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BLOG

FTC Proposes Two Significant Changes to HSR Rules

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On September 21, 2020, the Federal Trade Commission (FTC) announced a Notice of Proposed Rulemaking (NPRM) that proposed significant changes to the implementing rules of the Hart-Scott-Rodino (HSR) Act of 1976, as amended. [1] If adopted as written, these proposed changes have the potential to significantly affect the types of transactions that are required to be reported under the HSR Act, particularly for investment funds.

The Proposed Expansion of the Definition of "Person" Would Require More HSR Filings from Investment Funds

The most significant rule change is the proposed revision to the definition of "Person" in 16 C.F.R. § 801.1(a)(1). Under the current rules, an HSR filing is made by the ultimate parent entity (UPE) of the acquiring person. For investment funds, even funds under common management, each fund typically is its own UPE. For this reason, currently, entities not controlled by the same UPE are not required to aggregate the holdings of affiliated funds with common management when determining whether an acquisition is reportable. Instead, these commonly managed funds typically are deemed to be "Associates" of the UPE and are required to provide information on the UPE's HSR form only in limited circumstances.

Under the proposed rule change, investment funds that are currently defined as Associates of a UPE will be deemed to be within the same Person as the UPE. The result is likely to be a substantial increase in the number of acquisitions by investment funds that are HSR-reportable, in addition to increased reporting obligations about related funds when a transaction is reportable. For example, if a Sponsor of Fund 1 and Fund 2 arranges a transaction where Fund 1 and 2 would each acquire $50 million in a target's stock, the transaction would not be HSR-reportable under the current rules so long as Funds 1 and 2 are each separate Persons. The transaction would not be reportable because the $100 million investment in the target by Sponsor is viewed as two separate $50 million transactions by different Persons (*i.e.*, Fund 1 and Fund 2). Because each of these separate $50 million investments are below the $94 million size-of-transaction threshold, the transaction is not reportable. Under the new rules, however, because Funds 1 and 2 are commonly managed by Sponsor, they will be considered to be part of the same Person and their separate $50 million acquisitions will need to be aggregated and become a single reportable $100 million acquisition for HSR purposes. Because these funds in the same family are now more likely to be within the same Person instead of merely being Associates, the new HSR rules also will require these related funds to disclose additional information when a transaction is HSR-reportable. According to the FTC, the proposed changes would bring the HSR rules in line with how such funds are managed. [2]

The new rules also would result in more filings under other scenarios. For example, acquisitions by newly formed entities are sometimes non-reportable when the newly formed acquisition vehicle is not "controlled" for HSR purposes by an existing fund. For example, if each of three related funds held 33 percent of the membership interests of a newly formed LLC, that newly formed LLC would likely be its own UPE. In these circumstances, the newly formed entity often will not have sufficient assets to meet the HSR size-of-person test. If the newly formed entity does not meet the size-of-person test and the value of the transaction for HSR purposes is below $376 million, the transaction is not reportable. Under the proposed rules, it is much more likely that the three related funds that each hold 33 percent of the membership interests of the newly formed entity will be within the same Person. As a result, the size-of-person test is much more likely to be met because the assets of the newly formed entity would need to be aggregated with each of the three funds and any other entities within the same Person.

Additionally, before the proposed changes, a new fund's first acquisition (even if for 100% of a target) did not require an HSR filing if the new fund had no assets other than cash to make the acquisition (because cash is not considered an asset for HSR purposes). Now, however, if the new fund is commonly managed with other funds, those other funds' assets will be included, making it more likely the size-of-person test is met.

Proposed *De Minimis* Exemption

Under the current HSR rules, acquisitions that result in the acquiring person holding 10 percent or less of the voting securities of an issuer are exempt from reporting if the acquisition was made solely for the purposes of investment.[3] Because the FTC has interpreted this exemption quite narrowly,[4] the investment-only exemption often is not available for hedge funds and other investors that may actively participate, even if to a limited degree. To address this concern, the FTC has proposed a *de minimis* exemption that would apply when an acquisition results in an acquiring person holding 10 percent or less of the voting securities of an issuer, so long as the acquiring person does not have a competitively significant relationship with the issuer.

The theoretical advantage of the new rule is that it would allow hedge funds and other investors to hold board seats and otherwise actively participate in the management of the target so long as they continue to hold 10 percent or less of the target's voting securities. However, the broad definition of "competitively significant relationship" threatens to greatly reduce the facial benefit of the exemption. Under the proposed rule, the *de minimis* exemption only would apply if:

- The acquiring person is not a competitor of the issuer;
- The acquiring person holds 1 percent or less of the voting securities or non-corporate interests of any competitor of the issuer;
- No person acting on behalf of the acquiring person (including principals, employees, and agents) is an officer or director of the issuer; and
- There is no vendor-vendee relationship between the acquiring person and the issuer.

For two reasons, this exemption is likely to be quite narrow in practice. First, the particularly broad definition of a "competitor" would include any person that reports revenues in the same six-digit North American Industry Classification System Code as the issuer or competes with the issuer in any line of commerce.[5] This broad definition of competitor is likely to make the *de minimis* exemption unavailable to many strategic buyers, or investment funds with existing investments in portfolio companies, that merely operate in the same broad space as the target even if the target is not in any way a competitor of the investor.

Second, the *de minimis* exemption is likely to be quite narrow because the proposed expansion of the definition of Person will also apply to the exemption. For example, if Fund 1 will hold 10 percent or less of the voting securities of an issuer, the *de minimis* exemption may not be available to Fund 1 if related Fund 2 or Fund 3 hold more than 1 percent of a competitor of the issuer because Funds 1, 2, and 3 may all be within the same Person.

Takeaways

- Commonly managed investment funds will likely be required to make more HSR filings and the filings they make will require more information.

- Funds under common management are now considered the same "person" under the new rules. Thus, assets of commonly managed funds, as well as acquisitions by separate funds in the same target, will now be aggregated, making it more likely relevant HSR thresholds are met. Also, additional information on other commonly managed funds will be required in the HSR filing itself.
- The exceptions to the proposed *de minimis* exemption may greatly reduce the benefit of that exemption for many investors. In particular, any interest greater than 1% in any competitor (very broadly defined) by the acquiring fund or any commonly managed fund makes the exemption inapplicable.

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[1] 16 C.F.R. Parts 801-803: Hart-Scott-Rodino Coverage, Exemption, and Transmittal Rules, Project No. P110014, proposed Sept. 21, 2020, https://www.ftc.gov/system/files/documents/federal_register_notices/2020/09/p110014hsractamendnprm09182020_0.pd (hereinafter "Proposed HSR Rules").

[2] Id. at 9.

[3] 16 C.F.R. § 802.9.

[4] Debbie Feinstein, *"Investment-only" means just that*, (Aug. 24, 2015), https://www.ftc.gov/news-events/blogs/competition-matters/2015/08/investment-only-means-just.

[5] Proposed HSR Rules at 31.

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