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UK to introduce foreign investment rules for critical infrastructure

The UK Government will significantly reform its approach to the ownership and control of critical infrastructure to ensure that the national security implications of foreign ownership are scrutinised. This will include a review of the public interest regime in the Enterprise Act 2002 and the introduction of a national security requirement for the continuing Government approval of the ownership and control of critical infrastructure.

The fall-out from Brexit continues

Following the EU referendum vote, Theresa May suggested that the UK should pass legislation giving the Government greater powers to block or impose conditions on mergers on public interest grounds unrelated to competition. The Government has now announced plans to introduce new foreign ownership rules in the infrastructure sector.

The announcement was made in the context of the Government's decision to proceed with measures to support the construction of the new nuclear power station at Hinkley Point C (HPC).

The HPC plant will be constructed by EDF together with its partner, China General Nuclear (CGN). The strategic partnership between EDF and CGN, which also covers two further nuclear power stations, Sizewell C and Bradwell B, was announced by the previous UK Prime Minister, David Cameron, and Chinese President Xi Jinping in October 2015.

In the aftermath of the UK referendum vote, the new Prime Minister Theresa May announced a review of the project. The Government has now decided to proceed with the project on the basis of confirmation that the Government will be able to prevent the sale of EDF's controlling stake prior to the completion of construction, without the prior notification and agreement of ministers.

By the time the HPC plant is operational, the Government plans to have a new foreign investment regime in place, under the Enterprise Act 2002, which would provide the Government with the powers to intervene in the sale of EDF's stake.

Specifically in relation to future new nuclear power stations, there will also be special share arrangements and new requirements will be introduced to require developers or operators of nuclear sites to provide notice of changes of ownership to the Office for Nuclear Regulation (ONR).

These new arrangements appear to place multiple overlapping approval requirements on developers of new nuclear power stations. The implications for other types of critical

Key issues

- The Government plans to review the public interest regime under the Enterprise Act 2002
- This allows the Secretary of State to intervene in mergers on certain specified public interest grounds.
- In future these grounds will be expanded to include national security in relation to critical infrastructure
- Apart from nuclear power stations, it is unclear what infrastructure will be covered and which countries will give rise to national security issues
- The new rules will need to comply with EU and WTO rules, as well as any trade agreements which the UK may enter into in future
- A formal consultation on the proposed changes is expected in early 2017.

infrastructure are as yet unclear.

Dawn of a new industrial strategy?

The UK Government has stated that the planned changes will bring the UK's rules on the ownership and control of critical infrastructure into line with other major economies.

It is not yet clear how far ranging the changes will be in practice. The Government already has the power to intervene in merger cases on national security grounds, however, this power has to date only been used in mergers involving defence companies. The Government has golden shares in a number of companies active in the nuclear, defence and infrastructure sectors.

It is also unclear whether the new arrangements will be limited to national security issues. The new Prime Minister has previously suggested that the UK should have a "clear industrial strategy" which would not automatically stop the sale of British firms to foreign ones, but would provide the UK Government with powers to step in to "defend a sector" that is strategically important to the UK.

An expansion of foreign investment rules beyond national security issues would be a significant departure from current merger policy, creating uncertainty for business and potential conflict with EU law.

At the EU level, the European Commission assesses mergers solely on competition grounds and has consistently rejected calls for it to take account of industrial policy or other non-competition considerations. While the Commission has carefully scrutinised Chinese investments in the EU, including the CGN / EDF strategic partnership, this has been done on the basis of competition considerations.

This approach has been strongly supported by the UK Competition and Markets Authority (CMA), which has argued that the foundations of a sound merger control regime consist of a rules-based system that:

- provides legal certainty,
- limits itself to minimal, economically justified distortions, and
- inspires business confidence.

Existing powers to intervene in mergers

The UK Government already has powers to intervene in mergers on specified public interest grounds. The Government has also maintained special shares in a number of companies.

Intervention notices under the Enterprise Act 2002

The Secretary of State (SoS) has the power under the Enterprise Act 2002 to issue an intervention notice in cases raising certain specified public interest issues, namely,

- national security
- newspaper public interest issues (e.g. plurality)
- broadcasting and cross-media public interest issues
- the stability of the UK financial system.

To date the SoS has issued:

- six intervention notices based on national security grounds[1]
- three intervention notices on media plurality grounds[2] and
- one intervention notice in the interest of maintaining the stability of the UK financial system.[3]

The majority of intervention notices in public interest cases have, therefore, been issued in respect of national security considerations. In most of these cases, the SoS was advised by the Ministry of Defence and the acquirer was required to give undertakings to maintain the UK's strategic capabilities in certain areas and to protect classified information and the intellectual property rights of the Ministry of Defence.

There is also a foreign ownership component to the media public interest test. The SoS has previously reserved the right to intervene in cases where media ownership rules were removed by the Communications Act 2003. These include mergers involving owners from outside the EEA. To date, these rules have not been used.

The SoS has the power to add new public interest considerations to the list by order. For example, in the context of the proposed acquisition of AstraZeneca by Pfizer in May 2014, the Government explored whether the public interest grounds could be expanded to include the impact on

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[1] Alvis Plc/General Dynamics Corporation. 2004, Finmeccanica/AgustaWestland 2004, Finmeccania/ BAE Systems 2005, Lockheed Martin UK Holdings Limited/Insys Group Limited 2005, General Electric/Smiths Aerospace Division 2007, and Atlas Elektronik/QinetiQ 2009

[2] BSkyB/ITV 2007, Global/GMG Radio 2012, Newscorp/BskyB 2010

[3] Lloyds/HBOS, 2008

research and development in the UK. Ultimately no decision was taken, as the transaction did not proceed.

It is likely that the Government will implement the new rules on foreign ownership of critical infrastructure through an expansion of the public interest considerations under the Enterprise Act 2002. It is, as yet unclear how the new public interest test will be defined and which government department will advise the SoS on national security issues in relation to critical infrastructure.

The UK Government has in the past been reluctant to issue guidance on how it will assess national security concerns. This is likely to be a particularly sensitive issue, given the Government's desire to enter into new trade agreements with countries outside the EU.

The Industry Act 1975 – relic of a bygone era?

In addition, the SoS also has the power under the Industry Act 1975 to make an order prohibiting a change of control of an important manufacturing undertaking where it would be contrary to the interests of the UK. A prohibition order takes effect immediately but expires after 28 days unless subsequently approved by a resolution of both houses of Parliament.

While this power was introduced by the Wilson Government at a time when the UK sought to pursue an active industrial strategy, it has never been relied upon to block an acquisition of a UK business.

Recent reforms to the Takeover Code

Following recent reforms to the Takeover Code, bidders in public transactions have the ability to give binding undertakings or to make statements of intention to address potential public interest concerns.

Bidders may give post-offer undertakings, which are commitments to take (or not take) certain action in a specified period of time given under Rule 19.7 of the Takeover Code. Alternatively bidders may make post-offer intention statements, which specify actions that the party intends to take (or not take) under Rule 19.8 of the Takeover Code.

These provisions have been used to address potential public interest concerns arising from the Softbank acquisition of ARM Holdings, the first major foreign takeover transaction since the Brexit referendum.

In July 2016, Softbank announced its intention to acquire ARM Holdings by way of a scheme of arrangement. Under the terms of that scheme, Softbank made post-offer undertakings to:

- double the total number of UK employees within 5 years;
- increase the total number of non-UK employees within 5 years;
- maintain ARM's global headquarters in Cambridge; and
- maintain the number of technical and non-technical employees.

In addition, Softbank made a number of statements as to its post-offer intentions. The Softbank bid has been welcomed by the Government on this basis.

Golden share arrangements

A golden share is commonly a single special rights redeemable preference share in a company held by a government minister, whose consent is required for, among other things, material disposals, share issues or a voluntary winding-up. In addition to the nuclear power sector, golden shares are held by the UK Government in a small number of companies active in the defence or infrastructure sectors, such as BAE, Rolls-Royce and NATS.

The EU Courts have considered golden shares to be: (i) a restriction on the principle of free movement of capital; and (ii) justifiable only on the grounds of public security or public policy (such as continuity of supply of services in the public interest or strategic services), or overriding requirements relating to the general interest. A golden share will not be considered to be justified unless it is a proportionate way to protect the relevant interest and the measures prescribed are based on precise criteria which are known in advance, are open to review by the Courts and cannot be attained by less restrictive measures.

A potential source of conflict with the EU?

Given the powers already available to the SoS to intervene in foreign takeovers and the historical reluctance of the UK Government to exercise these powers, a real question is whether the announcement heralds a shift in government policy towards foreign investment.

The Government has been at pains to point out that "the UK will remain one of the most open economies in the world" but has sought to provide reassurance to the public that foreign direct investment "works in the country's best interests". It is, as yet unclear how this will be objectively assessed.

While the UK remains part of the EU, foreign investors will be able to take a

significant degree of comfort from the fact that EU law restricts the UK's ability to limit free movement of capital and foreign direct investment, both from other EU countries, but also countries outside the EU.

However, while EU law imposes significant constraints on the ability of EU member states to adopt foreign investment rules, it does not preclude it.

In particular, EU member states may adopt and maintain such rules provided that they do not:

- impinge on the EU's exclusive competence in the areas of foreign direct investment and competition or
- contravene the rules on freedom of establishment or free movement of capital.

In addition, such rules may not be applied in a manner which would infringe the Treaties or, where it applies, the EU Merger Regulation.

As such, there are a number of EU countries (e.g. Germany, France, Austria and Italy) which have specific rules governing foreign investment, particularly in cases related to national security.

The impact of future trade agreements?

In introducing new foreign investment rules the UK Government will need to consider WTO rules and other international treaties which apply to the UK, such as the Energy Charter Treaty and bilateral investment treaties. It will also need to consider the likely terms of any future trade agreements (FTAs) it enters into with the EU and other countries.

While there is currently no multilateral agreement on competition in the WTO and merger control rules are only dealt with briefly (if at all) in most FTAs, there are a range of other provisions which limit the ability of governments to discriminate against foreign investors.

For example, market access commitments in FTAs will typically cover the rights of businesses to establish a presence in the other country. These commitments are, however, generally limited in scope.

Commitments on establishment may (depending on the FTA) include:

- the removal of certain limitations on the participation of foreign capital,
- the right to establish or expand a commercial presence within the territory of the other party, including through the acquisition of existing enterprises,
- national treatment obligations for establishments and investors.

These obligations generally apply to specific sectors and are subject to qualifications. Under the proposed EU-Canada trade agreement, for example, Canada will continue to apply its foreign investment rules to EU investors, albeit with more relaxed thresholds.

Modern FTAs contain investment protection provisions which provide additional protection to investors, particularly where they are accompanied by provisions for investor-state dispute settlement.

In addition to provisions on expropriation, investment protection provisions may restrict the ability of a government to adopt measures which require, directly or indirectly an investor of the other party, by reason of nationality, to sell or otherwise dispose of an investment existing at the time the measure or series of measures become effective.

The UK Government will, therefore, be expected to offer investment protection provisions in the FTAs it negotiates following the UK exit from the EU. As such, the Government's aim of becoming a "global leader in free trade" will place important limits on its ability to control foreign direct investment coming into the UK.

Conclusions

Given the broad range of powers already available to the UK Government and the sparing use of such powers, it is unclear whether this announcement marks a major change in UK government policy on foreign ownership. Further details will become available when the Government publishes its review of the public interest regime in the Enterprise Act 2002. We understand that a formal consultation on the proposed changes is expected in early 2017.

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