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Investment Funds Beware: Proposed HSR Amendments Would Increase Reporting Obligations

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The US Federal Trade Commission and Department of Justice announced proposed changes to the rules governing Hart-Scott-Rodino (HSR) filings that, if implemented, would significantly increase the number of transactions that must be reported to the antitrust agencies – primarily by private equity, venture capital and other investment funds – as well as greatly expand the amount of information included in those filings.

The HSR Act requires parties to transactions that meet specified thresholds and do not fall within an exemption to report them to the antitrust agencies and observe a waiting period before consummating reported transactions. The HSR Act allows the agencies to investigate whether such proposed acquisitions are likely to lessen competition and to challenge them under antitrust law before they are consummated.

The FTC is proposing two amendments to current HSR Act rules.

- The first modifies the definition of "person" under the rules, which would require filers to aggregate "associates" managed by the same investment manager, even if not within the same "ultimate parent entity" under current rules
- The second adds a new exemption that would release parties from filing obligations if the acquiring person will have 10% or less of an issuer's voting securities, unless the acquiring person has a "competitively significant relationship" with the issuer

As the proposed rules are currently drafted, the first amendment would substantially increase the HSR filing obligations of investment funds, and the second appears unlikely to provide much relief for filers.

While the FTC voted to issue the rules for comment, the agency's two Democratic commissioners voting against doing so.

The Democratic commissioners each issued statements, taking issue with the exemption proposal, with Rohit Chopra, for example, expressing concern that it would "add to the burdens and information asymmetries that the [FTC] already faces when it comes to detecting potentially harmful transactions." The DOJ concurred in announcing the proposed rules for public comment but also invited comments on two specific issues relating to the proposed rule changes.

The new proposed rules were announced September 21, with the public comments due 60 days after publication in the Federal Register.

Expanded definition of 'person'

HSR filings must be made by both acquiring and acquired "persons," defined in the HSR rules currently as the "Ultimate Parent Entity" (UPE), which is the person or entity that has the right to vote for 50% or more of the company's board of directors of a corporation or the contractual right to appoint 50% or more of a corporation's board, or the right to 50% or more of the profits or the assets upon dissolution of the entity of a non-corporate entity.

Private equity, venture capital and other investment funds are often structured as limited partnerships, or limited liability companies, where no single partner has a 50% or greater economic interest in the fund. As a result, under the current HSR rules, such funds are treated as their own UPEs without the need to aggregate across funds.

The current HSR rules define an "associate" to include any entity under "common operational or investment decision management" with the filer, solely to specify information that must be reported in a filing. Associates do not, however, have to be aggregated for purposes of determining whether the size-of-person or size-of-transaction thresholds are met and therefore whether a filing is required.

The proposed rule change would amend the definition of "person" to include "associates" of the UPE and require the filing party to aggregate holdings for purposes of analyzing the size-of-person thresholds and aggregate proposed acquisitions in the same issuer with the holdings of other associated funds for purposes of analyzing the size-of-transaction test. In announcing the proposed change, the FTC said that the impetus for this revision is concern that current filings do not capture the complete competitive impact of a transaction.

The implications could be substantial. If adopted, the new definition of "person" would mean that investors will be required to aggregate positions to determine if the HSR Act threshold is met. For example, newly created funds in a fund family, which currently do not need to file for the fund's first investment, will likely have to file, since the "size of person" test will be met.

Fund families with small investments in a company will have to aggregate total holdings, making it more likely that the "size of transaction" threshold will be met, as the value of existing holdings must be aggregated with proposed new investments, for instance, when investing a later funding round in a startup company.

New de minimus exemption

The proposed rule changes would also exempt parties from filing HSR notification if, as a result of the acquisition, the filer will hold 10% or less of an issuer's voting securities and the acquiring person does not have a "competitively significant" relationship with the issuer.

Under the proposed rule, an acquiring person would not have a "competitively significant" relationship with the issuer if the acquirer will hold 10% or less of the issuer and the following criteria are met.

- The acquiring person is not a competitor of the issuer or any entity within the issuer
- The acquiring person does not hold voting securities in excess of 1% of the outstanding voting securities or non-corporate interests of any entity that is a competitor of the issuer
- No individual employed by or otherwise acting on behalf of the acquiring person is a director or officer of the issuer
- No individual employed by or otherwise acting on behalf of the acquiring person is a director or officer of a competitor of the issuer (or an entity within the issuer)
- There is no vendor-vendee relationship between the acquiring person and the issuer, where the value of sales between the parties in the most recent year is greater than $10 million in the aggregate

For purposes of implementing this exemption, the FTC proposes to define a "competitor" as "any person that (1) reports revenues in the same six-digit NAICS Industry Group (a classification system issued by the Census Bureau used currently to report revenue) as the issuer, *or* (2) competes in any line of commerce with the issuer." Thus, to rely on the exemption, a fund may need to determine the NAICS codes in which its portfolio company reports revenues. Some NAICS codes, such as those for "software publishers" – covering everything from video games to software for the healthcare industry – are so broad that they would prevent investors in some industries from ever taking advantage of the exemption.

The FTC announcement suggests that NAICS codes have long been the basis for reporting revenues under HSR and provide "an objective and easy to administer" measure of whether an acquiring person and an issuer compete, apparently not recognizing that identifying applicable NAICS codes is not always simple and investors are likely to have little insight or ability to obtain information on the applicable NAICS codes for portfolio companies in which they have small minority investments.

The HSR Act rules currently exempt acquisitions of 10% or less of the voting securities of an issuer made "solely for the purpose of investment," which requires that 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." While the rule focuses on the investor's intention, the FTC has said that certain activities, including nominating a candidate for the issuer's board of directors, soliciting proxies or proposing corporate action that would require shareholder approval all disqualify an acquirer from the exemption. The FTC has also said that being a competitor of the issuer makes the exemption inapplicable, but it has never defined "competitor" for that purpose.

In its announcement of the proposed rule, the DOJ asked for feedback on whether (1) the director/officer carve-out should be removed, given that the new exemption already has carve-outs for competitors and common ownership, and (2) whether the vendor/vendee carve-out should be removed. The DOJ asked for comments whether the carve-outs meaningfully increase the likelihood of receiving filings that have the potential to raise competition concerns.

Additional requests for public comments

At the same time the FTC announced the two proposed HSR rule changes, it invited public comment on several additional issues that may portend changes to HSR rules down the road. The separate advance notice of proposed rulemaking seeks comment on seven additional topics, ranging from how a transaction's "acquisition price" and "fair market value" are determined, to whether a seller's issuance of an extraordinary dividend before its sale, causing the seller to fall below the HSR "size of person" threshold, should be considered a "device for avoidance" of the HSR rules. Other topics explore special rules applicable to real estate investment trusts and institutional investors; the possibility of requiring reporting for acquisitions of certain instruments that do not constitute voting securities, such as convertible voting securities; the role of board observers; and information required with filings. The FTC has said that the response to these comments "will help to determine the path for future amendments to the premerger notification rules."

Key Takeaways

- The impacts of the proposed rule changes, if adopted, would be significant.
- The modifications to the definition of "person" would result in a substantial increase in the number of HSR filings by investment funds that operate through a family of commonly-managed funds, as well as the amount of information that would be included in the filing. This would impact funds' reporting burden, increasing regulatory compliance costs and slow investment timelines.
- While the proposed exemption for minority investments that are not "competitively significant" appears to be intended to provide some relief from HSR filing obligations, it is not clear whether it would work in practice. Defining a competitor to any person that "reports revenues in the same six-digit NAICS Industry Code" results in the exemption being unavailable for many investors – including investors that do not, in fact, compete.
- Investors that expect to be impacted by these rule changes can take advantage of the public comment period to influence the FTC's final rules, which are not likely to be issued until sometime in 2021.

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