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Proposed Amendments to HSR Rules Would Impact Hostile Acquirers, Activist Investors, Investment Funds and MLPs

Proposed Amendments to the Pre-Merger Notification Rules Under the Hart-Scott-Rodino Antitrust Improvements Act Would (i) Expand the Definition of an Acquiring Person, Thereby Increasing HSR Scrutiny of Investment Funds and Master Limited Partnerships, and (ii) Exempt Many Acquisitions Of Up To 10% of Voting Securities Regardless of Investment Intent, with Potential Implications for M&A Transactions and Shareholder Activism.

SUMMARY OF PROPOSED RULEMAKING

On September 18, 2020, the Federal Trade Commission ("FTC") and the Antitrust Division of the Department of Justice ("DOJ") called for public comment on a Notice of Proposed Rulemaking ("NPRM"), available here, setting forth two significant changes to the rules promulgated under the Hart-Scott-Rodino Antitrust Improvements Act (the "HSR Act"). The NPRM proposes (1) to expand the definition of "person" to include an acquirer's "associates," broadening the scope of the filing requirement and increasing the amount of information filers are required to disclose, and (2) to create a new reporting exemption for investments of up to 10% of a target company's voting securities—regardless of value or whether the investor intends to influence management or remain passive—when the acquirer does not have a "competitively significant" relationship with the target company.

Proposed amendment to the definition of acquiring "person"

The NPRM proposes to amend the definition of an acquiring "person" to require acquirers to disclose additional information about their "associates," a term that is broadly defined in the existing HSR rules to capture entities that are not affiliates but that have a management or control relationship with the acquiring entity. Acquirers would also be required to aggregate acquisitions in the same issuer with those of their associates when making an HSR filing. This amendment is a response to the agencies' perception that, when certain entities—such as investment funds and master limited partnerships ("MLPs")—make an acquisition, the current HSR rules and HSR Form do not require the provision of sufficient information "concerning both the complete structure of the acquiring person and the complete economic stake being acquired in an issuer."

The HSR Act's rules historically have treated the non-corporate entities through which many investment funds and MLPs function as separate entities. In practice, this has permitted funds that are controlled by the same investment adviser to acquire large stakes in public companies, without filing under the HSR Act, by conducting their activity though different fund entities. The NPRM suggests that this approach to non-corporate entities may be inconsistent with how fund families and MLPs are managed and, as a consequence, may limit the agencies' ability to assess the competitive implications of acquisitions made by those entities. To address this concern, the proposed amendment takes into account a broader contingent of related entities for filing purposes. In doing so, the amendment would give the agencies greater visibility into the activities of fund families and MLPs.

Proposed creation of a new exemption for acquisitions of up to 10% regardless of investment intent

In addition, the NPRM proposes a new provision that would exempt from the HSR Act's filing requirements acquisitions of up to 10% of an issuer's voting securities if the acquirer does not otherwise have what the NPRM describes as a "competitively significant" relationship with the issuer. Specifically, the proposed 10% exemption applies if five conditions are met:

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

The term "competitor" is proposed to be defined broadly to mean "any person that (1) reports revenues in the same six-digit NAICS Industry Group as the issuer, or (2) competes in any line of commerce with the issuer." Even though the broad definition of the word "competitor" makes the 10% exemption inapplicable if there is even a trivial level of competition, the proposal nevertheless represents a significant expansion of the current exemption of acquisitions of less than 10% if the acquisition is purely passive.

U.S. antitrust agencies seek comments

The FTC's vote to issue the NPRM was split 3-2 along party lines, with Democratic Commissioners Rebecca Slaughter and Rohit Chopra voting against the NPRM and issuing statements articulating concerns about the impact of the 10% exemption. In her statement, Commissioner Slaughter made a direct call for comments "from those in the corporate governance and securities community, and experts on investor behavior, to help [the Commission] better understand the implications" of the proposed 10% exemption. The DOJ also identified two topics about which it would particularly like to receive public comments: (1) the proposed director/officer carve out to the 10% exemption, and (2) the vendor/vendee carve-out to the 10% exemption. Interested parties will have 60 days to comment following publication in the Federal Register.

POTENTIAL IMPLICATIONS

If passed in its current form, the NPRM would have a range of implications for companies and investors. On the one hand, the NPRM would make it harder for activists and potential hostile acquirers to avoid HSR filings by acquiring shares through different entities within a fund family. On the other hand, it would provide a "safe harbor" for many activists investors and potential hostile acquirers to acquire as much as 10% of an issuer's voting securities without having to make an HSR Act filing and thereby alert the issuer. The NPRM does not address other techniques such as the use of forwards, calls, swaps or other derivatives that activists may employ as part of their investment strategy and that do not require HSR Act filings because they are not considered voting securities under the HSR Act.

Acquiring "person" definition

As a practical matter, the expansion of the term "person" to include "associates" would increase the filing burden for certain acquirers by expanding the scope of information that must be included in an HSR filing and increasing the number of transactions that trigger reporting obligations. While this change would increase filing burdens for certain acquirers, issuers with an interest in detecting and preventing large accumulations by activist investors stand to benefit. Activist transactions that were previously non-reportable due to the existing, narrower definition of "person"—and thus could be consummated in secrecy—would trigger an HSR filing and immediate notice to the target company under the proposed rules.

Acquirers that have relationships with a significant number of "associates" would be most impacted by the amended definition of acquiring "person." For example, large private equity firms that manage multiple funds that each have different groups of investors, or the merchant banking arms of investment banks that invest in large numbers of companies, would have a substantial number of "associates." This amendment would also require close monitoring by acquirers to ensure that holdings of their "associates" in an issuer are included when assessing whether an open market purchase triggers an HSR filing. The expansion of the term "person" would also reduce the availability of the size-of-person filing exemption to newly formed partnerships or limited liability companies that have "associates."

Exemption for acquisitions of 10% or less, regardless of investment intent

While the proposed amendment to the definition of acquiring "person" in the HSR rules may frustrate the efforts of certain activists desiring to shield their activities from public scrutiny, the proposed 10% exemption may have the opposite effect by providing a new means for certain activists to achieve non-reportable acquisitions. An acquirer's ability to take advantage of the exemption will, however, depend significantly on the particular industry at issue and the acquirer's other interests. For instance, as currently proposed, any person that derives revenue in the same NAICS code as the issuer will be considered a "competitor," and thus, ineligible for the exemption. As a result, in certain industries in which particular NAICS codes have very broad coverage—such as pharmaceuticals—this criterion would limit the availability of the exemption. In addition, the one percent threshold for ownership of a competitor of the issuer may disqualify many acquirers from availing themselves of this exemption.

The 10% exemption could have significant implications for M&A transactions and shareholder activism. In recent years, the HSR filing threshold has been viewed as an early warning mechanism or limitation on certain types of accumulations of a target company's securities. Should a hostile acquirer wish to take a stake in a target before launching its bid, the NPRM's exemption may allow the acquirer—so long as it does not share NAICS codes or otherwise have a "competitively significant" relationship with the target — to buy up to 10% of the target's voting securities (even if the value of that stake exceeds the current $94 million size of transaction threshold) without being required to observe a waiting period or notify the target through the HSR process. For mid- and large-cap public companies, the proposed 10% threshold will often be significantly in excess of the current $94 million threshold.

Likewise, under the exemption included in the NPRM, many activist positions—which often involve acquisitions of less than 10% of a company's voting securities—will no longer be HSR reportable. This proposal represents a meaningful expansion of an existing exemption for acquisitions of up to 10% of a company's voting securities, which currently applies only if such acquisition was made "solely for the purpose of investment." The antitrust agencies have previously construed this investment-only exemption narrowly; it does not apply if an activist investor or other acquiring person intends to participate in and influence business decisions of the target company. The newly proposed exemption, on the other hand, would be available to an investor regardless of whether the investor intends to influence management or remain passive, marking a significant departure from the antitrust agencies' current policy.

While some investors use certain types of derivatives to delay an HSR filing, the implementation of the 10% exemption would give activists and other acquiring persons more investment latitude and a longer lead time to acquire a significant stake without the need to make an HSR filing or other public disclosure. Although acquirers of more than 5% of a company's voting stock are required under the rules of the Securities and Exchange Commission to file a Schedule 13D disclosing the size of their position and intent, activists and hostile acquirers have taken advantage of the ten-day window before their initial Schedule 13D filing is due to acquire stock beyond the 5% level without detection. Moreover, the NPRM does not address the ability of aggressive stake builders to use swaps or other cash settled derivatives (because ownership of those instruments normally does not create beneficial ownership of the underlying voting stock under the Section 13(d) rules because they do not confer voting or investment power) to increase their economic position before—or even without—creating a Schedule 13D filing obligation and triggering the ten-day window period.

Conclusion

This proposed rule change, if adopted, would further increase the importance of active monitoring and advance preparation by public companies to reduce the likelihood that they are caught unaware by a hostile transaction or an activism campaign. Sullivan & Cromwell is actively consulting with clients and other interested stakeholders about the potential effects of the NPRM. Parties that anticipate being affected by the final rule may also want to consider submitting comments.

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