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FTC Proposals Could Significantly Expand Registered Funds' Pre-Acquisition Notice Requirements Under the Hart-Scott-Rodino Act

February 1, 2021 was the Federal Trade Commission (the "FTC") closing date for public comments on two FTC proposals published in the Federal Register on December 1, 2020 – (i) Notice of Proposed Rulemaking and (ii) Advance Notice of Proposed Rulemaking (collectively, the "Proposals") – with respect to the Premerger Notification Rules (the "Rules")[1] that implement the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSRA").[2]

If adopted as proposed, the Proposals would require an investment adviser to aggregate the voting securities of any issuer held by the registered funds, private funds and other accounts it advises for purposes of the HSRA and the Rules' "notification threshold."[3] This change would result in a significant increase in the number of premerger notification form (each, an "HSR Form") filings that advisers would be required to make with the FTC and the Department of Justice Antitrust Division (the "DOJ"). Investment advisers and, therefore, their clients, would have to bear very significant compliance costs. In addition, application of the Rules' 30-day waiting period, which commences after the filing of a completed HSR Form, would interfere with portfolio management.

Background

The HSRA and the Rules are intended to enable the FTC and the DOJ to determine which acquisitions are likely to be anticompetitive under the Clayton Antitrust Act.[4] The 30-day waiting period permits the FTC and the DOJ to challenge anticompetitive transactions before they occur, instead of attempting to unscramble transactions after the fact.

Unless an exemption applies, the HSRA and the Rules require any "person" that is a party to any private or open-market purchases or other transactions involving the acquisition of an issuer's voting securities that would result in holding voting securities with a value of at least $92 million (as adjusted for inflation from time to time) to file an HSR Form with the FTC and the DOJ, and to observe a 30-day waiting period before completing the proposed transaction. The HSR Form requires information and documents regarding the parties and the proposed transaction. The filing fee for an HSR Form is substantial (from $45,000 to $280,000)[5] and, for any acquiring person filer, would be in incurred in addition to the costs of preparing the HSR Form (consisting of ten pages with eleven pages of instructions).

- Currently, a registered fund may rely upon the "Institutional Investor Exemption"[6] to acquire up to 15 percent of an issuer's voting securities without triggering the HSR Form filing requirements and the 30-day waiting period. Under the Rules' existing aggregation requirements, a registered fund is *not required to aggregate* the voting securities it holds with the voting shares held by other registered funds and other accounts that are managed by the registered fund's investment adviser for purposes of the 15-percent ceiling.

- Separately, private funds and accounts that are "passive" investors[7] but are not institutional investors as defined in the regulation (*e.g.*, private funds and separately managed accounts for natural persons, endowments and non-qualified plans; hereinafter, each a "Non-Institutional Investor")[8] may currently rely upon the Investment-Only Exemption.[9] The exemption permits any registered fund or Non-Institutional Investor to acquire and hold up to ten percent of an issuer's voting securities without triggering the HSR Form filing requirements and the 30-day waiting period. Under the Rules' existing aggregation requirements, a registered fund or a Non-Institutional Investor is *not required to aggregate* the voting securities it holds with the voting shares held by other investors that are managed by the same investment adviser for purposes of the ten-percent ceiling.

The Proposals and Their Possible Effects

Aggregation. If adopted as proposed, the Proposals would amend the Rules' definition of "person" to include other registered funds and Non-Institutional Investor accounts managed by the same investment adviser. As amended, the definition is likely to eliminate the Institutional Investor Exemption for registered funds because the exemption is available to an acquiring person only if *each* entity within the acquiring person is an institutional investor.[10] Investment advisers are likely to replicate investment strategies across multiple types of clients. Therefore, if an investment adviser manages *any* Non-Institutional Investor's account (*e.g.*, any private fund or separately managed account for a natural person, endowment or non-qualified plan) that holds voting securities of an issuer, the registered funds and all Non-Institutional Investor accounts managed by the adviser would be unable to rely on the Institutional Investor Exemption with respect to their aggregate holdings of that issuer.

With the likely elimination of the Institutional Investor Exemption, many investment advisers would have to rely on the Investment-Only Exemption. This exemption would be available only if the *aggregate* holdings of the registered funds and Non-Institutional Investor accounts managed by an investment adviser hold no more than ten percent of an issuer's voting securities.[11]

Enactment of the Proposals would result in a substantial number of HSR Form filings from investment advisers managing (i) registered funds and institutional investor accounts that, in aggregate, exceed the Institutional Investor Exemption's 15-percent limit with respect to any issuer and (ii) registered funds and Non-Institutional Investor accounts that, in aggregate, exceed the Investment-Only Exemption ten-percent limit with respect to any issuer. In its February 1, 2021 comment letter to the FTC, the Investment Company Institute (the "ICI") estimated that enactment of the Proposals would result in at least 1,000 HSR Form filings from its members. In comparison, the ICI observed, in 2019 and 2020, there were only approximately 2,000 HSR Form filings each year.

In addition to the burden of filing HSR Forms, the Rules' 30-day waiting period would interfere with (i) investment advisers' day-to-day portfolio management, which involves regular time-sensitive acquisitions and (ii) the ability of index investment products to track their index.

The investment decisions of investment advisers seeking to avoid an HSR Form filing and a 30-day waiting period may be distorted by the unavailability of "headroom" under either the 15 percent Institutional Investor Exemption or the ten percent Investment-Only Exemption. Consequently, some registered funds and Non-Institutional Investor accounts may have to forego, in whole or in part, portfolio transactions that their investment adviser believes are in their best interests, including ordinary allocation decisions and rebalancing transactions.

The De Minimis Acquisition Proposal. To retain some of the flexibility of the Institutional Investor Exemption and the Investment-Only Exemption, the Proposals would create a new De Minimis Acquisition Exemption (the "DMA Exemption") that would exempt acquisitions of up to ten percent an issuer's voting securities.[12] The DMA Exemption would not rely on the intent of any investor. However, the DMA Exemption would be unavailable if the acquiring person holds more than one percent of the voting securities of any entity that is a "competitor" of the relevant issuer. A competitor would be any person that (i) reports revenues in the same six digit North American Industry Classification System (NAICS) industry group ***or*** (ii) competes in any line of commerce with the issuer.

The NAICS industry groups are broad in that they encompass entities that do not compete with each other. For example, NAICS 511210 includes all "software publishers." Moreover, the FTC acknowledges that "[f]iling parties can still be 'competitors' even if they report in different NAICS codes." Many investment advisers invest across a broad number of issuers, frequently pursuing different investment strategies. If the DMA Exemption were enacted, investment advisers (especially large investment advisers) would (i) require access to how each issuer classifies its revenues under the NAICS and (ii) have to determine whether each entity for which the adviser's registered funds and other accounts hold more than one percent "competes in any line of commerce" with the issuer of the voting securities that the adviser would like to acquire. This information will frequently be unavailable publicly for each issuer whose voting securities might be acquired. Moreover, antitrust challenges to proposed mergers frequently involve a dispute over the relevant "line of commerce." Consequently, investment advisers seeking to rely on the DMA Exemption would be required to make determinations under considerable uncertainty. For these reasons, multiple commenters to the FTC noted that the DMA Exemption is likely to be unworkable.

Observations

The FTC does not offer much of a rationale for the Proposals. The Proposals state that the existing definition of "person" is too limited to provide the FTC and DOJ "with a sufficient overview of investment funds and [master limited partnerships] as acquiring persons." The Proposals refer to "investment funds and MLPs [that] facilitate investment through structures utilizing limited partnerships and limited liability companies," and the examples provided by the FTC (in which it is difficult for the FTC to gather sufficient overview data) appear to contemplate control scenarios. None of the "investment funds" in these scenarios is a registered fund. In short, it is unclear that the FTC focused to a significant extent on registered funds and other passive institutional investors in proposing to amend the definition of "person."

In the Proposals' discussion of the DMA Exemption, the FTC states that, recently, "there has been ongoing discussion of the impact of a single entity holding small percentages of voting securities in competitors within the same industry, sometimes referred to as common ownership." However, the FTC states that this "debate is not yet settled," which raises the question why the FTC is making the Proposals at this time.

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.

1. The Rules appear at 16 C.F.R. § 801.1 *et seq*.
2. 15 U.S.C. § 18a.
3. Specifically, the Proposals would amend the definition of "person" in 16 C.F.R. § 801.1
4. 15 U.S.C. §§ 12-27.
5. The filing fee is $45,000 (if the value of the voting securities exceeds $92 million but is less than $184 million), $125,000 (if the value of the voting securities exceeds $184 million but is less than $919.9 million) and $280,000 if the value of the voting securities exceeds $919.9 million).
6. 16 C.F.R. § 802.64.
7. The term "passive" investor is used here to indicate any investor that holds or acquires voting securities without the "intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." *See* 16 C.F.R. § 801.1(i)(1).
8. 16 C.F.R. § 802.64(a) defines institutional investor as any entity of the following types: "(1) A bank . . . ; (2) Savings bank; (3) Savings and loan or building and loan company or association; (4) Trust company; (5) Insurance company; (6) Investment company registered with the [SEC under the 1940 Act]; (7) Finance company; (8) Broker-dealer . . . ; (9) Small Business Investment Company or Minority Enterprise Small Business Investment Company regulated by the U.S. Small Business Administration . . . ; (10) A stock bonus, pension, or profit-sharing trust qualified under section 401 of the Internal Revenue Code; (11) Bank holding company within the meaning of 12 U.S.C. 1841; (12) An entity which is controlled directly or indirectly by an institutional investor and the activities of which are in the ordinary course of business of the institutional investor; (13) An entity which may supply incidental services to entities which it controls directly or indirectly but which performs no operating functions, and which is otherwise engaged only in holding controlling interests in institutional investors; or (14) A nonprofit entity within the meaning of sections 501(c) (1) through (4), (6) through (15), (17) through (20), or (d) of the Internal Revenue Code."
9. 16 C.F.R. § 802.09.
10. Specifically, 16 C.F.R. § 802.64(c)(2) provides that "[n]o 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. The Institutional Investor Exemption also would be unavailable to an investment adviser with respect to an issuer if an account managed by the adviser is an activist (*i.e.*, non-passive) investor holding shares of that issuer.
12. *See* Proposed Rules 16 C.F.R. § 802.15.