

Unpacking the Proposed HSR Rule Changes

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The Federal Trade Commission and the Antitrust Division of the Department of Justice (the “Agencies”) recently proposed two changes to the Hart-Scott-Rodino (“HSR”) Rules (16 C.F.R. §§ 801-803 et. seq.): (1) an expanded definition of “Person” and (2) a De Minimis Exemption. These proposed changes have important implications for the financial services industry.

The proposed definition of person would primarily impact investment firms such as private equity funds, venture capital funds, and asset managers by expanding the entities that must be aggregated to determine whether an HSR filing is required, and if required, expanding the information that the filing person must report in its notification. The proposed De Minimis Exemption, on the other hand, aims to provide an additional exemption to acquiring persons that will hold 10% or less of an issuer where the acquiring person does not have a competitively significant relationship with the issuer.

On November 9, 2020 and November 10, 2020, the FTC hosted virtual sessions to answer questions about these proposed changes, and has encouraged all stakeholders to submit comments to help the Agencies clarify questions about the proposed changes and consider alternate approaches that may be less burdensome, but nonetheless enable the Agencies to receive sufficient information to conduct a thorough competitive analysis of each proposed acquisition. The Federal Register published the notice on December 1, 2020 and the deadline to submit comments to the Agencies is February 1, 2021.

Expanded Definition of “Person”

The first change the Notice of Proposed Rulemaking (NPRM) proposes is an expanded definition of “person.” Currently, under 16 C.F.R. § 801.1(a)(1), a person means an ultimate parent entity and all the entities it controls directly or indirectly. To determine the ultimate parent entity, one starts with the acquiring or acquired entity, as the case may be, and using the definition of control in 16 C.F. R. § 801.1(b), continues up the chain of control until reaching an entity that is not controlled by any other entity. The NPRM proposes amending the definition of person to include associates, as defined in current Rules in 16 C.F.R. § 801.1(d)(2). Generally, the associates of a fund include 1) its

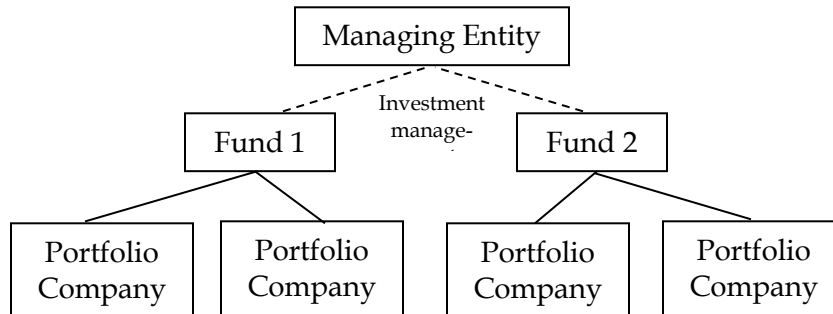
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investment manager, 2) other funds managed by the same investment manager, 3) entities that control, are controlled by, or under common control with the investment manager and 4) any entity that manages the investment manager or is under common management with the investment manager. The variety of complex fund structures complicates the associates analysis, and it can be difficult to determine associates of a fund. Nonetheless, the NPRM would require acquiring persons to aggregate acquisitions from the acquired person (which would now include its associates) across their associates when making an HSR filing and to disclose additional information about their associates in Items 4 through 8 of the HSR Form.

Aggregating acquisitions from the same acquired person across associates has important implications for how the HSR size-of-transaction (15 U.S.C. § 18a(2)(A), 2(B)(i)) and size-of-person thresholds (15 U.S.C. § 18a(2)(B)(ii)) apply and how an acquiring person's percentage ownership is determined:

- *Size of Transaction:* Investment firm could currently invest more than the \$50 million (currently, \$94 million) size-of-transaction threshold and still not be subject to HSR filing requirements if different funds or acquisition vehicles that are their own ultimate parent entities are making separate investments. Under the aggregation requirements of the NPRM, if the investing funds are associates, their holdings will need to be aggregated and it will be easier to exceed the \$94 million threshold (and each of the subsequent HSR thresholds).
- *Size of Person:* New funds with little or no investments currently in many cases do not meet the size of person threshold, which looks to total assets and sales of the ultimate parent entity. Such funds that make acquisition under the \$200 million threshold (currently \$376 million) in shares of an issuer are not currently required to make an HSR filing. Under the NPRM, the total assets and sales of funds that are associates would be aggregated to assess the size-of-person threshold. If a new fund has associates that, when their sales and assets are aggregated, meet the relevant size of person threshold, a filing would likely be required.
- *Percentage Ownership:* Some acquisitions of 10% or less (or 15% or less for certain institutional investors) of an issuer that are solely for the purpose of investment are exempt. Under the NRPM, a fund that holds less than this amount will no longer qualify for the exemptions if its associates also hold shares of the issuer such that their combined holdings exceed 10% or 15%, as applicable. In addition, it will be easier to exceed the 50% control threshold, which is especially important for acquisitions of non-corporate entities, which are not reportable unless control is acquired.

Not only would the expanded definition of person change how the HSR Act's jurisdictional thresholds apply and how percentage ownership is calculated for purposes of exemptions, but also it would require acquiring persons to report additional information in Items 4 through 8 of the HSR Form. In the November 9th FTC session, FTC Staff walked through the following simple example, which is instructive:



Assume two funds, Fund 1 and Fund 2, are under common investment management as shown in the illustration above. Currently, under the HSR Rules, if Fund 1 were making an acquisition, limited information about its associates would be included in the HSR Filing. Fund 1 would be the filing person, and in Items 6 and 7 of the HSR form, Fund 1 would need to provide information about any holdings of the Managing Entity or Fund 2 that report in the same NAICS code as the acquired entity. Under the NPRM, the Managing Entity, Fund 1 and Fund 2 are all within the same person. Assume that person is the acquiring person, then in the HSR filing:

- The Managing Entity would be the filing person.
- Item 4(a) of the Form would include the CIK number, if applicable, for all entities within the acquiring person: the Managing Entity, Fund 1, each of Fund 1's Portfolio Companies, Fund 2, and each of Fund 2's Portfolio Companies.
- Item 4(b) of the Form would include the financial statements for all entities within the acquiring person: the Managing Entity, Fund 1, each of Fund 1's Portfolio Companies, Fund 2, and each of Fund 2's Portfolio Companies.
- Items 4(c) and 4(d) would include responsive documents from all entities within the acquiring person: the Managing Entity, Fund 1, each of Fund 1's Portfolio Companies, Fund 2, and each of Fund 2's Portfolio Companies.
- Item 5 would include revenues by NAICS and NAPCS codes for all entities within the acquiring person: the Managing Entity, Fund 1, each of Fund 1's Portfolio Companies, Fund 2, and each of Fund 2's Portfolio Companies.

- Item 6(a) would list the name and principal locations of all entities within the acquiring person: the Managing Entity, Fund 1, each of Fund 1's Portfolio Companies, Fund 2, and each of Fund 2's Portfolio Companies.
- Item 6(b) would list minority shareholders of the Managing Entity, Fund 1, Fund 2 and the acquiring entity.
- Item 6(c) would list any minority holdings of any entity within the acquiring person, that report in the same NAICS codes as the acquired entity.
- Item 7 would include overlap and geographic information about all entities within the acquiring person that report in the same NAICS code as the acquired entity.
- Item 8 would list prior acquisitions within the last 5 years by any entity within the acquiring person; however, this information would be limited to acquired entities that report in the same NAICS code as the acquired entity in the present acquisition.

Even this simple example demonstrates that significantly more information would need to be reported in the HSR Form. The expanded definition of person raises questions about how third-party asset managers and fund managers will gather this information regarding entities they do not control. For some large investment firms and asset managers, hundreds of entities could be included in the scope of Items 4, 5 and 6. The FTC has explained that their goal is to ensure the Agencies receive all information necessary to provide a complete picture of the competitive implications of a transaction. In response to a question about whether other items in the Form such as Item 4, 5, 6(a) and 6(b) could be limited to entities that report in the same NAICS codes, FTC staff noted that this question implicates whether NAICS codes are accurate indicators of competitive overlaps or vertical relationships and invited comments on the topic.

FTC staff also addressed several other questions about the expanded definition of person in the virtual session on this part of the NPRM. Importantly, they explained two instances where the proposed definition of person would result in fewer HSR filings. First, where multiple funds invest in the same issuer and each would have an HSR filing today, if the funds are associates, only one HSR filing would be required. Second, FTC staff explained that for transfers within an acquiring person (e.g., between two funds that are separate UPEs), an HSR filing would not be required. The basis for that conclusion appears to be 15 U.S.C. §18(c)(3), which exempts acquisitions of a company where the acquiring person to the transaction owns at least 50% of the company's securities prior to the acquisition, and §18(c)(10), which exempts acquisitions that do not increase the acquiring person's shareholding in the company. Because under the proposed rules, two associated funds that are separate UPEs would be part of the same "person," these two exemptions would apply to transactions among them. The FTC staff specifically noted that the intraperson exemption in 16 C.F.R. § 802.30 does not apply to such a

transfer because that exemption considers only whether the interests being transferred have a common ultimate parent entity rather than a common person. Overall, the message of the virtual session was that the FTC invites comment on all portions of the NPRM to help clarify and tailor the proposed rule.

De Minimis Exemption

The second part of the NPRM would exempt the acquisition of 10 percent or less of an issuer's voting securities unless the acquiring person already has a competitively significant relationship with the issuer. Currently, the investment-only exemption, 16 C.F.R. § 802.9, provides an exemption for investors who will own 10% or less of an issuer and have no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer. Application of the current exemption depends on the investor's passive investment intent at the time of the acquisition. The Agencies have interpreted the exemption very narrowly and the FTC has stated it is inapplicable to investors who intend to influence the business decisions of the issuer.

The proposed De Minimis Exemption would permit acquisitions up to 10% of an issuer regardless of the investor's intent. However, an investor would not be able to use this exemption if the investor has a relationship with the issuer that the FTC deems would have an impact on the competitive analysis of the transaction. As a result, the De Minimis Exemption would only be available to an Acquiring Person's acquisition of 10% or less of an issuer if:

- the acquiring person is not a competitor of the issuer and does not hold in excess of 1% of a competitor of an issuer. "Competitor" would be defined as any person that reports revenues in the same six-digit NAICS code as the issuer or competes in any line of commerce with the issuer;
- the acquiring person does not hold in excess of 1% of a competitor of an issuer;
- the acquiring person does not have a representative who is an officer or director of the issuer or a competitor of the issuer; and
- there is no vendor-vendee relationship between the acquiring person and the issuer, where the value of sales between the acquiring person and issuer in the most recent fiscal year were greater than \$10 million in the aggregate.

Given the expanded definition of person, the broad definition of competitor, and the low 1% threshold, it would be difficult for many investment firms to take advantage of this exemption. At a minimum, the acquiring person's holdings would need to be completely diversified, so the exemption would not apply to any funds that specialize in particular sectors. In addition, executive compensation is an area in which the current

investment-only does not apply, but has often been viewed as unlikely to raise any competitive concern. The proposed exemption, however, does not cover officers and directors who receive executive compensation in the form of company shares.

In the virtual session on this section of the NPRM, FTC staff invited comments on whether 1% is an appropriate threshold, explaining that although they are not taking a position on the common ownership debate, their goal was to provide a low enough threshold that common ownership would not raise any significant competitive concern. FTC staff also confirmed that the exemption would not apply to officers and directors who acquire shares the companies in which they are officers or directors. Staff noted that officers and directors have access to competitively sensitive information and their role is competitively significant. As with the session on the expanded definition of person, FTC staff encouraged all stakeholders to submit comments on the proposed rule so that they can continue to evaluate potential scenarios and how the proposed exemption would or would not apply.

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On one hand, the proposed definition of person would in many cases result in HSR filings where a filing is not required under the current rules because either the HSR Act's size-of-transaction or size-of-person thresholds would not be met, or exemptions based on percentage ownership thresholds would apply. Further, where an investment fund has associates, the HSR filing will require reporting additional information about associates and entities held by associates in Items 4 through 8 of the HSR Form. The proposed De Minimis Exemption, on the other hand, would potentially reduce filings by exempting acquisitions by persons that will hold 10% or less of an issuer where the acquiring person does not have any competitively significant relationship with the issuer. Given the expanded definition of person's broad application to investment firms and the limited applicability of the De Minimis Exemption to these and other investors, if the NPRM were adopted as drafted, it appears likely that the increase in the number of filings due to the expanded definition of person would outpace the reduction in filings under the De Minimis Exemption such that more filings overall would be required. To date, the FTC has made clear that it hopes to receive many robust comments to enable it to continue to evaluate the proposed rules and consider alternate approaches so that the Agencies can potentially reduce burdens on filing parties while ensuring the Agencies receive full and complete information about the competitive nature of a proposed acquisition.