Memorandum

To: ISO Board of Governors

From: Roger Collanton, Vice President, General Counsel and Chief Compliance Officer

Date: September 11, 2014

Re: **Decision on revision to the ISO Code of Conduct prohibited investments rule**

This memorandum requires Board action.

Introduction

Management recommends the Board adopt a revised Code of Conduct that refines the prohibited investments rule by implementing recent FERC authority which permits financial interests in certain entities that have no more than a *de minimus* interest in, or impact on, the ISO market. This change will lessen the negative impact the prohibited investments rule has on recruitment and retention of employees and Governors while maintaining appropriate restrictions on ownership of securities necessary to avoid conflicts of interest. The current rule prohibits ISO employees, Governors and their immediate family members from having a financial interest in any entity that is an ISO market participant, or that entity's "affiliates," which includes the entity's corporate parent. Some of the publicly traded parent companies whose securities are treated as prohibited investments under this rule are not electricity companies and have at most an immaterial interest in or impact on the ISO market. The proposed revised rule, however, would preclude owning securities of only those entities or affiliates (including parent companies) that are active in the ISO market and that are either electric sector companies, companies whose ISO market activity is material to the company's revenues, or companies whose ISO market activity is material to the ISO. The revised rule would also prohibit investments in entities that are participants in an active competitive solicitation related to the California ISO's transmission planning process. The revised rule is modeled on, and closely parallels, the FERC-approved tariff rules recently implemented by NYISO and MISO. Management recommends that the revised Code of Conduct, which also includes various non-substantive revisions, be effective immediately to avoid any unnecessary divestment of securities.

Management recommends the following motion:

> ***Moved, that the ISO Board of Governors approves the revised prohibited investments rule in the ISO Code of Conduct and Ethical Principles as described in, and attached to, the memorandum dated September 11, 2014, with an effective date of September 18, 2014.***

DISCUSSION AND ANALYSIS

Background

To ensure independence, FERC requires that ISOs and RTOs implement conflict of interest rules that restrict directors and employees and their spouses and minor children from maintaining financial interests in market participants of the markets they administer and in entities whose economic or commercial interests would be materially affected by the RTO's or ISO's actions or decisions. ISOs and RTOs, including the California ISO, have implemented this requirement through rules that apply to market participants and their corporate affiliates, including parent companies. From the perspective of their overall business interests, a number of these parent companies have at most a very limited interest in the ISO market or in energy. For example, the California ISO rule currently prohibits investments in certain very large, multinational financial institutions, even though these companies are merely parent companies to small ISO market participants where no act of the ISO could ever be expected to affect the parent company's stock price, nor could the parent company's actions have a substantial impact on the ISO's market. Because owning stock in such companies would not pose any real conflict of interest, the current investment rule is overly restrictive. The prohibited investments rule has had a particular impact over the past few years as several entities that have only a *de minimus* interest in the RTO and ISO markets have become market participants as parent-company affiliates.

For this reason, several other ISOs and RTOs have attempted, over recent years, to persuade FERC to relax its financial interest rule. Two such recent attempts have been successful, as FERC accepted earlier this year prohibited investments rule changes submitted as tariff amendments by NYISO and MISO. These organizations' new prohibited investments rules allow their directors and employees to hold financial interests in companies that are outside the electricity sector if the companies have only immaterial interests in and impact on their markets, as defined by a specific formula. Further, the MISO rule prohibits directors and employees from investing in any transmission project sponsor that is participating as a "Qualified Transmission Developer" in its competitive transmission developer selection process undertaken pursuant to FERC Order No. 1000. These new rules do not, however, alter the general conflict of interest standards for NYISO or MISO.

The California ISO prohibited investments rule

The California ISO satisfies the financial interest independence requirement by implementing a prohibited investments rule in its Code of Conduct and by periodically publishing a Prohibited Investments List that includes a list of prohibited investments and guidance on how to apply the rule. Historically, most California ISO market participants, and their corporate affiliates, were traditional electric utilities. With the ongoing development and integration of demand-side resources and the increase in non-traditional electricity suppliers and merchant generators, the number and types of entities that qualify as market participants and affiliates has expanded significantly. Consequently, this has significantly increased the number of securities that are subject to the ISO's prohibited investments rule, many of which have little or nothing to do with the ISO market. This dramatic increase in the number of securities that must be divested has made it more challenging for the ISO to attract and retain qualified employees and Governors, and in some instances has required employees or Governors (or their immediate family members) to needlessly divest long-term investments that are often integral parts of their overall financial investment strategies and retirement plans.

Proposed change to the California ISO prohibited investments rule

Management proposes the Board revise the Code of Conduct to implement the prohibited investments rule consistent with recent FERC authority, and thus allowing Management to adopt the rules that FERC recently approved for NYISO and MISO, which will be utilized within the Prohibited Investment List. The revised Code of Conduct is included as Attachment 1.

The specific rule, consistent with current FERC precedent, will require that employees, Governors and their immediate family members (i.e., spouse and minor children) be prohibited from holding a security of a market participant. For the purpose of the prohibited investments rule only, the term market participant will be limited to entities that have been active in the California ISO market in the previous calendar year, and their affiliates (including parent companies), if:

(1) the entity or its affiliate is an electric sector company based on its North American Industry Classification System (NAICS) classification or otherwise determined by the California ISO to be in the electric, power, generation, transmission or distribution business; or

(2) the total activity in the California ISO market (purchases and sales) for all entities affiliated with the publicly traded company at issue during its most recently completed fiscal year is equal to or greater than 0.5 percent of its gross revenues for the same time period; or

(3) the total activity in the California ISO market (purchases and sales) for all entities affiliated with the publicly traded company at issue during its most recently completed prior calendar year is equal to or greater than three percent of the total California ISO market activity (purchases and sales) for the same time period.

In addition to these three criteria, an entity and its corporate affiliate, including its parent company, will be considered a market participant for purposes of the prohibited investment rule, regardless of whether the entity had any activity in the California ISO market in the previous calendar year, and therefore will be a prohibited security, if the entity is a transmission project sponsor participating in the competitive solicitation process under the California ISO's transmission planning process pursuant to the ISO tariff and FERC Order No. 1000.

The purpose of this four-pronged test is to prohibit direct investments in securities of companies that have a material interest in, or impact on the operation of, the California ISO market (by virtue of being defined as an electric sector company, or of the volume of the entity's California ISO transactions in relation to the total California ISO transactions over a given 12-month period), or for which participation in the California ISO market has a material impact on their overall revenues. In addition, it is to prohibit direct investment in transmission development project sponsors that have a potential financial interest in the California ISO's transmission planning decisions in the competitive solicitation process as part of its transmission planning process. The proposed rule will significantly reduce the prohibited investments overall while continuing to prohibit investments in traditional electric utilities and other entities that have a material interest in, or impact on, the ISO market. Accordingly, this rule will continue to protect the independence of the California ISO Governors and employees while reducing unnecessary impediments to their financial planning decisions.

Unlike the NYISO and MISO, which implement their prohibited investment rules as part of their tariffs, the ISO implements its rule in the Code of Conduct, which is not part of the ISO tariff. Accordingly and upon Board approval, it is appropriate that the ISO revise its Code of Conduct to be consistent with FERC requirements, as it has done when implementing previous changes to the investment rule in 2010 and 2013. The revised rule will thus be implemented as part of the ISO's Code of Conduct, and the specific detailed rule, which defines market participant for the purposes of prohibited investments, set forth above, will be embodied in the Prohibited Investments List. By doing so, the ISO will provide the exact guidance, as to what constitutes a "market participant" for purposes of prohibited investments, as part of the document that provides employees and Governors other relevant guidance, including the list of entities that are currently known (as of the date of the publication of the list) to be prohibited investments.

Management also proposes that the Board accept various non-substantive changes to the Code of Conduct that reflect typographical corrections, new personnel, title changes, and minor clarifications to the guidance provided therein. These changes are incorporated in the revised Code of Conduct provided in Attachment 1.

MANAGEMENT RECOMMENDATION

For these reasons, Management respectfully requests that the Board authorize the proposed changes to the Code of Conduct to implement the prohibited investments rule consistent with recent FERC authority, and to address various non-substantive issues such as personnel changes, as described herein and as contained in the attached revised Code of Conduct. Management also recommends the Board make the revised Code of Conduct effective immediately.