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Alert

Proposed HSR Act Rules to Increase Reporting for Funds Making Minority Investments in Foreign Issuers

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The Federal Trade Commission ("FTC") recently published, with the concurrence of the Department of Justice Antitrust Division ("DOJ"), proposed regulations that would considerably narrow the availability of the HSR Act "foreign to foreign" minority shareholding exemption provided by 16 CFR § 802.51(b)(1).

The proposed regulations primarily affect U.S.-managed/foreign-domiciled investment funds and foreign-managed/foreign-domiciled funds making minority investments in foreign issuers.[1] The proposed rules will instantly transform the HSR status of every Cayman (or other foreign domiciled) limited partnership fund with a U.S. manager to the United States, denying them the ability to use the § 802.51(b) exemption.[2] And for foreign-managed/foreign-domiciled funds, many of the foreign entities in which they invest will no longer be considered foreign for HSR purposes, denying the § 802.51(b) exemption for their holdings in these issuers.

The new rules also may make it more difficult, and in some cases impossible, for a prospective minority investor to ascertain whether the company in which it wishes to invest is eligible for the "foreign to foreign" exemption. The proposed rules accomplish these results by changing the longstanding test for what constitutes an entity's "principal offices."[3]

This *Alert* describes the current rule, the proposed new rules, and the impact that the proposed new rules would have on funds that may acquire minority holdings in foreign issuers.

The Current Rule

The Hart Scott Rodino Antitrust Improvements Act ("HSR") requires that certain transactions, including the acquisition of voting securities valued in excess of $90 million, be notified to the FTC and DOJ prior to consummation, unless otherwise exempt.[4] The purpose of HSR notification is to permit the antitrust agencies to evaluate transactions in advance to determine whether they raise competitive concerns.

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[1] Transactions that give a U.S. or foreign person control (50% or greater ownership) over a foreign person or issuer will continue to be potentially subject to HSR notification, as at present.

[2] However, a U.S.-managed Cayman fund organized as a "Limited" company (regardless as to whether it elects to be taxed as a partnership) could still be considered foreign if it has a majority of non-U.S. officers and directors. *See* PNO Informal Interpretation 1412010, Dec. 30, 2014, annotated April 1, 2015, available here.

[3] 84 Fed. Reg. 58348 (Oct. 31, 2019).

[4] While there is an HSR exemption for parties that acquire less than 10% of an issuer's voting securities "solely for purposes of investment" (16 CFR § 802.9), that exemption does not apply to activist funds, funds with a board seat, and funds meeting other criteria. Further, the FTC has aggressively challenged parties' reliance on this exemption. Given the chilling effect of the $42,530 per day civil penalty for failing to file under HSR, parties may be reluctant to rely on the § 802.9 exemption if there is a risk that the FTC disagrees with its application to a particular transaction.

Under 16 CFR § 802.51(b)(1), the acquisition by a foreign person of the voting securities of a foreign issuer is exempt from HSR reporting, so long as the foreign acquiring person will not obtain control (50% or more) of the foreign issuer. This is commonly referred to as the "foreign to foreign exemption." The FTC stated in promulgating this rule that the exemption "recognizes that considerations of comity may be significant in the area of international business transactions. With respect to some acquisitions whose principal impact is foreign, it is appropriate for the agency, in its discretion, to exercise a self-imposed limitation and decline to subject them to the [HSR] act's requirements…an anticompetitive impact upon United States commerce is less likely to occur when a foreign person is acquiring foreign…voting securities."[5]

Under the current definition of "foreign person," foreign status is determined by meeting three objective criteria: (1) the entity must be incorporated in a foreign country; (2) the entity must be organized under the laws of a foreign country; and (3) the entity must have its "principal offices," which the FTC describes as the "single location which the person regards as the headquarters office of the ultimate parent entity,"[6] outside of the United States.

In the vast majority of cases, the headquarters location for a publicly listed or large private company can be easily found in SEC or foreign securities law filings, the company's annual report or its website. If there are multiple headquarters, or the headquarters location is unclear, the FTC Premerger Notification Office ("PNO") has issued informal interpretations to guide parties in evaluating additional factors to determine a company's principal office.

The PNO has also advised as to determining principal offices for investment funds organized as a partnership under the laws of a foreign country and that have no principal offices. For such entities, the PNO treats the fund as foreign even if the fund's general partner or management company (a third party not within the same "person" of the fund) has its principal offices in the United States.[7]

Thus, the current rules exempt both U.S.-managed and foreign-managed, foreign-domiciled funds (e.g., Cayman Islands limited partnerships), in acquisitions of minority positions in a foreign issuer's voting securities. For such funds that invest only in non-controlling positions, the current rules mean that they do not need to worry about HSR compliance for the acquisition of any foreign issuer because of the § 802.51(b)(1) exemption.[8] This broad exemption simplifies the fund's compliance obligations.

The Proposed Rule

Under § 802.51(b)(1), the acquisition by a foreign person of the voting securities of a foreign issuer will remain exempt, so long as the foreign acquiring person will not obtain control (50% or more) of the foreign issuer. This rule will not be changed. However, its application may be narrowed considerably by the redefinition of what constitutes a foreign entity or foreign issuer, turning many entities that are now considered foreign under the HSR rules into U.S. entities and making issuers no longer entitled to benefit from the § 802.51(b)(1) exemption.

[5] 43 Fed. Reg. 33497, 33498 (July 31, 1978).

[6] *See* 43 Fed Reg. 33461.

[7] *See ABA Premerger Notification Practice Manual*, 5th Edition (2015), at 275-6.

[8] Because the § 802.51(b) exemption applies to any position under 50%, the intent of the investor is not relevant.

Under the proposed definitions of foreign person,[9] foreign status is determined by meeting the same three criteria: (1) the entity must be incorporated in a foreign country; (2) the entity must be organized under the law of a foreign country; and (3) the entity must have its "principle offices" outside of the United States, which the proposed regulations change from a simple test as to the location that the entity regards as its headquarters to the location at which more than 50%[10] of:

1. The ultimate parent entity's officers reside; or
2. The ultimate parent entity's directors reside (in the case of an entity lacking officers and directors, the analysis is based on individuals exercising similar functions); or
3. The ultimate parent entity's assets are located (including the assets of all entities that the ultimate parent entity controls directly or indirectly), based on fair market value.[11]

The FTC states that "officers" will be defined as:

> Individuals in positions that are either (1) provided for in the entity's articles of incorporation or by-laws, or (2) appointed by the board of directors. [T]he proposed rule looks to the officers and directors of the entity's ultimate parent [or the issuer].[12]

The FTC also says that for entities that do not have officers or directors:

> If, for example, a limited partnership is not organized under U.S. law and does not have officers and directors, it must look to individuals exercising similar functions for the partnership. Serving as the equivalent of an officer or director includes making decisions regarding, and overseeing, the day-to-day affairs of the partnership. For example, those "exercising similar functions" for an investment fund partnership may include the general partner of the partnership, and/or any investment manager.[13]

The FTC appears uncertain as to how it will assess the residency of officers and directors:

> The Commission invites comments on whether clarification is needed on the question of how an individual's residency is to be determined and, if so, what factors should be used in that determination. Factors could include:
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> a. The location of an individual's primary residence;
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> b. The individual's primary tax residence;
>
> c. The country where he or she resides for at least half of the calendar year; or

[9] To be codified as a new 16 CFR § 801.1(e)(1)(i) and (ii), and (2)(i) and (ii).

[10] A 50% — 50% tie, or greater than 50% of any of these criteria being U.S. renders the entity or issuer.

[11] 84 Fed. Reg. 58352.

[12] 84 Fed. Reg. 58350.

[13] *Ibid.*

d. The location of at least half of the total real property owned by the individual.[14]

Under the proposed rules, the asset evaluation analysis is not guided by accounting or book value, rather:

> In determining whether 50% or more of the UPE's or issuer's assets are located in the U.S., the proposed amendments rely on the *fair market value* of the relevant entity's assets, determined in accordance with § 801.10(c)(3) of the Rules. This includes both tangible and intangible assets.[15]

In sum, the proposed regulations (1) repeal the current PNO guidance and re-designate U.S.-managed foreign-domiciled LP funds as U.S. persons; and (2) require a foreign investor making a minority acquisition of a foreign issuer's voting securities to obtain and evaluate a new list of information about the foreign issuer, its officers and directors in order to determine whether the § 802.51(b) exemption applies.

Comments and Observations

1. *The proposed rules will expand the HSR reporting obligations for certain foreign-domiciled funds making minority acquisitions of foreign voting securities.*

The managed fund industry had initially hoped that under the current administration, the FTC would take a more measured approach toward requiring HSR notification for minority voting securities holdings by funds, a category of transactions unlikely to raise antitrust concerns. This hope stemmed from the two Republican Party appointed FTC commissioner dissents in the 2015 *Third Point* HSR Act enforcement action.[16] In dissenting, these commissioners "strongly encourage[d] …potential modification to the HSR Rules…to eliminate filing requirements for a category of [minority interest] stock acquisitions that have proven unlikely after 40 years of experience to raise competitive concerns."[17] [18] Thus, the proposed FTC regulations that *increase* HSR filing requirements for minority investments by funds may seem somewhat surprising to some observers.

2. *The rules propose a potentially problematic test for determining a foreign issuer's status.*

a. *The information required for the test may be indeterminable by a potential investor.*

Setting aside the policy merits of extending HSR reporting obligations to funds making minority investments in foreign issuers, it is potentially problematic that a rule that applies to minority investments in foreign legal entities requires the potential minority investor to obtain and evaluate a

[14] *Ibid.*

[15] *Ibid.* (emphasis supplied).

[16] Dissenting Statement of Commissioners Maureen K. Ohlhausen and Joshua D. Wright, *In the Matter of Third Point*, April 24, 2015, available here.

[17] *Id.* at 4.

[18] We can find no record of an investment fund's minority investment that has been challenged as a violation of substantive antitrust law. In FY2018 and FY2017, for HSR filings where the acquiring person reported the NAICS code for "funds, trusts and other financial vehicles," out of 160 reported transactions, none resulted in either agency seeking clearance to investigate, no second requests were issued, and no transactions were challenged. See HSR Annual Reports available here. Indeed, over the past decade, there have only been two second request investigations out of 434 transactions where the acquiring person filed under the investment fund NAICS code.

significant amount of non-public information about the foreign legal entity, its officers and directors. It is not common for a potential minority investor to be afforded the extensive due diligence potentially required to determine the issuer's "principle offices" under the proposed rules.

Indeed, it may at times be impossible for a potential minority investor to be able to obtain such information. There is no legal or fiduciary obligation for any issuer, U.S. or foreign, to supply the information the proposed rules necessitate be evaluated. Indeed, under restrictive EU privacy rules, an EU-based foreign issuer may be unable, as a matter of law, to provide to a potential third-party investor the detailed personal and financial information on its officers and directors required by the proposed rule. See attached Exhibit A for a comparison of the information and analysis required by the current test and for the proposed test.

b. The information required for the test is subject to frequent change.

Further, even if it were easy for a third-party minority investor to obtain sufficient information to undertake the multi-factor assessment required by the proposed rules, the criteria the FTC prescribes for determining the principle offices will be a moving target. The current criteria for determining a company's headquarters is simple and not subject to frequent change. Moving a physical headquarters office or legally re-domiciling a company are rare events.

Under the new rules, for a foreign entity, the mere election of a new director with a different residence from the predecessor, the acquisition by a company vice president of a new vacation home, or the acceptance of a visiting faculty position with a U.S. business school, could each potentially tip the 50% balance of the officer/director residency ratio — instantly transforming an exempt foreign issuer into a non-exempt U.S. issuer. Similarly, if a foreign issuer sells a large foreign subsidiary or pays a significant dividend to shareholders from funds accumulated in a foreign bank account, its relative over/under 50% fair market value asset allocation between the United States and the rest of the world could flip, converting the issuer's status from foreign to U.S. Thus, for some foreign entities close to the 50% line on any of the criteria, a potential minority investor may need to undertake the proposed extensive analysis each and every time it buys a share of stock.[19]

Conclusion

The proposed regulations will have the likely effect of increasing the number of HSR filings by investment funds (both U.S. and foreign managed) making minority investments in the voting securities of foreign issuers. The proposed rules extend HSR reporting obligations to a category of acquisitions that the original regulations noted are unlikely to have an anticompetitive impact within the United States, and that in the over 40 years since have proven unlikely to raise competitive concerns. In many cases, foreign investor minority acquisitions of foreign issuers that are not reportable to competition authorities in their home countries will now be reportable to the United States antitrust agencies.

Further, the proposed rules require a potential minority investor to assess confidential non-public information about the foreign issuer that may not be available to it in order to determine whether the "foreign to foreign" exemption applies. Parties unable to determine whether the exemption applies will either have to guess, at the risk of a civil penalty that exceeds $1.2 million per month if they are wrong,

[19] If a foreign investor relies on the foreign to foreign exemption and previously acquired $90 million of the voting securities of an issuer newly meeting the new "foreign" criteria without filing under the HSR Act, the change of the status of the foreign issuer to U.S. would mean that the purchase of a single additional share would potentially trigger the need for HSR reporting.

or to be safe, file a perhaps unnecessary HSR notification, pay the $45,000 to $280,000 HSR filing fee, and wait the full 30-day review period prior to making a minority investment in a foreign issuer.

The FTC is accepting comments on the proposed regulations through Dec. 30, 2019. If you would like further information or assistance in commenting on the proposed rules, please contact the authors.

Authored by Peter Jonathon Halasz and Gregory L. Kinzelman.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com

Exhibit — A Comparison of the Current and Proposed Rules

The FTC states that the new regulations "provide a clearer way to determine the location of an entity's principal offices."[20] It notes that the proposed rule "will simplify and clarify the analysis" for determining whether an entity is foreign:

> The Commission does not anticipate that the proposed definitions will increase the burden on parties, because identifying both where officers and directors reside, and whether half of an entity's assets [on an appraised fair market value basis] are located in the U.S. or abroad, should not be overly complicated or onerous.[21]

The following chart compares the analysis a potential minority investor is required to undertake under the current and the proposed rules.

Information Needed to Determine the Location of an Issuer's "Principal Offices"	
Current Rule	Proposed Simplified Rule[22]
1. Identify the country that the Issuer regards as the location of its headquarters.[23]	1. For the Issuer's directors, determine their total number and the following personal information for each director: a. The location of each individual's primary residence; b. The location of each individual's primary tax residence; c. The country where each individual resides for at least half of the calendar year; and d. The total value of the real property owned by each individual director and whether the value of the director's real property in the United States is greater than the value of the director's real property located in foreign countries.[24] Based on this analysis, determine whether 50% or more of the directors are U.S. Note that the Issuer is likely under no United States or foreign legal obligation to assist the potential minority investor in obtaining this information, and certain foreign countries may restrict the disclosure of sensitive personal financial information of a company's directors to third parties.

[20] 84 Fed. Reg. 58351.

[21] *Ibid.*

[22] Note that as soon as any of the three tests show 50% or more U.S., the analysis can be terminated. However, to definitively confirm that a foreign entity has a foreign principal office, all of the above steps may need to be undertaken.

[23] Usually this can be found as public information on the Issuer's website, latest annual report, and/or its SEC or other regulatory filings.

[24] The FTC suggested all of these as possible criteria, and may choose to include some or all of these in the final regulations.

	2. Determine the total number and the following personal information for all of the Issuer's officers. This will require the potential minority investor to obtain and review: a. The Issuer's articles of incorporation; b. The Issuer's by-laws; and c. All of the Issuer's board minutes from the preceding year or more to determine the number and names of any other currently serving officers appointed by the board of directors. 3. For the Issuer's officers, identified by reference to the above documents, determine their total number and the following personal information for each: a. The location of each individual's primary residence; b. The location of each individual's primary tax residence; c. The country where each individual resides for at least half of the calendar year; and d. The total value of the real property owned by each individual officer and whether the value of the officer's real property in the United States is greater than the value of the director's real property located in foreign countries. 4. Based on this analysis, determine whether 50% or more of the Issuer's officers are U.S. Note that the Issuer is likely under no United States or foreign legal obligation to assist the potential minority investor in obtaining this information, and certain foreign countries may restrict the disclosure of sensitive personal financial information of a company's officers to third parties. 5. Determine the fair market value of all of the Issuer's tangible assets, including the assets of all subsidiaries it controls directly or indirectly. Note that this requires a fair market value analysis, and likely cannot be obtained directly from the Issuer's financial statements showing the book value of its assets. Note that the Issuer is likely under no United States or foreign legal obligation to assist a potential minority investor in conducting a fair market value appraisal of all of its tangible global assets. 6. Determine the fair market value of all of the Issuer's intangible assets (e.g., patents, licenses, brand value, customer

	data/lists, self-developed software, research and development, etc.), including the assets of all subsidiaries it controls directly or indirectly. Note that this requires a fair market value analysis, and likely cannot be obtained directly from the Issuer's financial statements showing the book value of its assets. Note that the Issuer is likely under no United States or foreign legal obligation to assist a potential minority investor in conducting a fair market value appraisal of all of its intangible global assets. 7. Determine the total fair market value of all of the Issuer's tangible assets located in the United States, including the assets of all subsidiaries it controls directly or indirectly. 8. Determine the total fair market value of all of the Issuer's intangible assets located in the United States, including the assets of all subsidiaries it controls directly or indirectly. 9. Based on this analysis, determine whether 50% or more of the Issuer's total tangible and intangible assets, including the assets of all subsidiaries it controls directly and indirectly, are located in the United States