HERBERT SMITH FREEHILLS

SIGNIFICANT AMENDMENTS TO UK MERGER CONTROL REGIME TARGETING FOREIGN INVESTMENT

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Legal Briefings

The UK government has announced two significant amendments to the UK merger control regime, intended to enhance its powers to scrutinise certain foreign direct investment ("FDI") into the UK, against the backdrop of the Covid-19 pandemic and wider national security concerns. These amendments come ahead of the National Security and Investment Bill ("NS&I Bill"), which is expected to be brought before Parliament in the coming weeks to create a new distinct FDI regime in the UK, introducing standalone powers enabling the government to review a broad range of transactions on the grounds of national security (following on from a White Paper published in July 2018, although the detail of the regime has not yet been confirmed – see our previous briefing).

The headline changes are:

- the addition of "to combat and mitigate the effects of a public health emergency" as a criterion for intervention in a transaction by the government on public interest grounds, under the existing public interest merger regime contained in the Enterprise Act 2002 ("EA02") – to be implemented by way of a statutory instrument The Enterprise Act 2002 (Specification of Additional Section 58 Consideration) Order 2020 tabled today, which will take effect from tomorrow (23 June 2020); and

- the introduction of lower jurisdictional thresholds for review of transactions in three specific sectors: artificial intelligence, cryptographic authentication technology and advanced materials – also to be implemented by way of two statutory instruments (the Enterprise Act 2002 (Share of Supply Test) (Amendment) Order 2020 and the Enterprise Act 2002 (Turnover Test) (Amendment) Order 2020) tabled today, but to be debated before they enter into force.

The intention behind these reforms is to enable the government to review proposed acquisitions of businesses directly involved in the response to a pandemic (including any future pandemic, other than Covid-19), whilst also expanding the government's powers to intervene in mergers in sectors which are deemed to be central to national security. The reforms cover not only companies directly involved in the response to a pandemic (e.g. pharmaceutical or medical equipment suppliers) but also companies which mitigate its effects (examples given include internet service providers and food supply companies) as well as, potentially, usually stable UK businesses suffering a short-term impact to their share price or profitability as a result of the economic uncertainty caused by a pandemic. Further guidance from the department of Business, Energy and Industrial Strategy is expected shortly and should provide additional clarity on the circumstances in which the government would exercise its powers.

These amendments are significant for investors in the identified sectors, particularly non-UK investors, although notification of affected mergers to the Competition and Markets Authority ("CMA") will remain voluntary. However, it is also important to note that – as expressly flagged in the government's press release – these changes are primarily intended to "*mitigate risks in the short term*", ahead of the introduction of "*more comprehensive powers*" in the NS&I Bill. We expect that Bill to be brought before Parliament in the coming weeks, and will provide a further update as soon as it is published.

NEW PUBLIC INTEREST INTERVENTION CRITERION

The press release announcing the amendments expressly refers to concerns that "*the economic disruption caused by the pandemic may mean that some businesses with critical capabilities are more susceptible to takeovers – either from outwardly hostile approaches, or financially distressed companies being sold to malicious parties*." Similar concerns have led to a raft of recent changes to FDI regimes in other jurisdictions, including France, Germany, Australia and Canada amongst others (see our recent briefing).

In the UK, there is currently no standalone FDI regime; instead, the government has the power to intervene in transactions on certain specified public interest grounds as part of the merger control regime. Prior to this latest amendment, these grounds were limited to national security, media plurality and financial stability. However, the Secretary of State is empowered to specify additional grounds by way of an order made under section 58(3) EA02 (indeed, this was how the "financial stability" ground was added, in the context of the 2008 financial crisis). Whilst the concept of "national security" is fluid and continues across FDI regimes to be extended to include critical infrastructure, communications assets, advanced technology and data and – influenced by the pandemic – healthcare, the government appears to have concluded that it is preferable to add a new public interest ground relating to combatting a public health emergency, rather than to rely on the existing "national security" ground.

With effect from tomorrow, Tuesday 23 June 2020, the Secretary of State will be able to issue a public interest intervention notice in any transaction which meets the jurisdictional thresholds of the UK merger control regime,[1] where potential concerns are identified relating to combatting a public health emergency. Examples given by the government include the acquisition of a manufacturer of vaccines or personal protective equipment ("PPE"). However, although the Explanatory Memorandum indicates that this issue was brought into focus by Covid-19, the purpose of the amendment is not limited to companies involved in the treatment or medical management of a pandemic but also the mitigation of its effects. Examples given by the government of companies that mitigate the effects of a pandemic (and thus where government intervention could be necessary if a company is subject to a takeover attempt) include internet service providers or food supply companies. Moreover, the Explanatory Memorandum suggests that, at least in principle, the government could use the amendment as the basis for reviewing transactions involving usually stable UK businesses whose share price or profitability has suffered a short-term impact due to the economic effects of a pandemic. Intervention on the latter basis is potentially very broad, and further guidance will be needed on the government's intentions in this respect.

Where such an intervention notice is issued, the Secretary of State takes over the role of final decision-maker from the CMA, with the power to clear or prohibit the merger (including a power to accept undertakings to secure clearance, which is frequently used in practice).

LOWER JURISDICTIONAL THRESHOLDS IN SPECIFIED SECTORS

In June 2018, the government lowered the jurisdictional thresholds of the UK merger control regime in three specified sectors: the development or production of items for military, or dual military/civilian use, computing hardware and quantum technology. In those sectors, the threshold relating to the target's UK turnover was lowered from £70 million to £1 million, and the 25% "share of supply" threshold was amended so as to no longer require any incremental increase (see our previous briefing). This amendment was described as a temporary "short term" reform, ahead of the introduction of a new national security regime set out in the government's subsequent July 2018 White Paper.

The government has now tabled a statutory instrument to extend these amended jurisdictional thresholds to three further sectors: artificial intelligence, cryptographic authentication technology and advanced materials. The legislation sets out in some detail the type of products to which it is intended the lower jurisdictional thresholds should apply. The definitions are nonetheless purposefully quite broad:

- **Artificial intelligence** covers any technology which enables software or a device (without further input or programming) to undertake complex or specific tasks involving automated data analysis or decision making or analogous processing or data use. As the accompanying Explanatory Memorandum makes clear, it is intended to cover all UK businesses (including providers of components or related services) which produce, develop and design digital AI and machine learning technologies (with the exception of robotics) and the related IP.

- **Cryptographic authentication** means the method of verifying a person, user process or device or the origin or content of electronic messages, data or information which has been encrypted for security reasons. Again this extends not only to producers of solutions but also those who are researching technology or providing services to the cryptographic authentication sector.

- **Advanced materials** is designed to cover a broad range of materials including those that can modify their appearance, detectability, traceability or identifiability within a range of 1.5e13 Hz up to and including ultraviolet, any advanced material alloys, mechanical alloying processes (i.e. solid state formation of alloys into forms), additive manufacturing or metamaterials (i.e. engineered materials) with the exception of fibre-reinforced plastics where the coating is applied at random or packaged device components intended for civil applications.

- The government will produce guidance on these new sectors and this will be welcomed by businesses, particularly on the definition of artificial intelligence, with so many companies now developing this. For transactions caught by the amended thresholds, notification will continue to be voluntary. Parties can choose to notify the transaction to the CMA or take the risk that the CMA or Secretary of State will decide to initiate an investigation up to four months after completion of the transaction (or completion of the transaction is made public, if later).

It is not expected that the amended thresholds will result in any material change to the CMA's approach to the assessment of mergers on competition grounds. However, they will increase the potential scope for the Secretary of State to intervene in mergers in the affected sectors under the public interest regime (given that the jurisdictional thresholds must usually be met in order for an intervention notice to be issued).[2] It is worth noting in this regard that public interest intervention notices have been issued in four cases on the basis of the lower jurisdictional thresholds previously introduced in June 2018 (all on national security grounds).[3]

WHAT DO THESE CHANGES MEAN FOR INVESTORS?

All investors currently engaged in or contemplating the acquisition of a UK company involved in the response to the pandemic, or active in the artificial intelligence, cryptographic authentication technology or advanced materials sectors, should carefully consider the potential implications of these amendments for their transaction.

Non-UK investors should be particularly mindful of the increased potential for intervention on public interest grounds. Whilst the amendments apply equally to acquisitions by both domestic and foreign investors, the tightening of the UK regime is in line with the global trend towards increased protectionism and enhanced scrutiny of foreign investment on broad national security grounds, which has been accelerated by the economic fall-out of the pandemic.

As already highlighted above, notification to the CMA remains voluntary, and the amendments are not expected to result in any material change to the CMA's approach to the assessment of mergers on competition grounds. However, where there is a material risk of intervention on public interest grounds, it is likely to be advisable to engage with the relevant authorities at an early stage, both by notifying the CMA of the proposed transaction and initiating informal discussions with relevant government departments. Possible mitigants should also be considered upfront – both behavioural and structural – alongside any potential impact on transaction structure (for example through the inclusion of domestic co-acquirers or a reduction in the level of control acquired).

HOW DOES THIS FIT IN WITH THE WIDER CHANGES EXPECTED IN THE NS&I BILL?

As noted above, the government press release announcing these amendments clearly stated that these changes are intended to "*mitigate risks in the short term*", ahead of the introduction of "*more comprehensive powers*" in the NS&I Bill.

It is unclear whether this means that the changes are intended to be temporary, pending the implementation of the new standalone regime to be set out in the NS&I Bill (although it is notable in this regard that the government has previously indicated that it intends to unwind the earlier June 2018 amendments to the jurisdictional thresholds once the new regime is implemented). It also remains to be seen how closely the NS&I Bill will follow the 2018 White Paper. The proposals set out therein envisaged a voluntary notification regime allowing companies to flag transactions potentially raising national security concerns, alongside a "call-in" power to enable the government to review non-notified transactions. The proposed framework had no target turnover or market share threshold, and was intended to be applicable across all sectors, subject to certain "core areas" being identified as being particularly likely to give rise to concerns (including parts of national infrastructure and certain advanced technologies). It will be important that the NS&I Bill continues to adopt a targeted approach, which will be welcomed by businesses.

NEXT STEPS

The government has stated that the statutory instrument adding the new public interest criterion will take effect from tomorrow, Tuesday 23 June 2020. However, the amendments to the jurisdictional thresholds in additional specified sectors will be debated in and approved by Parliament before entering into force.

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1. Either the target's UK turnover exceeds £70 million or, as a result of the transaction, the merged entity will supply or purchase 25% or more of goods or services of a particular description in the UK as a whole or in a substantial part of it (amended for companies involved in the development or production of items for military, or military and civilian, use, computing hardware, or quantum technology, such that the test is met if the target company has UK turnover of over £1 million or either party has an existing share of supply of at least 25%).

2. In certain limited circumstances, a "special public interest intervention notice" may be issued by the Secretary of State in relation to a merger which does not meet the jurisdictional thresholds of the EA02. However, this is currently limited to mergers involving government defence contractors and certain media mergers.

3. Gardner Aerospace/Northern Aerospace (cleared subject to undertakings), Connect BidCo/Inmarsat (cleared subject to undertakings); Gardner Aerospace/Impcross (ongoing); and Aerostar/Mettis Aerospace (abandoned in February 2020).

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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