FTC Settlement with Activist Fund Clarifies Scope of HSR Passive Investment Exemption

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The Federal Trade Commission ("FTC") and the United States Department of Justice ("DOJ") on Monday **reached a settlement** with fund management company Third Point LLC and its affiliated funds ("Third Point") concerning agency allegations that Third Point violated pre-merger reporting laws in connection with certain acquisitions in 2011 of stock in Yahoo! Inc. ("Yahoo"). Specifically, the agencies alleged that Third Point (founded by activist investor Daniel Loeb) acquired Yahoo shares valued greater than the reporting threshold and that this acquisition was not undertaken "solely for purposes of investment." Accordingly, Third Point could not avail itself of the HSR Act's "investment" exemption. The settlement provides important guidance as to how the FTC interprets that exemption, particularly in the context of investments by activist funds.

The key points of the settlement are:

- The settlement prohibits Third Point from relying on the investment exemption if, at the time of the acquisition of shares or in the four months preceding it, Third Point engaged in various activities with respect to the issuer, including: nominating a candidate for the board of directors; soliciting third parties to become board candidates; discussing board or CEO candidates with the issuer; soliciting proxies; or assembling a board slate.
- The government did not seek a civil penalty, which it routinely does in cases involving HSR Act violations. In this case, the government noted, the violation "was inadvertent and short-lived, and this was the defendants' first violation of the HSR Act." It sought only a declaration that Third Point's conduct violated the HSR Act and an injunction prohibiting future violations.
- An order proposed in this matter sets forth specified compliance obligations for the defendants, effective for five years unless during that period the FTC issues a "flat exemption" covering all acquisitions under a specified percentage, except those by a competitor. Two dissenting Commissioners advocated for a modification to the existing rules with the goal of limiting investment fund filing requirements.

Background

The HSR Act requires parties to investments that exceed certain jurisdictional thresholds make filings with the FTC and the DOJ and to observe a waiting period before closing. The HSR Act and the Rules provide numerous exemptions from the reporting and waiting period requirements.

One important exemption provides that an acquisition of up to 10% of the outstanding voting securities of an issuer is exempt, regardless of value, so long as the acquisition is made "solely for the purpose of investment," meaning that the holder of voting stock "has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." The question of intent is assessed at the time of each purchase of voting securities of the issuer.

In the absence of an exception, the HSR Act requires a firm to make a filing before acquiring $76.3 million or more of a target's voting securities. The filing is not itself public, but the target must be notified of the planned acquisition and the target may elect (or be required) to disclose the filing. This obviously has important implications for activist funds, which may prefer to accumulate larger positions before notifying the target or the general public.

The Alleged Violation

According to the complaint, Third Point, at the time of the stock purchases, was engaged in the following activity which the agency deemed evidence that Third Point did not intend to acquire Yahoo stock solely for the purpose of investment:

> [Third Point] and/or their agents contacted certain individuals to gauge their interest and willingness to become the CEO of Yahoo or a potential board candidate of Yahoo, took other steps to assemble an alternate slate of board of directors for Yahoo, drafted correspondence to Yahoo to announce that Third Point LLC was prepared to join the board of Yahoo, internally deliberated the possible launch of a proxy battle for directors of Yahoo, and made public statements that they were prepared to propose a slate of directors at Yahoo's next annual meeting.

The Third Point funds exceeded the size of transaction threshold then in effect between August 10, 2011 and August 31, 2011, and each submitted corrective notifications on September 16, 2011. The FTC did not specify whether or not the alleged violation was self-reported, but noted that Third Point had not previously violated the HSR Act.

The Settlement

Under the terms of the proposed five-year settlement order, the defendants are prohibited from relying on the "solely for the purpose of investment" exemption if they have contacted third parties to gauge their interest in joining the board of the target company, communicated with the target company about proposed candidates for its board, or engaged in other specified conduct in the four months prior to acquiring voting securities above the HSR Act threshold. They must also appoint a compliance officer to monitor compliance with the order and submit compliance reports.

The order would expire earlier if a "flat exemption" is effective in the meantime, defined as a modification to the HSR Act or rules "to exempt from the reporting requirements of the HSR Act the acquisition of voting securities of an issuer by an acquiring person, or by an acquiring person who is not a competitor of the issuer, on the sole basis that the acquisition results in the acquiring person's holding less than a specified percentage of the outstanding voting securities of the issuer."

Implications

The applicability of the passive investment exception in the context of activist investing has been a subject of controversy. Some activists and antitrust lawyers have argued that funds should be able to avail themselves of the investment exception and acquire up to 10% of a target's voting securities without making a filing. They have argued, among other things, that requiring a filing at the lower dollar threshold (today $76.3 million) is unduly expensive and requires investors to disclose their positions prematurely. They have also complained that the precise scope and application of the passive investment exception is unclear.

The controversy over this application of the passive investment exemption is a longstanding one. Indeed, at one point the FTC proposed to discontinue the passive investment exemption in favor of a "flat exemption" up to 10% of the type referenced in this settlement.[1]

[1] In a 1988 Notice of Proposed Rulemaking, the FTC, with the concurrence of the DOJ, proposed exempting from the HSR Act's notification and waiting period requirements all acquisitions that did not result in the acquiring person holding in excess of 10% of the issuer's outstanding voting securities. See Premerger Notification; Reporting and Waiting Period Requirements, 53 Fed. Reg. 36,831 (proposed Sept. 22, 1988). The proposal met with some opposition and was quietly abandoned.

For now, the FTC has apparently rejected these arguments for a broader reading of the investment exemption. "The investment-only exemption is a narrow exemption limited to those situations in which the investor has no intention to influence the management of the target firm," said Bureau of Competition Director Deborah Feinstein. "Here, Third Point's conduct demonstrated that it intended to have more than a passive interest in Yahoo."

The Commission issued a statement explaining the rationale for challenging Third Point's conduct in this matter, stating that "there is [ ] a public interest associated with the legitimate expectation of the business community, practitioners, and the general public that the antitrust agencies will act clearly, consistently, and transparently in their interpretation and enforcement of the HSR Act and rules" and that "the public interest does not hinge on whether Third Point's acquisitions of Yahoo stock were likely to produce any competitive harm."

The Commission's current position in this settlement does not represent a departure from previous interpretations of this exemption, and in fact the FTC has enumerated since the early days of the HSR Act a number of activities that it would consider beyond "passive investment."[2]

The FTC vote to refer the complaint and proposed settlement to the DOJ for filing in federal court was 3-2, with Commissioners Maureen K. Ohlhausen and Joshua D. Wright dissenting.

Commissioners Ohlhausen and Wright (who recently announced that he is stepping down as a Commissioner) disagreed with the "narrow" interpretation of the exemption and the need to bring any action in this matter, stating in their dissent: "The relevant question is not whether the probability that shareholder advocacy produces harm is zero, but rather whether the probability is sufficiently low so as not to justify requiring an HSR filing and the costs associated with it including deterring activity on the margin." They also suggested that either the HSR Act or rules be amended or modified to circumscribe filing requirements in this area, eliminating them for "a category of stock acquisitions that have proven unlikely after 40 years of experience to raise competitive concerns."

Especially in light of the two dissents, the scope of the passive investment exception appears likely to remain a subject of controversy.

[2] For example, the FTC's Statement of Basis and Purpose accompanying the initial issuance of HSR regulations states that certain activity "could be" viewed as inconsistent with investment intent, including, "(1) nominating a candidate for the board of directors of the issuer; (2) proposing corporate action requiring shareholder approval; (3) soliciting proxies; (4) having a controlling shareholder simultaneously serving as an officer or director of the issuer . . . The facts and circumstances of each case will be evaluated whenever any of these actions have been taken by a person claiming that voting securities are acquired . . . solely for the purpose of investment." 43 Fed. Reg. 33450, 33465 (July 31, 1978); see also Letter of Thomas J. Campbell, Dir., Fed. Trade Comm'n Bureau of Competition, to Michael N. Sohn, Arnold & Porter (Aug. 19, 1982), at 1–2 ("The Bureau construes the term 'solely for the purpose of investment' . . . to apply only to purchasers who intend to hold the voting securities as passive investors . . . . It is irrelevant for purposes of the exemption why the shareholder intends to influence management, even if it is only to protect its original investment."). Any one of those practices has been sufficient to provoke enforcement activity.

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