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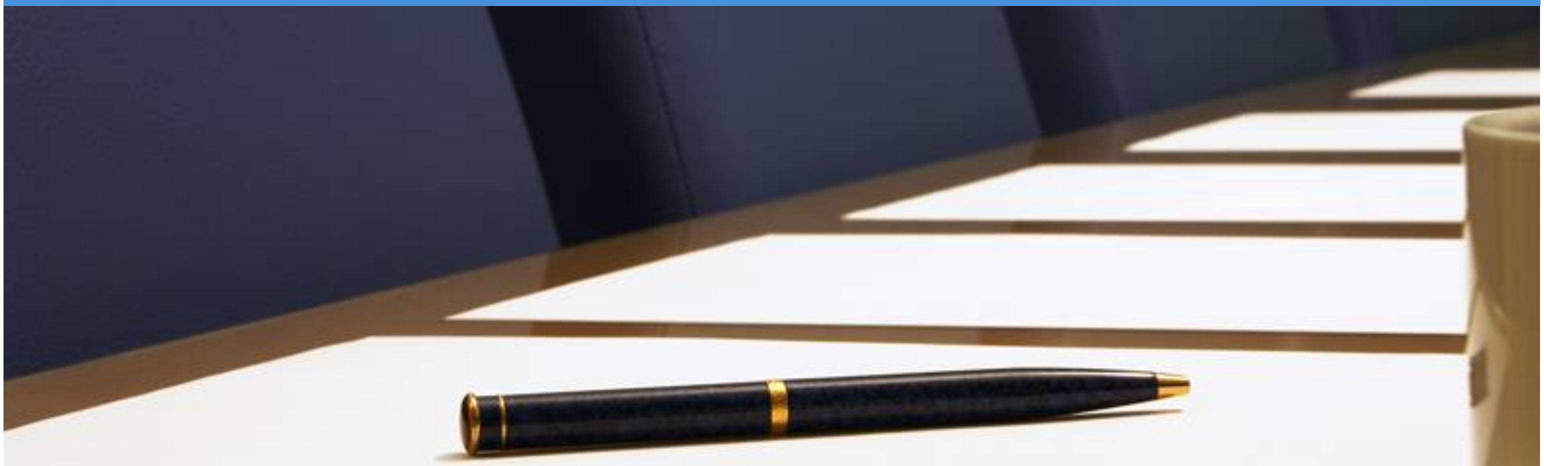

Antitrust & Trade Regulation/Antitrust Litigation & Competition Regulation | Alert

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Agencies Continue to Actively Enforce the Limits of the Passive Investment Exemption Under the HSR Act

The U.S. Department of Justice (**DOJ**) announced July 12, 2016, that ValueAct Capital (**ValueAct**) has agreed to pay **$11 million** to settle allegations contained in a complaint filed in April of this year in the U.S. District Court for the Northern District of California that ValueAct violated the reporting and waiting period requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the **HSR Act**). The highest fine previously paid for an HSR violation was $5.67 million. ValueAct is an investment firm headquartered in San Francisco that manages over $16 billion on behalf of investors, and frequently acquires minority positions in public companies.

The proposed settlement filed by the DOJ yesterday, would also specifically enjoin ValueAct from relying on the "investment-only" exemption when it "intends to influence, or is considering influencing, certain basic business decisions, including those relating to merger and acquisition strategy, corporate restructuring, and the company's pricing, production capacity, or production output." The settlement is subject to a sixty (60) day notice and comment period, after which the Court must enter a final judgment.

Background

The HSR Act requires parties with investments that exceed certain jurisdictional thresholds to make filings with the FTC and the DOJ and to observe a waiting period before closing. The HSR Act and the HSR Rules provide numerous exemptions from the reporting and waiting period requirements. One important exemption provides that an acquisition of up to 10 percent of the outstanding voting securities of an issuer is exempt, regardless of value, so long as the acquisition is made "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." The question of intent is assessed at the time of each purchase of voting securities of the issuer.

In the absence of an exception, the HSR Act requires a firm to make a filing before acquiring an aggregate amount of voting securities of the target issuer valued in excess of the minimum threshold, as adjusted ($76.3 million in 2015, and currently $78.2 million). The filing is not itself public, but the target must be notified of the planned acquisition and the target may elect (or be required) to disclose the filing. This obviously has important implications for activist funds, which may prefer to accumulate larger positions before notifying the target or the general public.

Given the "seriousness" of the alleged current violation and the fact that ValueAct settled alleged violations of the HSR Act in the past, the DOJ's complaint sought a maximum fine of $19 million (based on the HSR Act's maximum civil penalty of $16,000 for each day a person is in violation).[1] Notably, the HSR Act's maximum civil penalty will increase to $40,000 per day effective Aug. 1, 2016, potentially subjecting ValueAct to a 150 percent increase in penalties in the event that the firm did not agree to settle.

The Alleged Violation

On Nov. 17, 2014, Halliburton Co. (**Halliburton**) and Baker Hughes Incorporated (**Baker Hughes**) announced their plan to merge in a transaction valued at approximately $35 billion. Thereafter, ValueAct began to purchase voting stock of both companies, accumulating a holding of over $2.5 billion worth of stock of the companies (though respectively less than 10 percent of each issuer). ValueAct did not file an HSR notification or observe any waiting period prior to any such acquisition.

According to the DOJ's Competitive Impact Statement (**CIS**) filed with the proposed settlement, ValueAct is "well known for actively involving itself in the management of the companies in which it invests." The complaint alleged that ValueAct purchased the shares with the intent to influence the companies' business decisions as the merger process progressed. It detailed how ValueAct approached senior executives of both companies to formulate strategies designed to help the merger survive antitrust scrutiny or, failing that, achieve maximum shareholder value through divestiture of certain businesses. The approach took the form of numerous informal communications as well as presentation materials.

The CIS states that "ValueAct executives met frequently with the top executives of the companies (both in person and by teleconference), and sent numerous e-mails to these the top executives on a variety of business issues." These meetings "identified specific business areas for improvement" and included "presentations on post-merger integration." According to the DOJ, ValueAct's failure to file under the HSR Act "prevented the agencies from reviewing ValueAct's acquisitions in advance, compromising the agencies' ability to protect competition and consumers."

ValueAct's website, cited in the complaint, states that the firm focuses on "acquiring significant ownership stakes in a limited number of companies," and "[t]he goal in each investment is to work constructively with management and/or the company's board to implement a strategy or strategies that maximize returns for all shareholders."

Settlement

The settlement reached by the DOJ and ValueAct provides for payment of a record $11 million fine, an injunction against relying on the investment-only exemption for acquisitions above the HSR Act thresholds when proposing similar activities, and a framework of oversight to monitor ValueAct's future compliance with the HSR Act, the latter of which will remain in place for a ten (10) years. The penalty was adjusted downward from the maximum because ValueAct is "willing to resolve the matter by consent decree and avoid prolonged litigation."

The settlement enjoins ValueAct from using the investment-only exemption if they intend to take, or "identif[y] circumstances in which they may take," the following actions:

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[1] In 2007, ValueAct settled alleged violations of the HSR Act for multiple transactions, paying a $1.1 million fine. These acquisitions resulted in ValueAct holding in excess of 10 percent of the outstanding voting securities of the issuer, and so the "passive investment" exemption was not at issue.

> (1) proposing a merger, acquisition, or sale to which the issuer of the acquired voting securities is a party; (2) proposing to another person in which the Defendant has an ownership stake the potential terms for a merger, acquisition, or sale between the person and the issuer; (3) proposing new or modified terms for a merger or acquisition to which the issuer is a party; (4) proposing an alternative to a merger or acquisition to which the issuer is a party, either before consummation or upon abandonment; (5) proposing changes to the issuer's corporate structure that require shareholder approval; or (6) proposing changes to the issuer's strategies regarding pricing, production capacity, or production output of the issuer's products and services.

The term "propose" is also defined in the settlement to include "communicating a plan of action for consideration, discussion or adoption."

To monitor compliance with the settlement, ValueAct must designate a compliance officer to "supervise the review of current and proposed activities" and to distribute, at regular intervals, copies of the settlement to all persons "who ha[ve] responsibility for or authority over acquisitions." Further, the settlement permits the DOJ, on written request and with reasonable notice, access to records and to employees who the agency may interview "informally or on the record." Finally, ValueAct's directors, officers, and other employees, also upon written request from the agency, must provide reports to DOJ regarding compliance with the HSR Act, which material will be kept confidential.

The settlement also requires that, upon learning of any violation of the settlement, ValueAct must submit a corrective notification under the HSR Act within ten (10) business days.

Implications

The DOJ emphasized that acquisitions exempt from HSR Act reporting and waiting period requirements as passive investments must be undertaken solely for the purpose of investment and that an investor who intends to influence "merger and acquisition strategy, corporate restructuring, and other competitively significant business strategies (e.g., relating to price, production capacity, or production output) is not passive."

The form of settlement appears to now serve as a template in the enforcement by the DOJ and the Federal Trade Commission (**FTC**) of the "solely for the purpose of investment" exemption in that it (1) includes, in addition to a fine, a formal procedure of HSR Act compliance monitoring and a requirement to appoint a compliance officer, and (2) expressly permits the DOJ to affirmatively "check in" with the investment firm and interview employees and demand reports containing details of the background of transactions and efforts to address HSR Act implications of those transactions. These same compliance monitoring provisions were included in the settlement last year between the FTC and Third Point for alleged violation of the HSR Act resulting from improper reliance on the "solely for the purpose of investment" exemption. Past settlements generally provided only for the payment of a fine, and the agencies have required that parties who file corrective notifications provide, in an explanatory letter accompanying the notification, a detailed description of the steps that have been taken to ensure future compliance, such as implementation of training programs with antitrust counsel and monitoring of transactions for HSR purposes by a designated officer.

However, the DOJ mentioned several unique factors in determining the sanctions that would be appropriate in this case. First, ValueAct has previously been fined for HSR Act violations, and prior to that fine had made corrective filings in 2003 for other acquisitions, for which it was not fined. Because of its HSR Act compliance history and the extent of its "active role in the business decisions of both Halliburton and Baker Hughes," ValueAct "should have recognized its filing obligation" and "could have sought the advice of the Federal Trade Commission's Premerger Notification Office, but did not do so."[2] Second, the DOJ considered it "an aggravating factor that the [merger between Halliburton and Baker Hughes] raised substantive competitive concerns" and alleged that ValueAct's failure to fully disclose its potential holdings of the companies in HSR Act notifications "prejudiced the [DOJ]'s ability to enforce the antitrust laws."

[2] The Premerger Notification Office often provides no-names advice to parties on HSR Act filing obligations.

The ValueAct case also cautions investment funds to carefully consider the HSR Act implications of both public statements on their websites as to the funds' strategies and objectives and SEC filings related to investments in public companies. These statements and filings were cited in the complaint as evidence that the funds did not intend to be passive investors qualifying for the exemption from filing under the HSR Act.

Specifically, the complaint included the aforementioned quoted statements from the ValueAct website. The complaint also stated that ValueAct filed a Beneficial Ownership Report (Schedule 13D) with the Securities and Exchange Commission publicly disclosing its substantial stake in the target company and reported that it might discuss "competitive and strategic matters" with target's management, and might "propos[e] changes in [target's] operations." Further, it stated that, before submitting the Schedule 13D, ValueAct's CEO notified buyer's CEO of the impending filing, explaining that the filing "gives us the flexibility to engage with the company [target] on all issues" and that, on the same day, ValueAct's CEO emailed buyer's CEO a copy of its investment memoranda for both buyer and target.

The ValueAct case is also important because of the types of statements and conduct alleged by the agency to run afoul of the passive investment exemption; including internal ValueAct discussions regarding proposed changes to buyer's executive compensation plan and a meeting between ValueAct and buyer's CEO detailing the fund's proposals. While many other instances of ValueAct's engagement with management of both companies are discussed in the complaint (including certain divestiture proposals proposed to the parties by ValueAct), proposals on compensation, at least on their own, may not strike investment firms, who are otherwise not seeking to influence management, as "basic business decisions" of the type contemplated by the passive investment exemption.

The settlement continues the vigorous enforcement by the agencies of the limits of the passive investment exemption. As mentioned, the FTC last year filed a complaint against Third Point. That complaint alleged that Third Point "contacted certain individuals to gauge their interest and willingness to become the CEO of Yahoo or a potential board candidate of Yahoo, took other steps to assemble an alternate slate of board of directors for Yahoo, drafted correspondence to Yahoo to announce that Third Point LLC was prepared to join the board of Yahoo, internally deliberated the possible launch of a proxy battle for directors of Yahoo, and made public statements that they were prepared to propose a slate of directors at Yahoo's next annual meeting." The agency viewed this activity, in the aggregate, as evidence of "[intent to participate] in the formulation, determination, or direction of the basic business decisions of the issuer."

The applicability of the passive investment exception in the context of activist investing has long been a subject of controversy. The FTC itself once proposed to discontinue the passive investment exemption in favor of a "flat exemption" up to 10 percent, which met a legislative roadblock. Such a future flat exemption is in fact referenced in the Third Point settlement as a possibility during the term of the settlement.[3] Some activists and antitrust lawyers have argued that funds should be able to avail themselves of the investment exception and acquire up to 10 percent of a target's voting securities without making a filing; arguing that requiring a filing at the current monetary threshold is unduly expensive and requires investors to disclose their positions prematurely. They have also complained that the precise scope of the passive investment exception is unclear.

The current FTC staff does appear receptive to arguments that it should reconsider the scope of the passive investment exemption. In a blog post last year, the agency wrote:

> We understand that activist investor conduct can be – but is not inevitably – beneficial for shareholders, competition and consumers. To date, we are not aware of specific conduct our rules are inhibiting. Nevertheless, we remain open on this issue – as with other HSR rules – to consider the views of those subject to our rules on ways we can make our rules better or more clear.

[3] The FTC vote to refer the Third Point complaint and proposed settlement to the DOJ for filing in federal court was 3-2, and the dissenters expressed a desire to revisit the benefits of requiring activist funds to file in light of the associated costs of doing so, referring to such fund acquisitions as "a category of stock acquisitions that have proven unlikely after 40 years of experience to raise competitive concerns."

It is also worth emphasizing here that the determination of whether or not a fund is a "passive" investor is made prior to each new acquisition of stock. If an investor acquires stock as a passive investor and later engages with senior management, the subsequent acquisition of any additional shares may require filing and observance of the waiting period prior to completing that subsequent acquisition if the investor's aggregate holdings will exceed a HSR threshold.

The ValueAct complaint should serve as a reminder to institutional investors that have traditionally considered themselves to be passive investors for HSR purposes to carefully consider the HSR Act implications of communications with executive management of companies in which they hold voting securities (and even internal drafts of those materials proposed to be presented to management), as well as public statements on company websites and in SEC filings.

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