CLIENT ALERT

New HSR Rule Proposal: 10% *De Minimis* Exemption and Aggregation Across Funds — A Regulatory Improvement or More Ambiguity and Burden?

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In an important development for the investment and business communities, the Federal Trade Commission (the "FTC"), with the concurrence of the Antitrust Division of the Department of Justice (with the FTC, the "Agencies"), issued a Notice of Proposed Rulemaking ("NPR") on Monday, September 21, 2020, that proposes amendments to the filing requirements under the Hart-Scott-Rodino Antitrust Improvements ("HSR") Act.

The Agencies propose two new rules: (1) a 10% *de minimis* exemption that would be unavailable if an acquiring person, which would be more broadly defined per the second new rule, owns more than a 1% interest in "competitors" of the issuer (among other disqualifying conditions); and (2) an amendment to the definition of "person" that would require certain acquiring persons to include associated funds under common management.

The current investment-only exemption in § 802.9 "would remain unchanged and would still be available to exempt acquisitions resulting in a position of 10% or less of an issuer where there is no intention to be involved in the basic business decisions of that issuer."[1] If the proposed *de minimis* exemption is adopted, "acquiring persons would have two

[1] Premerger Notification, Reporting and Waiting Period Requirements at 34, here (*hereinafter, "NPR"*).

potential ways to exempt the acquisition of 10% or less of an issuer's voting securities."[2] "Institutional investors [could] also continue to rely on § 802.64," which, subject to conditions, exempts purchases resulting in a position of 15% or less of the outstanding voting securities of an issuer that are made by institutional investors solely for the purpose of investment.[3]

The expanded definition of "person," however, may make the exemptions less frequently available because the "person," even if an institutional investor, that is planning to acquire the voting securities must include associates of the relevant fund or other investment vehicle.[4]

Interested parties, or groups of parties through trade associations and law firms, by name or anonymously, can submit comments during a 60-day period. The comment period will begin when the NPR is published in the Federal Register, which has not yet occurred. We would be pleased to receive your input on the proposed rule changes.

The Proposed *De Minimis* Exemption

The HSR Act and rules currently exempt acquisitions resulting in a position of 10% or less of the issuer that are "solely for the purpose of investment."[5] The boundaries of the investment-only exemption, however, have been subject to many costly investigations, and "even the simplest of topics can present subtleties that complicate whether" the exemption applies.[6] That the investment-only exemptions in §§ 802.9 and 802.64 would remain in the HSR rules without a clarification of the meaning of "solely for the purpose of investment" provides the investment community with little benefit.

The motivating force of the new *de minimis* exemption thus seems to be the view that transactions under the 10% threshold should be exempt regardless of the intent of the acquiring person "when they are unlikely to violate the antitrust laws."[7] Although the proposed 10% *de minimis* exemption would avoid the ambiguity that arises from the "intention" of the acquiring person and the meaning of "for the purpose of investment," the proposed exemption introduces new sources of significant ambiguity.

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2 *Id.*

3 We expect to publish another bulletin that addresses more directly the practical impact of the NPR on investment companies registered with the U.S. Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) and on the application of Rule 802.64.

4 Section 802.64 exempts the acquisition of voting securities if, among other things, the acquisition is made by an institutional investor and, "[a]s a result of the acquisition[,] the *acquiring person* would hold fifteen percent or less of the outstanding voting securities of the issuer." 16 CFR § 802.64(b)(1), (4) (emphasis added).

5 *NPR* at 20-21 (quoting 15 U.S.C. 18a(c)(9)).

6 *Id.* at 23.

7 *Id.* at 28-29.

The exemption would not be available where "the acquiring person already has a competitively significant relationship with the issuer, such as where the acquiring person operates competing lines of business, has an existing vertical relationship with the issuer, or employs or is otherwise represented by an individual who is an officer or director of the issuer or a competitor."[8] The exemption would also be unavailable where the acquiring person has more than a 1% ownership interest in a "competitor" of the acquired person.[9]

Applying both the "competitor" and "vertical relationship" tests under the proposed rule would involve ambiguity and burden. The 1%-ownership threshold in competitors of the acquired person will likely require an assessment of numerous holdings of private equity firms and asset managers, especially given the broad definition of "competitor." An entity would be a "competitor" if (a) the entity has the same six-digit NAICS code[10] as the acquired person *or* (b) the entity competes with the acquired person "in any line of commerce."[11]

Regarding the first prong of the "competitor" definition, six-digit NAICS codes may encompass a broad range of activities that are not "competitive" in the antitrust sense. For example, the "software publishers" NAICS code covers all types of software businesses irrespective of subject matter and industry. The practical burden of identifying NAICS codes also would be substantial. Determining all of the NAICS codes of every entity in which the acquiring person has more than a 1% ownership interest would be challenging, if not impracticable, in the absence of an open line of communication between the acquiring person and the relevant entities.

As to the second, *disjunctive* prong of the definition of "competitor," determining whether an entity "competes" with the acquiring person "in any line of commerce" can be more difficult than assessing intent or investment purpose. Indeed, virtually every merger challenge arises from a dispute over the relevant "line of commerce." The ambiguities arising from the "line of commerce" assessment, combined with the breadth of possible competitor holdings, may leave the Agencies at least as much latitude to challenge claims of the proposed *de minimis* exemption as they have under the current investment-only exemption.

Given the aggregation rule, as described below, the initial 10% ownership threshold determination would need to include the holdings of all funds under common management. The competitor assessment reviewed above would have to be

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8 *Id.* at 29-30.

9 *Id.* at 30. The proposed prohibition against owning 1% of a competitor seems to respond to the ongoing debate about the antitrust significance of a "single entity holding small percentages of voting securities in competitors within the same industry, sometimes referred to as common ownership." *Id.* (citing FTC Hearings on Competition and Consumer Protection in the 21st Century, Session 8, FTC.GOV (Dec. 6, 2018), here.)

10 *NPR* at 31.

11 *Id.* at 31-32.

made not only with respect to the holdings of the acquiring fund but also with respect to every entity in which any fund under common management holds more than a 1% interest.

In addition, the *de minimis* exemption would not apply "if the acquiring person and the issuer are in a vertical relationship valued at $10 million or greater."[12] That disqualifying criterion would require an examination of every vendor and customer of every controlled portfolio company of any fund under common management. Although the "Commission intends to exclude the purchase of ordinary course services and goods (e.g., office supplies, financial services, etc.),"[13] the distinction between the purchase of "ordinary course services and goods" and other goods and services may not be self-evident.[14]

The Proposed Amendment to the Definition of "Person"

The Agencies also propose to expand the definition of "person" to include all "associates" of a fund (or other investment vehicle) that acquires voting securities. The proposed broadening of "person" would likely affect investment structures, recordkeeping practices, and perhaps the frequency of HSR filings for private equity and asset management firms.

As the Agencies acknowledge, both investment funds and master limited partnerships ("MLPs") "facilitate investment through structures utilizing limited partnerships and limited liability companies," which are defined as non-corporate entities under the HSR rules.[15] When no one person holds the right to 50% of the profits or assets upon dissolution of a non-corporate entity, that entity does not have a "controlling" interest holder and is considered its own Ultimate Parent Entity ("UPE").[16] Investment funds often meet that criterion and, accordingly, are often their own UPE and constitute the acquiring "person."

According to the Agencies, treating investment funds or MLPs as separate "persons" for purposes of the HSR Act is "often at odds with the realities of how fund families and MLPs are managed."[17] The Agencies claim that treating funds or MLPs under common management as separate "persons" makes it "difficult for the Agencies to assess the competitive impact of

12 *Id.* at 33.

13 *Id.* at 33.

14 The proposed *de minimis* exemption would not appear to cover share receipts by officers and directors of the issuer. The Commission does not identify, however, any possible competitive impact of such share receipts.

15 *NPR* at 8.

16 *Id.*

17 *Id.* at 9.

a transaction based on the HSR filing."[18] Those ostensibly separate entities, the Agencies contend, often operate "under common management" and should be aggregated for antitrust purposes.[19]

The Agencies previously addressed funds under common management by adding the concept of "associates" to the HSR rules in 2011. "Associates" are, essentially, entities under common management with the acquiring person.[20] The 2011 rule required "certain acquiring persons to disclose in their HSR filings [limited information concerning significant minority or controlling stakes held by associates] in entities that generate revenue in the same NAICS codes as the target."[21] The Agencies now contend that those disclosure obligations are inadequate and propose to expand the definition of "person" to include all associates of the fund that acquires the stock.

A "non-corporate entity UPE filing as an acquiring person [would be required] to disclose additional information from its associates in Items 4 through 8 of the Form and to aggregate acquisitions in the same issuer across its associates."[22] The additional information (such as the aggregation of revenue information across all associated funds and the disclosure of a "subsidiary list" that would identify the names of significant controlled portfolio companies of all of the funds under common management), according to the FTC, "would be of tremendous value to the Agencies in assessing the potential competitive impact of a pending transaction."[23]

The proposed expansion of "person" would likely have far-reaching implications for private equity firms, hedge funds, and MLPs. Although treating such groups as a single "person" may align more closely with the manner in which non-U.S. antitrust agencies treat such groups for merger-control purposes, private equity firms have structured U.S. investments on the basis of each fund's qualifying as a separate "person."

If the proposed amendment is enacted, many organizations may wish to reevaluate investment-structuring strategies and recordkeeping processes. Indeed, the FTC acknowledged that the new requirements would result in an increased burden for "certain acquiring persons," and has invited comments on how to obtain the same information in a less burdensome way. [24]

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18 *Id.*

19 *Id.*

20 *Id.* at 9-10.

21 *NPR* at 10.

22 *Id.* at 12.

23 *Id.* at 16.

24 *Id*. at 17.

Conclusion

The proposed revisions of the HSR rules relating to a 10% *de minimis* exemption and the definition of person are significant developments with broad consequences that warrant the close attention of and commentary by the investment and business communities. Please contact us if you would like to offer your reactions to the proposed amendments.

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