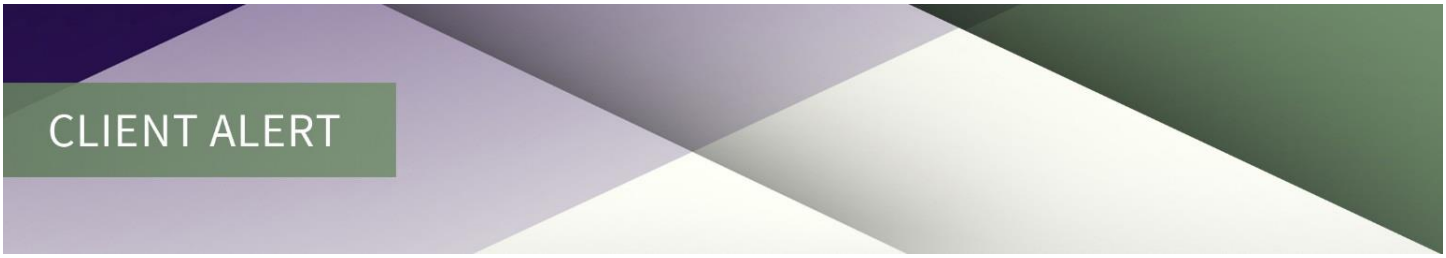

Reviewing Proposed HSR Rule Changes from the Perspective of the Institutional Investor

December 15, 2020

AUTHORS

William H. Rooney | Benjamin J. Haskin | Jonathan J. Konoff | Agathe M. Richard
Timothy G. Fleming

We have previously reported that the Federal Trade Commission (the "FTC" or "Commission"), 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 two amendments to the filing rules under the Hart-Scott-Rodino Antitrust Improvements ("HSR") Act. We address those proposed amendments specifically from the perspective of institutional investors.

The Agencies propose two new rules: (1) an amendment to the definition of "person" that would require certain acquiring persons to include associated funds under common management (referred to below as the "aggregation" rule and the "aggregated acquiring person," respectively); and (2) a 10% *de minimis* exemption that would be unavailable if an acquiring person has a so-called "competitively significant" relationship with the issuer. The "competitively significant relationship," according to the FTC, would include (among other disqualifying conditions) an ownership by any entity within the aggregated acquiring person of more than a one percent interest in "competitors" of the issuer (referred to below as the "common-ownership" disqualifying condition).

The Commission has also published an Advanced Notice of Proposed Rulemaking ("ANPR") that seeks comments on issues that the Commission is considering addressing through additional proposed rules or rule changes. Among the issues on which the Commission is seeking comments are the definitions or current interpretations of "institutional

investor" and "solely for the purpose of investment."[1] Although we do not address either issue in this memo, we would be pleased to discuss them with anyone interested in considering commenting in response to the ANPR.

Comments on both the NPR and ANPR are due on February 1, 2021.

The Definitions of "Person" and "Associate"

The HSR rules define "person" as "an ultimate parent entity and all entities which it controls directly or indirectly."[2] An acquiring person, in turn, is "any person which, as a result of an acquisition, will hold voting securities or assets, either directly or indirectly, or through fiduciaries, agents, or other entities acting on behalf of such person."[3]

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").[4] Investment funds often meet that criterion and, accordingly, are often their own UPE and constitute the acquiring "person."

The proposed rule would alter the definition of "person" to read: "[T]he term person means (a) an ultimate parent entity and all entities which it controls directly or indirectly; *and (b) all associates of the ultimate parent entity*."[5] An "associate" of an acquiring person is now defined as "an entity that is not an affiliate of such person [i.e., controlled, directly or indirectly, by the ultimate parent entity of such person][6] but

(A) Has the right, directly or indirectly, to manage the operations or investment decisions of an acquiring entity (a 'managing entity'); or

(B) Has its operations or investment decisions, directly or indirectly, managed by the acquiring person; or

(C) Directly or indirectly controls, is controlled by, or is under common control with, a managing entity; or

(D) Directly or indirectly manages, is managed by, or is under common operational or investment decision management with, a managing entity."[7]

---

1 Advance Notice of Proposed Rulemaking, Premerger Notification; Reporting and Waiting Period Requirements, IV(A)and (B) 85 FR 77042 (Dec. 1, 2020), here.

2 16 C.F.R. § 801.1(a)(1).

3 16 C.F.R. § 801.2(a).

4 *Id.*

5 Notice of Proposed Rulemaking, Premerger Notification, Reporting and Waiting Period Requirements 85 Fed. Reg. 77053, 77056 (Dec. 1, 2020) (emphasis added), here (hereinafter "NPR").

6 16 C.F.R. 801.1(d)(1).

7 16 C.F.R. 801.1(d)(2). The proposed rule would also include associates in acquired persons. NPR, 85 Fed. Reg. at 77058.

Even though an investment fund would remain its own UPE, its associates (essentially, the commonly managed funds or accounts, along with the managing entity), would be included along with the specific fund within the aggregated acquiring person.

The Possible Effect of Aggregation on the Availability of Exemptions

The institutional-investor exemption under Rule 802.64 exempts from HSR filing obligations "institutional investors" that purchase voting securities under specified conditions. "Institutional investor" is not defined by specification but rather by listing 14 types of entities, perhaps the most common of which is an "[i]nvestment company registered with the U.S. Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 *et seq.*)."[8]

Potential Loss of Institutional-Investor Exemption Due to Aggregation of Managed Accounts. The Rule 802.64 exemption has numerous conditions. We address three of those conditions that institutional investors may no longer be able to meet as a result of the proposed aggregation rule: (1) the institutional investor may not hold, as a result of the acquisition, more than 15% of the outstanding voting securities of the issuer;[9] (2) the acquiring person may not include any entity that is not an institutional investor and that holds securities of the issuer;[10] and (3) the institutional investor must acquire the securities "solely for the purpose of investment."[11]

First, aggregation would eliminate the Rule 802.64 exemption if the commonly managed funds would hold, as a result of the contemplated acquisition, more than 15% of the voting securities of the issuer. That may occur especially if the issuer has a relatively small total value of outstanding securities. If the aggregated acquiring person (which includes both the fund acquiring the voting securities and all associated funds under common management) holds more than 15% of the outstanding voting securities of the issuer, the aggregated acquiring person would also exceed all other percentage-share thresholds of HSR exemptions.[12]

Second, aggregation would also eliminate the institutional-investor exemption if some of the commonly managed funds are not institutional investors within the definition of Rule 802.64 and hold any voting securities in the issuer. Third, aggregation would eliminate the institutional-investor exemption if any of the commonly managed funds holds voting securities of the issuer other than "solely for the purpose of investment." Those disqualifications are of less concern under

8 16 C.F.R. 802.64(a)(6).

9 16 C.F.R. 802.64(b)(4) (requiring that, "[a]s a result of the acquisition[,] the acquiring person would hold fifteen percent or less of the outstanding voting securities of the issuer.")

10 16 C.F.R. 802.(c)(2) ("No acquisition by an institutional investor shall be exempt under this section if any entity included within the acquiring person which is not an institutional investor holds any voting securities of the issuer whose voting securities are to be acquired.")

11 16 C.F.R. 802.(b)(3) (requiring that the acquisition be made by the acquiring person "solely for the purpose of investment").

12 The percentage threshold of ownership of the issuer's voting securities that cannot be exceeded is 15% in 802.64 and 10% in 802.9 and the proposed *de minimis* exemption.

the current HSR rules in which the acquiring fund is its own acquiring person and is unaffected by commonly managed funds or accounts.

Impact on the Investment-Only Exemption. If the institutional investor exemption is not available because any of the commonly managed funds within the aggregated acquiring person are not institutional investors and hold any voting securities in the issuer (the second possibility noted above), an acquisition by the aggregated acquiring person might still be exempt under the investment-only exemption (Rule 802.9). The investment-only exemption under Rule 802.9 would not be available, however, if any of the commonly managed funds holds voting securities of the issuer not "solely for the purpose of investment." The investment-only exemption also would not be available if the aggregated acquiring person, as a result of the acquisition, would hold voting securities of the issuer in excess of 10% of the issuer's outstanding voting securities.

In addition, the Agencies have interpreted the phrase "solely for the purpose of investment" narrowly.[13] Some have observed that the narrow interpretation has introduced uncertainty as to when the Rule 802.9 exemption can be relied upon if the shareholder intends to engage with the management of the issuer.[14]

Potential Loss of *De Minimis* Exemptions for Holding Securities of Competitors. The proposed *de minimis* exemption would be available without regard to investment intent or institutional-investor status. If, however, any of the funds within the aggregated acquiring person holds voting securities that exceed one percent of any *competitor* of the issuer, the *de minimis* exemption would not be available.[15]

The assessment as to whether any fund within the aggregated acquiring person holds voting securities in a competitor, and, if so, whether those holdings exceed one percent of the voting securities of that competitor, must include the holdings of all commonly managed funds as well as of the acquiring fund. Including commonly managed index and sector funds within the acquiring person under the aggregation rule may make avoiding the common-ownership disqualifying condition difficult.

Additional technical issues would likely arise regarding the application of the definition of "associated funds," as quoted above, and which includes funds under common management, given the many complex fund structures and the varying degrees of independence of fund managers.

[13] NPR, 85 Fed. Reg. at 77059.

[14] *Id.*

[15] NPR, 85 Fed. Reg. at 77061.

General Issues for Institutional Investors

Number of Filings, Investment Efficiency, and Cost

We understand that a number of asset managers believe that the aggregation rule in many instances will likely eliminate the exemptions upon which they often rely, thereby causing a substantial increase in the number of HSR filings by institutional investors and asset managers.[16] Such an increase would in turn require delays in purchases of securities until "early termination" of the HSR waiting period (usually ten to twenty days following the filing of the HSR notification form) is inevitably granted to filings that present no competitive concerns. Those delays may also impose adverse economic consequences for managers' clients.

Financial costs associated with HSR filings are themselves significant. HSR notification fees per filing are either $45,000, $125,000 or $280,000, depending on the "transaction value," and payable by the acquiring person. Legal fees are added to the cost of filing. The trading and cost concerns are heightened for funds that use algorithmic models or tracking indices to guide security purchases.

Some institutional investors have observed that the policy rationale for proposing the aggregation rule does not appear to be consistent with obligations or operational practice in the asset management industry. Although the Agencies claim that funds under common management should be viewed as a single purchasing and investing entity for antitrust purposes,[17] some argue that "common management," however understood, need not entail common control. Funds within the same managing entity may have different fund managers whose fiduciary duties run to different investors and warrant different investment decisions. In that event, "common management" may not be sufficient to identify a singly controlled share ownership or "economic stake."[18]

On November 10, 11, and 16, 2020, the FTC held informational sessions on the proposed rule changes. The FTC consistently invited commentary to inform its final consideration of the proposed rule changes. Those comments are due on Monday, February 1, 2021.[19]

---

16 Although we understand that most institutional investors have averted HSR notifications by way of the institutional-investor exemption under Rule 802.64, and not by remaining below the size-of-transaction threshold or the size-of-person threshold, both of those thresholds would be satisfied more frequently under the aggregation rule. Crossing those thresholds would require the institutional investor to rely on a filing exemption, probably most often on the institutional-investor exemption in 802.64, the investment-only exemption in 802.9, or the newly proposed *de minimis* exemption. We have reviewed the impact of the aggregation rule on all three of those exemptions above.

17 NPR, 85 Fed. Reg. at 77056-57.

18 *Id.*

19 Kate Walsh and Ken Libby, File Comments in HSR Rulemaking by February 1, FTC.GOV (Dec. 7, 2020), https://www.ftc.gov/news-events/blogs/competition-matters/2020/12/file-comments-hsr-rulemaking-february-1

The Common-Ownership Disqualifying Condition

The common-ownership disqualifying condition in the proposed *de minimis* exemption appears to credit a disputed theory of antitrust harm that asserts that a single investor's ownership of minority shares in competitors' voting securities causes incentives in the competitors to reduce competition between each other.[20] The disqualifying condition sets the minority ownership share that purportedly may reduce competition at any percentage greater than one.

The Agencies acknowledge that the academic debate over the common-ownership theory of competitive harm is not resolved.[21] They contend, however, that the disqualifying condition in the *de minimis* exemption is designed to ensure that the Agencies have an opportunity to review common-ownership holdings at thresholds greater than one percent for anticompetitive effects.[22]

Issues open for comment include whether a regulation should incorporate a theory of competitive harm that has not been recognized, regardless of the minority threshold of commonly owned shares, by the judiciary and that has not supported a merger challenge by the Agencies. Other issues on which comments may be made include the implications that the common-ownership disqualifying condition may have regarding the competitive effects of ordinary-course practices by index and sector funds as well as other investment vehicles and strategies.

Conclusion

The Agencies' proposed HSR rule changes may require a higher number of filings by institutional investors. Those filings would likely raise costs for investors, delay the acquisition of voting securities, and increase recordkeeping and administrative burdens. The common-ownership disqualifying condition in the proposed *de minimis* exemption may credit an uncertain theory of competitive harm that may affect investment strategies.

The FTC has solicited comments from the investment community, which are due on both the NPR and ANPR on February 1, 2021. We would be pleased to discuss any questions that you may have regarding the proposed rule changes and to assist in the preparation of brief or detailed comments.

[20] *Compare* Hon. Douglas H. Ginsburg and Keith Klovers, *Common Sense About Common Ownership*, Concurrences Review N° 2-2018 (2018) (arguing against common ownership posing an antitrust risk) with Einer Elhauge, *Horizontal Shareholding*, 129 Harvard L. Rev. 1267 (Mar. 2016) (arguing that common ownership leads to higher prices and urging antitrust action against common ownership).

[21] NPR, 85 Fed. Reg. at 77061.

[22] *Id.*

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

William H. Rooney
212 728 8259
wrooney@willkie.com

Benjamin J. Haskin
202 303 1124
bhaskin@willkie.com

Jonathan J. Konoff
212 728 8627
jkonoff@willkie.com

Agathe M. Richard
212 728 8190
arichard@willkie.com

Timothy G. Fleming
212 728 8538
tfleming@willkie.com