Freedom from Filing: The FTC Should Reconsider Investor Activism Under the Hart-Scott-Rodino Act

By Michael L. Keeley

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As a way of maximizing the value of portfolio companies, more and more hedge funds and other investors have embraced shareholder activism, including letter-writing campaigns designed to persuade (and sometimes embarrass) management into taking actions to boost share prices.

The Federal Trade Commission staff, which is responsible for enforcing the Hart-Scott-Rodino Antitrust Improvements Act of 1976, has discussed whether to revise its position that investors that make statements to influence management are ineligible for the so-called investment-only exemption to HSR. Exempting from the HSR Act acquisitions by vocal investors that do not intend to influence management through more direct means such as board representation would boost market efficiency and remove an unnecessary restriction on desirable investor speech.

Absent an exemption, an investor must file a Notification and Report Form, known as an HSR form, with the FTC before accumulating more than $53.1 million in company's stock. This assumes the HSR Act's other requirements are satisfied: that the fund or company has more than $10.7 million in assets or annual revenues and the other has more than $106.2 million in assets or annual revenues. (These monetary thresholds will increase to $56.7, $11.3, and $113.4 million, respectively, on Feb. 17, 2006.) The investor must then wait 30 days after filing before buying the stock unless the agencies grant "early termination," or "ET," of the waiting period.

The investment-only exemption provides that investors that acquire stock solely for investment purposes are exempt from filing an HSR form as long as they do not buy more than a 10% stake. A separate exemption permits certain banks, registered investment companies and other institutions to buy up to 15% of a company's stock "solely for the purposes of investment." The exemptions were inserted to avoid submitting to antitrust scrutiny investments unlikely to present threats to competition.

Few would quibble with most of the FTC's rules regarding whether an acquisition is "solely for the purposes of investment." The agencies will not consider an acquisition to have been made "solely for the purposes of investment" if a rival makes it. Combinations of competitors are at the heart of the agencies' enforcement responsibilities and raise the greatest competition concerns. Nor will the agencies consider an acquisition made by an investor that intends to ultimately gain control to be "solely for the purposes of investment."

In contrast, an otherwise passive investor's speech (however acerbic and persistent) urging management to take action is consistent with traditional notions of "investment." The FTC staff, however, has adopted the position that even writing a letter to management suggesting a course of action would be inconsistent with the intent required to rely on the investment-only exemption.

The FTC position that an effort to influence management through shareholder speech is, by itself, inconsistent with the investment-only exemption is far too restrictive. Good reasons exist to permit hedge funds and other investors to use the exemption even if they buy stock with the intent of communicating views to management or publicly commenting about the conduct of the business.

First, it is unlikely that speech by a hedge fund or other investor will result in anticompetitive effects. The investment-only exemption is unavailable to investors that hold more than 10% of a company's stock. Even in companies with no other significant stockholders, such a position is unlikely to allow a hedge fund to direct significant corporate decisions. Moreover, the investment-only exemption is unavailable to investors that own a rival of the company, further limiting competitive concerns.

Second, the current interpretation of the exemption places a heavy tax on an enshrined right of shareholder democracy and thus harms the investing public. Hedge and private equity funds are sophisticated investors that have the resources to identify poor management and suggest profit-maximizing actions. In most cases, all shareholders will benefit from management improvements an investor's statements can bring about.

Third, the FTC's interpretation interferes with the efficient operation of the markets. Vocal investors must now pay thousands of dollars in HSR filing fees because they are ineligible for the investment-only exemption, and they must to wait up to 30 days to make an acquisition, likely leading to suboptimal acquisition prices (to say nothing of purchases that are prevented or discouraged). The public disclosure of ET grants means some investors may decline to seek ET to protect proprietary trading strategies. Hedge funds are required to disclose their holdings only in limited situations; it is unreasonable for the HSR Act to mandate a level of transparency not required by securities laws.

The FTC should change its interpretation so that investors who intend to make statements about corporate management are not automatically ineligible for the investment-only exemption. This interpretation would still require investors that intend to take more concrete steps to influence a company to file an HSR form. Such a balance would enhance the efficiency of the capital markets while preserving the ability of regulators to review deals that might lessen competition.

Michael L. Keeley is a partner with Axinn, Veltrop & Harkrider LLP, specializing in antitrust and trade regulation and commercial litigation.