PROPOSED AMENDMENTS TO HART-SCOTT-RODINO ACT REGULATIONS MAY AFFECT DOMESTIC MANAGERS OF FOREIGN INVESTMENT FUNDS

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The Federal Trade Commission (FTC) has proposed amending its regulations used to determine whether a person is designated as a domestic or foreign entity under the Hart-Scott-Rodino Antitrust Improvements Act (HSR Act) to define the "principal offices" of a filing entity for purposes of determining whether it is a "U.S. person" and/or a "U.S. issuer" for filing purposes. The definitions of a "foreign person" and a "foreign issuer" are also to be "simplified." [1] If adopted, the new regulations may limit the availability of exemptions particularly for certain investment fund entities and require an HSR filing for certain transactions where none was previously required, thus potentially increasing transaction costs for those funds. Comments are due by December 30, 2019.

BACKGROUND

The HSR Act requires parties to acquisitions meeting certain threshold criteria to submit a premerger notification and report, commonly referred to as an HSR filing, and observe a waiting period, prior to closing on any reportable transaction. [2] The purpose of the waiting period is to provide the antitrust agencies time to review the pending transaction to determine whether it is likely to violate U.S. antitrust laws. In addition to imposing a waiting period, reporting also requires payment of a filing fee of at least US$45,000.

There are several exemptions to the reporting requirements, including exemptions for certain acquisitions of foreign assets or foreign issuers. [3] Application of these exemptions depends in large part on whether the buyer is considered a U.S. person or a foreign person. [4] A person is currently considered a U.S. person if at least one of the three criteria are met:

1. It is incorporated in the United States;
2. It is organized under U.S. law; or
3. Its principal offices are in the United States.

The term "principal offices," however, is not defined under the HSR Act or its implementing regulations. The FTC's Premerger Notification Office has interpreted the term "principal office" to be synonymous with an entity's headquarters office, or the office where the officers are located, regardless of where its actual operations or assets are located. [5] Thus, an entity incorporated in the Cayman Islands and under its laws, with its headquarters physically located in the Cayman Islands, but most of its operations and assets located in the United States, would be considered a foreign person or entity under current regulations and interpretations.

THE PROPOSED CHANGES

The proposed regulations are intended to remove what is considered by some to be a lack of clarity and to provide a more concrete basis for the location of an entity's principal offices. Under the new regulations, an entity's principal offices will be considered located in the United States if any of the following are true:

4. 50 percent or more of the officers of the entity are located in the United States;
5. 50 percent or more of the directors of the entity are located in the United States; or
6. 50 percent or more of the assets (by fair market value) are located in the United States. [6]

Using the above Cayman entity as an example, under the new regulations, that entity would now be considered a U.S. entity or person, as the majority of its assets are located in the United States.

THE EFFECTS ON INVESTMENT FUNDS

For investment funds without formal officers or directors, the determination of "principal offices" would require looking to "individuals exercising similar functions." [7] The FTC proposal expressly states that "those 'exercising similar functions' for an investment fund partnership may include the general partner of the partnership, and/or any investment manager, if one exists." [8] Thus, an investment fund LP with its assets and headquarters located in the Cayman Islands would nevertheless be considered a U.S. entity if either its general partner or fund manager is located in the United States. Additionally, even if a fund did not have an officer, director, or person exercising similar functions in the United States, it would be considered a U.S. person if 50 percent or more of the assets were located in the United States.

The new regulations are not likely to have an effect on acquisitions of controlling interests in issuers, at least from the buyer's perspective. If the issuer to be acquired is deemed to be a U.S. issuer, the exemptions under 802.51 will not apply in any event, and the acquisition will be reportable if the criteria under 15 U.S.C. § 18a are met, including a transaction valuation of over US$90 million. [9] Additionally, if the entity to be acquired is deemed to be a foreign issuer, the same basic criteria will determine whether the transaction is exempted by 802.51, regardless of whether the buyer is a U.S. or foreign person. [10]

However, for non-controlling minority investments in foreign entities, the proposed regulation may result in a significant increase in the number of transactions requiring notification under the HSR Act. This is because *all acquisitions by a foreign person of less than 50 percent of the equity of a foreign issuer are **<u>currently</u>** exempt from HSR notification requirements, regardless of the value of the issuer's sales in or into the United States, or the value of its assets located within the United States.* [11]

By way of example, an acquisition of 25 percent of a foreign company by an entity located in the Cayman Islands would, under the current regulations, likely be exempt if the buyer is a foreign person, but under the proposed regulations be reportable if the entity is a U.S. person (assuming the HSR notification thresholds are met and no other exemption applies). Thus, if the general partner or investment manager of the Cayman entity is located in the United States, the transaction would now be reportable under the FTC proposal.

Not only would this potentially increase the number of filings by certain investment funds, it could also significantly increase the burdens on those funds in determining whether a particular target issuer is foreign or domestic; to establish whether an exemption under 802.51 may be available:

7. It will need to determine where the officers and directors of the issuer reside; and
8. It will need to determine the location and fair market value of the issuer's assets.

The question from a policy perspective thus becomes whether the new rules are likely to identify transactions of concern that currently avoid reporting, and do so with sufficient frequency to justify these increased burdens, which could be significant.

THE COMMENT PERIOD

The comment period for the proposed regulations is open until December 30, 2019. Please feel free to contact K&L Gates attorneys if you are interested in formulating a strategy to respond to the proposed changes.

NOTES

[1] Notice of Proposed Rulemaking, 84 Fed. Reg. 58,348 (Oct. 31, 2019).

[2] 15 U.S.C. § 18a (2019).

[3] 16 CFR § 802.50 (covering assets), and 16 CFR § 802.51 (covering equity).

[4] A "person" under HSR regulations includes the ultimate parent entity of the acquiring or acquired entity, and every other entity controlled by that ultimate parent. 16 CFR § 801.1(a)(1).

[5] *See* ABA Section on Antitrust Law, Premerger Notification Practice Manual, 156 (5th ed. 2015).

[6] 84 Fed. Reg. at 58,350.

[7] 84 Fed. Reg. at 58,351.

[8] *Id.*

[9] Generally speaking, an HSR filing is required, unless otherwise exempted, where the transaction is valued above US$90 million, one of the parties has annual net sales or total assets of US$180 million or more, and the other party has annual net sales or total assets (total assets only for the acquired person if it is not a manufacturer) of US$18 million or more. The above amounts are adjusted every year.

[10] 802.51, in general, exempts transactions of a foreign issuer where the issuer neither has sales in or into the United States of more than US$90 million (2019 threshold), nor has assets located in the United States valued at more than US$90 million (2019 threshold). Note that 802.51(c) provides for higher, aggregated buyer, and seller thresholds for U.S. sales or assets where both buyer and seller are foreign.

[11] 16 CFR § 802.51(b).

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