MEMORANDUM

To: Human Resources and Governance (HR&G) Committee

From: Chad V. Seely, Vice-President, General Counsel & Corporate Secretary

Date: February 12, 2018

Re: Item 10 – Annual Review of ERCOT Governing Documents

The HR&G Committee Charter provides that the HR&G Committee shall perform an annual review of "proposed modifications to the ERCOT (i) Articles of Incorporation, (ii) Bylaws, or (iii) the Board Policies and Procedures."[1]

Articles of Incorporation

The Amended and Restated Articles of Incorporation of Electric Reliability Council of Texas, Inc. (Articles of Incorporation) have been in effect since December 19, 2000.

ERCOT Legal will recommend amendments the Articles of Incorporation for HR&G Committee and Board of Directors (Board) approval at a future meeting, as early as the April 2018 HR&G Committee meeting, after consultation with its outside tax-exempt organization and corporate counsel. The proposed amendments will maintain ERCOT's current Section 501(c)(4) status and will focus on legal updates to conform to current corporate law requirements which could be approved at the same time as the proposed amendments to the Bylaws. All amendments to the Articles of Incorporation and Bylaws are required to be submitted to the HR&G Committee, the Board, the Membership and the Public Utility Commission of Texas (PUCT or Commission) for approval. In the past, ERCOT Legal has also presented proposed amendments to the Bylaws to the Technical Advisory Committee (TAC) for stakeholder input.

By way of background, ERCOT Legal had submitted a set of amendments to the Articles of Incorporation to the Membership for approval in 2009, primarily for the purpose of potentially changing its tax-exempt organization status. Due to additional considerations which occurred after Membership approval, those proposed amendments were never submitted to the Commission for approval (and, thus, never became effective) since the change to ERCOT's tax-exempt organization status no longer was advisable.

[1] *See HR&G Committee Charter* (effective February 13, 2017), Attachment A, Item No. 2(b)(1).

Bylaws

As discussed in prior HR&G Committee meetings since October 2017, ERCOT Legal is proposing amendments to the ERCOT Bylaws in relation to:

- A Membership Segment definition based on the PUCT directive related to Southern Cross Transmission, LLC;
- The Affiliate definition;
- The Officer definition;
- Updates to legal code references; and
- Corrections to scrivener's errors.

ERCOT Legal has not presented TAC with any options to date on the Membership Segment definition, but expects to do so before the April 2018 HR&G Committee meeting.

Proposed language on the other amendments has been provided to TAC. Although ERCOT has not received any comments to date on these proposed amendments, there is still time at the next two TAC meetings in February and March 2018 (at a minimum) for comments to be submitted and considered.

For the HR&G Committee's review and consideration, attached is the memo provided by ERCOT Legal to TAC on the Affiliate definition for its January 25, 2018 meeting.

Board Policies & Procedures

The Board Policies and Procedures (Board Policies) were most recently approved by the Board of Directors on August 12, 2014.

I look forward to discussing all of these matters with you at the February 19, 2018 Committee meeting.

MEMORANDUM

To: Technical Advisory Committee (TAC)

From: Chad V. Seely, Vice President, General Counsel and Corporate Secretary
Vickie Leady, Assistant General Counsel and Assistant Corporate Secretary
Jonathan Levine, Senior Corporate Counsel

Date: January 18, 2018

Re: Proposed Modifications to ERCOT Bylaws for Determination of Non-Affiliation of ERCOT Members

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This memorandum sets forth certain proposed amendments to the Bylaws of ERCOT, and the rationale therefor, for purposes of clarifying when an Affiliate relationship may arise between two or more ERCOT Members.

Background/History[1]:

On September 5, 2017, Craven Crowell, Chairman of the ERCOT Board of Directors (Board), received a letter from Vistra Energy Corp. (Vistra) requesting that the Board determine that Vistra and its subsidiaries are not Affiliates of any other ERCOT Member by virtue of the ownership of Vistra securities by Vanguard Group Inc. (Vanguard). Vistra is the indirect parent company of ERCOT Members Luminant Generation Company LLC (a Corporate Member in the Independent Generator Market Segment) and TXU Retail Energy Company LLC (an Associate Member in the Independent Retail Electric Provider Market Segment). Vistra's letter reported that Vanguard had an ownership interest of at least five percent in several ERCOT Members or their family companies. In response to the Vistra letter, ERCOT staff solicited feedback from ERCOT Members regarding the affiliation issue raised by Vistra, and received requests for a determination of non-affiliation on behalf of several additional Members (with Vistra, each a **Requesting Company**), which identified at least seven companies in addition to Vanguard with investments of 5% or more in at least 30 different ERCOT Members or their family companies which could trigger the current definition of Affiliate (ERCOT currently has about 309 Members, 285 of whom are Corporate Members, and ERCOT Legal estimates that about one-third of its Members have the possibility of encountering a common equity investor situation based on their corporate structure).

The Requesting Companies raised several material issues with the current definition of Affiliate under the ERCOT Bylaws. Many of the letters from the Requesting

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[1] For additional details regarding the background and the Board resolutions adopted as an interim solution, please see the materials for the October 17, 2017 ERCOT Board meeting regarding Agenda Item 13, available at http://www.ercot.com/calendar/2017/10/17/103997-BOARD.

Companies noted that they did not share board members with other ERCOT Members, which, while it could be an indication of common influence or control, is not a specific item under the current Affiliate definition. Several of the letters noted that with respect to ERCOT Members whose securities are publicly traded, ownership percentages may change on a daily basis, making the percentage-based determination of affiliation (without more) a moving target for many ERCOT Members.[2] Several Members pointed out that the definition should include an exclusion for investments by certain investment companies, funds and other large investors, similar to the exclusion from the Public Utility Regulatory Act (**PURA**) definition. One letter noted that while an investment adviser such as Vanguard or Fidelity may be identified as the "owner" of an ERCOT Member's securities, each fund operates separately, has its own investors, assets and liabilities and differing investment strategies, such that determination of affiliation requires a substantial amount of research and investigation into the holdings of each fund. Further, in Vanguard's own filings, Vanguard notes that 99.2% of its shareholder voting rights are for routine matters such as selection of accountants, uncontested elections of directors and annual report approval. Thus, even where two ERCOT Members were in the same Vanguard (or other investment company) fund, it is unlikely that the investment adviser is voting on anything other than routine matters and not attempting to exercise influence or control. Finally, many ERCOT Members make up stocks in the S&P 500 and/or the Russell 2000/3000 stock indices such that investment companies managing mutual funds based on such indices are required to purchase shares in those ERCOT Members, not for purposes of influence or control, but to meet the requirements of such index funds. For these reasons, and to avoid attribution of Affiliate status to unrelated entities simply based on a common passive equity investor, ERCOT Legal has determined that it is time to update the definition of Affiliate to more closely align with the reality of the ERCOT Members' ownership situations.

While these issues may have arisen for one or two Members in the past[3], changes and consolidation in the industry, as well as overlapping investments by many of the nation's largest investment companies and institutional investors, have led to many more recent issues or potential issues with the Affiliate definition. The basic premise for inclusion of the definition of Affiliate in the ERCOT Bylaws is to avoid a concentration of influence or control over ERCOT by multiple Members controlled by the same person. Where Members are considered Affiliates of one another, ERCOT's bylaws limit such Members' ability to hold memberships in more than one segment, to elect directors and to vote. The current definition essentially creates a presumption of influence or control if an Investing Company owns 5% or more of an ERCOT Member, which must be rebutted in each case. A preferable amendment to the definition would make the subtle distinctions necessary to

[2] While this issue is not resolved with the proposed definition change, it is set at a higher level of 10% rather than at 5%.

[3] There have only been two Board determinations before the Board since the Affiliate definition was modified in 2013 – one involving TCEH Corp. (October 2016), and the other involving Calpine Corporation (September 2013). Each determination arose out of facts similar to those raised by the Requesting Companies in 2017 – an investment company, or its affiliates, owning a passive investment of five percent or more in two ERCOT Members. In each case, as in the case of all of the Requesting Companies in 2017, the Board determined that the passive investment did not result in affiliation of the two ERCOT Members. In each case the Board analyzed whether the Investing Company was a common parent, held influence or control over the ERCOT Member, or had board representation on the ERCOT Members' boards of directors.

avoid submitting every potential investment to the Board for a determination of non-affiliation.

In order to temporarily resolve the issues with the Affiliate definition for the 2017 and 2018 Membership years and until such time as the Board could amend the Bylaws permanently, on October 17, 2017, as an interim solution, the Board adopted several resolutions (as noted in footnote 1) to address the requests for non-affiliation and other similar situations that might arise before the Affiliate definition is amended. Following the meeting, ERCOT Legal consulted with outside counsel in an effort to propose a revised definition of Affiliate that supports corporate best practices while allowing for consistent interpretation and appropriate outcomes.

Without a permanent change in the definition of Affiliate, either (i) the Board will have to make determinations of non-affiliation on a much more regular basis to the point of becoming over burdensome, or (ii) ERCOT Members will be forced to change their Market Segments more regularly to comply with the Bylaws. Because neither outcome is preferable, ERCOT Legal proposes to update the definition of Affiliate to reflect market conditions and investment reality within its Membership.

Proposed Changes to Affiliate Definition in Bylaws:

The following proposed definition of "Affiliate" under Article 2 of the Bylaws was submitted to the Technical Advisory Committee on November 22, 2017:

1. Affiliate*. Affiliate shall mean, with respect to any person, (i) any other person who, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with such person, and (ii) any other person determined by ERCOT, after notice and opportunity for hearing, to exercise, directly or indirectly, through one or more intermediaries, substantial influence or control over such person. As used in this definition, (x) person shall mean any individual, corporation, limited liability company, partnership, firm, joint venture, association, joint stock company, trust, unincorporated organization, or other entity, and (y) "controls", "controlled by", or "under common control with" means the possession, directly or indirectly, through one or more intermediaries, of the power to direct or cause the direction of the management and/or policies and procedures of another person, whether through voting securities, contract or otherwise. Ownership of equity securities (whether publicly traded or not) of another person shall not result in control or affiliation for purposes of this definition if (a) the securities are held as an investment, (b) the holder owns (in its name or via intermediaries) less than 10 percent of the outstanding securities of the person, (c) the holder does not have representation on the person's board of directors (or equivalent governing body) or vice versa and (d) the holder does not in fact exercise influence over day to day management decisions. A voting interest of ten percent or more shall create a rebuttable presumption of control. In cases where the level of control or influence is disputed, the Board shall have discretion to determine whether or not the entities are Affiliates of one another for the purpose of determining Member Segment and voting rights by reference to the foregoing factors and other persuasive evidence.*

Considerations in Proposed Definition:

The base definitions within the definition of Affiliate – "affiliate", "control" and "persons" – are all standard corporate governance definitions, and closely track the definitions used by other U.S. independent system operators (ISOs) and regional transmission organizations (RTOs).

The standard corporate definition of "affiliate" typically takes some variation of the following language: *as to any Person, means any other Person that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, such Person*.[4] This language is common across corporate formation documents, loan agreements, change in control agreements, etc. and is found in SEC Rule 144(a)(1), SEC Rule 405, SEC Rule 12b-2, Section 23A of the Federal Reserve Act, and the Texas Business Organizations Code Section 1.002(1).

The definitions of "persons" and "control" are relatively uniform across the ISO/RTO governing documents, and ERCOT's language regarding evidence of influence or control ("the possession, directly or indirectly, of the power to direct or cause the direction of the management and/or policies and procedures of another") is similar to standard definitions of control, so we maintained that language. However, to track the 10% threshold amount of ownership indicating a rebuttable presumption of control, we added language similar to that in the other ISO/RTO's governing documents – i.e., ownership of equity securities (whether publicly traded or not) of another person shall not result in control or affiliation for purposes of the Affiliate definition if the holder owns less than 10 percent of the outstanding securities of the person. Rather than state a positive presumption of control where an entity owns between 5-20% of a Member, and put the burden on the ERCOT Member to seek determination of non-affiliation from the ERCOT Board, we chose instead to set forth a four-prong test, which if met eliminates the need for the Member to affirmatively request that the ERCOT Board make a determination of non-affiliation. The prongs of the test are similar to the PJM Operating Agreement definition of Control, and we felt would more accurately reflect the types of Investing Companies investing in ERCOT Members than would the more narrow exclusions found in PURA and the Public Utility Holding Company Act (**PUHCA**, 42 U.S.C. § 16451) for certain regulated institutional-type investors. In addition to the 10% threshold, the other prongs include (i) holding the securities as an investment, (ii) lack of representation on the Member's board of directors (most of the Requesting Companies raised this as a counterargument to the assumption that the Investing Company exercised influence or control over them), and (iii) lack of influence over day to day management decisions. Taken together, if all four prongs are true, then no further action need be taken by the ERCOT Member or the ERCOT Board, unless the level of control or influence is disputed.

Both PURA and PUHCA contain exclusions from their regulations for certain large investors, typically in regulated industries. The PURA definition contains an exclusion from the definition of affiliate for registered brokers, dealers, banks, insurance companies, investment advisers, investment companies, pension plans, etc. PUHCA contains an exclusion from the definition of holding company for banks, savings associations, trust companies or their operating subsidiaries so long as the securities they hold are collateral for a loan, held as a fiduciary, or acquired in a liquidation. In each definition, the common denominator for the exclusion is the passivity of the investment; i.e., the entity did not acquire the securities with intent to exercise influence or control. The threshold for determination of holding company and subsidiary company status under PUHCA is 10 percent. 42 U.S.C. § 16451(8).

While the definition of "affiliate" in PURA is similarly worded to the current ERCOT Bylaws definition, and several of the Requesting Companies requested that the new

[4] Similar language is found in the Midcontinent ISO Agreement of Transmission Facilities Owners to Organize; NYISO FAQs, OATT & Services Tariff; ISO New England Code of Conduct.

definition at a minimum contain similar exclusions for institutional investors, it should be noted that the PURA exclusion is limited in scope to investment advisers and public utilities. The current fact patterns extend beyond the definition of investment advisers to a broader group of institutional investors (who may not meet the minimum threshold asset requirements for registration with the SEC) and beyond public utilities, given the broad range of Market Segments at ERCOT. Absent the broadening of this type of exception language, any of the institutional investors who do not fall under the registered investment advisers umbrella would have to be specifically excepted by the Board for any determinations of non-affiliate relationships. ERCOT Legal determined that it would be more appropriate to benchmark its Affiliate definition to its ISO and RTO counterparts rather than the PURA definition.

Similarly, for each of the bylaws and/or operating agreements of the ISOs/RTOs that we reviewed, the threshold for attribution of affiliate status was 10 percent[5], not five percent. It seems that the five percent floor used by PURA[6] (and thus ERCOT) makes more sense in the public utility regulatory realm. ISOs, RTOs and PUHCA are using 10% as the ownership percentage creating the rebuttable presumption of control. It is worth noting that the definition of affiliate in the context of the United States Bankruptcy Code presumes affiliate status based on ownership, control or the power to vote 20% or more of the debtor's outstanding securities, other than in a fiduciary capacity or solely to secure a debt. *See* 11 U.S.C. §§ 101(2)(A)-(B).

Finally, the last sentence of the ERCOT definition was maintained as it gives the ERCOT Board discretion to analyze affiliate status in cases where the level of control or influence is disputed. Language similar to PURA Section 11.006(a), authorizing the Board to make a determination of Affiliation after notice and opportunity for hearing, was added to the introductory language of the definition at subsection (ii). While such language was not included in the other ISOs/RTOs Affiliate definitions, there are benefits to including board discretion to make rational decisions. As demonstrated by the letters from the Requesting Companies, there may be other convincing factors that have not been thought of yet, and there is no reason to limit the factors in the Affiliate definition.

The proposed Affiliate definition is consistent with the Board's prior non-affiliation determinations regarding TCEH Corp. and Calpine Corporation as well as the more recent situation involving the Requesting Companies – i.e., the ERCOT Members involved in each of those instances would have been considered unaffiliated from other ERCOT Members as they had requested without any need for affirmative action by the ERCOT Board, as all four prongs of the test for non-affiliate status would have been satisfied.

[5] See Midcontinent ISO Agreement of Transmission Facilities Owners to Organize; PJM Operating Agreement; SW Power Pool Bylaws; NYISO FAQs, OATT & Services Tariff; ISO New England Code of Conduct.

[6] The five percent threshold dates back to 1975 for electric utilities, but research did not identify any history instructive on the reasoning supporting the adoption of this threshold. See Public Utility Regulatory Act, 64th Leg., R.S., ch. 721, 1975 Tex. Gen. Laws 2327, repealed by Act of April 5, 1995, 74th Leg., R.S., ch. 9 (SB 319), § 2(a), 1995 Tex. Gen. Laws 88 (PURA75).