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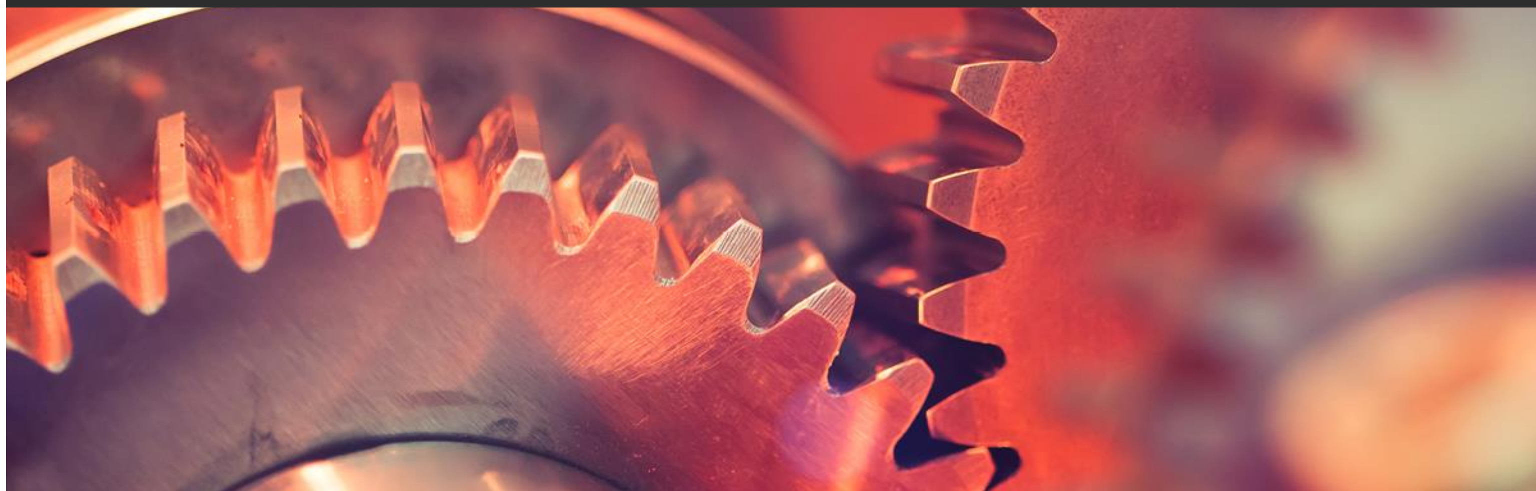

September 2020

Antitrust Agencies Propose Amendments to HSR Rules to Exempt Certain Minority Investments but also Increase Filing Burdens on Private Equity Acquirers

On Sept. 21, 2020, the Federal Trade Commission (FTC), with the support of the Antitrust Division of the Department of Justice (DOJ), published a Notice of Proposed Rulemaking (NPRM) to revise the premerger notification rules (Rules) for mergers and acquisitions under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (HSR Act).

The proposed revisions would create a new reporting exemption for certain *de minimis* investments of 10% or less, but with several important limitations on the proposed exemption. At the same time, the proposed revisions would also significantly expand the scope of private equity investment transactions that would be subject to HSR Act notification, as well as the information and documents which must be included in a notification under the HSR Act. In the latter case, the proposed revisions would require additional detail with respect to portfolio holdings of private equity funds which are not directly participating in the acquisition, but which are commonly managed within the same “family” as the fund(s) participating in the investment.

Additionally, the FTC published on the same day an Advance Notice of Proposed Rulemaking (ANPRM) for the purpose of soliciting information on several topics to “help determine the path for potential future

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amendments" to the Rules. These topics include: how parties must calculate the size of transaction for threshold value; how current filing exemptions are applied to acquisitions by real estate investment trusts (REITs); minority acquisitions of limited partnerships and LLCs (non-corporate entities); minority acquisitions of voting securities; "influence outside the scope of voting securities" such as acquisitions of convertible securities or rights to board observers; the impact on jurisdictional thresholds of issuing extraordinary dividends to shareholders prior to closing a transaction; and other miscellaneous issues pertaining to the HSR filing process, such as exemptions for certain incremental purchases of stock in the same issuer, and the scope of prior acquisitions of an acquirer that must be reported in a notification.

Interested parties are invited to submit comments on the NPRM and ANPRM, per the instructions provided therein, no later than sixty (60) calendar days following publication of the NPRM and ANPRM in the Federal Register, which is expected this week.

The HSR Act requires that, subject to any applicable exemption, mergers or acquisitions, including minority acquisitions, that exceed a minimum jurisdictional threshold value (currently $94 million) be reported to the FTC and the DOJ (the Agencies), and that a waiting period be observed, prior to closing. Numerous exemptions exist from filing, including one for acquisitions of 10% or less of the voting securities of an issuer, but only if the acquirer is making the acquisition "solely for the purpose of investment," meaning that the holder of voting stock "has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." In a number of HSR enforcement actions, acquirers have been found by the FTC to have improperly relied on this exemption and have received significant fines in recent years, and uncertainty persists as to what type and degree of shareholder activism disqualify an investor from the "investment only" filing exemption. The proposed exemption aims to set clearer boundaries for this 10% or less exemption.

Proposed exemption for minority investments of 10% or less, without regard to investment intent

The FTC is proposing a blanket *de minimis* exemption from notification for investments of 10% or less of the outstanding voting securities of an issuer,[1] without regard to the investment intent or degree of activism planned or executed by the investor, subject to several important carve outs. The FTC recognizes that minority acquisitions of 10% or less of voting stock have never been a focus of the enforcer's resources.[2] The purpose of the proposed exemption is "to focus their resources more effectively on those transactions that present the potential for competitive harm."

The Agencies recognize that shareholder advocacy and communication are important to accountability and can improve the competitiveness of the company. The current interpretation of the "solely for the purpose of investment" exemption may chill such behavior, as well as place HSR Act notification requirements at odds with reporting rules issued by the Securities and Exchange Commission (SEC). The proposed exemption eliminates the need for an acquirer to examine investment intent and instead focuses on more salient aspects of antitrust review, namely the extent of competitive relationship between the acquirer and the issuer.

[1] "Voting securities" means "any securities which at present or upon conversion entitle the owner or holder thereof to vote for the election of directors of the issuer, or of an entity included within the same person as the issuer," and does not include partnership interests or LLC units. Acquisitions of equity in non-corporate entities are currently not reportable unless the acquirer will, as a result of the acquisition, hold the right to 50% or more of the profits of the entity or, in the event of dissolution of that entity, the right to 50% or more of its assets after payment of its debts.
[2] From FY 2001 to FY 2017, the Agencies received a total of 26,856 HSR filings, including 1,804 for acquisitions of 10% or less of outstanding stock. During that same period, the Agencies did not challenge any acquisitions involving a stake of 10% or less.

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Towards that goal, the proposed 10% exemption contains some important exceptions, as follows:

- The acquirer (including its controlled portfolio) is a “competitor” of the issuer (including any subsidiary);
- The acquirer holds voting securities in excess of *1%* of a competitor;
- An individual employed by a principal of, an agent of, or otherwise acting on behalf of the acquirer is a director or officer of the issuer (or a subsidiary), or a competitor of the issuer;
- There is a vendor-vendee relationship between the acquirer and issuer (or a subsidiary), where the value of sales between the acquirer and the issuer in the most recently completed fiscal year exceeds $10 million in the aggregate.

The proposed revisions define “competitor” as an entity which either “reports revenues in the same six-digit NAICS Industry Group as the issuer” or “competes in any line of commerce with the issuer.” Defined in this manner, filing parties can still be “competitors” even if they report in different NAICS codes, and the FTC would rely on a “good faith assessment” by the parties as to whether they compete notwithstanding the use of different industry codes.[3] However, the reverse would not apply: parties which use the same NAICS code but do not compete, such as software publishers who offer solutions to entirely different business needs, would still be considered “competitors.” As a result, certain sector-specific private equity investors may be considered “competitors” when making any new portfolio investments.

The FTC references the “ongoing discussion” of the potential concerns with a fund group holding “small percentages of voting securities in competitors within the same industry,” and invites comment on its proposed limitations to the exemption to address this concern, specifically “whether a different level of ownership in a competitor of the issuer would be more appropriate in determining that the proposed exemption should not apply” and whether there are “other ways to define ‘competitor’ that would still provide the Agencies with thorough information on the competition that exists between filing parties.”

It also calls for comment on whether the proposed $10 million threshold applicable to vendor-vendee relationships between the acquirer and issuer is an “appropriate threshold to distinguish ordinary course vertical relationships from those with competitive significance.”

It is not entirely clear from the language of the draft whether the FTC believes that an acquisition of voting securities of an issuer by an officer or director of that issuer is included in “these types of relationships [which] render even a small stake potentially competitively significant,” other than to state that officers and directors are “intimately connected” to the issuer. The draft proposed rule focuses on the existence of an officer or director acting *on behalf of* the acquirer and also serving for the issuer or a competitor, and thereby does not specifically contemplate the individual officer or director being the acquirer. Officers and directors are often subject to HSR notification requirements for receipt of stock of the issuer as part of a compensation package under the current interpretation of the “solely for the purpose of investment” exemption, and these stock grants have been the subject of several enforcement actions over the years for failure to file notification in advance of receipt of the securities.[4] The DOJ is “particularly interested” in comments addressing this exception to the exemption, referring to it as “The Director/Officer Carve-Out.” The agency asks whether the exception should be removed, “given that the new exemption already has

[3] The NPRM suggests that an acquirer may determine whether or not a target issuer is a “competitor” in similar fashion to an internal assessment of whether the thresholds of “competitive sales” applicable to an analysis of interlocking directorates under Section 8 of the Clayton Act are exceeded.

[4] *See, e.g. United States v. Barry Diller*, 2013-1 Trade Cas. (CCH) 78,446 (D.D.C. 2013).

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carve-outs for competitors and common ownership." It will be critical to clarify whether officers and directors receiving stock will be exempt under the proposed exemption.

In sum, the proposed exemption would only apply if an investor does not hold any interest in any competitor and has no existing significant business relationship or management role with the issuer or a competitor. Even a 1% holding of a competitor would disqualify an investor from using the exemption.

Increased burden on private equity acquirers; more deal structures will now require filing

The proposed revisions would also expand the scope of notifications to include information and documents covering all portfolio investments within the same family of fund entities under common management. They would further subject additional private equity investment transactions to the notification and waiting period requirements of the HSR Act that would otherwise not exceed the jurisdictional thresholds above which a notification is required.

Firstly, the Rules define limited partnerships and limited liability companies as "non-corporate entities," and control of a non-corporate entity is defined under the Rules solely by reference to equity, and not to management or governance rights. So long as no single investor has the right to 50% or more of the profits, or assets upon dissolution, of the investing entity, the entity is not considered to be controlled by any higher-level entity in the fund structure. As such, each specific limited partnership within a family of investment funds under common management is often considered its own "ultimate parent entity" and a separate acquirer for HSR notification purposes.

When notification is filed for an acquisition by one of the fund entities, or a newly formed vehicle in which it holds a majority equity stake, the notification largely includes only information pertaining to the existing portfolio holdings of the entity making the acquisition, and very limited information about holdings of other fund entities within the same family.

The FTC notes that "treating these non-corporate entities as separate entities under HSR is often at odds with the realities of how fund families … are managed," thereby "making it difficult for the Agencies to determine whether an [investment by a fund entity which family might also have other holdings in a competitor through another fund entity] might create a competitive concern." As a result, the proposed revisions aim to include as the "acquiring person" all funds and their respective portfolio holdings within the same family as the acquiring fund, as well as the entity(s) which manages the funds, and to require that the filing party provide the same level of detail on the portfolio holdings of the entire fund family as if the investing fund held such holdings directly. This detail includes financial statements, revenues by NAICS code for each portfolio company, subsidiaries and indirect minority holdings, and geographic market information.

Secondly, because of the way in which the revisions propose to define "acquiring person," the entire family of fund entities under common management may need to be considered when determining if the acquirer meets certain jurisdictional thresholds. In addition to meeting the transaction size threshold, an acquiring party to a transaction must meet the so-called "size of person" test, which refers to the amount of total sales or annual net sales of an acquiring party. In cases where an acquisition vehicle is formed for the purpose of an acquisition, and no single fund within the family has the right to 50% or more of the profits, or assets upon dissolution, of the acquisition vehicle, the vehicle is considered its own acquiring person. Because it does not typically hold any sales-generating assets, and instead holds only cash or commitments to fund the acquisition, it may not meet the size of person thresholds. Therefore, no filing

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would be required, even if the transaction value exceeds $94 million.[5] The proposed revisions would include all fund entities within the same commonly managed family which are investing into the acquisition vehicle as the same "acquiring person," and as a result the size of person thresholds would often be exceeded.

The FTC suggests that the consolidation of a fund family into a single acquirer may result in fewer notifications for private equity investors in certain circumstances, such as when multiple funds are acquiring stakes in the same issuer at the same time, and more than one fund's investment would individually exceed the size of transaction threshold. Instead of separate filings for each fund, a single filing may consolidate the investments. Additional incremental investments by other funds in the same family may also not be reportable because the family of funds has already filed to exceed a certain monetary threshold of total holdings.

Finally, the FTC acknowledges that applying the proposed rules to certain non-corporate entities structured as index funds, exchange-traded funds, and the like may not be appropriate, and invites comments on that front.

Further amendments to HSR Rules on the horizon

In addition to the NPRM, the FTC, with support from the DOJ, also issued an ANPRM, which contains a number of open-ended questions on a variety of topics related to HSR notification, the answers to which will help the FTC to craft future amendments to Rules. As with the NPRM, interested parties are invited to submit comments for the next sixty (60) calendar days.

Of note in the ANPRM are questions focused on the following issues:

- the manner in which parties perform a fair market valuation for transaction value threshold purposes;
- the applicability of exemptions from notification to acquisitions by REITs;
- minority investments in non-corporate entities and corporate issuers;
- acquisitions of other securities which are not "voting securities";
- issuance of extraordinary dividends to target shareholders prior to closing in order to get below the size of person threshold; and
- application of the exemption for incremental acquisitions of the same issuer not exceeding, in the aggregate, a higher notification threshold.

Acquirers must perform a fair market valuation of the acquired entity or assets in many instances where the acquisition price is not determined at closing (for example, when consideration includes earn-outs or other contingent payments of cash or equity upon reaching certain milestones). In those instances, the acquirer must essentially determine, in "good faith" and on any "commercially reasonable basis," what a purchaser would pay for the target business in cash in a single payment, without regard to contingencies. The FTC has long eschewed offering specific advice on which method of determining fair market value is "commercially reasonable" and has not required that parties submit documentation to verify the basis used. The ANPRM questions aim to gather information from the investors to better understand how valuations are performed.

[5] Transactions valued in excess of $376 million, however, are subject to notification regardless of the size of person, unless an exemption from notification applies.

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The FTC has long taken the informal staff position that when a REIT acquires real property (and assets incidental to the real property), the acquisition is exempt from HSR notification on the basis that "REITs are solely buying, owning, leasing, and selling real property, and therefore any acquisition of real property is exempt because it is done in the ordinary course of the REIT's business and is unlikely to violate the antitrust laws." However, the ANPRM notes that "REITs are now engaged in the active operation of businesses" such as "assisted living and other healthcare businesses, as well as companies that own cell towers and billboards, located on REIT-owned real property." Because of this expansion of a REIT's permitted activities, the FTC "believes it is possible that a REIT's acquisition of real property may no longer be suitable for the blanket exemption" and invites comments to address the Commission's concerns.

Finally, the other topics for discussion contained in the ANPRM aim to discern (1) whether acquisitions of minority interests of non-corporate entities – which the Rules define separately from voting securities and assets – should be reportable,[6] (2) the extent to which investment intent should be relevant to minority acquisition exemptions (citing conflict between current HSR notification requirements and SEC reporting requirements), (3) whether acquisitions of convertible securities or other rights, such as board observers, should be reportable; (4) whether the issuance of extraordinary dividends to shareholders prior to closing, which dividends would result in the target issuer falling below the size of person threshold, is problematic; (5) whether the five-year exemption for incremental acquisitions which do not cross next threshold should be reduced; and (6) expanding reporting obligations in the HSR form to require an acquirer to report all prior acquisitions within a certain period, rather than only those businesses which generated revenue in a NAICS common to the target business being acquired.

The FTC voted 3-2 to publish the proposed rulemaking, with Democratic Commissioners Rohit Chopra and Rebecca Kelly Slaughter voting no. Chopra issued a statement praising the Rule changes expanding the scope of reporting obligations on funds under common management, but stating that the proposed 10% *de minimus* exemption will remove "visibility into a large set of transactions involving non-controlling stakes."

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[6] *See* fn 1.

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