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FTC ACTION ALERTS FUND MANAGERS THAT SIGNIFICANT INVESTMENTS MAY BE SUBJECT TO PRE-ACQUISITION NOTIFICATION REQUIREMENTS UNDER THE HART-SCOTT RODINO ACT¹

To: Clients and Friends of Tannenbaum Helpern Syracuse & Hirschtritt LLP

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A recent Federal Trade Commission enforcement action pointedly serves to alert hedge fund and private equity fund managers to the possibility that significant investments in issuers involved in commerce in the United States may be subject to the advance reporting requirements of the Hart-Scott-Rodino Pre-merger Notification Act (the “HSR Act”).² On May 21, 2007, the U.S. Department of Justice, at the FTC’s request, filed a complaint and a stipulated final judgment in Federal District Court that will require a Dallas hedge fund manager, personally, to pay a \$250,000 civil penalty to settle charges that he acquired shares in an issuer that put his fund’s holdings above the HSR pre-acquisition filing threshold without filing the required notification under the HSR Act. The violation resulting in the civil penalty was this particular manager’s second in less than a year. The FTC let him off the hook the first time, based on his representations that he would put procedures in place to prevent future violations. Unfortunately, the procedures did not work.

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² The HSR Act was enacted as part of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 and is codified as § 7A of the Clayton Act, 15 U.S.C. § 18a.

Hedge fund managers cannot necessarily expect the FTC to allow them a similar “one bite” in the future. In announcing the FTC action, the Director of the FTC’s Bureau of Competition publicly stated that, “This significant but fair civil penalty should once again highlight the need for private individuals, counsel, and businesses – including hedge funds – to pay close attention to the Commission’s rules when considering a transaction where a pre-merger filing is required. Our goal is to make the process as open and transparent as possible to ensure that all appropriate filings are made in a timely manner. But we will not hesitate to bring enforcement action when violations occur.”

Fund managers need to consider the possibility that an acquisition of an interest in an issuer will be subject to HSR pre-acquisition reporting requirements whenever the acquisition would put the fund’s total holdings of an issuer (or the combined holdings of the issuer of all funds under common control) above \$50 million, adjusted for inflation annually since 2005. The current inflation-adjusted threshold is \$59.8 million. The next threshold adjustment will be in February 2008.

Not all acquisitions that would cross the \$59.8 million threshold will be reportable, but a careful determination always needs to be made to avoid possible violations. The potential penalty is up to \$11,000 per day of non-compliance.

It is important to understand that in determining whether an HSR filing is required fund managers cannot consider only the size of the currently contemplated acquisition. Under the complex regulations that govern HSR compliance, all of a fund’s holdings of securities (or assets) of an issuer are deemed to be attributable to the current acquisition. Accordingly, the total holdings determine whether filing is necessary. Valuation of total holdings is also subject to complex regulations that must always be consulted, but, in general (a) total holdings are measured by current market value, not the fund’s cost basis, and (b) holdings are valued at the greater of purchase price or current market, not necessarily what is being paid. Increase in market value of existing holdings will not alone trigger a filing requirement. However, a filing will need to be made before the next acquisition.

Somewhat oversimplified, for the HSR Act to apply to a particular acquisition, the acquisition must satisfy three tests: a “commerce test,” a “size of person test,” and a “size of transaction test.” For fund managers, the size of transaction test will usually be the determining factor. The other two tests will typically be satisfied.

The commerce test is met if either the fund or the issuer is engaged in U.S. commerce or in any activity that affects U.S. commerce. Thus, only a foreign investment by an off-shore fund might possibly fail to meet the commerce test.

The size of person test is met if either the fund or the issuer has sales or assets of at least \$100 million as adjusted since 2005 (the current threshold is \$119.6 million) and the other party has sales or assets of at least \$10 million as adjusted (the current threshold is \$12.0 million). Given the typical sizes of funds and the businesses they invest in today, this test will almost always be satisfied. In addition, for very large acquisitions of

over \$200 million as adjusted (currently \$239.2 million), the size of person test drops away and the transaction is reportable based on size of transaction alone.

Thus, in most cases the determining factor will be the size of the transaction. And it is important to remember that no matter how small an individual acquisition may be, if it would put the total holdings of the fund, or commonly controlled group of funds, in the issuer over \$59.8 million, an HSR pre-acquisition notification requirement is a distinct possibility.

There are, to be sure, some exemptions available under the HSR regulations that can save a transaction that would cross the threshold from the HSR filing requirement. Potentially the most important for fund managers is an exemption for acquisitions for investment purposes only. However, this exemption ceases to apply if the fund's holdings constitute an interest of 10% or more in the issuer. Thus, acquisitions of less than 10%, but more than \$59.8 million will not be subject to HSR filing unless and until the fund crosses the 10% threshold.

It is important to note, however, that if a fund makes acquisitions for investment purposes only, but later decides to assume an active role in management, the exemption will not be available for its next acquisition and a pre-acquisition filing will be required (unless some other exemption applies). Also, once the initial threshold is crossed and a filing is made, a new filing is not required every time a fund acquires more shares. The regulations establish five thresholds for the acquisition of voting securities and a new filing is not required for subsequent acquisitions within the next five years until the next threshold is crossed. There are three size of transaction thresholds: \$59.8 million, \$100 million as adjusted (currently \$119.6 million), \$500 million as adjusted (currently \$567.0 million), and a percentage threshold of 25% if the total valuation is greater than \$1 billion as adjusted (currently \$1.1958 billion). In addition, because acquisition of control is considered a separate trigger, there is an additional threshold of 50% if the total valuation is greater than \$50 million as adjusted (currently \$59.8 million).

Other HSR exemptions potentially relevant to fund managers include stock splits or stock dividends that do not increase the percentages owned by any person and acquisitions of additional voting securities by funds that already hold 50% or more of the voting shares of an issuer. Also, acquisitions in certain regulated industries whose competitive effects are reviewed by agencies other than the FTC and the DOJ may be exempt or subject to modified reporting requirements. The banking industry is the primary example.

If an acquisition does have to be reported under HSR, the filing must be made *before* the acquisition and the acquisition that crosses the threshold may not be made until the end of the waiting period. A fund may, however, make additional acquisitions that still leave it short of the threshold before the end of the waiting period. Sales are also permissible.

Depending on the nature of the transaction, the issuer or the person from whom the shares will be acquired may also have to make a filing before the waiting period ends. HSR filings themselves are confidential and not subject to public disclosure, but if shares are going to be acquired on an exchange, the issuer will have to be notified. Once the filing is made and the waiting period expires, the fund has up to a year to make the acquisition.

The statutory waiting period is 30 days, but early termination will be granted if the reviewing agency determines that no action is necessary. If granted, however, the early termination will be publicly disclosed. This can be a reason not to seek early termination. Many fund acquisitions should, in theory, be good candidates for early termination because the purpose of HSR reporting is to determine in advance whether an acquisition will adversely affect competition and in most cases it will be readily apparent that the acquisition will have no substantial effect. However, either the FTC or the DOJ can extend the waiting period for an additional 30 days if it determines that it needs more time.

Finally, we note that not only are the penalties for non-compliance with HSR potentially drastic, but the filing fees are steep as well. The filing fee is \$45,000 for transactions up to \$119.6 million, \$125,000 from that level up to \$597.9 million and \$280,000 above that.

The above is merely an overview of potential issues for fund managers in connection with compliance with HSR pre-acquisition reporting requirements. The statute and regulations are considerably more complex. An individual evaluation, with counsel, of each situation is necessary.

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If you have any questions regarding compliance with HSR, please contact the Tannenbaum Helpert attorney with whom you regularly work or one of the following partners:

L. Donald Prutzman
(212) 508-6739
prutzman@thshlaw.com

Andre R. Jaglom
(212) 508-6740
jaglom@thshlaw.com

Michael G. Tannenbaum
(212) 508-6701
tannenbaum@thshlaw.com