]

The Commission noted elsewhere that:

> It should be emphasized at this juncture that we are not concerned here with a newcomer seeking to buy into several utility enterprises. The problem before us would then be at what point in the process of acquisition control and its statutory consequences would come into being. The problem presently before us is entirely different. For many years now the subsidiary companies in the United system have been subject to the latter's control or controlling influence. United is now attempting to divest itself of any "possibility of control" and to this end has filed a plan with us for the reduction of its holdings in its subsidiaries to less than 10 percent. Pending such reduction, United would not vote the securities it now holds in its subsidiaries, but thereafter would resume the right to vote the securities retained. The voting power thus retained, we believe, might leave United, not a mere stockholder holding less than 10 percent of the voting stock, but in a position of considerable authority.[46]

The results in *H. M. Byllesby* and *United Corp.* are distinguishable from the proposed transaction in the *Berkshire Hathaway* no-action letter. The holding companies at issue in the orders were *prima facie* holding companies within the meaning of section 2(a)(7) of the Act. These companies also had a long history of control over subsidiaries. Furthermore, in the *H. M. Byllesby* order, the Commission identified certain of the abuses set forth in section 1 of the Act that had characterized the parent companies' control and made their regulation as holding companies appropriate for the protection of the public interest and the interests of investors and consumers.

In contrast, Berkshire Hathaway was essentially the "newcomer" to the industry mentioned in the citation, *supra*, from *United Corp.* More importantly, Berkshire Hathaway did not own, directly or indirectly, 10% or more of the securities of a public utility or public-utility holding company that it was then entitled to vote, and thus it was not a *prima facie* holding company under section 2(a)(7) of the Act. Finally, the staff did not conclude that Berkshire Hathaway's ownership of voting securities, together with the other features of the transaction, amounted to the ability to exert a controlling influence

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[45] *Id.* at 885, citing House Report, *supra* note 2, at 9.

[46] *Id.* at 886-87.

over MidAmerican under section 2(a)(7)(B). The result in *Berkshire Hathaway* is therefore not inconsistent with either *H. M. Byllesby* or *United Corp.*

17. Is it common for SEC staff no-action letters to reverse decisions previously made by the Commission itself?

Whether in issuing no-action letters or in acting pursuant to delegated authority, the staff cannot, on its own, reverse prior Commission decisions. Previous Commission decisions, particularly those interpreting the scope of statutory provisions, guide the staff's consideration of a no-action request.

18. What is the process through which a company obtains a no-action letter from the SEC staff? Does it make a difference whether the request is routine or one that raises novel or controversial issues or that asks the staff to reverse prior positions?

The process is informal.[47] Counsel for the requesting party submits a no-action request, either in draft or in final form, to the Office. The request is reviewed by staff, including senior staff, who provide comments to counsel. The staff may request further information and analysis. If the staff determines that it would not be appropriate to grant the request for no action, counsel is given the opportunity to withdraw the request, which counsel generally does. If the staff ultimately determines to grant no-action relief based on a draft request, the request may be revised and submitted in final form and the response is issued. As noted above, however, the staff would not use a no-action letter to reverse a prior Commission decision under the Act.

19. Is the no-action process open to the public? If not, why not? Is a no-action appealable to the courts? Are potential intervenors given notice and an opportunity to comment on whether the no-action letter should be granted? Are potential intervenors afforded an opportunity to submit evidence and get discovery? If not, doesn't that mean that the "facts" that form the basis for the no-action letter are only those represented by the applicant? Do those who seek no-action letters cite prior no-action letters as precedent? If so, isn't the SEC setting important policy using a process that is inconsistent with the accountability intended by the drafters of PUHCA?

As outlined above, the no-action process is not one of Commission action, but is rather an informal process routinely conducted at the staff level throughout the Commission. Pursuant to Commission regulations, responses to no-action letters are

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[47] The Commission has outlined the process on a number of occasions. *See, e.g., Procedures Applicable to Requests for No Action and Interpretive Letters*, Securities Act Release No. 6269 (Dec. 5, 1980); *Procedures Applicable to Requests for No Action or Interpretive Letters*, Securities Act Release No. 5127 (Jan. 25, 1971).

generally not released until the staff formally responds to them.[48] Most importantly, in reviewing, analyzing and issuing no-action letters, the staff does not grant exemptions from or otherwise waive the requirements of the Act, but rather engages in a process of considering the Act and the regulations issued pursuant to it, generally in the context of a specific proposal. The staff does not find facts. Further, the Commission is not ultimately bound by the action of the staff and, because no-action relief does not represent final action by the agency, it is not appealable.[49]

We do not believe that the no-action process is inconsistent with the accountability required by the Act. No-action letters are issued based on the applicant's particular facts and representations. Previous no-action letters (as well as formal Commission opinions and rulemakings) are typically discussed, where relevant.[50] However, neither the Commission nor private parties are bound by the staff's no-action letters, so they are not "precedent" in the way that, for example, Commission decisions are precedent.[51]

20. Does the SEC staff conduct any independent analysis or investigation to verify whether the claims made by the applicant for a no-action letter with respect to the question of holding company status under PUHCA are in fact true, or whether there may be additional evidence that might bear on the question of whether or not the applicant should be considered to be a holding company for purposes of the Act?

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[48] *See* 17 C.F.R. § 200.81(a). Pursuant to 17 C.F.R. § 200.81(b), the release of staff responses to requests for no-action letters can be delayed, in appropriate circumstances, for up to 120 days after the date of the staff response.

[49] "In certain instances, an informal statement of the views of the Commission may be obtained. The staff, upon request or on its own motion, will generally present questions to the Commission which involve matters of substantial importance and where the issues are novel or highly complex, although the granting of a request for an informal statement by the Commission is entirely within its discretion." *Securities and Exchange Commission Rules of Practice,* 17 C.F.R. § 202.1(d).

[50] As noted in the Lemke Article:

> . . . the request must include the requestor's opinion on resolution of the problem and the basis of that opinion. In explaining this basis there should be a discussion of relevant precedent, including any applicable case law or administrative positions and particularly any no-action letters relevant to the issues involved.

Id., *supra* note 25, at 1027.

[51] *See* 17 C.F.R. § 202.1(d) (distinguishing between formal Commission positions and the rendering of informal advice by the staff).

The staff requests information from the applicant and often seeks additional information, including information that would corroborate the representations made in the request. The staff may decline to issue a no-action letter because of the failure of the applicant to provide sufficient information or because of the inability of the staff to determine certain facts. As a general matter, the staff relies on its understanding of the utility industry and its knowledge of the activities of other industry participants as part of the process of analyzing no-action requests. Where appropriate, the staff also reviews available materials regarding the persons requesting a no-action letter or the transaction described in the request. However, in analyzing no-action requests, as in performing other tasks related to the administration of the Act, the staff does not have the resources or ability independently to verify every representation made in a no-action request.

The recipient of a no-action letter cannot rely on a letter obtained through the making of false or misleading representations, and thus may be subject to, among other things, enforcement action if the actual conduct in which the person engages (as opposed to the proposed conduct described in the letter) violates the Act. These potential penalties provide a strong incentive for parties to furnish accurate and full descriptions of the conduct proposed by a no-action letter and provide a basis for the staff to rely upon the facts and representations presented in no-action requests as well as in other filings under the Act.

21. Do companies ever negotiate the terms of a no-action letter in private with SEC staff prior to the issuance of a no-action letter? Did this occur with respect to the Berkshire Hathaway no-action letter, or the other no-action letters referred to in footnotes 18 and 22 on pages 8 and 9 of the SEC staff memorandum?

As indicated previously, the staff must determine whether its response to a no-action request will be favorable or unfavorable. To this end, the staff may pose questions and seek additional information or analysis or provide initial guidance on what it believes the scope of a particular statutory section is. In response to this process, a person requesting no-action relief may choose to modify the conduct or transaction in which it seeks to engage to bring it within the staff's views of what the Act permits. This, however, is not a process in which both sides compromise to reach an agreement, and thus we do not believe that it can appropriately be termed a "negotiation." If the staff's ultimate determination is unfavorable, it declines to grant no-action relief. Berkshire Hathaway's no-action request, like all others, was dealt with in this manner.

22. Following the grant of a no-action letter, does the SEC ever conduct any follow-up to determine whether the facts and circumstances cited in the applicant's letter remain accurate?

As noted in the response to questions 13 and 20, *supra*, the staff, in issuing a no-action letter, bases its determinations on the particular facts and circumstances stated in the request and the representations of the requestor. Because the parties subject to a no-action letter cannot continue to rely on it if the facts and circumstances described in the letter have materially changed, they have an incentive to seek a revised letter if those

facts and circumstances do change. In appropriate circumstances, including circumstances in which the staff believes that a person's actual conduct or circumstances are not in accord with those described in an issued no-action letter, the staff would initiate a review of the situation with a view to determining whether more formal action under the Act is warranted.

23. On how many occasions over the last 10 years has a request for a no-action letter under PUHCA been filed and granted on the same day? On how many occasions has such a request been filed and granted within less than a month? How do you explain acting on no-action letters so quickly, but letting the Arizona Corporation Commission's complaint against Pinnacle West sit for years?

We believe there are no instances in which we have issued a no-action letter immediately after learning of the request for relief. As explained above, no-action requests involve repeated communication between the staff, on the one hand, and the person requesting relief, on the other hand. The Bar is aware of this and generally submits a request, in draft or final form, long in advance of the proposed transaction. If the staff ultimately determines to grant the requested no-action assurance, it typically informs counsel, who then submits a revised request. In many instances, the staff's no-action letter is issued on the same day that the final revised request is filed by counsel.

The circumstances surrounding the petition and complaint ("Complaint") of the Arizona Corporation Commission ("Arizona Commission" and "ACC") against Pinnacle West Capital Corporation ("Pinnacle West"), a holding company claiming exemption from registration under section 3(a)(1) of the Act pursuant to rule 2, are as follows.

The Arizona Commission filed its Complaint on May 1, 1990 challenging Pinnacle West's exemption. The Complaint alleged that (i) exempt status allowed Pinnacle West to engage in an extensive and reckless program of diversification into nonutility ventures,[52] and (ii) the business failures resulting from such diversification hampered the Arizona Commission's ability to regulate effectively Arizona Public Service Company ("APS"), Pinnacle West's wholly owned electric utility subsidiary, and endangered APS and its ratepayers. The Arizona Commission further stated that on March 14, 1990, it had adopted holding company rules ("Arizona Rules") concerning utility investment in nonutility businesses, but expected that they would be the subject of protracted litigation.[53]

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[52] One such nonutility venture was the acquisition of MeraBank, a federal savings bank, for $426 million in December 1986. MeraBank subsequently recorded substantial losses and was placed in receivership by the federal Office of Thrift Supervision on January 31, 1990.

[53] The Arizona Rules, among other things, would require APS to obtain approval of the Arizona Commission prior to (1) obtaining an interest in, or guaranteeing or assuming the liabilities of, any affiliate not regulated by the commission; (2) lending to any such affiliate, except for small short-term loans; or (3) using utility funds to form a subsidiary or divest itself of any established subsidiary. The Arizona Rules also gave the Arizona

During the following months, the Commission received various communications from the company, its shareholders and the Arizona Commission. Pinnacle West urged the Commission not to act, explaining that diversification-related difficulties were largely behind it and the requested relief would adversely affect its recovery program.[54] In December, the Arizona Commission filed a letter describing its efforts regarding the Arizona Rules and stating that adoption of the rules would address many of its concerns. The Arizona Rules went into effect at the end of 1992. Early the next year, Pinnacle West wrote to the staff that it had largely achieved its goal of reducing its debt, interest expense and operating costs. It also noted "a greatly improved relationship between [Pinnacle West], APS and the ACC."

The staff believes that the amount of time that elapsed between receipt of the Arizona Commission's Complaint and the final communication from Pinnacle West allowed the holding company and the state regulator a sufficient opportunity to resolve their differences concerning appropriate state regulation, particularly in view of the Commission's statements that "[t]he purpose of the Public Utility Holding Company Act, as shown by its legislative history, was to supplement state regulation – not supplant it."[55]

24. The SEC staff memorandum (p. 7) advises that the staff has agreed not to recommend enforcement to the Commission for an entity's failure to register under the Act in situations where "the entity has acquired up to 9.9 percent of the voting securities of a utility or utility holding company and has also made a significant investment in the non-voting securities of the utility or utility holding company." Why wouldn't the fact that a person holds 9.9 percent or less of the common stock of a public-utility holding company, plus substantial ownership of warrants or convertible stock in the company, provide evidence that such person exercises a controlling influence?

The Act does not preclude an acquisition of the economic benefit of ownership of a public-utility company without acquiring voting control. The Act bases its presumption of control on ownership of voting stock. Section 2(a)(17) of the Act defines "voting security," in pertinent part, to mean "any security *presently* entitling the owner or holder thereof to vote in the direction or management of the affairs of a company" (emphasis

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Commission access to the books and records of any affiliate with which APS transacts business.

[54] The Arizona Commission clarified, among other things, that it was *not* proposing that the Commission: (i) order fire sales, (ii) ban APS diversification permanently, (iii) order the dissolution of Pinnacle West, (iv) disrupt the arrangements between Pinnacle West and the MeraBank creditors, or (v) declare the MeraBank creditors to be holding companies under the Act.

[55] *Alabama Electric Cooperative, Inc. v. SEC*, 353 F.2d 905, 907 (D.C. Cir., 1965), *cert denied*, 383 U.S. 968 (1966).

supplied). In general, convertible securities, warrants and options are not voting securities until they are converted into securities with voting rights.[56]

The ownership of 9.9% or less of the outstanding voting securities does not bring the owner within the presumption created by section 2(a)(7)(A) of the Act that the owner is a holding company. The ownership of 9.9% or less of the outstanding voting securities, combined with the ownership of convertible securities, could be relevant to an inquiry under section 2(a)(7)(B) of the Act, but would not, without more, support a conclusion that the owner exercises "such a controlling influence of the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties or liabilities imposed in this title upon holding companies" within the meaning of section 2(a)(7)(B). This determination must be made upon the basis of all of the facts and circumstances of a particular case.[57]

25. Since Kohlberg, Kravis & Roberts (KKR) and Texas Pacific Group (TPG) are not publicly traded companies who must comply with SEC registration and reporting requirements, how would interested parties be able to obtain access to information about how these entities are organized, governed, what agreements or arrangements they may have entered into with other parties with respect to their utility investments, so that such parties might be able to independently assess whether KKR or TPG might be able to exercise a controlling influence over a public utility or utility holding company?

Interested parties would have access to all publicly available information, including any filings with the relevant state commissions and with the Commission. Several sources are available that provide information on privately held companies like KKR and TPG. Because KKR has invested in DPL, Inc., a publicly held company, information on the nature of KKR's investment (and to a more limited extent, on KKR itself) can be obtained from public filings made with the Commission by DPL, including DPL's 10-K, 10-Qs, 8-Ks and Proxy Statement. KKR must file a Schedule 13D that

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[56] *See, e.g.*, *Pinnacle West Corp.*, SEC No-Action Letter (Feb. 7, 1990, publicly available April 23, 1990; 1990 SEC No-Act. Lexis 696) ("The two salient features of a 'voting security,' therefore, are: (i) that it provides the owner or holder thereof with a present right to vote; and (ii) that such present right to vote may be exercised in the direction or management of the affairs of a company." Memorandum of Law accompanying incoming letter).

[57] *See American Gas & Electric Co. v. SEC*, 134 F.2d 633, 642 (D.C. Cir.), *cert. denied*, 319 U.S. 763 (1943) (noting that the existence of a "controlling influence" is a "factual determination to be ascertained in the Commission's expert judgment by the weighing of circumstantial evidence and the drawing of reasonable inferences therefrom"). It should be noted in this regard that section 2(a)(7)(B) of the Act is directed to "any person, which the Commission determines, after notice and opportunity for hearing" to merit regulation under the Act as a holding company.

describes its ownership interest in DPL. Other sources of information are filings that the utility must make with its state regulators and the FERC.

26. In a filing before the Oregon Public Utilities Commission (*see* attachment), TPG lists 25 "consent rights" that empower it to exercise veto power over a wide array of corporate transactions, financings, acquisitions, sales, and corporate governance decisions made by the Oregon Electric Utility Company (Oregon Electric), the shell corporation created for the purpose of acquiring PGE. Does the Commission believe that these consent rights give TPG a controlling influence over Oregon Electric, and hence over PGE? If not, why not? If so, will TPG be required to register under the Act?

The proposed consent rights are only one feature of the proposed transaction, which the staff is currently reviewing. Because we have not completed our review, we have not yet reached a conclusion about whether the consent rights would give TPG a controlling influence. The staff cannot at this time state what the result of the review will be.

27. The aforementioned TPG filing also notes that several aspects of the consent rights remain "to be negotiated with the SEC." Has the SEC or its staff entered into negotiations with TPG over its consent rights? Will these "negotiations" be conducted in a public forum, allowing other interested parties to participate, submit comments, or filings in support or in opposition?

As explained in the response to question 18, *supra*, the no-action process is an informal one in which participation is limited to the requestor of the no-action assurance and the staff of the Commission. In addition, we do not view the grant of no-action assurance as a negotiated resolution. In our view, the discussions preceding the issuance of a no-action letter are not negotiations, which generally involve compromise by both parties. Rather, in the no-action process the requestor must describe the proposed transaction in a way that conforms to the staff's understanding of the Act, or no assurance will be granted. The discussions enable requestors to understand the staff's position and staff to understand the intricacies of the proposed transactions in order that we may ensure that the Act's requirements are met. While we have not yet provided any comments to TPG, we have requested additional information to enable us to begin our analysis.

28. In another filing submitted to the Oregon Public Utilities Commission, TPG reports that after the application, TPG "will hold approximately 79.9 percent of the economic interest in Oregon Electric, but they will have only five percent of the voting securities." Electric, which in turn will – after completion of the transaction – hold 100 percent of the voting securities of PGE, render the successor company and its affiliate a registered holding company under the Act? Why wouldn't TPG be able to exert a controlling influence over Oregon Electric and PGE?

TPG is seeking no-action relief under section 2(a)(7) similar to that granted in the *Berkshire Hathaway* no-action letter and other similar letters. The Commission will consider the legal issues on the basis of all of the facts and circumstances.

29. Since the SEC determined in the *Enron* decision that PGE was not predominantly intrastate in character and that Enron would have to file with the SEC as a registered holding company, why wouldn't the sale of PGE to another holding company also require that company to either have to register with the SEC or divest itself of the assets that gave rise to the SEC's decision in the Enron case?

That outcome is certainly possible. However, a new holding company system would have the option of restructuring so as to qualify for an exemption.

30. Has TPG made any material representations to the Commission to suggest that Oregon Electric will cap or otherwise maintain interstate wholesale sales below the level conducted by PGE that contributed to the revocation of PGE's exemption?

TPG has not made any such representations.

B. Pending and Existing Investments in the Utility Sector

31. The SEC staff memorandum (p. 11) notes that "KKR did not seek the staff's or the Commission's approval of" its acquisitions of DPL, a holding company that owns Dayton Power & Light, and International Transmission Company (ITC), a company that owns transmission assets in Michigan and is involved in developing transmission facilities elsewhere in the United States. Has the SEC or its staff reviewed whether KKR's claim of exempt status is valid, or whether the public interest and the interests of consumers would be better protected by requiring it to register under the Act? If not, why not?

KKR does not claim exemption from registration. KKR is not a *prima facie* holding company within the meaning of section 2(a)(7) of the Act because it does not hold 10% or more of the outstanding voting securities of a public-utility company. *See* the discussion in the response to question 24, *supra*.

32. Why wouldn't the fact that KKR owns a 4.9 percent voting interest in DPL, along with unexercised warrants to purchase another 19.2 percent voting interest in DPL, and that KKR holds an approximate 66.5 percent limited partnership interest in the entity that effectively controls ITC provide sufficient evidence of KKR's control over those entities, trigger a requirement for registration under the Act?

As noted in the response to the preceding question, KKR is not a *prima facie* holding company under section 2(a)(7) of the Act. For the reasons explained in the discussion in response to question 24, *supra*, the unexercised DPL warrants are not considered to be "voting securities" of DPL. Because we have typically treated general partnership interests, but not limited partnership interests, as voting securities for

purposes of the Act, KKR's additional ownership of an approximately 66.5% limited partnership interest in the parent of ITC is not, in itself, sufficient evidence to support a determination under section 2(a)(7)(B) of the Act that KKR should be subject to regulation as a holding company. Concluding that KKR was a holding company pursuant to section 2(a)(7)(B) would thus require demonstrating that KKR was, in fact, exercising over one or both of those companies a controlling influence of a type requiring regulation in the public interest under the Act.

33. Does the SEC or its staff believe that the utility assets owned or controlled by DPL and ITC would meet PUHCA's integration test? Please explain.

These assets are not required to conform to the integration requirements of section 2(a)(29)(A) of the Act because they do not appear to be under common ownership by one holding company. We thus have not analyzed whether the assets are or could be integrated.

34. The SEC staff memorandum (p. 12) notes that "we anticipate that we will carefully review KKR's interests in DPL and International Transmission as part of our review of any application we receive in connection with a proposed acquisition of UniSource and its three utility subsidiaries." Will this review occur in a forum that would allow other interested parties to obtain access to all materials filed with or presented to the SEC and to submit statements or other evidence in opposition to the request for a grant of exempt status?

An application was filed in this matter on March 31, 2004. The application in *Sage Mountain, L.L.C.* (File No. 70-10221) seeks authorization under sections 9(a)(2) and 10 of the Act for the proposed acquisition of UniSource Energy Corporation. The application provides details of the proposed ownership structure of the new holding company. Although the Commission has not yet issued a notice of the application, it is available for public inspection.[58] Once a notice has been issued, interested persons will have an opportunity to submit comments and requests for a hearing. KKR is seeking a no-action letter, which the staff will analyze in the same way as any other no-action request. We recognize, however, that the two matters are related. *See also* our response to Question 35, *infra*.

35. The SEC staff memorandum (p. 11, fn. 25) notes that Saguro Utility Group, the shell company that has been created to facilitate KKR's acquisition of Unisource, is 62 percent owned by KKR. Does the SEC have sufficient evidence to know whether KKR has a controlling influence over Saguro? Has the SEC obtained copies of any agreements, consent rights or other documents that set forth any arrangements between KKR and Saguro?

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[58] Any materials for which confidential treatment is requested might not be publicly available.

The staff has received a no-action request on behalf of the limited partners in Saguaro Utility Group and has just begun its review of the materials. We have therefore not reached a conclusion as to whether a no-action letter should be issued. The staff has received copies of various agreements, consent rights and other documents setting forth arrangements between Saguaro Utility Group and the limited partners, including the KKR investment funds.

36. The SEC staff memorandum (p.12) states that a key part of the review that it will conduct of the Unisource transaction will focus on whether KKR or some intermediate holding company should be required to register and become subject to PUHCA requirements, including physical integration. Does the SEC believe utility assets located in Ohio, Michigan, and Arizona would actually meet PUHCA's "integrated public-utility system" test? Is the SEC intending to rely on the reasoning it used to approve the merger of American Electric Power (AEP) and Central and Southwest (CSW), the same reasoning struck down by the Court of Appeals in *National Rural Electric Cooperative Association and American Public Power Association v. SEC*?

Because we have not completed our review of this matter, we have not reached a conclusion on whether any entity should be registered were the transaction to be completed as proposed. We therefore have not analyzed whether any particular combinations of utility assets would or would not satisfy the Act's integration requirements. We recognize, however, that under existing precedent, it likely would be difficult to argue that utility assets located in Michigan, Ohio and Arizona could constitute an electric integrated public-utility system within the meaning of section 2(a)(29)(A) of the Act.

III. Review of Existing Exemptions Pursuant to Section 3(a)(1)

37. The SEC staff memorandum (p. 12) states that "it is important for both the staff and the commission to review exempt entities' compliance with the requirements of the exemption on a regular basis. We agree that it is important to conduct such reviews and we do so." How many reviews has the SEC and its staff conducted of exempt entities compliance with PUHCA over the last five years? How many over the last ten years? In how many instances did the SEC or its staff find the exempt entity to not be in compliance with the requirements of the exemption? What actions were taken in response? How many of these entities were required to register under PUHCA as a result of these reviews?

The responses to questions 3 and 4, *supra*, largely address the issues raised by this question. In addition to the information discussed in our responses to those questions, we engaged in particularly rigorous reviews of holding companies claiming exemptions as intrastate holding companies pursuant to rule 2 in 1998, 1999, 2002 and again this year. We are currently addressing specific issues that have arisen in the context of this year's review. We are unable to predict whether, as a result of our reviews, any additional holding companies will register under the Act.

38. The SEC staff memorandum (p. 13) reports that the utility holding companies claiming exemption pursuant to rule 2 are required to file an annual statement on Form U-3A-2 and that the staff reviews these filings "carefully to determine if they raise any questions as to any holding company's exempt status under the Act" and that "in conducting these reviews, we focus most specifically on data regarding potential interstate sales of electricity at wholesale by the holding company's utility subsidiaries – the type of sales that were central in the Enron proceeding." Other than the Enron example, in how many instances over the last five years has the SEC found an exempt utility to have engaged in interstate sales of electricity at wholesale?

Filings on Form U-3A-2 demonstrate that many utilities owned by exempt holding companies engage in some amount of out-of-state, wholesale sales of electricity. The relevant question, for purposes of determining the holding company's continuing entitlement to the exemption it claims, is whether those sales are within existing precedent, as outlined most recently in the Commission's *NIPSCO* decision.[59] While the Commission has not formally revoked any exempt holding company's exemption in recent years, the staff does continue to review the out-of-state utility assets and operations of various holding companies.

39. What is the threshold (if any) for interstate sales of electricity at wholesale that the SEC has determined should result in a revocation of a previously issued exemption? How was that threshold (if any) established? What steps does the SEC take to verify that the interstate electricity sales data submitted in Form U-3A-2 filings is accurate?

The staff believes that the recent *NIPSCO* decision (as discussed in the *Enron* decision) establishes a baseline for determining whether or not a holding company is clearly within existing precedent.[60] In cases where information provided in a single filing or in a number of different filings seems inconsistent or otherwise raises questions, we seek to verify the information. To verify information regarding sales of electricity, we would likely need to seek information from the company itself, other regulatory agencies or other third parties with information about the transactions. In particular, total wholesale and retail sales (Item 3(a) of Form U-3A-2) can be verified from the FERC Form 1 for electric utilities and in MCFs or dekatherms from FERC Form 2 for gas utilities. Item 3(b) reports of retail sales of electricity or gas sold in another state by each holding company or utility subsidiary can be verified in some cases through review of reports (if available) to state regulatory commissions. Independent verification of Items 3(c) and (d) is very difficult and generally requires that the staff make independent inquiries of the holding companies and their utility subsidiary(ies).

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[59] *See NIPSCO Industries, Inc., supra note* 16.

[60] *Id.*

40. The SEC staff memorandum (p. 13) says that "we are committed to following up any concerns that we have based on these filings." How many audits, inspections, or examinations has the SEC staff conducted to follow-up on any concerns raised by exempt holding companies' Form U-3A-2 filings?

In many cases, the appropriate first step is informally to contact an exempt holding company to make sure that we properly understand its filing and, if necessary, to discuss any concerns that we have. The staff has not formally audited or inspected any exempt holding companies in recent years. Moreover, we believe that there are more appropriate ways to follow up our concerns than through an audit or inspection. In particular, while the Commission likely has the necessary authority under section 15 to examine an exempt holding company, we believe that it would generally be preferable for the Commission instead to exercise its authority under section 3 in the context of determining whether a company should be granted an exemption by order, whether a company continued to qualify for its order, or whether a company's claim of exemption by rule 2 was warranted. As described more fully above, rule 6 effectively permits the Commission to require that a company currently claiming exemption pursuant to rule 2 instead seek an exemption from the Commission by order upon application pursuant to section 3.

41. The SEC staff memorandum (p. 13) reports that the staff is planning to update Form U-3A-2 "so that it will be more readily apparent if a holding company's utility subsidiaries are engaging in practices that may raise an issue concerning its continuing claim to exemption under the Act. Have some exempts submitted false or misleading Form U-3A-2's in the past, or submitted forms which may have omitted information which might be material to determining whether they should continue to remain exempt? Which companies? What action was taken by the SEC in response?

The staff is not aware of any recent filings on Form U-3A-2 that are intentionally false or misleading. Were the staff to believe that false filings had been made, we would view the situation very seriously, and would consider, among other things, the possibility of recommending enforcement action. The staff's plan to update Form U-3A-2 is not based on a concern that it is being used to facilitate false filings, but rather upon our view that we can improve the usefulness of the form as well as reduce any unnecessary burdens imposed on the industry by the filing requirement by better and more clearly specifying the precise data we need in order to review efficiently exemptions claimed pursuant to rule 2.

42. The SEC staff memorandum (p. 13) reports that the D.C. Circuit Court of Appeals remanded the AEP-CSW merger to the Commission in 2002, concluding that the SEC "had not adequately explained its conclusions that the two utilities were integrated and that they were in the same area or region." The memo goes on to report that "we expect the record in that matter will be reopened sometime this spring and that the Commission will reassess the permissability of the merger shortly thereafter." Why has it taken two years for the SEC to respond to an order

by the Court in this matter – a major judicial reversal of what is perhaps the largest PUHCA transaction in decades – while it expedites no action letters? Why wasn't the record reopened immediately after the Court issued its order remanding the decision back to the SEC? How many staff lawyers are working on this case and for how long? Is it true that most of the SEC's original decision in this matter was copied or paraphrased from AEP-CSW submissions?

The elapsed time is a function of many different factors, including Office workload and the complexity of the matter. Although the staff does try to take into account industry members' deadlines, we do not, as a general matter, expedite no-action letters. The staff does try to provide necessary authorizations in time for the companies to carry out their proposed financings and other transactions.

Currently, as is typical with most matters under review in the Office, one staff attorney is assigned to the AEP/CSW matter on remand. More senior members of the staff in the Office have also been involved in the review and analysis of this matter.

As for the drafting of the original order, the description of the system, the proposed merger, the related transactions, and other facts and representations were included by the applicants in their application and the exhibits to the application and are reflected in the Commission's order. The legal analysis was drafted by members of the staff and ultimately approved by the Commission.

43. It has been suggested to us that the SEC and its staff chose simply to ignore the Court's remand of the AEP-CSW merger in the hope that Congress would simply repeal PUHCA and thereby render the entire case moot. Is this true?

No. As noted in our response to question 42, the staff is actively working on this matter. The Commission has always emphasized its responsibility faithfully to administer the Act.

44. We understand that ChevronTexaco appears to be enjoying an exemption from being regulated under PUHCA as a holding company despite owning 25 percent of the voting shares of Dynegy. Prior to the time it filed this exemption in July 2003, ChevronTexaco appears to have had a pending – since 1999 – Section 3(a)(3) application that claimed it was only "incidentally" a holding company for the purposes of the Act, or that in the alternative, that it was not a holding company within the meaning of Section 2(a)(7) of the Act. ChevronTexaco's Form U-1 has been amended five times since the initial submission in 1999, and it apparently remains pending before the Commission. The most recent amendment is dated June 27, 2003. Did the SEC or its staff ever inform ChevronTexaco that its application would be denied? Isn't it true that the Commission's failure to act on this application has the effect of granting ChevronTexaco the exemption it is seeking? Does the commission believe that is an effective way to administer PUHCA?

The staff has never informed ChevronTexaco that its application would be denied. Time has elapsed largely because of the complexity of the policy and legal issues involved in analyzing this matter. Granting ChevronTexaco an order under section 3(a)(3) would require the Commission to revisit and reinterpret its precedent, which rests on the existence of a functional relationship – absent, in terms of precedent, in this case – between the nonutility business of the holding company and the utility operations.[61] The success of a no-action request was uncertain in view of ChevronTexaco's ownership of more than 10% of the voting shares of Dynegy. For the same reason, an order under section 2(a)(7) of the Act declaring ChevronTexaco and Chevron USA not to be holding companies, and an order under section 2(a)(8) of the Act declaring Dynegy not to be a subsidiary, would be novel and difficult to obtain.

We agree that the statute must be administered effectively. To do so, we must take account of the fact that our resources are not boundless and, accordingly, priorities must be established. Congress contemplated that applicants would rely on the statutory "good faith" exemptions pending Commission action. Although it may have been preferable, at least when viewed in isolation, for the staff to have acted on the applications more quickly, we are unaware of any allegation that the maintenance of the *status quo* has adversely affected the interests of investors or consumers.

On November 3, 2003, Exelon Corporation ("Exelon"), a registered holding company, announced its agreement to acquire the operating assets of Illinois Power from Dynegy. This transaction, if consummated, would have mooted the pending applications because, upon completion of the sale, Dynegy, ChevronTexaco and Chevron USA would cease to be holding companies within the meaning of the Act.

The Exelon transaction was conditioned upon the receipt of certain relief from the Illinois General Assembly. On November 22, 2003, Exelon and Dynegy announced that the Illinois General Assembly had not acted in the fall legislative session to approve the legislation necessary to facilitate Exelon's proposed acquisition of Illinois Power. In the absence of the legislation, Dynegy and Exelon terminated the existing agreement through which Exelon would have acquired substantially all of the assets and liabilities of Illinois Power. Since that time, Ameren Corporation ("Ameren"), a registered holding company, has agreed to purchase Illinois Power from Dynegy. On March 31, 2004, Ameren filed an application with the Commission seeking approval to acquire Illinois Power.[62] A notice of that application issued on June 25, 2004.[63] Ameren's proposed transaction is not subject to the conditions to which Exelon's proposed acquisition was subject. If the transaction is completed, Dynegy, ChevronTexaco and Chevron USA would cease to be holding companies within the meaning of the Act.

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[61] Two of the seminal section 3(a)(3) cases are *Cities Service Company.*, 8 S.E.C. 318 (1940) and *Standard Oil Company*, 10 S.E.C. 1122 (1942).

[62] S.E.C. File No. 70-10220.

[63] Holding Co. Act Release No. 27862.

45. How does ChevronTexaco's ownership of 26 percent of the shares of Dynegy comply with the 9.9 percent threshold in the SEC staff's previous no-action letters, or with the requirements of the Act with respect to the exercise of a controlling influence over a public utility or utility holding company?

There is no question of ChevronTexaco relying on a no-action letter issued to a company that is not a *prima facie* holding company within the meaning of section 2(a)(7)(A) of the Act. Because ChevronTexaco is a *prima facie* holding company, it would never be able to rely on the *Berkshire Hathaway* letter.

46. How much longer does the SEC and its staff intend to grant ChevronTexaco this exemption from the Act simply by taking no action on this matter?

As noted in the response to question 44, *supra*, a denial of the requested exemption under section 3(a)(3) would almost certainly lead ChevronTexaco to sell its utility interest. Ameren now seeks the necessary authority under the Act to purchase Illinois Power. That sale, if approved, would moot all of the applications described above, because Dynegy, ChevronTexaco and Chevron USA would cease to be holding companies within the meaning of the Act.

47. Eleven days after ChevronTexaco submitted its most recent amendment to its Form U-1, on July 7, 2003, Dynegy filed its own Form U-1 with the Commission, also seeking exemption from PUHCA (more specifically, from being declared a subsidiary of ChevronTexaco within the meaning of the Act). Why wouldn't the SEC also reject this application, based on the 9.9% percent threshold outlined in the SEC staff memorandum and the no-action letters referenced therein? Moreover, why wouldn't ChevronTexaco's ownership of 26 percent of Dynegy's shares, as well as its ownership of other convertible preferred shares and the rights attendant to these shares also allow it to exercise a controlling influence over Dynegy?

As discussed in the response to question 44, *supra*, Dynegy's application for an order declaring it not to be a subsidiary of ChevronTexaco is a novel filing. Because Dynegy was *prima facie* a subsidiary of ChevronTexaco within the meaning of section 2(a)(8) of the Act, just as ChevronTexaco was a *prima facie* holding company, a no-action request could have been rejected. In addition, because ChevronTexaco is a *prima facie* holding company over Dynegy under section 2(a)(7)(A) of the Act, it is presumed to exercise a "controlling influence" over Dynegy.

48. Please describe the efforts the SEC and its staff has made subsequent to the rendering of a decision in the Enron case to examine whether Dynegy's exemption under Section 3(a)(1) is proper, and whether ChevronTexaco's 26 percent ownership of Dynegy's voting shares should trigger registration under the Act.

The staff has not made any special efforts since the *Enron* decision to reexamine Dynegy's exemption from registration. As for consideration of whether ChevronTexaco

should be required to register, it would first be necessary for the Commission to act upon the request for an order declaring it not to be a holding company. If the Commission acted favorably upon the request, the issue of Chevron's holding company status would be resolved.

49. Over the last five years, how many audits, examinations, inquiries, or investigations has the SEC or its staff conducted to determine whether registered holding companies are complying with the requirements of Section 12 (dealing with intercompany loans, dividends, security transtions, sales of utility assets, proxies, and other transactions) and Section 13 (dealing with service, sales, and construction contracts) of PUHCA? How many staff people worked on the audits and for how many hours each? How frequently is each registered holding company audited under these sections?

During the past five years, applications filed pursuant to the Act have resulted in the review of over three hundred inter-company loans, dividends, securities issuances and utility asset sales. The orders issued as a result of these applications are designed to ensure that the transactions are consistent with the requirements of the Act.

In addition, during the past five years, the Office staff has examined seventeen registered holding company systems. These examinations reviewed the managerial and administrative structure of the holding company system, cash management/money pool operations, service, sales and construction contract transactions, service company operations, cost allocation systems and internal controls. On average, five members of the staff worked directly on each examination. During this period, approximately 5,000 hours of staff work were devoted to the audit program. Based on current resources (and other than in the context of processing applications), each registered holding company system is formally examined approximately every six years. In addition, registered holding companies are evaluated in the context of processing their annually filed Form U5S and their regularly filed applications.

50. How many SEC staff personnel are assigned to the task of auditing or inspecting registered holding companies to ensure their compliance with Sections 12 and 13 of the Act? Does the Commission believe that sufficient personnel have been allocated for this purpose? If not, why hasn't the Commission reassigned additional personnel to this mission? Can the Commission honestly say that there are no transactions under Section 12 and 13 that are priced in excess of reasonable cost?

The Office includes a Branch of Auditing and Financial Policy ("Branch") that has primary responsibility for examining registered holding companies. Between five to seven Branch and Office personnel are assigned to examine each registered holding company system. The growth in the number of registered companies during recent years has increased the amount of resources devoted to the examination process. We are currently hiring additional staff for the office, and will likely add at least two analysts or accountants to the Branch. While we believe that our current examination program is very effective, and that registered holding companies generally seek to comply with the

requirements of the Act, this expansion will permit us to continue to improve our examination program, including our review of intrasystem transactions subject to sections 12 and 13.

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I hope that the above provides an adequate explanation of how the staff is approaching our duties in assisting the Commission in its administration of the Act. We on the staff remain committed to administering and enforcing the Act in accordance with its statutory requirements as interpreted by the Commission. I would be pleased to meet with you, with Congressmen Dingell or Markey or with members of their staffs to explain further any of the issues addressed in this memorandum.