HUNTON ANDREWS KURTH

# BASELOAD

**Current Topics in the Power and Utilities Capital Markets**

October 2020

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## Equity Units: A Structured Legal Guide for Utility Issuers

| Date | Issuer | Underlying Host |
|---|---|---|
| September 2020 | NextEra Energy, Inc. | Senior Notes |
| August 2020 | American Electric Power Company | Junior Subordinated Debentures |
| July 2020 | PG&E Corporation | Treasury Strips |
| February 2020 | NextEra Energy, Inc. | Senior Notes |
| October 2019 | DTE Energy Company | Senior Notes |
| September 2019 | NextEra Energy, Inc. | Senior Notes |
| August 2019 | The Southern Company | Junior Subordinated Notes (two series) |
| June 2019 | Dominion Energy Inc. | Cumulative Perpetual Convertible Preferred Stock |
| March 2019 | American Electric Power Company | Junior Subordinated Debentures |
| April 2018 | South Jersey Industries, Inc. | Junior Subordinated Notes |
| September 2016 | DTE Energy Company | Senior Notes |
| August 2016 | Dominion Energy Inc. (f/k/a Dominion Resources, Inc.) | Junior Subordinated Notes (two series) |
| August 2016 | NextEra Energy, Inc. | Senior Notes |
| November 2015 | Black Hills Corporation | Junior Subordinated Notes |
| September 2015 | NextEra Energy, Inc. | Senior Notes |
| June 2014 | Dominion Energy Inc. (f/k/a Dominion Resources, Inc.) | Junior Subordinated Notes |
| June 2014 | Exelon Corporation | Junior Subordinated Notes |

## Overview – Why Choose Equity Units?

As previously reported, we have seen a number of utility issuers look to the equity unit structure in order to meet their equity needs. In 2019 and thus far in 2020, utility issuers have issued nearly $15 billion of equity units. Facing an ultra-low interest rate environment and robust capital expenditure plans, we expect that utilities will continue to look to the equity unit as a preferred form of equity-linked financing in the future.

An equity unit transaction is a mandatory convertible equity product (typically having a stated amount of $50) that is initially in the form of a corporate unit, consisting of (1) a purchase contract issued by the issuer and (2) a fractional undivided beneficial ownership interest in a $1,000 principal amount debt security of the issuer (although, as described below, the debt "host" is not always debt and at least one issuer utilized  US treasury strips in lieu of its debt securities as the debt host). Interest on any host debt security will accrue at an initial rate and typically will be paid quarterly until a successful remarketing occurs. "Contract adjustment payments" will also be paid periodically with respect to the underlying purchase contract. Note that the contract adjustment payments are typically subordinated in right of payment, regardless of whether the host is senior or subordinated. For investment grade issuers, S&P awards 100% equity credit to equity units while Moody's only awards 25% equity credit. Note also that the equity units transactions discussed here are different than a "tangible equity units" offering, whereby the product consists of a prepaid forward purchase contract and an amortizing note.

One upside of equity units to the issuer is that it generates cash proceeds and locks in a share price of an equity offering today while largely avoiding the dilution from the offering for a few years. Compare this to an equity forward offering, where the issuer does not initially receive any proceeds and will receive proceeds only upon physical settlement of the forward sale agreement by delivering shares in exchange for cash proceeds. If the issuer's share price appreciates, an equity units offering is also a more efficient cost of capital relative to common equity. An issuer can look to an equity units offering to satisfy immediate equity needs or as a more opportunistic issuance, potentially as one tool to finance a future acquisition. Additionally, an equity units offering allows an issuer to remove any equity overhang and give their investors better clarity into their near to medium term equity needs. Lastly, as discussed further in more detail, the fact that coupon payments on the underlying debt are tax-deductible thanks to a 2003 IRS revenue ruling[1] is an extra incentive for issuers.

Prior to conversion of the purchase contracts, the payments received by investors are set at a premium to any common dividend yield in order to compensate investors for potential loss of upside participation. In exchange for a high yield, investors face an unfavorable asymmetry in terms of participating in stock price appreciation.[2] Conversion premiums are typically set at approximately 20% above the issuer's stock price at issuance. Investors also bear all downside risk. The settlement rate for conversion to the common stock is calculated at the time of the issuance of the equity units, not the conversion date.

## Upside/Downside

Take for example an equity units offering where the issuer's common stock traded at $55 per share on the date of pricing (also known as the "reference price"). The "threshold appreciation price" will often be set at a 20% premium over the reference price (at about $66). If at the time of settlement of the purchase contracts the stock is between the reference price and the threshold appreciation price (e.g., $62), then the issuer keeps 100% of any upside in stock price and, accordingly, delivers fewer shares. If the stock price at the time of settlement exceeds the threshold appreciation price (e.g., $77), then the investor retains approximately 83% of the upside exposure over the threshold appreciation price. On the other hand, a stock price below the reference price at

1 See IRS Rev. Rul. 2003-97.

2 Fotios Tsarouhis, *To avoid dilution, big US utilities turning to mandatory convertible issuances*, S&P Global Market Intelligence (Sep. 20, 2019).

the time of settlement of the purchase contracts (e.g., $40) will result in the investor retaining 100% of the downside, with the issuer issuing the maximum number of shares and paying a higher yield in comparison to its normal dividend yield.

### Components of an Equity Unit

The equity unit is made-up of two components: a purchase contract and an interest in an underlying host. With the exception of one example above, issuers have chosen to issue either a senior or subordinated debt security or preferred stock as the underlying host. The PG&E Corporation example above is unique in that the underlying debt host is an interest in specified zero-coupon US treasury strips that mature on a quarterly basis.

Putting aside the PG&E Corporation example, issuers can choose between senior or subordinated debt or preferred stock as the underlying host for the equity unit. In the past several years, a number of utility issuers have utilized senior debt as the underlying host, including NextEra Energy, Inc. (September 2020, February 2020, September 2019 and August 2016), American Electric Power Company, Inc. (August 2020, March 2019) and DTE Energy Company (September 2019 and September 2016). Other issuers have used underlying subordinated debt, including The Southern Company (August 2019), South Jersey Industries, Inc. (April 2018), Dominion Energy, Inc. (August 2016 and June 2014), Black Hills Corporation (November 2015) and Exelon Corporation (June 2014). Lastly, an issuer may also use preferred stock, as Dominion Energy, Inc. did in their June 2019 equity units offering, with each equity unit included an undivided beneficial interest in 1/10th of a share of cumulative perpetual convertible preferred stock. There is also precedent for the underlying host to be a convertible debt instrument, converting into preferred stock, as Stanley Black & Decker offered in 2007.

In order to comply with the 2003 IRS revenue ruling, the maturity of the underlying host must exceed the purchase contract both in absolute and relative terms. The host is only considered to be outstanding during the period when it is not subject to redemption for these purposes. Note that any optional redemption for the underlying host must be at least two years after the purchase contract settlement date.

Several issuers have chosen to utilize two different debt securities with different maturities as the underlying host (see, e.g., The Southern Company (August 2019) and Dominion Energy Inc. (August 2016)). Note that despite two different maturities, the coupon on each series is the same until the purchase contract settlement date. Only at the time of remarketing the debt securities can the interest rates be adjusted to correspond with their respective maturities. The underlying series of debt securities must be evenly split in size. This is because a holder is purchasing a unit at a set price (e.g., $50) that contains a partial interest in each underlying security. For instance, a $50 unit would have (i) a 1/40 undivided beneficial ownership interest in $1,000 principal amount of one series of underlying debt securities and (ii) a 1/40 undivided beneficial ownership interest in $1,000 principal amount of another series of underlying debt securities. Anything other than an even split of the underlying debt securities would result in holders having a greater interest in one series over the other series and would complicate any ability to separate the underlying debt securities from the equity unit and replace with US treasury strips prior to the purchase contract settlement date (which is significant for the 2003 IRS revenue ruling).

Regardless of whether there are one or multiple underlying series that are the host, issuers normally “lock-in” the maturity, redemption features and ranking of the host at the time of pricing the equity unit and usually cannot change such elections even in the event of a failed remarketing. We understand that this is largely driven by accounting and rating agency considerations.

The purchase contracts will be issued pursuant to a purchase contract agreement between the issuer and the purchase contract agent. The purchase contract agent acts as agent for the holders of the equity units to enter into and perform the purchase contract on behalf of the holder. Typically the entity serving as trustee for the underlying debt host (if debt and not preferred stock) will perform these functions, although we have seen several deals where a different entity from the trustee fulfills these roles. The issuer will also enter into a pledge agreement (often combined with the purchase contract agreement as a single agreement). Holders of an equity unit will pledge their interest in the underlying host to the issuer through a “collateral agent” acting pursuant to the pledge agreement to secure such holders’ obligations under the purchase contracts. Note that, in most cases, neither the purchase contract agreement nor the pledge agreement will be qualified under the Trust Indenture Act of 1939, as amended. The collateral agent’s perfection of the lien on the underlying collateral is typically by control, so no UCC-1 financing statement is required.

Because investors have three years prior to the settlement of the purchase contracts, issuers give holders the ability to elect early settlement upon a “fundamental change” prior to the purchase contract settlement date. Typically, such fundamental change rights would include a change in ownership of at least 50% of the common stock of the issuer or an event whereby the issuer’s common stock ceases to be listed on a major national exchange.

If a Treasury portfolio has replaced the host as a component of units as a result of a successful remarketing of the host or a special event redemption, then a holder may (1) substitute Treasury securities for a portion of the Treasury portfolio or (2) early settle, only in specified multiples.

This “multiple” is provided from the banks at pricing. The Treasury portfolio must pay par plus the last quarterly coupon before maturity. Note that treasuries come in whole numbers of par, but the unit itself is in $50 increments. So a quarter of interest plus par (at X% interest rate) gets an amount slightly greater than $1,000 (we’ll call this amount “Y”). It’s up to the underwriters to figure out a multiple that would make “Y” a whole number.

## Accounting and Tax Considerations

Tax and accounting considerations play an important role in why an issuer chooses to offer equity units. Such considerations also impact the holder of the securities. Because of the analysis the issuer must conduct and the related disclosure, issuers should start this process early, involving their internal and external audit teams, as well their own counsel and counsel for the underwriters.

The 2003 IRS revenue ruling concluded that the debt host of an equity unit was separate from the forward purchase contract for the common stock. As a result, interest on the debt host of the equity unit was tax deductible. The IRS cited several key factors as the reasons for its determination, including the ability of the holder to convert the unit from a purchase contract and debt security to a purchase contract and US treasury strip or to settle the purchase contract with separate cash and retain the debt security and that at issuance, it will be substantially certain that the remarketing of the notes will succeed.

Note that, while there have been exceptions, the equity unit components are typically included on the issuer’s balance sheet. The debt portion will be recorded at face value. Before the issuance of the common stock to settle the purchase contracts, the purchase contracts will be reflected in the issuer’s diluted earnings per share calculations using the treasury stock method. Under this method, the number of shares of common stock used in calculating diluted earnings per share (based on the settlement formula applied at the end of the reporting period) is deemed to be increased by the excess, if any, of the number of shares that would be issued upon settlement of the purchase contracts over the number of shares that could be purchased by the issuer in the market (at the average market price during the period) using the proceeds receivable upon settlement. Consequently, there will be no dilutive effect on the Company’s earnings per share except during periods when the average market price of the Company’s common stock is above the threshold appreciation price. Thus, off-balance sheet treatment is rare for this product, unlike a “tangible equity unit” which utilizes “if-converted” accounting, but does not benefit from full interest deductibility.

The prospectus supplement for the offering will generally describe an equity unit debt host as treated for US federal income tax purposes as either (1) a variable rate debt instrument or (2) a contingent payment debt instrument. If an issuer treats the underlying host as a variable rate debt instrument, a holder will be required to take into account interest payments on such security at the time the interest is paid or accrued in accordance with the holder’s regular method of tax accounting. However, if an issuer treats the

underlying host as a contingent payment debt instrument, a holder would generally be required to (A) accrue interest income based on a projected payment schedule and comparable yield and (B) treat any gain recognized on a sale, exchange, redemption or other taxable disposition of such security as ordinary income. The disclosure typically describes the tax treatment for contract adjustment payments as unclear and that the issuer will treat such payments as taxable ordinary income.

In addition to including relevant disclosure regarding tax treatment in the prospectus supplement, in our experience, an issuer will also request a letter from the lead underwriter (or lead underwriters) regarding the likelihood of successful remarketing of the host and the valuation of each component of the equity unit—(1) the purchase contract and (2) the applicable ownership interest in the underlying host. Typically, per $50 equity unit, the purchase contract is valued at $0, while the applicable ownership interest in the underlying host is valued at $50. This representation letter, delivered to the issuer, supports the issuer's tax disclosure as well as issuer counsel's tax opinion. While each representation letter contains the same basic elements, each underwriter may have its own form and different analysis, so it is important to allocate ample time to preparing and negotiating such letters (and the associated indemnity therein).

## Regulation M

Regulation M prohibits certain activities by distribution participants that could manipulate the market for an offered security. A "distribution participant" under Regulation M includes any person who has agreed to participate in or is participating in a distribution of securities, such as an underwriter. While the issuer's common stock underlying the equity unit is likely an actively traded security for purposes of Regulation M (satisfying the average daily trading volume exemption) and thus exempt from compliance with Regulation M, such exemption does not flow up to the equity unit. Thus, the equity units are subject to the restricted period pursuant to Rule 101 of Regulation M, which begins on the later of five business days prior to the pricing date or such time that a person becomes a distribution participant, and ends on the completion of such person's participation in the distribution.

## FINRA

Given the peculiarities of the offered securities, issuers, underwriters and counsel are well advised to revisit the FINRA rules with respect to, among other things, conflicts. A conservative reading of FINRA Rule 5121 takes into account that at closing, the issuer is offering two distinct securities: (1) the host (usually an interest in a debt security of the issuer) and (2) a purchase contract. To the extent that the underwriters determine that there is a conflict, the exceptions for the use of a Qualified Independent Underwriter (bona fide public market, investment grade rated, etc) may not apply to the offering of the purchase contract. In such cases, the underwriters may need to determine whether the appointment of a Qualified Independent Underwriter is necessary for the offering.[3]

## Considerations for Closing of Equity Units Offering

Once the transaction has successfully launched and priced, the issuer, legal counsels and the underwriting syndicate must begin preparing for settlement and listing of the equity units, in addition to the possible exercise of a customary green shoe option (which typically must close within 13 days of the initial closing so as to assure tax fungibility of the reopened debt). Given the unique nature of this product and the number of associated securities (i.e., the underlying host and the ability of holders to create treasury units), special consideration should be given to the settlement process with DTC and the lead billing and delivering underwriter. Note that this process is typically handled by the underwriter's

3 In a similar vein, counsel may wish to involve Canadian counsel in order to confirm that the particular structure of the offering does not run afoul of the Canadian regulations with respect to the exemption from the use of a Canadian wrapper. Most of the "red flags" checklists generated by Canadian law firms with respect to the exemption list, for example, the scenario where a security converts into a different issuer from the issuer of the security.

equity operations team. Early communication with the lead underwriter's operations team, DTC and the purchase contract agent (which will issue the corporate units at closing) are crucial to avoiding any hiccups on the morning of closing.

The subsequent listing process for the equity units with the NYSE (for NYSE-listed issuers) is similar to the process for other structured products. The issuer should aim to have a completed application into the NYSE prior to closing so that trading of the corporate units can begin shortly after closing. Note that the NYSE application requires the issuer to state the number of shares to be reserved for issuance. The formula for such amount is: (number of Units issued X the max settlement rate) + (number of Units issued X the highest rate listed in the Make Whole table).

In our experience, assuming all deliverables with the NYSE are properly made, trading will typically begin three business days after closing. In order to bridge the several day gap between closing and the commencement of trading on the NYSE, some offerings are assigned an OTC trading symbol by FINRA. This measure is temporary. Once trading begins on the NYSE, the OTC symbol will be "inactivated" by FINRA.

Before pricing, the underwriters will obtain CUSIP numbers for: (1) the corporate units, (2) the underlying host and (3) the treasury units. For the corporate units and treasury units, the underwriters will obtain equity CUSIPs and for an underlying debt host, the underwriters will need to obtain a debt CUSIP. At settlement, only a closing for the corporate units CUSIP will occur, as the remaining two CUSIPs will have a $0 balance at closing. It is important that the CUSIPs for the underlying host and treasury units be set up correctly with DTC at the time of initial issuance of the equity units. We recommend obtaining the three CUSIPs several days prior to pricing in order to ensure they are set up correctly in order to avoid any delays completing the term sheet.

In our experience, because settlement of equity units is somewhat uncommon (compared to other "plain vanilla" debt securities or equity), other last minute issues may arise. One item we encountered on several transactions is a request from DTC that the issuer provide an attestation form regarding Section 871(m) of the Internal Revenue Code of 1986, as amended. Section 871(m) (which was initially effective in 2017) generally treats "dividend equivalents" under certain contracts as US source dividends that are subject to withholding for non- US persons. In our experience, although the issuer already intends to treat contract adjustment payments as subject to withholding, DTC may nonetheless request a rider from the issuer at closing. Further, DTC requires additional time before closing for the "packaging" of this type of security. In our experience, it is important to confirm with DTC or the purchase contract agent in advance of closing that this has occurred. Otherwise, settlement may be delayed.

Because of the US federal income tax treatment of an equity unit as two components, with interest payments on the underlying debt host treated as interest and contract adjustment payments treated as ordinary income (thus subject to withholding in a manner similar to dividends), we have also encountered some confusion with Euroclear. Because ongoing payments on the equity units are derived from these different components, we have received clarification requests from Euroclear on how such equity units should be classified in the Euroclear system. Because Euroclear's system cannot allow for a security with different tax treatment of various components, it is likely that Euroclear cannot be used for settlement.

## Considerations for the Remarketing

The remarketing is a unique element of equity units and allows for the underlying host to continue after the conversion of the purchase contracts. The proceeds of the remarketing are typically used to fund the purchase of new underlying US treasury strips. Although the remarketing process will not begin until almost three years after the issuance of the equity units, a form of remarketing agreement is agreed to (and in some cases, entered into) by the issuer and the underwriters at the time of issuance of the equity units.

Until the remarketing of the underlying host, the host CUSIP and the treasury unit CUSIP will likely retain a zero balance (or minimal balance). Issuers can run into trouble at the time of a remarketing when such host CUSIP is not DTC eligible, lists incorrect interest payment intervals or has been dormant for a long enough time such that DTC has temporarily put a "chill" on the CUSIP on its system. In these instances and others, both issuer's and underwriter's counsel will work with DTC to make the necessary updates on DTC's system for proper settlement of the remarketing. In some instances, an issuer may be asked by DTC's General Counsel's office to provide a letter from the issuer requesting such a change to the information on DTC's records with respect to such CUSIP.

Despite being approximately three years out from the time of initial issuance of the equity units, proper planning for the remarketing is crucial at the time of initial issuance. The remarketing (and settlement thereof) should not occur within the issuer's quarterly black-out period, as standard deliverables (comfort letters, legal opinions, etc.) are required at the time of closing. And the issuer will also want to ensure it has adequate time to conduct an optional remarketing (discussed below) during an ideal window.

At the time of issuance of the equity units, the issuer agrees to enter into a remarketing agreement to remarket the underlying host. Such optional remarketing will sometimes require a remarketing agent to use its "commercially reasonable efforts" to obtain a set price for the underlying host. Such language is important. The issuer's tax counsel will likely want considerable efforts to be made in order to ensure a successful remarketing. At the same time, it is beneficial to have some flexibility built into the remarketing procedure in the event that the remarketing period chosen by the issuer turns out to be a particularly bad time to market the host for sale. The remarketing agreement essentially functions as the underwriting agreement at the time of remarketing and provides for customary representations and warranties, conditions precedent to closing such as legal opinions, 10b-5 letters and comfort letters and underwriting indemnity. While the form of remarketing agreement is agreed to at the time of the issuance of the equity units, the issuer and the remarketing agent(s) will need to enter into an agreement at the time of pricing the remarketing to document the time of sale and pricing terms just as would be the case in a standard underwritten offering.

Settlement for the remarketing is a multi-step process. The parties involved will benefit from a detailed funds flow memo prepared well in advance of closing that includes step by step instructions for each wire and the responsibilities of each participant (issuer, remarketing agent, trustee, purchase contract agent and collateral agent).

The first step of the remarketing closing is typically the settlement of the treasury portfolio. The remarketing agent will settle on its prior purchase of the treasury portfolio and deliver the treasury portfolio via "DWAC" (Deposit/Withdrawal At Custodian) to the collateral agent. At the same time, the remarketing agent will allocate the funds from investors for the remarketed underlying host for such treasury portfolio purchase. Before the trustee (or transfer agent) can transfer the remarketed underlying host to the remarketing agent, however, the purchase contract agent must receive the pledged host from the collateral agent. The issuer must also separately pay any accrued interest (or dividends) on the underlying host. All of these steps need to occur quickly, as multiple DWAC closings will need to occur. While DTC's DWAC system closes at 5:30 pm (ET), the remarketed securities must be transferred to the remarketing agent's account at DTC earlier in the day so as to permit ample time to allocate the remarketed securities to the new investors.

## Autumn Closes In on LIBOR: The "Fixed-to-Fixed" Workaround in the Hybrid Market

Our team continues to follow the transition from LIBOR closely. See, for example, "Float On: The Market Tweak to the ARRC's Language" in the August 2020 issue of Baseload. Market participants have been focused now for years on the transition away from LIBOR. Issuers continue to review their outstanding LIBOR-denominated instruments in order to determine how the transition will affect each. And given that the varieties of "old LIBOR" language in outstanding securities are many, the solutions to bring those instruments up to date are equally varied (redemptions, liability management (including consent solicitations and exchange offers), etc). And while acceptance of the ARRC language has been fairly widespread, a certain amount of uncertainty regarding the transition remains.

In June 2018, NiSource Inc. offered its perpetual preferred on a "fixed-rate reset" basis. There was a fixed rate period of approximately five years at the outset of the security. But after such period, and on each five-year anniversary thereafter, the rate is reset off of the "Five-Year US Treasury Rate" rather than LIBOR. Dominion Energy, Inc. offered a comparable deal in December 2019, again pricing off of the "Five-Year US Treasury Rate." And in June 2020, Sempra Energy also offered a perpetual preferred on a "fixed-rate reset" basis. Over the past several years, a number of financial institutions have also done fixed-rate reset preferred.

It appears that the "fixed-to-fixed reset rate" structure has migrated to the hybrid market at the end of 2019. Based on our review of recent SEC filings, below is a list of issuers that have recently taken advantage of the new structure.

| | |
|---|---|
| **Axis Capital Holdings Limited** | **December 2019** |
| **Stanley Black & Decker, Inc.** | **February 2020** |
| **CMS Energy Corporation** | **May 2020** |
| **Prudential Financial, Inc.** | **August 2020** |
| **Enstar Group Limited** | **August 2020** |
| **The Southern Company** | **September 2020** |

We also note that in the past months there has been at least one issuer in the utility capital markets that has launched but subsequently pulled an offering for this security. Given the long maturities and subordinated structure, it may be that finding a "good window" from both a market and issuer marketing perspective is significantly more challenging than plain vanilla debt.

We note that many of the recent offerings have tended to utilize a shorter maturity (at least comparatively speaking within the hybrid market). For example, both the CMS and Southern Company offerings set the maturity at 30 years. This is in a market where maturities have often been extended much further (40y, 50y or 60y). Also, in all of the above instances, this new security was offered on an institutional rather than retail basis (without listing the security on an exchange). Further, in each offering, the security contained a call for a "Tax Event" at par and a call for a "Rating Agency Event" at 102%.

Presumably the move from using Three-Month LIBOR to the Five-Year US Treasury Rate has required a corresponding change in the applicable spread used in pricing these securities on the front end. But that question aside, it appears that investor interest has remained strong in the past year despite the tweak to the structure.

## Utility Social Bonds: New ESG Financing Method

As noted previously in *Baseload*, utility issuers have looked to “green bonds” with increasing popularity over the last several years to raise funds for new and existing projects with environmental benefits. In addition to green bonds, lately we have seen several utilities offer “social bonds” and, in effect, take advantage of a different segment of the ESG framework.

Social bonds allow issuers to finance projects with social objectives, fitting within the Social Bond Principles published by the International Capital Market Association (“ICMA”), most recently in June 2020. As described in ICMA’s guidance, social bonds “raise funds for new and existing projects that address or mitigate a specific social issue and/or seek to achieve positive social outcomes.”[1] From 2016 to 2019, the market for social bond issuances increased fivefold and over $20 billion of social bonds were issued in 2019 alone.[2] Indeed, as S&P Global Ratings noted in a June 2020 research report, the growth of social bonds is outpacing that of green bonds, demonstrating a “pivot away from a historically climate-centric sustainable debt space and reflecting a diversification of sustainability objectives financed by investors.”[3]

Like ICMA’s Green Bond Principles, the Social Bond Principles provide guidance on the same four components: (1) use of proceeds; (2) process for project evaluation and selection; (3) management of proceeds; and (4) reporting. Notably, ICMA’s June 2020 Social Bond Principles contain additional guidance on the types of projects supported by the social bond market. Such projects include, but are not limited to, providing and/or promotion of affordable basic infrastructure, access to essential services, affordable housing, employment generation, food security and sustainable food systems and socioeconomic advancement and empowerment.[4] ICMA’s guidelines also provide examples of target populations, but the list is not intended to be exclusive. Note that much like green bonds, the use of proceeds, reporting and any second party opinions do not form part of the terms and conditions of the social bonds and typically do not create specific contractual obligations. However, these elements are referenced in the disclosure documents.

An issuer’s first step when considering a social bond offering will be looking at its own investments and expenditures in light of the Social Bond Principles. Given the broad nature of the Social Bond Principles, we have seen a number of issuers both inside and outside of the utility-space put together a unique framework outlining existing or new programs under which the funds could be utilized. This framework effectively serves as the issuer’s “shelf” for social bond offerings and will often be posted on its website for investors to view. An issuer’s individual framework will follow the four components of the Social Bond Principles. For instance, Oncor Electric Delivery Company LLC, the Texas-based regulated transmission and distribution utility highlighted eligible projects such as those working toward socio-economic advancement and empowerment. Oncor’s debut “social bonds” offering in September 2020 directed funds to projects in the socio-economic advancement and empowerment category, which includes investments in and expenditures with minority- and women-owned business suppliers.

Reporting is perhaps the area that differs the most significantly from the green bond market, particularly in the utility space. This is because benefits from the issuance of social bonds are often more qualitative than quantitative. Hence, ICMA recommends that issuers report quantitative performance indicators where feasible and disclosure of the key underlying methodology and/or assumptions used in the

1 International Capital Market Association, Social Bond Principles: Voluntary Process Guidelines for Issuing Social Bonds (June 2020), *available at* https://www.icmagroup.org/green-social-and-sustainability-bonds/social-bond-principles-sbp/.

2 Dieter Holger, Bonds that Do Good-and, Maybe, Well, The Wall Street Journal (Sep. 22, 2019).

3 A Pandemic-Driven Surge In Social Bond Issuance Shows The Sustainable Debt Market Is Evolving, S&P Global Ratings (Jun. 20, 2020).

4 International Capital Market Association, Social Bond Principles: Voluntary Process Guidelines for Issuing Social Bonds (Jun. 2020), *available at* https://www.icmagroup.org/green-social-and-sustainability-bonds/social-bond-principles-sbp/.

quantitative determination. As S&P Global Ratings noted, social bond reporting and disclosure will continue to gain importance in light of concerns around "social washing" (the misrepresentation of the social impact of an issuer's financed projects).[5] Unlike in the utility green bond space, we have seen increased importance placed on second party opinions, perhaps given the qualitative nature of evaluating the impact of a social bond issuance. Indeed, issuers such as Alphabet Inc., National Rural Utilities Cooperative Finance Corporation, Oncor Electric Delivery Company LLC and Pfizer Inc. all pledged to provide a second party opinion verifying their specific framework's environmental and social credentials and its alignment with the Social Bond Principles. The second party opinion is in addition to the other reporting the issuer will provide, such as a website detailing use of proceeds and a report from an independent auditor regarding such use of proceeds.

One issue of which issuers should be aware when looking to launch an initial social bond offering is timing for posting their framework and second party opinion or other guidance to their websites. While some issuers already regularly provide ESG-focused information on their website, and maybe even an annual report, other issuers might not have previously disseminated such information publicly. Issuers pursuing a registered offering should be mindful of Rule 168 to ensure that any information posted to their websites immediately prior or during the offering regarding their framework or attestation will fall within the safe harbor and not be considered part of the offering.

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5 A Pandemic-Driven Surge In Social Bond Issuance Shows The Sustainable Debt Market Is Evolving, S&P Global Ratings (June 20, 2020).

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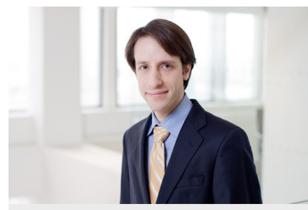

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