

UK GOVERNMENT CONSULTS ON PROPOSALS TO EXPAND NATIONAL SECURITY REVIEW OF FOREIGN INVESTMENTS BEYOND CURRENT MERGER CONTROL REGIME

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Legal Briefings - By **Molly Herron, Senior Associate/Professional Support Lawyer**

On 17 October 2017 the Department for Business, Energy & Industrial Strategy (**BEIS**) published its long-awaited Green Paper *National Security and Infrastructure Investment Review* for consultation. The Green Paper contains proposals to extend the UK merger control public interest intervention regime, as first foreshadowed when the Government approved the Hinkley Point C new nuclear project over a year ago. BEIS proposes to extend the UK Government's powers to review transactions on national security grounds in two tranches.

In the short term, for transactions in the military/dual use sector and parts of the advanced technology sector it plans to reduce the UK turnover threshold for reviewable transactions from £70m to £1m, to enable national security review of acquisitions of smaller companies.

In the longer term, BEIS is proposing a more significant overhaul: the extension of the current national security regime to a wider category of transactions, regardless of sector, and/or the introduction of a new mandatory notification regime for transactions involving specified "essential functions" in key sectors (including civil nuclear, telecommunications, defence, energy and transport).

The BEIS proposals come against a backdrop of an increase in public interest intervention in the M&A process globally, spurred in part by high levels of outbound investment by Chinese companies. Whilst the Green Paper stresses that the UK is open to trade and foreign direct investment (**FDI**), the proposals clearly have at least the potential to deter FDI, in particular as a result of uncertainties about the scope of any new regime and the application of the substantive test. Much will depend on the design details of the regime under the second tranche of reforms (on which the Green Paper is relatively light) and how the test is applied in practice – in particular whether intervention is rigorously limited to genuine national security concerns, or whether this process allows other public interests to be introduced by the back door.

1, BACKGROUND

Current merger control regime

The Enterprise Act 2002 (**EA02**) largely removed politics from the UK merger control regime and, to date, the UK has not had a separate FDI screening regime. For transactions falling within the jurisdictional scope of the EA02 (where the target's UK turnover exceeds £70m and/or the transaction will create or enhance a share of supply in the UK of 25% or more), the vast majority of merger control decisions are taken by the Competition and Markets Authority (**CMA**) applying a pure competition test.

This is subject to a number of limited exceptions where the Secretary of State retains the power to intervene on specified public interest grounds (which can be expanded by statutory instrument). These grounds are currently national security, media plurality/accurate presentation of news, and maintenance of the stability of the UK financial system (added in order to clear the *Lloyds/HBOS* merger at the height of the financial crisis). None of these are specifically related to foreign investment. Intervention is possible only in relation to transactions which fall within the jurisdictional scope of the EA02, i.e. which meet the turnover or share of supply test, with the exception of certain defence and media mergers.

In relation to transactions falling within the jurisdictional scope of the EU Merger Regulation (**EUMR**), the scope for intervention is limited by Article 21 EUMR, which allows Member States to intervene to prohibit or impose conditions on such transactions to protect narrow legitimate interests only: public security, media plurality and prudential rules (further interests may be invoked, but only with the consent of the European Commission). Under the EA02 regime, ministers can intervene in EUMR cases only on the grounds of national security and media plurality.

Interventions under the existing regime have been relatively limited, although there are a number of recent examples, both on the grounds of national security (which led to the acceptance of undertakings in [Hytera/Sepura](#)) and media plurality (in the ongoing [21st Century Fox/Sky](#) review).

Both the prospect of release from the limitations of Article 21 EUMR and the EU law rules on free movement of capital and freedom of establishment as a result of impending Brexit, and wider trends in M&A across Europe and beyond, have prompted the UK Government to revisit its powers of intervention.

Changing M&A landscape

The BEIS proposals come against a backdrop of increased public interest intervention in the M&A process globally, including the recent proposals by the European Commission for a FDI screening framework following pressure from France, Germany and Italy (see our ebulletin [here](#)), the expansion of the German FDI regime, and the upswing in the intervention rate of the Committee on Foreign Investments in the US (**CFIUS**) (including most recently the blocking by President Trump of the bid by China-backed Canyon Bridge for Lattice Semiconductors), and of increased protectionist rhetoric in the US and beyond. This has resulted in part from high levels of outbound investment by Chinese companies, in particular acquisitions of key strategic technologies (such as the Midea/KUKA transaction and the abortive acquisition of Aixtron by Fujian Grand Chip).

Even before these most recent trends, disquiet had been raised in the UK about foreign takeovers of strategically important UK businesses, and their impact on employment, R&D and other national interests, but no concrete proposals for reform were put forward until 2016.

Just prior to becoming Prime Minister in July 2016, Theresa May referred to the attempted bid by Pfizer for AstraZeneca and the earlier takeover of Cadbury by Kraft and the need for a "proper industrial strategy" enabling Government to step in to defend key sectors. The intention to introduce wider national security controls on foreign investment in critical national infrastructure specifically (see our ebulletin [here](#)) was announced alongside the September 2016 approval for the Hinkley Point C new nuclear project (including China General Nuclear's stake), which was not subject to a formal review under EA02. This plan was repeated in the Conservative Party general election Manifesto in May 2017, together with high level proposals for reform in relation to public takeovers (see our article [here](#)).

The Takeover Panel launched a consultation in September 2017 on proposed changes to the Takeover Code in respect of statements of intention, timing, and post-offer undertakings (see [here](#)), and the detailed proposals in relation to national security have now finally been published within the Green Paper.

2. GREEN PAPER

The Green Paper (see [here](#)) stresses the benefits of FDI and that the UK is open to investment, but states that it is necessary to update the UK's arrangements for safeguarding national security, in line with other "developed and open economies" with national security screening procedures (citing regimes in the US, Canada, Australia and France). It flags the risk that ownership or control of critical businesses or infrastructure could provide opportunities to "undertake espionage, sabotage or exert inappropriate leverage", and states that foreign nationality is considered a risk factor when making assessments of the threat to national security.

Overall BEIS states that the UK's current approach to national security protection appears less developed than in other jurisdictions, and proposes short- and long-term steps to remedy this.

Proposed short term changes - military/dual use and advance technology sectors

BEIS proposes to amend the EA02 jurisdictional tests, which it considers are not appropriate for Government intervention in mergers on national security grounds, given that niche businesses with relatively low turnover can be involved in activities which raise national security risks.

It proposes to amend these tests to close the perceived "loophole" for transactions in:

- The military and dual-use sectors (by reference to products or technology on the Strategic Export Control Lists); and
- Parts of the "advanced technology" sector (namely businesses involved in multi-purpose computing hardware and quantum-based technology).

BEIS proposes that for transactions in these sectors:

- The UK turnover threshold be reduced to £1m; and
- The share of supply test will not require any aggregation (and therefore could be met if the target alone has a share of supply of 25% or more in the UK).

The proposed reforms do not distinguish between foreign and other acquirers (although in practice national security concerns may only arise in relation to the former), or make any changes to the level of ownership or control which triggers the EA02 regime (which covers both acquisition of control and the lesser "material influence" threshold).

Although driven by national security concerns, the proposed amendments will also apply to the CMA's powers of review on competition grounds, and therefore will significantly extend its jurisdiction in these sectors. While the UK merger control regime is voluntary and merging parties are not obliged to make a notification, given the CMA's powers to review unnotified mergers (and impose stringent "hold separate" requirements while it investigates) this change may well lead to a significant increase in notifications to the CMA in these sectors, even in relation to transactions that do not raise competition (or national security) concerns, by parties keen to ensure legal certainty.

BEIS states that the Government would publish guidance on its approach to public interest review in the sectors, and that it would engage with any business wishing to discuss whether a proposed or actual merger might raise national security issues.

The consultation on these proposals closes on 14 November 2017.

Proposed longer term reform - options for wider national security review

BEIS canvasses a number of different options for a more significant overhaul of the regime, which it states could be adopted alone or combined as a package. It seeks views on how best to achieve "targeted and proportionate" reforms, given the merits and demerits of voluntary versus mandatory systems in terms of burdens on business, transparency and legal certainty, and the potential for gaps in the Government's awareness of potentially relevant transactions.

The consultation on these proposals closes on 9 January 2018.

Option 1: voluntary notification regime and "call-in" power

Under this option the EA02 regime would be retained in terms of structure, allowing the Secretary of State to intervene in qualifying transactions (within a specified time window), whether notified to the CMA or not, on national security grounds. However, the range of transactions susceptible to national security interventions (as opposed to competition review) would be expanded beyond those currently covered.

The Green Paper is not precise on this point, but it appears that the intention is to extend the concept of qualifying transactions for national security review to:

- Acquisitions which would not qualify as a "merger" under the current EA02 regime, for

example acquisitions which do not involve the acquisition of control or material influence over a business, but do involve the acquisition of control or "significant influence" (as to which it is not entirely clear whether this would be defined by reference only to a 25% stake or more widely) over a business or assets in the UK (for example an investor obtaining unrestricted access to sensitive sites or data), potentially extending to bare assets and greenfield projects; and

- Transactions which do not meet the EA02 turnover or share of supply jurisdictional tests (it is not clear whether any alternative jurisdictional test is envisaged - as under the short term reforms - or whether this will be truly unlimited).

The proposed reforms under this option do not distinguish between foreign and other acquirers (although in practice national security concerns may only arise in relation to the former), and are not limited to specific sectors.

BEIS states that the Government could provide informal advice to businesses about whether it has national security concerns in particular cases.

Option 2: mandatory notification regime for "essential functions" in "key sectors"

Under this option a mandatory notification regime would be introduced under which prior approval would need to be obtained from the UK Government before a qualifying transaction (defined as under Option 1) could be completed, and sanctions could be imposed for failure to comply.

Such a review would apply only to companies which undertake specified "essential functions" (a proposed list of which is annexed to the Green Paper, for example civil nuclear fuel production, the operation of broadcast infrastructure that carry national radio or television services, upstream oil and gas infrastructure of a specified size, and power generation above a specified capacity), within specified key sectors. Key sectors would include civil nuclear, defence, energy, telecommunications and transport (together with military and dual-use items and advanced technology), and potentially also the government and emergency services sectors (and would be extendable by secondary legislation). BEIS is also considering whether specified individual businesses/assets which do not fall within those functions/sectors, and certain acquisitions of land, which nevertheless raise potential national security concerns, should also be specifically covered.

It appears that such a regime would apply only to the acquisition of foreign ownership or control.

Design details

The Green Paper provides relatively little detail on how such a new regime would operate, for example in terms of notification procedures, timing, or which departments or agencies would be involved, other than to state that the Government would aim to set out a "clear, short timeframe" within which investors would receive a decision and that an effective mechanism for judicial review of the Secretary of State's decision would be available. It does make it clear that the Government would have the power to impose conditions on a deal or ultimately block it (and to unwind transactions implemented without approval).

BEIS states that it wishes to retain the independence of the CMA and maintain a clear separation between competition and national security assessments, which is to be welcomed (although the extent to which the expanded security review would sit within current EA02 processes is not entirely clear).

No further detail is provided on the substantive grounds for intervention, i.e. whether national security would be interpreted as under the current regime or more widely, although the Green Paper does state more generally that the focus is firmly on national security review and would not be used for protectionist purposes.

BEIS indicates that the Government would publish the outcomes of its reviews, in the interest of transparency and clarity, except where to do so would harm national security or other public interests.

Other measures

In relation to national security, the Green Paper notes that the Government will also implement reforms to require companies in the civil nuclear sector to inform the Office for Nuclear Regulation about specified changes in ownership. The Green Paper also states that where the UK Government provides public funding to companies, for example in respect of R&D, it will include change of control provisions in funding agreements allowing it to claw back funding in certain circumstances.

3. IMPACT

The Green Paper emphasises the UK's openness and commitment to investment and to FDI in particular, and that any changes will be limited to necessary and proportionate steps to safeguard national security. It recognises the need for new rules to be transparent and to provide as much clarity and certainty to investors as possible. BEIS is also careful to draw a distinction between screening to prevent national security threats and screening to control market access for protectionist reasons.

However, whether these aims are met, and whether there is an impact on investment activity, depends in large part on the design details of any new regime. Whilst the short term steps are relatively clear in scope, many aspects of the longer term proposals lack clarity at this stage (in particular precisely which transactions will fall in the scope of the new regime), and therefore give rise to real concerns about legal certainty. This is in addition to potential concerns about the prospect of dual competition and national security review, and the impact on deal costs and timetables arising from this. Despite the Government's assurances, wider questions will also remain about the predictability and consistency of a more extensive national security review process, and the risk of protectionism or other political motivations (such as those highlighted by Theresa May in July 2016) entering the process by the back door. The outcome of the consultation will therefore be hotly anticipated.

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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