NEW UK THRESHOLDS FOR NATIONAL SECURITY REVIEWS OF MERGERS

For transactions that close on or after 11 June 2018, new, lower thresholds apply to determine whether the UK Government can call them in for a national security review. The new thresholds apply only to deals involving targets with certain activities involving intellectual property or roots of trust relating to computer processing units (CPUs), military or dual use products, or quantum technologies.

Key issues

- What are the new thresholds?
- Which transactions are subject to the new thresholds?
- When might a deal be called in for a national security review?
- Is the assessment limited to national security issues?
- Are foreign-to-foreign transactions caught?
- How can businesses obtain legal certainty?
- What other developments are on the horizon?

What are the new thresholds?

The new thresholds are met if the target has certain "relevant activities" (see below) and also has either:

- a share of the supply in the UK of the relevant products or services (see table below for a list of the these) of 25% or more. Unlike the generally-applicable thresholds, this test will be met even if the purchaser has no overlapping activities in the UK; or
- turnover in the UK of £1 million or more - in any products or services, not just those listed below. This is significantly lower than the £70 million threshold that will continue to apply to all other transactions.

In line with the UK's merger control regime, there is no obligation to notify transactions meeting these thresholds and there is no automatic prohibition on closing or otherwise implementing the transaction prior to clearance. Rather, the thresholds determine whether the Government can "call in" the transaction for a review on national security grounds, and either prohibit the transaction or require remedies to address any national security concerns that it identifies. Completed mergers that are called in for review are routinely subject to interim hold separate orders requiring the independent operation of the target.

Which transactions are subject to the new thresholds?

Only acquisitions of targets with any of the following "relevant activities" are subject to the new thresholds:

- Military / dual use: (i) developing or producing "restricted goods", i.e. goods, software or information specified in Schedules 2 and 3 to the Export Control Order 2008, the Schedule to the Export of Radioactive Sources (Control) Order 2006 or Annex I to Regulation (EC) 428/2009, but excluding items which are prohibited from being exported or transferred to one country only; or (ii) holding information (e.g. in software, blueprints,

manuals, diagrams and designs) that can be used in connection with the development or production of restricted goods and is responsible for achieving or exceeding the performance levels, characteristics or functions of the restricted goods that are specified in the legislation referred to above.

- CPUs: (i) owning, creating or supplying IP (including know how) relating to the functional capability of CPUs, the instruction set architecture for such units or computer code that provides low level control for such units; or (ii) designing, maintaining or providing support for the secure provisioning or management of roots of trust of CPUs, or computer code that provides low level control for such units. "Roots of trust" means hardware, firmware, or software components that are inherently trusted to perform critical security functions (e.g. cryptographic key material that can identify a "bound" device or verify a digital signature to authenticate a remote entity).
- Quantum technologies: research into the following technologies: quantum computing, simulation, imaging, sensing, timing, navigation, communications or resistant cryptography (the legislation includes definitions of each of these technologies), as well as developing or producing anything designed for use in such technologies or supplying services employing such technologies.

For transactions involving targets with no relevant activities, the generally-applicable thresholds will (subject to certain exceptions for deals involving a party with defence contracting, newspaper or broadcasting activities) continue to apply to determine whether they are susceptible to being reviewed on public interest or competition grounds, i.e. where the target has UK turnover of £70 million or more or the merger will create or enhance a share of supply of 25% or more in the UK or part of the UK.

When might a deal be called in for a review?

In a guidance note accompanying the revised thresholds, the Government identifies three broad types of national security concern that could be raised by a deal:

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

Applying these principles to the sectors affected by the new thresholds, the Government identifies some specific potential concerns:

- For military/dual use items, the direct concern is that they do not fall into the hands of those who might use them against the UK. An indirect concern would also arise if a merger led to the UK military and defence forces losing operational advantages over others.
- For computing hardware, the concern is that hostile actors do not obtain access to, control of, or knowledge and expertise about "ubiquitous" computing products with the potential to be directed remotely.

- For quantum technologies, the concern is that hostile actors could use such technologies to break currently secure computer and telecommunications systems, or to transform their military power by giving vehicles and weapons systems substantial additional abilities.

As will be apparent, the likelihood that a transaction in these sectors is called in for a review on national security grounds is likely to be largely dependent on the identity of the investor and the degree and nature of influence over the target that it will have as a result of the transaction. However, beyond a broad statement that foreign investors are less likely than domestic buyers to have the UK's interests at heart and are more likely to be controlled or influenced by hostile state actors, the Government has not given detailed guidance about what factors might cause national security concerns in a particular merger.

In an earlier green paper, the Government was clear that it would not limit its reviews to foreign investors that are State-owned or controlled, but acknowledged that investors from countries which have a free trade agreement covering the UK may receive less scrutiny. The Government's recent decision to seek commitments from the British business Melrose in respect of its takeover of GKN shows that it will not even limit its reviews to acquisitions by foreign investors. In that case, the Government expressed the view that long-term investment and stability in the target's business was a matter of national security and that the British buyer's business model was potentially incompatible with that need.

The green paper also suggested 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.

Is the assessment limited to national security issues?

If a transaction meeting the new, lower thresholds is called in by the Government on national security grounds, then the Competition and Markets Authority (**CMA**) will also carry out a review of the transaction on competition grounds.

In addition, the CMA can call in a transaction meeting the new thresholds on competition grounds alone, even if it does not raise national security concerns. The CMA has indicated, however, that it does not anticipate doing so. The "regular" thresholds already allow the CMA to review transactions between competitors of any size that meet the 25% share of supply test, so transactions meeting only the new thresholds will not be susceptible to review except on the basis of relatively uncommon competition concerns, such as those arising out of vertical (e.g. supplier/customer) relationships or the offer of complementary products or services. The CMA has observed that it has not identified any historic transactions in the relevant sectors giving rise to such issues that it was not able to review under the regular thresholds, and therefore does not expect to identify any in the future. There is of course an element of speculation in that prediction. At minimum, transactions involving targets with relevant activities will incur some additional compliance costs in assessing whether any such competition concerns might arise.

In addition, it would also be possible for the Government to review such transactions on the basis of certain other public interest considerations unrelated to national security, such as the impact on media plurality, the stability of the UK financial system or any other public interest that the Government adds by way of a statutory instrument (which may be in response to a particular transaction). However, the Government has stated that it has

no intention of calling in transactions meeting only the new thresholds on any of these other public interest grounds.

Are foreign-to-foreign transactions caught?

Acquisitions of an overseas business that has sales in the UK (e.g. through imports or a domestic subsidiary) can satisfy the new thresholds. Curiously, the threshold of £1 million of UK turnover can be satisfied by sales of any products or services, not just those relating to "relevant activities". Consequently, if the target meets that UK turnover threshold it will be possible for the Government to review its acquisition, even if the target engages in the relevant activities only outside the UK and makes no related sales in the UK. So, for example, the Government would have the power to review the acquisition of an overseas business that licenses IP relating to CPUs only to third party manufacturers in Asia, provided it makes more than £1 million of sales in the UK of other products or services.

The Government has stated that it is "highly unlikely" to conclude that the acquisition of a business with no activity in one of the relevant sectors in the UK would give rise to a risk to national security. However, that is no guarantee. Accordingly, buyers of targets with relevant activities anywhere in the world should consider whether there may be a perceived impact in the UK. For example, a foreign supplier of IP for CPUs might have knowledge and expertise of computer hardware that is ubiquitous in the UK, without itself having any related UK sales.

How can businesses obtain legal certainty?

For most transactions, parties and their business advisors will be able to establish whether a particular transaction falls within the scope of the new thresholds, but in borderline cases it will be possible to seek informal (non-binding) advice from the relevant Government department. For military and dual use products, additional certainty can also be obtained through the Government's Goods Checker Tool.

Similarly, the Government's guidance provides that businesses or investors can notify the Government about a proposed merger in any of the relevant sectors, in order to obtain comfort that the Government does not consider it to give rise to national security concerns. This may lead to the Government indicating that it has no national security concerns and that it does not intend to open a Phase 1 investigation into the transaction by issuing a "public interest intervention notice" (PIIN). For acquisitions falling under the UK Takeover Code, it may be possible to achieve that outcome by offering binding post-offer commitments that assuage any initial national security concerns raised by the Government, as happened in the Melrose/GKN takeover

If the Government does decide to issue a PIIN, the CMA will prepare a report for the Government advising on whether the deal merits a Phase 2 investigation on competition grounds and summarising any representations it receives as to whether the deal raises national security concerns. The Government may then decide to open a lengthy Phase 2 investigation into the relevant competition and/or national security concerns, or to clear the transaction, either unconditionally or on the basis of commitments offered by the parties.

Unlike reviews that are decided by the CMA, there is no statutory timetable for the Government to make its Phase 1 decision, although a decision to open a Phase 2 investigation must be made within 4 months of the date on which the

deal closes or, if later, the date on which it is brought to the Government's attention. Phase 2 investigations take around 6-8 months. For transactions involving targets with low levels of UK turnover, the cost of a Phase 2 investigation is likely to be disproportionate to the value of the transaction.

Any decision not to issue a PIIN or not to initiate a Phase 2 investigation on national security grounds is not binding and the Government can change its mind (e.g. in response to new information or changed circumstances) at any point up to the end of any parallel Phase 1 investigation into competition issues by the CMA or, if there is no such parallel investigation, 4 months from the date of completion of the merger.

In the past, national security concerns have typically been dealt with by behavioural commitments, rather than structural divestment obligations or outright prohibitions.

What next?

The new thresholds are just the first step in a series of proposed reforms to bolster the Government's powers to review foreign investments on national security grounds. Later this year, the Government is expected to publish a white paper setting out its further proposals. These are expected to include one or both of the following options:

- 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 UK reforms come at a time when a number of other jurisdictions are expanding their powers to screen foreign investments. In particular:

- proposed EU-wide legislation is expected to be finalised later this year and would create an EU framework to coordinate the screening of foreign takeovers and investments by national EU governments on grounds of security and public policy (see our September 2017 briefing for details).
- in France, proposed legislation is expected to expand Government powers to take "golden shares" in French companies (where justified for the protection of essential interests of the French State) and to require prior authorisation of foreign investments in a number of additional sectors, including artificial intelligence, robotics, space, data storage and semiconductors; and
- in the US, the Foreign Investment Risk Review Modernization Act (FIRRMA) is expected to be enacted later this year and would substantially expand the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS) (see our February 2018 briefing), although proposals to allow CFIUS review of overseas joint ventures have now been dropped.

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