Clients&FriendsMemo

Proposed HSR Amendments Will Affect Financial Investors

October 1, 2020

What happened?

On September 21, 2020, the Federal Trade Commission ("FTC"), with the concurrence of the Antitrust Division of the U.S. Department of Justice ("DOJ"), announced a Notice of Proposed Rulemaking and an Advance Notice of Proposed Rulemaking regarding proposed changes to the rules and interpretations implementing the Hart-Scott-Rodino ("HSR") Act. The amendments proposed by the Notice of Proposed Rulemaking and some of the changes contemplated by the Advanced Notice of Public Rulemaking may greatly affect financial investors.

The Notice of Proposed Rulemaking ("NPRM") proposes two significant amendments to the HSR rules. The first change would broaden the definition of "person" to include associate entities. The second change would create a new exemption for the acquisition of 10% or less of an issuer's voting securities unless the acquiring person already has a competitively significant relationship with the issuer. These two rules are not necessarily conditioned on each other (*i.e.*, the Commission may finalize one but not the other). Note that, although Democratic Commissioners Rohit Chopra and Rebecca Kelly Slaughter voted against publishing the NPRM because of their concerns regarding the 10% exemption, both Commissioners support the NPRM's proposed aggregation of associate entities.

The Advanced Notice of Public Rulemaking ("ANPRM") seeks to gather information on specific topics that will help determine the path for future amendments to the premerger notification program. These topics include several that would impact financial investors, such as the competitive effect of an investor holding small minority positions in issuers that operate competing lines of businesses, whether the definition of "solely for the purpose of investment" as applied to the investment-only exemption should be rethought, and whether the acquisition of convertible voting securities or the use of board observers should be reportable events. The FTC unanimously voted to publish the ANPRM.

Why does this matter?

The NPRM proposes changes, and the ANPRM seeks information regarding potential changes, that may significantly impact investment funds and similar financial investors. Over the next two months, investors have the opportunity to submit input for the Commission's consideration. We have detailed below the proposals and topics that would most significantly affect financial investors.

TWO PROPOSED AMENDMENTS

Aggregation of Associate Entities. The Commission seeks to capture the complete structure of the acquiring person and the complete economic stake being acquired in the issuer. For example, if Funds A, B and C, each its own ultimate parent entity ("UPE"), exist within the same family of funds managed by an Investment Manager, the funds and their manager all are "associates" under § 801.1(d)(2). For example, under the current rule, if Fund A plans to acquire 6% of Issuer X for $100 million, and Funds B and C each plan to acquire 3% of Issuer X for $50 million, only the acquisition by Fund A is large enough to cross the $50 million (as adjusted) size-of-transaction threshold. Under the current HSR Rules, Fund A does not need to disclose in its HSR filing the less-than-5% interests in Issuer X of Funds B and C. Under the proposed changes, the Investment Manager would make a single filing for the fund family's aggregated acquisition of 12% in Issuer X for $200 million. Similarly, if Funds A, B and C each were to acquire 3% of Issuer X for $50 million, no filing would be required under the current Rules because none of the acquisitions would exceed the size-of-transaction threshold. Under the proposed changes, however, a filing *would* be required for the aggregated acquisitions by the fund family of 9% in Issuer X for $150 million. On the other hand, if Funds A, B, and C each will acquire 6% of Issuer X for $100 million, the current HSR rules would require three separate filings from each UPE. Under the proposed changes, only a single filing by the Investment Manager for an aggregated 18% of Issuer X for $300 million would be required.

- Under the proposed rule, a UPE filing as an acquiring person would be part of a new, larger Acquiring Person. This Acquiring Person would include the UPE (*e.g.*, the investment fund), its associates (*e.g.*, funds within the same family that each are their own UPEs), the manager of the UPE and its associates (*e.g.*, the investment manager), and any entities controlled by the UPE or its associates (*e.g.*, portfolio companies owned by any of the commonly-managed funds).

- The managing entity would make the HSR filing on behalf of the Acquiring Person. If two UPEs within the same Acquiring Person are making reportable acquisitions in the same issuer, the managing entity may choose which one will be the relevant UPE for purposes of the form. The relevant UPE also may file on behalf of the managing entity.

- The NPRM's proposed changes to the HSR form would require information (*e.g.*, revenues, ownership, minority holdings and prior acquisitions) and documents (*e.g.*, financial statements, 4(c) and 4(d) documents) from *all* entities within the new, larger Acquiring Person: the managing entity, all funds managed by the managing entity (even if the particular fund is not investing in the issuer), and all portfolio companies controlled by any of the commonly-managed funds.

- The Commission acknowledges that the proposed changes would result in more filings and an increased burden for non-corporate entity UPEs within families of funds and master limited partnerships ("MLPs"). Although the FTC believes that the burden would be manageable, the Commission invites comments on alternative ways that the Agencies could obtain the necessary information that would be less burdensome for investment funds and MLPs.

- Certain non-corporate entity UPEs within families of funds and MLPs and their associates may be structured as index funds, exchange-traded funds ("ETFs") or the like. Because these entities base their investments on an index, the Commission acknowledges that the proposed changes may not be appropriate for these entities and invites comments as to whether index funds, ETFs or the like should be differentiated under the proposed rule.

Proposed Exemption for *De Minimis* Acquisitions of Voting Securities. The Rules currently include an exemption for acquisitions of 10% or less of the voting securities of an issuer made "solely for the purpose of investment" (*see* § 802.9). "Voting securities are held or acquired 'solely for the purpose of investment' if the person holding or acquiring such voting securities has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer" (*see* § 801.1(i)(1)). Aside from the specific factors set forth in the Statement of Basis and Purpose for the original 1978 Rules, there is little guidance as to what type of conduct—other than simply holding the stock—may fall under the "solely for the purpose of investment" umbrella. Communications between investors and management generally serve to encourage corporate accountability to shareholders and to stoke competition. However, the Commission acknowledges that "seemingly innocuous" topics may touch on basic business decisions (*e.g.*, a discussion on executive compensation may evolve into how each executive's compensation will be determined by the company's performance) that may preclude the use of the § 802.9 exemption. The uncertainty related to the subjective assessment of investment intent may dampen shareholder activism and its attendant benefits to competition.

A decade after the promulgation of the original Rules, following complaints by investors about the negative impact of HSR on their small stock purchases and a study that showed the Agencies had never challenged one, the Commission considered a blanket exemption for all acquisitions of 10% or less of an issuer's voting securities, regardless of intent of the acquiring person (*see* 53 FR

36831 (Sept. 22, 1988)), but did not issue a final rule. Commissioner Noah Phillips states, "[t]ransactions of 10% or less are just as unlikely to lessen competition today as they were 30 years ago; and small stock purchases have almost never needed even a second look." According to the NPRM, *none* of the 10%-or-less standalone acquisitions reviewed by the Agencies over the last four decades has warranted a challenge, and rarely have the Agencies engaged in a substantive initial phase investigation of such an acquisition. The Commission believes that proposed acquisitions of 10% or less should be exempt "when they are unlikely to violate antitrust laws and that exempting this category of acquisitions will allow the Agencies to better focus their resources on transactions that create the potential for competition concerns."

- Although the proposed exemption eliminates the subjective assessment of investment intent, it is not a blanket exemption. The Commission proposes new § 802.15 to exempt acquisitions of 10% or less of an issuer's voting securities only under certain conditions:
    - The acquiring person does not compete with the issuer or any entity controlled by the issuer;
    - The acquiring person does not hold more than 1% of the outstanding voting securities (or 1% of the non-corporate interests of a non-corporate entity) of any entity that competes with the issuer or any entity controlled by the issuer;
    - The acquiring person does not have a person serving as a director or officer of the issuer or an entity controlled by the issuer;
    - The acquiring person does not have a person serving as a director or officer of a competitor of the issuer or an entity controlled by the issuer; and
    - There is no vendor-vendee relationship between the acquiring person and the issuer or any entities controlled by the issuer, where the value of the sales between the entities within the last fiscal year is greater than $10 million.
- Notably, the proposed § 802.15 exemption does not subsume the § 802.9 exemption. The § 802.9 exemption would remain unchanged and be available to exempt acquisitions of less than 10% where there is no intention to be involved in the basic business decisions of that issuer. If § 802.9 does not apply, then proposed § 802.15 may apply (since investment intent is irrelevant), unless the acquiring person already has a competitively significant relationship with the issuer (*e.g.*, the acquiring person has interests in entities with competing lines of business, has an existing vertical relationship with the issuer, or employs an individual who is an officer or director of the issuer or a competitor).

- To address concerns relating to the impact of a single entity holding small percentages of voting securities in competitors within the same industry (sometimes referred to as "common ownership"), the Commission proposes that the § 802.15 exemption not apply if the acquiring person and its associates hold more than 1% in a competitor of the issuer *on an aggregate basis*. For example, if Fund A plans to acquire 6% of Issuer X for $100 million, and one of its associates, Fund B (a separate UPE), has a 2% interest in a competitor of Issuer X, Fund A may not rely on proposed § 802.15. The Commission seeks comment on this approach, including whether a different level of aggregate ownership in a competitor of the issuer would be more appropriate to determine whether the proposed § 802.15 should not apply.

- The NPRM also proposes to define the term "competitor" in order to implement the exception to § 802.15: "the term *competitor* means any person that (1) reports revenues in the same six-digit NAICS Industry Group as the issuer, or (2) competes in any line of commerce with the issuer." Accordingly, an acquiring person first must compare the NAICS codes of the entities which it controls with the NAICS codes the issuer reports. If there is no NAICS code overlap, then the parties must conduct a good faith assessment to determine whether any part of the acquiring person competes with or holds interests in entities that compete with the issuer, in any line of commerce. The Commission acknowledges that this proposed two-prong definition of "competitor" is broad and invites comment on other ways to define "competitor" that would still provide the Agencies with thorough information on the competition that exists between filing parties.

- Commissioners Chopra and Slaughter do not support the proposed 10% exemption because they are concerned that the Agencies will not receive any information at all regarding the exempted transactions. Commissioner Chopra states that "[e]ven if one believes that transactions involving a minority stake are less likely to be illegal, there are many potential alternatives to the outright elimination of reporting," such as "tailored, simplified filing requirements or shortened waiting periods" for minority stakes. Commissioner Slaughter echoes Commissioner Chopra, noting her concerns arise from the proposed exemption's "broadening of the black box of unseen transactions and its effect on corporate governance."

INFORMATION SOUGHT IN ADVANCE NOTICE OF PROPOSED RULEMAKING

Common Ownership. Since the promulgation of the HSR program, there has been significant expansion of the holdings of investment entities, such as investment funds and institutional investors, as well as expanded interest and ability of such shareholders to participate in corporate governance. Through the ANPRM, the Commission seeks to explore the potential competitive effect

of an investor holding small minority positions in issuers that operate competing lines of business. The Commission seeks input on the following:

- *Definition of "solely for the purpose of investment."* The Commission is interested in understanding the incentives involved in applying the § 802.9 exemption through responses to specific questions relating to:
    - How to differentiate between investors who invest solely for the purpose of investment and those who do not.
    - The benefits and drawbacks of adopting the Securities and Exchange Commission's ("SEC") approach to "passive" investors (see SEC Rule 13d-1(c)) and whether the Commission should adopt the elements that must be disclosed in Item 4 of Schedule 13D filed with the SEC.
    - Whether different types of investment companies should be treated differently (*e.g.*, mutual funds versus hedge funds).
- *Definition of "institutional investor."* The Commission also is looking at the § 802.64 exemption for institutional investors making acquisitions of 15% or less of voting securities in the ordinary course of business and solely for purpose of investment. Specifically, the Commission is seeking input on questions, including:
    - Whether the list identifying the types of entities considered an "institutional investor" for purposes of the exemption should be updated.
    - Whether the definition should be made consistent with the SEC's definition of "qualified institutional investor" for purposes of SEC Rule 13d-1(b).

Influence Outside the Scope of Voting Securities. Through the ANPRM, the Commission is exploring the ability of an acquirer to gain influence over a company without the acquisition of the right to vote for the election of directors inherent in voting securities. Specifically, the Commission seeks to understand whether the acquisition of convertible voting securities or board observer rights—neither of which currently requires filing—provide opportunities to influence an issuer's business decisions such that they should be reportable events.

What happens next?

Interested parties may file comments to the Notice of Proposed Rulemaking and the Advance Notice of Proposed Rulemaking online or on paper. Comments are due 60 days after publication of

the notices in the Federal Register, and any comments will be placed on the publicly accessible website, https://www.regulations.gov.

How can Cadwalader help?

Cadwalader's antitrust team, located in key jurisdictions in the United States (New York, Washington, D.C., Charlotte) and London, is composed of specialists that offer 'end-to-end' advice on compliance, investigations and related litigation. Our practitioners are experienced in counseling on HSR and merger issues and are available to discuss the possible impact of the notices of proposed rulemakings and to help with the drafting and submission of comments during the public comment period.

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If you have any questions, please feel free to contact either of the following Cadwalader attorneys.

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