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THE FEDERAL TRADE COMMISSION RELAXES HART-SCOTT-RODINO NOTIFICATION REQUIREMENTS FOR 'PUT-CALL' COMBOS

BY BRUCE J. PRAGER AND HANNO F. KAISER

As hedge funds become more active and aggressive in seeking to influence the companies in which they invest, they have come under increased scrutiny by the Federal Trade Commission for possible violations of the Hart-Scott-Rodino Act. Absent an exemption, the HSR Act requires buyers of stock valued in excess of $56.7 million to file a premerger notification form with the federal antitrust enforcement agencies.

There are two primary areas in which the requirements of the Hart-Scott-Rodino Act fly in the face of the hedge fund business model.

First, activist investors can usually not avail themselves of the "for investment purposes only" exemption, which—as presently construed by the FTC—applies only to truly passive investors.

Second, while profit-maximizing trading requires both speed of execution and secrecy, the HSR Act imposes a 30-day waiting period on the buyer (an eternity in the life of a trader) and requires that the buyer notify the target of its acquisition plans. The target issuer, in turn, may have to make the fact of the buyer's proposed acquisition public under Securities and Exchange Commission rules, thus announcing the buyer's plans to the world.

Virtually none of the hedge fund stock purchases lead to a combination or coordination of competing businesses that could pose any conceivable antitrust concern.

For that very reason, foreign antitrust regulators, most significantly the EU, have excluded stock acquisitions that don't amount to taking control of the target company from premerger review. So one can reasonably ask why U.S. antitrust regulators get involved in what is essentially a securities regulation question.

Against that backdrop, what is a hedge fund to do if it wants to build a significant, noncontrolling position in a target company without having to go through the HSR process?

First, an outright acquisition of the target's voting securities without premerger notification is out of the question. The fund would subject itself to civil penalties of $11,000 for each day of noncompliance and the possibility of having to disgorge profits made during that period. If the fund wants to enjoy all the rights of stock ownership, including voting rights, appreciation in value and dividends, it has to comply with the act.

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But what if the fund is willing to forgo some of these rights, at least initially, and in particular, its right to vote the stock? In that case, the fund could enter into a "put-call" agreement with a third party, usually an investment bank.

According to the agreement, the fund may, at its discretion, buy target-company stock from the bank at an agreed-upon strike price. That's the "call" component of the agreement.

The bank, in turn, has the right to sell the target company stock to the fund at the same price or—at the fund's choice—to compensate the bank for any difference between the strike price and the market price at the end of an agreed-upon period. That's the "put" component of the agreement.

Dividends benefit the fund, not the bank. The bank receives from the fund a financing fee and interest.

The economic effect of the put-call combo, from the fund's perspective, is that of ownership of the shares minus the voting rights. The fund will profit from a rising stock price and bears the risk of a falling stock price. The fund is certain to acquire the underlying target company stock from the bank if it so chooses.

The bank bears no economic risk if it hedges its position by purchasing the underlying target company stock upon entering into the put-call arrangement and is guaranteed a profit from the financing fee.

Of course, once the fund exercises its option to receive the target company's shares from the bank, then the fund has to make an HSR filing before taking possession and getting the voting rights.

But since the benefits of (or the losses from) the trade have already been realized by way of the put-call combo, that filing is a mere formality, and the HSR-imposed delay before receiving the actual shares and the right to vote them is usually acceptable to the fund.

In the past, the problem with this approach was that the FTC had taken the position that put-call combos, because their economic effects resemble those of full beneficial ownership, required HSR notification.

However, in a recent staff interpretation, the FTC reversed its position on that issue. Based on the new interpretation, put-call combos no longer require HSR notification. Acquiring the economic equivalent of share ownership (minus the voting rights) as outlined above should therefore be permissible in most circumstances.

For hedge funds, this is big news. The FTC's change of heart now permits swift and nonpublic put-call trades in and out of significant positions without having to involve the antitrust regulators.

The change might also give hedge funds greater leeway in approaching a target company's management with suggestions on how to improve stock performance. The narrowly construed "only for investment purposes" exemption is needed to avoid a filing requirement only if the fund will hold actual voting securities.

But as long as the fund only has put-call option contracts with a third party at the time that it approaches the board of the (future) target company, no HSR limitations on shareholder activism apply. Only when the fund intends to exercise its option must it comply with the HSR filing requirements before acquiring the underlying voting securities.

How safe is it to rely on the staff's new position? Relatively safe, but not entirely without risk. The previous position according to which put-call combos required notification resulted in three enforcement actions, all of which were brought in 1988.

Ultimately, the holders of the put-call options settled with the government and paid civil penalties of $300,000, $400,000 and $750,000, respectively.

Enforcement actions in HSR matters are relatively rare so that interpretations underlying them carry significant weight. The new position, exempting put-call combos from the filing requirements, was confirmed orally by the staff in the Federal Trade Commission's premerger office and qualifies as an informal interpretation that supersedes the premerger office's prior interpretation. It is understood by both the antitrust bar and the antitrust agencies that informal staff interpretations will be respected in subsequent cases, and to our knowledge, parties have never been prosecuted for acting upon informal advice given by the Federal Trade Commission's premerger office when the facts were accurately presented to the staff.

The bottom line is that the FTC's new position of exempting put-call combos from the HSR filing requirements is a significant and welcome change to align the HSR Act not only with economic reality but also with the substantive purpose of the antitrust laws.

Hedge funds will find that with put-call combos, they now have a method at their disposal that will allow them to make profitable trades more quickly and in a nonpublic manner under the antitrust laws. (Of course, securities regulations may still apply.)

That said, given the recent nature of the change, hedge funds are well advised to seek informal guidance from the FTC that their particular put-call arrangements are indeed exempt from HSR notification before taking on positions in excess of the $56.7 million filing threshold. ■

Bruce J. Prager and Hanno F. Kaiser are partners at Latham & Watkins LLP in New York.

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