Proposed HSR Rules Amendments: Implications for Private Equity

October 15, 2020

On September 21, 2020, the Federal Trade Commission (the "FTC"), with the concurrence of the Antitrust Division of the U.S. Department of Justice (together the "agencies"), released a Notice of Proposed Rulemaking proposing significant changes to the rules implementing the Hart-Scott-Rodino ("HSR") Act.[1] The proposed amendments are subject to a public review and comment period and thus may be modified or even withdrawn. But, if approved, these changes are likely to increase the number and burden of HSR filings. Although the proposed amendments would apply generally, their implications are most likely to be felt by private equity funds. The proposed changes would:

- Expand the definition of acquiring "person" to include its "associates." For investment funds, this would require aggregating holdings across a fund family, increasing the likelihood that a transaction will satisfy the "size of transaction" and "size of person" tests triggering an HSR filing. If a filing is required, the proposed change would also require a filer to submit information and documents for all entities that fall within the expanded definition of "person."

- Add a new exemption for "de minimis" acquisitions of 10% or less of the voting securities of a corporate target, subject to several limitations that significantly narrow the exemption's practical benefit.

The FTC also separately issued an Advance Notice of Proposed Rulemaking inviting comment on seven diverse topics as part of its evaluation of the HSR rules, suggesting that the agencies may be contemplating further near-term amendments.[2] The public has 60 days to offer comments to both the Notice of Proposed Rulemaking and the

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1 Federal Trade Commission, Notice of Proposed Rulemaking: Premerger Notification; Reporting and Waiting Period Requirements (Sept. 21, 2020), https://www.ftc.gov/system/files/documents/federal_register_notices/2020/09/p110014hsractamendnprm09182020_0.pdf.

2 Federal Trade Commission, Advance Notice of Proposed Rulemaking: Premerger Notification; Reporting and Waiting Period Requirements (Sept. 21, 2020), https://www.ftc.gov/system/files/documents/federal_register_notices/2020/09/p110014_hsr_act_-_anprm.pdf.

Advance Notice of Proposed Rulemaking from the time they are published in the Federal Register.

Definition of "Person" Broadened to Include "Associates"

Under the current HSR rules, the "person" required to make an HSR filing is the acquiring or acquired company's "ultimate parent entity" (*i.e.*, the parent entity not itself owned or controlled by another entity) and all entities it directly or indirectly controls. "Control," in the case of a *corporation*, means holding 50% or more of the voting securities or having the contractual power to designate 50% or more of the directors. In the case of a *non-corporate entity* (*e.g.*, partnership or limited liability company), "control" means the right to 50% or more of the profits or of the assets in the event of dissolution. Thus, if a private equity fund vehicle is structured so that no single investor owns 50% or more of the fund's economic interest, the fund is its own ultimate parent entity. For this reason, each of a sponsor's fund under common management—and each vehicle in a set of parallel funds—is typically a separate person.[3]

Today, when a private equity fund makes an acquisition, it typically is not required to account for investments by other funds in the same family when determining whether the HSR filing thresholds are met, and if an HSR notification is required, the fund is not required to report detailed information about other funds' investments, even if the funds are under common management. The HSR definition of "associates" focuses on the common right to directly or indirectly manage investment decisions.[4] For private equity funds, associates include the general partner, other funds with the same general partner, other funds under common investment management (*e.g.*, whose general partners are under common control or management), as well as their portfolio companies. Under the current HSR rules, an acquiring person is not required to aggregate the holdings of associates to determine if the filing thresholds are met and is only required to report limited information about its associates where the associates' businesses activities overlap with the target's.

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[3] A fund of one or few investors may have an investor as an ultimate parent but is typically not under common "control" with other such parallel funds or with commingled funds.

[4] More specifically, an "associate" is an entity that

(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.

16 C.F.R. § 801.1(d)(2).

Thus, today for private equity funds, the HSR filing analysis typically turns on a single fund's holdings. Redefining "person" to include "associates" would combine fund family entities in a new, larger "person" increasing the likelihood of exceeding the "size of transaction" or "size of person" tests triggering the HSR notification requirements. This could significantly alter private equity sponsors' HSR filing obligations in several ways:

- The proposed change would require a fund to aggregate its holdings (both existing shares and those to be acquired) with those of its associates' in the same issuer to determine whether the "size of transaction" test is met. Acquisitions that do not independently exceed the filing threshold may be reportable if the shares' aggregate value exceeds $94 million.[5] Aggregating associates' investments also increases the likelihood that associates would acquire a controlling (and therefore reportable) interest in a non-corporate entity.

- Requiring a fund to aggregate all of its associates' sales and assets for purposes of the "size of persons" test increases the likelihood that mid-range transactions will be reportable. For example, if a newly formed fund's first investment exceeds $94 million but not $376 million, today it would typically not trigger a filing because the fund would fall below the $18.8 million "size of person" threshold. Under the proposed change, if aggregating associates' assets and revenues would result in a "size of person" exceeding $18.8 million, a filing would likely be required. A similar result would occur in structures where a newly formed aggregator vehicle is an ultimate parent. Aggregating the holdings of parallel funds above the aggregator would mean that the "acquiring person" controls the aggregator and would likely exceed the $18.8 million "size of persons" threshold.

- Finally, as the "size of transaction" increases, so does the HSR filing fee.

When an HSR filing is required, this change would also greatly increase the documents and information that a fund must submit with each filing. Currently, an acquiring person need disclose only limited information about its associates if their business activity overlaps with that of the target. By including associates in the broadened definition of "person," however, the proposed amendment would require HSR filings to include, for the ultimate parent entity *and each associate*, all of the categories of documents and information presently only required for the ultimate parent entity—including financial statements, documents related to the transaction, revenue information, subsidiaries and minority holdings, and prior acquisition information. This more burdensome filing obligation will increase HSR compliance costs and may lengthen transaction timelines.

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[5] The HSR jurisdictional thresholds became subject to annual indexing starting in 2005. Threshold values referenced herein are as adjusted.

It is noteworthy that, by including associates within the definition of "person," the FTC's proposed changes bring the HSR approach to private equity funds closer to the way sponsors and funds are treated by merger control regimes in Europe and other jurisdictions. The process of collecting, compiling, and submitting portfolio company data for HSR filings would resemble the broader approach applied overseas.

New "*de Minimis*" Exemption

The FTC has also proposed a new "de minimis" exemption for certain acquisitions of less than 10% of a corporation's voting securities.[6] The exemption would be in addition to the existing exemption for acquisitions of 10% or less of an issuer's voting securities where the acquisition is made "solely for the purpose of investment"[7]—an exemption the agencies have construed narrowly. Despite the agencies' recognition that acquisitions of 10% or less "almost never present competition concerns,"[8] the new provision would create a circumscribed exemption that may apply to few transactions.

First, the proposed new "de minimis" exemption is subject to a number of limitations that narrow its applicability. The proposed exemption would *not* apply if the acquiring person:

- is a competitor of the issuer;
- holds more than one percent of a competitor of the issuer;
- has any employee, principal or agent who also serves as an officer or director of the issuer or a competitor of the issuer; or
- has a vendor-vendee relationship with the issuer in which the annual sales exceed $10 million.

Significantly, the FTC also proposes to define "competitor" to include entities that either report revenues using the "same six-digit NAICS Industry Group code as the issuer," or compete "in any line of commerce with the issuer." Although the first prong is an objective assessment, it may nevertheless prove difficult to implement because a fund may not be able to easily identify all applicable NAICS codes, particularly for

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6 Acquisitions of non-controlling interests in non-corporate entities (such as partnerships or LLCs) are not reportable under the HSR Act.

7 16 C.F.R. § 802.9.

8 Federal Trade Commission, Advance Notice of Proposed Rulemaking: Premerger Notification; Reporting and Waiting Period Requirements, at 7 (Sept. 21, 2020).

minority holdings. Moreover, many six-digit NAICS industry codes are quite broad, capturing businesses that do not compete. A fund's existing investments in a company reporting revenues using the same six-digit NAICS code as the issuer would render the exemption inapplicable, even where there is no actual competitive overlap. The second prong would require the filer to make a good-faith assessment consistent with its ordinary course documents and informational practices.

Including "associates" in the definition of "person" would further limit this *de minimis* exemption for investment funds because, as explained above, funds would be required to aggregate holdings across their associates. Associates' holdings in the same issuer would be added to the acquiring fund's holdings increasing the likelihood of exceeding the 10% threshold, making it ineligible for the new exemption. And including all of the acquiring fund's associates in the new competitor analysis would not only further increase the likelihood that the transaction would be ineligible for the proposed exemption but would also substantially increase the complexity of making that determination.

Advance Notice of Proposed Rulemaking

The FTC has also separately issued an Advance Notice of Proposed Rulemaking inviting comment on seven varying topics as part of its ongoing evaluation of the HSR rules. According to the FTC, these topics—which relate to calculating the size of transaction, real estate investment trusts, acquisitions of non-corporate entities, acquisitions of small amounts of voting securities, influence outside the scope of voting securities, devices for avoidance of the HSR rules, and other filing issues—frequently arise in the agencies' discussions about the HSR rules. Some of these topics and subtopics, such as those related to real estate investment trusts, may be of little concern to private equity firms. However, others, such as the size of transaction threshold or minority acquisitions of non-corporate entities, may suggest that the agencies are contemplating further HSR rule amendments that could further impact the number of and burdens associated with HSR filings.

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Please do not hesitate to contact us with any questions.

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