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# UK REVIEWS NATIONAL SECURITY IMPACT OF FOREIGN INVESTMENT

— THOUGHT LEADERSHIP

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# UK REVIEWS NATIONAL SECURITY IMPACT OF FOREIGN INVESTMENT

The UK Government has published proposals to strengthen its powers to review, and potentially block or unwind, investments on national security grounds. Short term proposals include amending the thresholds of the existing public interest regime to catch a broader range of investments in the military and dual use sector and the advanced technology sector. These could affect transactions that are currently under contemplation. In the longer term, the Government is considering the introduction of a more extensive regime for screening transactions for national security issues. Options include powers to "call in" a wide range of foreign investments (including new projects and acquisitions of bare assets) for screening and/or a mandatory notification regime for foreign investment in certain key sectors such as nuclear, defence, energy, transport and telecoms.

## Key issues

- Imminent powers to conduct national security reviews of deals in the military/dual use and tech sectors. These could affect current deals.
- Longer term plans to introduce much broader powers to call in deals for national security screening and/or to require mandatory filing.
- Proposals would affect M&A, new projects and bare asset purchases in sectors such as nuclear, defence, energy, transport and communications.

## Emerging Government Thinking

On 17 October 2017, the Business and Energy Secretary, Greg Clark, announced proposals to enable the UK Government to intervene in mergers that raise national security concerns, even when they involve smaller businesses. Proposals to control foreign investment in critical infrastructure were first announced in September 2016, following the decision to proceed with the Hinkley Point C nuclear project. However, other than nuclear facilities, it was unclear what infrastructure would be regarded as critical.

The green paper now clarifies that the Government proposes to introduce new measures in the short term for companies that design or manufacture military and dual use products, and parts of the advanced technology sector, where the target has sales of £1 million or more in the UK or will have a share of 25% or more of the supply of the relevant products in any UK market.

The draft secondary legislation to implement this change has not been published. Instead, the Government has asked interested parties for views on the proposal and suggestions for the precise form of words to define these new powers by 14 November 2017. The green paper states that the Government intends to "press ahead with the specific amendments needed immediately after consultation", so transactions currently being planned could be affected.

In the longer term, the regime will also cover other sectors including telecommunications and broadcasting infrastructure, the wider (non-nuclear) energy sector, major airports and ports, air traffic control and certain services provided to the government and emergency services. While detailed proposals will be set out in a white paper to be published in 2018, the Government at this stage is seeking views on two broad options, which could be implemented alone or in combination:

- A voluntary notification regime with expanded powers for the Government to 'call in' transactions which may give rise to national security concerns; and/or
- A mandatory notification regime for foreign investment in certain key industries, including communications and broadcasting infrastructure, the energy sector, major airports and ports, air traffic control, emergency services and certain services provided to the government.

The deadline for responses on the longer term reforms is 9 January 2018.

## Potential National Security Concerns

The green paper for the first time identifies the national security concerns which the Government considers may arise from ownership or control of critical national infrastructure or advanced technology companies, as follows:

- increased access (to businesses, physical assets, people, operations or data) and ability to undertake espionage;
- greater opportunity to undertake disruptive or destructive actions or an increase in the impact of such action; and
- the ability to exploit an investment to dictate or alter services or to utilise ownership or control as inappropriate leverage in other negotiations.

While such risks may be more self-evident when dealing with governments or state owned entities, the green paper suggests that the foreign nationality of private investors may, of itself, be a risk factor due to divided loyalties (even in cases of dual nationality) or the risk of coercion by a hostile state. While no indication is provided as to the nationalities which will give rise to concerns, account will need to be taken of the UK's obligations under EU and international treaties. The green paper acknowledges that investors from countries which have a free trade agreement covering the UK may receive less scrutiny.

The green paper suggests that the risk of espionage may be increased where a single investor has multiple areas of investment or ownership across a sector or across various sectors or supply chains. The ownership or control of land which is close to a national infrastructure site may also give rise to 'proximity risk'.

## National Security and the Current UK Merger Regime

The key powers provided to the Government to intervene in mergers that may give rise to national security concerns are set out in the Enterprise Act 2002, which also establishes the UK's merger control regime. The merger regime is based on voluntary notifications, with the power for the Competition and Markets Authority (CMA) to 'call-in' transactions which meet certain thresholds.

Under the current merger regime, ministers may intervene on national security (including public security) grounds where the transaction meets the thresholds under the EU Merger Regulation or the UK merger regime. The thresholds under the UK merger regime are met if: (i) the UK turnover of the business being acquired exceeds £70 million; or (ii) the transaction results in the creation of, or increase in, a 25% or more combined share of sales or purchases in (or in a substantial part of) the UK, of goods or services of a particular description.

If these thresholds are not met, ministers may only intervene in relation to transactions where one of the parties is a defence contractor and carries on business in the UK or does so by or under the control of a UK company.

There have been 7 public interest interventions on national security grounds in the 15 years since the Enterprise Act 2002 was adopted, the most recent of which was decided in May 2017. All of these cases have involved acquisitions by foreign investors of businesses that supplied systems or equipment to the defence forces or emergency services and all were resolved in Phase 1 by the acquirer giving undertakings to maintain the UK's strategic capabilities in certain areas and to protect sensitive information and technology.

While the powers to intervene on national security grounds have been rarely used, the green paper identifies the following specific concerns with the current regime:

- most small businesses are not covered;
- new projects (e.g. new build nuclear power stations) are not covered;
- transactions involving the sale of bare assets that do not amount to a business (e.g. machinery, land or intellectual property rights (IPR)) are not covered; and

- the voluntary notification regime and call-in powers may be insufficient or create uncertainty for business.

## Short Term Reform Proposals

In the short term, the Government has identified two sectors where acquisitions of small companies may give rise to national security concerns and should therefore be subject to lower thresholds for review: (i) the military and dual use sector (other than defence contractors); and (ii) parts of the advanced technology sector.

### Companies in the military and dual use sector

The Government is concerned that small businesses which have niche activities or produce highly specialised products for military or dual use increasingly hold information or items which carry significant national security risks. The green paper therefore proposes to extend the special intervention regime to enterprises that design or manufacture items or hold related software and technology specified on the UK Military List, UK Dual-Use List, UK Radioactive Source List and EU Dual-Use Lists. Future updates to these lists, as well as technology and software subject to temporary export controls, may also be covered.

### Companies in the advanced technology sector

With an increasing focus on cybersecurity, the Government is also proposing to apply revised thresholds to enterprises that:

- own or create IPR in the "functional capability of multi-purpose computing hardware";
- design, maintain or support the secure provisioning or management of "roots of trust" of such hardware (i.e. system components that are inherently trusted and ensure integrity of hardware, software and data); or
- research, develop, design or manufacture goods for use in, or supply services based on, quantum computing or quantum communications technologies (including IP or components).

### Lower thresholds

It is proposed that acquisitions of target companies active in these sectors would become reviewable where either:

- the target has total sales of £1 million or more in the UK (seemingly of any products or services, not just those relating to military, dual use and advanced technology), in contrast to the £70 million turnover threshold that currently applies; or
- the target will have a share of the supply of the relevant products in a UK market of 25% or more. Unlike the share of supply threshold that currently applies, this test could be met even if the transaction does not result in any increase in market share, i.e. even if the purchaser is not active in the relevant market.

However, the green paper does not refer to any explicit requirement that the target business must carry on business in the UK or do so by or under the control of a UK company. It is therefore unclear at this stage whether the Government intends to assert jurisdiction over acquisitions of overseas businesses that export products or licence IPR to UK customers without having any physical presence or assets in the UK.

Moreover, while the green paper stresses that the Government's objectives in amending the thresholds relate solely to dealing with national security-related issues, it envisages that such transactions will nevertheless be subjected to a review on competition grounds (in the same way as for mergers meeting the current, higher thresholds) in addition to the national security vetting process. The rationale for this is unclear, given that the Government's impact assessment of the proposals considers it unlikely that any mergers caught by the lower thresholds would give rise to competition concerns.

### Investment vetting process

At this stage, there will be no mandatory filing requirement for transactions which meet the new jurisdictional thresholds. Accordingly, if the parties consider that

the merger is unlikely to raise the possibility of competition or public interest concerns they can choose not to notify the CMA and to accept the risk that the CMA and/or the Government calls in the transaction and takes a different view. The Government proposes to publish further guidance on the national security rationale for the new thresholds as well as on the process for reviewing transactions. However, the green paper states that national security assessments will remain confidential.

This highlights one of the key issues for business, which is that while notifications are made to the CMA, national security concerns may be raised by any part of Government. Business will want to understand these potential concerns in advance, particularly in the case of public takeovers. The green paper does not adequately address the need for confidential guidance to be provided at an early stage to parties considering a potential transaction.

The short term reforms are being fast-tracked and could therefore affect transactions that are currently being planned. Businesses and investors who wish to engage with the Government about transactions that may have a national security dimension are advised to contact the department that has responsibility for their sector. The Government has established an email address (publicinterestandmergers@beis.gov.uk) to which parties can send queries if the appropriate contact or department to contact is unclear. No phone number is provided for urgent queries, nor any guidance as to confidential treatment of queries or timeliness of responses.

In assessing transactions, the Government has established a cross-Government forum, known as the Investment Security Group, which will bring together relevant departments and agencies to consider the implications of foreign investment for national security and ensure that Ministers are provided with timely advice on such investment, as required. While the forum will be chaired by the Deputy National Security Adviser, it is currently unclear what role and resources the Cabinet Office National Security Secretariat will have to ensure that advice on transactions is provided in a timely manner.

## Options for Long Term Reform

In the longer term, the Government is considering two options for the introduction of a more comprehensive regime for screening foreign investments:

- an expanded version of the voluntary filing regime under the Enterprise Act 2002, to allow Government to "call in" and scrutinise a broader range of transactions for national security concerns, including new projects and bare asset sales; and/or
- a mandatory notification regime for foreign investment into the provision of a focused set of 'essential functions' in key parts of the economy, for example the civil nuclear and defence sectors. Mandatory notification could also be required for foreign investment in key new projects, certain real estate and/or specific businesses or assets.

The green paper explains that these options are not mutually exclusive and that the final package of reforms could include some or all of these measures. So, for example, the Government might decide that transactions in certain sectors or of certain types could be subject to mandatory filing, while others would come within the extended voluntary regime.

### Expanded voluntary regime

Under this option, the Secretary of State would be able to make a special "national security intervention" in respect of a broader range of transactions than is currently possible under the Enterprise Act, including the following:

- Acquisitions of "significant influence or control" over a UK business entity. Such acquisition could be by any investor, domestic or foreign, although the green paper hints that, in line with past

practice, domestic investors would be unlikely to be called in for review. The Government is minded to define the test for significant influence or control as satisfied by the acquisition of either: (i) more than 25% of a company's shares or votes; or (ii) less than 25%, but with other means of exercising such control. The scope of these "other means" would be clarified in Government guidance and would reflect issues specific to national security and national infrastructure, such as access to sensitive sites or data. In particular, it appears that this control test would be different to – and possibly broader than – the test for "material influence" which determines whether there is jurisdiction under the Enterprise Act to review transactions on competition grounds. Consequently, it may be that relatively small levels of non-controlling interests could be caught.

- New projects, in particular, developments and other business activities that are not yet functioning businesses but can reasonably be expected to have future activities that may affect national security interests.
- Sales of bare assets (i.e. assets such as machinery or intellectual property transferred without the other elements of a stand-alone business).

If not voluntarily notified, such transactions could be "called in" for review by the Secretary of State within a certain period (envisaged to be three months) if he or she believes that the transaction raises national security risks. The national security review would be a separate process to any review on competition or other public interest grounds. The green paper does not appear to envisage any turnover or market share thresholds, such that a very wide range of transactions would become potentially reviewable.

### Mandatory filing regime

Under this option, there would be a mandatory filing requirement for acquisitions by foreign investors of significant influence or control (as described above) over businesses with certain "essential functions" in key sectors. The table overleaf summarises the key functions that the Government is considering for inclusion in the mandatory screening regime. The Government is minded to exclude from any mandatory filing regime activities in a number of other sectors – such as chemicals, financial services, food, health, space and water – on the basis that existing regulatory regimes or the presence of strong competition already offer adequate safeguards against national security risks.

The green paper does not appear to envisage any turnover or market share thresholds: if the target operates or provides infrastructure, goods or services that meet the relevant criteria, any foreign investment conferring significant influence or control would be notifiable. Standstill obligations would apply to prevent completion or implementation of such a transaction prior to Government clearance, with civil and/or criminal penalties for breach of such obligations. The green paper does not indicate how long the screening process would take, other than to indicate that most transactions would be expected to receive rapid approval.

**Activities for which foreign investment may trigger mandatory filing requirements**

| Sector | Business activities |
|---|---|
| **Civil nuclear** | Operation of electricity generation reactors; nuclear fuel production; reprocessing, waste storage, disposal or transportation of certain nuclear material; and decommissioning and clean-up of nuclear facilities. |
| **Communications** | Provision of large voice or data communications networks; large internet exchange points; UK country code Top Level Domain (ccTLD) registry and associated name servers; emergency services networks; radio or television broadcast infrastructure; satellite infrastructure required for "safety of life" communications; and submarine communications cables. |
| **Advanced technology** | Own or creation of IPR in the "functional capability of multi-purpose computing hardware"; design, maintain or support the secure provisioning or management of "roots of trust" of such hardware; or research, develop, design or manufacture goods, services or IPR for use in/based on, quantum computing or quantum communications technologies. |
| **Defence** | Companies with facilities on "List X" (i.e. holding very sensitive information) and/or issued with a "Security Aspects Letter"; or design or manufacture items or hold related software and technology specified on the UK Military List, UK Dual-Use List, UK Radioactive Source List and EU Dual-Use Lists. |
| **Energy** | Large upstream infrastructure for production, transport, storage or processing of oil or gas; gas and electricity distribution and transportation networks and interconnectors; gas storage facilities and reception (including certain LNG terminals); large scale power generation; large energy suppliers; large scale supply of petroleum based fuels through import, storage, production, refining, blending, or distribution to storage or retail sites of crude oil, intermediates, components or finished fuels. |
| **Transport** | Ownership or operation of significant harbour authorities; operation of dominant airports; and provision of air traffic control services. |
| **Emergency services** | Provision of emergency services, control room services or main national IT systems to enable police operations. |
| **Government** | Provision of resilient, secure means to oversee co-ordination of response in times of emergency, provide for UK national security, Defence support and continued functioning of the state including protection of UK citizens. |
| **Real estate** | Land in proximity to a national security-sensitive site, where foreign ownership or control could give rise to national security risks (e.g. espionage or sabotage). |
| **Individual businesses or assets** | Government would have the power to specify individual businesses or assets not active in the above areas for inclusion in the mandatory screening regime, e.g. where they supply critical goods/ services to national infrastructure firms. |

## Comment

The green paper emphasises that the Government intends for the UK to remain amongst the most open economies to foreign investment and that its proposals have been designed with the sole aim of addressing legitimate national security concerns. This focus on defined national security issues, coupled with the possibility of judicial review of decisions to block, unwind or impose remedies on a transaction, suggests that the regime should not become a Trojan horse for other considerations to be taken into account, such as protectionism of national champions or a merger's impact on employment.

The green paper also emphasises the Government's intention to implement only those reforms that are necessary and proportionate to protect national security. However, it is questionable whether a mandatory filing regime would be consistent with that aim. The green paper cites the need for business certainty as the main potential advantage of such a regime. However, business certainty can also be obtained under a voluntary filing regime, if desired, by choosing to make a filing. It is clear from the favourable attitude of businesses to the UK's voluntary merger control regime that they value this choice, as it allows for the costs and delays of filing to be avoided if competition or public interest concerns are unlikely to arise, or if it is agreed that the purchaser will assume the risk that remedies are imposed to address any such concerns. The same would be true for a national security screening regime. Mandatory notification would impose filing burdens on a relatively large number of transactions, the great majority of which would (as the green paper acknowledges) pose no national security issues at all. The Government estimates that a mandatory regime would catch up to 100 transactions per year: almost double the number of transactions per year that are reviewed on competition grounds under the voluntary merger control regime.

The other potential justification for a mandatory regime – that the Government might not find out about relevant transactions – looks similarly weak. The CMA's merger intelligence unit has a strong track record of identifying relevant transactions for review on competition grounds, and the list of activities that the Government proposes to subject to mandatory filing suggests that relevant businesses and transactions should be easily identifiable. In the US, the Committee for Foreign Investment in the US (CFIUS) has operated an effective voluntary filing regime for many years, which recently led to the blocking of the acquisition of Lattice Semiconductor Corp. (a microchip maker) by Chinese-backed private equity firm Canyon Bridge (see our September 2017 briefing).

If a mandatory regime can be avoided, it is likely that relatively few transactions would be affected by these proposals, despite the (excessively) broad range of sectors and activities potentially affected. However, to ensure that adverse impacts on businesses and foreign investment are mimimised, it will be necessary to develop clear and sensible rules to determine the scope of transactions covered and the relevant review procedures and timing.

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