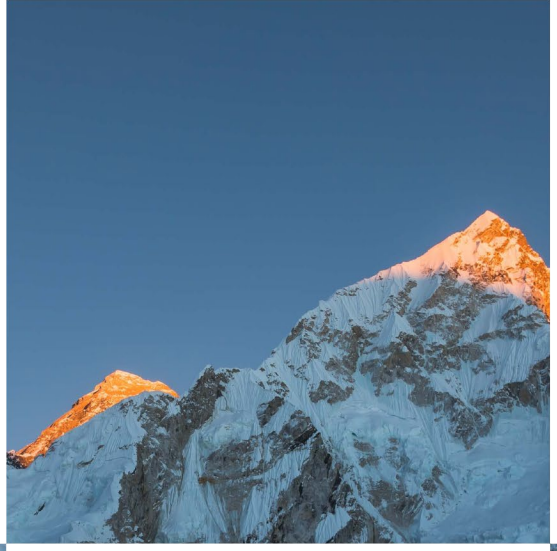

ALERT

Proposed HSR Changes: What Fund Managers Need to Know

July 14, 2023

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Proposed HSR Rulemaking Would Significantly Impact Investment Funds

On June 27, 2023, the Federal Trade Commission ("FTC") — in consultation with the Antitrust Division of the U.S. Department of Justice ("DOJ") — proposed sweeping changes to the premerger notification form and associated instructions and the premerger notification rules implementing the Hart-Scott-Rodino ("HSR") Antitrust Improvements Act. The new HSR form would require parties to reportable transactions to provide substantially more information and documents than they do currently, regardless of whether the proposed transaction affects competition.

The proposed overhaul of the HSR Act filing requirements — the first of its kind in over 45 years since the HSR program's inception — are detailed in a 133-page Notice of Proposed Rulemaking ("NPRM") published on June 29, 2023, triggering a 60-day public comment period that will end on Aug. 28, 2023 (although the FTC may extend the comment period depending on public response). After the comment period has expired, the FTC will review the public comments and potentially make revisions before issuing its final rule, which would take effect 60 days after publication in the Federal Register.

If implemented, the NPRM's changes to the HSR framework would disproportionately and acutely affect all types of investment funds, from hedge funds acquiring minority stakes to private equity funds buying portfolio companies. The HSR changes would burden them with significantly expanded and intrusive disclosure requirements, hampering their ability to execute deals quickly and increasing their legal costs.

HSR Filings: What Would the NPRM Change?

The HSR Act enables premerger screening of transactions for competitive issues by requiring parties to reportable transactions to file an HSR form with the FTC and DOJ, and to observe a statutorily prescribed waiting period prior to closing, unless an exemption applies. FTC Chair Lina Khan stated that the information currently collected by the HSR form is insufficient for the agencies to assess, within the initial waiting period, whether a proposed transaction may violate the antitrust laws. Chair Khan asserted that the proposed changes are intended to address the gaps routinely encountered by agency staff, including insufficient information about deal rationale, the structure of investment vehicles, and information about labor markets and research and development activity. The amendments also would fulfill a new requirement under the Merger Filing Fee Modernization Act of 2022 that HSR notifications include information regarding subsidies from certain foreign governments or entities that have been identified as economic or strategic threats to U.S. interests.

Although the agencies have proposed some deletions to the HSR form, the proposed amendments generally would add many burdensome requirements. The changes would increase dramatically the resources, time and expense required to make an HSR filing for all transactions, regardless of their potential competitive impact (or lack thereof).

The FTC itself estimates that the proposed changes could increase the time required to prepare and submit an HSR filing by a likely-underestimated average of 107 hours, with a range of 12 to 222 additional hours per filing depending on the particulars of the deal. The ability of investment funds to navigate nimbly the open market already is constrained by the 30-day waiting period when an HSR filing

is required. The proposed HSR changes would further encumber investors, requiring a minimum of 12 additional hours to prepare filings for even the simplest of transactions with no competitive issues. Investors with complex fund and transaction structures may need weeks instead of days to prepare their HSR filings, and possibly even months if the transaction involves any competitive overlaps between the parties.

Investment Funds in the Crosshairs

Some of the proposed changes to HSR reporting appear to be directed at private equity and other investment funds. For example:

- **Limited partners.** The current HSR form requires disclosure of the general partners of limited partnerships and the identities of shareholders of five percent or more of corporate entities. Asserting that limited partner ("LP") identities are critical to assessing potential antitrust violations, the FTC is proposing the disclosure of LPs with a stake of five percent or more at each level of an investment structure, even though LPs generally do not exert influence or control over the fund or the fund's portfolio companies. Protecting the identity of LP investors traditionally is paramount for investment firms, so the new disclosure requirements likely would negatively impact fundraising and potentially deal volume. The new form also would require the disclosure of significant creditors (lending 10 percent or more of the overall target value), option holders, management firms and investors with board appointment rights, as well as the submission of an organization chart for all funds and master limited partnerships.
- **Prior transactions in overlapping businesses.** For any potential overlaps, the current HSR form requires disclosure of acquisitions of control of entities with annual net sales or total assets of $10 million and of asset acquisitions that were of reportable size in the previous five years. The new HSR form would double the reporting period to 10 years and require disclosure of acquisitions of control of any size (capturing startups and nascent companies that currently would be excluded), as well as acquisitions of substantially all of the assets of an entity regardless of transaction size (in addition to asset acquisitions of reportable size). These additional reporting requirements are squarely aimed at private equity firms' "roll-up strategies," as noted in the NPRM and which both the FTC and DOJ have been vocal about the need to police. Investors will need to be mindful of potential antitrust concerns raised by any transaction — even if it is not reportable or exempt from the HSR Act — given that a subsequent reportable deal may require its disclosure. In addition to being subject to scrutiny themselves upon disclosure, these prior transactions could affect the agency's assessment of the competitive effects of the transaction under review.
- **"Interlocking" board directors.** Consistent with the DOJ's and FTC's stated intent to increase their scrutiny of companies with interlocking directorates, the NPRM seeks disclosure of the officers, directors or board observers (or similar positions for noncorporate entities) of an acquiring firm and all entities within it, as well as the other boards on which those individuals currently serve or have served within the last two years. The FTC also seeks information regarding prospective officers, directors or board observers post-transaction for both parties and any new entities created as a result of the transaction (or who would have authority to choose them). The recordkeeping demands presented by this new disclosure requirement would be particularly challenging for large investors with complex organizational structures. Notably, three of the four interlocks most recently unwound by DOJ involved private equity firms.

Additional Changes That Would Affect Investment Funds

All of the changes proposed in the NPRM would apply to all reportable transactions, regardless of their potential (or lack of) competitive effect. Many of those changes would significantly affect investment funds, even when their deals do not raise antitrust concerns.

- **Expanded document production.** The NPRM seeks various additional documents, significantly increasing the cost and time required to collect, review and produce HSR documents. For example, the new HSR form would require drafts of certain "Item 4" documents, documents created by or for non-officer "supervisory deal team leads," and ordinary course strategic plans in overlap markets, as well as all agreements (including all schedules and exhibits) related to the transaction, including agreements between the parties and agreements with third parties (e.g., supply or licensing agreements) that were in effect at the time or within one year of filing.
- **Document retention.** HSR filers will need to certify that they have taken steps to preserve documents and relevant information, including on all communications and messaging platforms, and also identify their communications, document and data storage systems.
- **Subsidies from foreign entities or governments of concern.** The proposed changes include the requirement that parties provide data about any subsidies they have received from certain foreign governments and other entities of concern, as mandated by the Merger Filing Fee Modernization Act of 2022. This disclosure requirement may apply to investors partnering with sovereign wealth funds and other foreign entities.
- **Shift to narrative-based notification.** The current HSR form generally requires information to be provided in an objective format, mostly in list form, with only the transaction description requiring a narrative response, as well as the production of existing documents the parties have collected in the ordinary course of business. If a transaction is deemed to potentially raise antitrust concerns, the agencies may conduct a more in-depth investigation and request additional information and documents through the "Second Request" process. Transactions that do not raise any antitrust concerns (which comprise the vast majority of reported transactions) are allowed to proceed with limited burden on filers.

  The proposed changes would subject all HSR filers to the expanded information and document requests more typical of Second Requests. Parties would be required to create new information, including comprehensive descriptions of the transaction and its strategic rationale, analysis of the relevant horizontal and vertical markets and the transaction's potential competitive impact, as well as providing a transaction diagram and projected closing timeline. The proposed more subjective, narrative responses are akin to the merger review processes in the European Union and other foreign jurisdictions. And while Chair Khan described these proposed amendments as consistent with the format of those jurisdictions, the new HSR requirements would exceed their foreign counterparts in many respects. For example:

  - The EU and most other jurisdictions generally require filings only for acquisitions of control or a substantial minority position. In contrast, hundreds of noncontrolling acquisitions are HSR-reportable each year, even when the shares held represent a fractional minority position. Moreover, the EU allows parties self-reporting overlaps with combined market shares of 20 percent or less to submit a "short form" that is less

burdensome. The NPRM does not provide a fast track process, nor does it account for the degree to which the transaction may affect competition.

- The extensive information and documents required under the proposed framework for transactions involving any overlaps at all are required in the EU only for transactions presenting substantial overlaps (e.g., a 20 percent combined market share). Requiring the collection of documents from employees other than officers and directors also goes beyond the typical EU approach.
- The EU allows a pre-notification process to ensure that filings will be deemed complete once formally submitted. Without a similar pre-notification process, HSR filers have no way to ensure that their submissions will be deemed complete and their waiting periods will run as anticipated. The newness, subjectiveness and breadth of the proposed changes also increase the risk that an HSR filing could be "bounced" (i.e., deemed incomplete and rejected), restarting the waiting period.

- **More difficult to file on a letter of intent.** Parties currently may file on the basis of preliminary agreements, such as a letter of intent ("LOI") or an indication of interest, and may, but are not required to, provide draft agreements. Under the proposed rules, parties must submit a draft agreement or term sheet that details the "scope of the entire transaction that will be consummated," including considerable detail on deal structure. Given that deal structures often are revised during negotiations, this requirement may curtail the ability of parties to "start the HSR clock" by filing on the basis of a "bare bones" LOI or preliminary term sheet. Parties also will need to weigh the benefits of submitting an HSR filing on the basis of an LOI given the significantly increased burden and costs that would be imposed by the new rules and the recently revamped filing fee framework that may require fees up of to $2.25 million for the largest transactions.
- **Extensive disclosure requirements for transactions with overlaps or vertical elements.** Investment firms with portfolio companies in the same lines of business as the other party will be required to provide additional information for each overlapping product or service, such as details on revenues (in addition to reporting revenues by NAICS code separately for each controlled entity, the NPRM seeks projected revenues by NAICS code for overlapping products and services under development), top customers (including contact information), licensing arrangements and non-compete or non-solicitation agreements, or, if the product or service is not yet in the market, then research and development information. Investors with portfolio companies in an upstream or downstream business must provide details regarding sales to the other party and the other party's competitors.

Key Takeaways

- **Proposed changes are extensive and would apply to all HSR filers.** The proposed changes to the HSR framework would substantially affect filers in all deals, including the vast majority that raise no antitrust concerns, as is the case for many investors acquiring minority stakes. Even though the FTC and DOJ reported in their most recent HSR Annual Report that only 1.9 percent of the 3,520 filings made in 2021 triggered an in-depth investigation, the agencies have proposed significant increased disclosure requirements enabling a level of scrutiny during the initial waiting period that currently is required only for the small percentage of deals that raise competitive issues.
- **Extensive additional lead time required for HSR preparation.** Investment funds acquiring minority stakes would need to account for the additional time and cost required to prepare an HSR

filing under the proposed framework, even if the transaction poses no legitimate competitive concerns. Buyout firms or groups will need to build sufficient time into their deal timetable to accommodate the proposed HSR changes and should rethink commitments to submit filings within the five to 10 business days provided in many purchase agreements, particularly where there are any potential competitive issues or overlaps in products or services. To meet deal timetables, parties may be forced to begin preparing HSR filings long before a definitive deal is agreed upon and will risk incurring those upfront costs even if deal negotiations fall apart.

- **Expanded and more intrusive disclosure requirements.** Significant among the many increased disclosure requirements is that buyers would be required to identify limited partners and provide the structure of their investment entities.
- **Mitigation of risks needed for document creation and retention.** Parties will need to be mindful about wording and perceptions when preparing documents, including drafts prepared months before an HSR filing will be submitted. Care should be taken to avoid, for example, defining a "market" (as it may limit or be inconsistent with the market to be defined in the competitive analysis required by the proposed HSR form), overstating a party's competitive significance, or using "buzz words" that tend to interest antitrust regulators (e.g., "dominate," "control," "leverage," etc.). Filers also will need to implement appropriate document retention policies.
- **Will agency review of transactions actually be more efficient and effective?** It is possible that the purported benefits of the NPRM's proposed changes will allow the agencies to review transactions within the initial waiting period or even to resume the granting of early termination (which has been "temporarily" suspended since February 2021). It also is possible that agency staff — already overtaxed by hundreds of HSR filings per month — will fall further behind when those filings will entail extensive and subjective narrative responses, and be accompanied by a vastly increased number of documents that currently are requested only when deals actually raise antitrust concerns.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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