UK NATIONAL SECURITY REVIEWS TO CATCH A SUBSTANTIALLY BROADER RANGE OF MERGERS

The UK Government is proposing to broaden substantially the scope of the national security screening regime to catch a wide range of transactions in any sector, with no minimum size of transaction. While the regime will remain voluntary, transactions that are called in for review by the Government would become subject to an automatic prohibition on closing (unless already closed) and potential interim measures. The Government expects around 200 transactions per year will be notified, with around 100 becoming subject to review on national security grounds, compared to only one or two at present.

Key issues

- What transactions would be affected?
- Would there be mandatory filing requirements or a prohibition on closing?
- How would the review process operate and how long would reviews take?
- How will national security be assessed?
- What are the next steps for the reforms and their implications, if passed?

THE WHITE PAPER

Following a green paper issued in November 2017 and the introduction of certain "short term" reforms to expand the existing regime for screening mergers on national security grounds, the Government has now published a white paper setting out its vision for a standalone national security regime which would be applicable to a much wider range of transactions.

WIDE SCOPE OF AFFECTED TRANSACTIONS

The new regime will cover a broad range of transactions and trigger events, potentially including the following elements.

Acquisitions of more than 25% of votes or shares in an entity, or less than 25% if "significant influence or control" is acquired

The test for significant influence or control would be based on that which is used to determine whether an entity must be included in the register of People with Significant Control introduced by Schedule 1A of the Companies Act 2006 (as opposed to the more subjective test for "material influence" under the UK merger control regime). That latter test focuses on legal rights to veto strategic commercial decisions of a target. However, the test under the proposed foreign investment regime goes significantly further than this, due to the focus on types of influence that may give rise to national security concerns. In particular, draft guidance issued in conjunction with the white paper indicates that the test could be met by:

- rights to appoint board members (or even an individual board member) even if those members would not have a collective power of veto; and

- a new element of significant influence or control where a buyer has legal rights to "shape an entity's operations or strategy", even in the absence of the legal power to veto commercial decisions of that entity, e.g. because other shareholders almost always follow the buyer's recommendations or because the buyer exercises control of key individuals.

The shareholding and control tests will be assessed by reference to all ownerships, relationships, positions and personal connections of the buyer entity, including direct and indirect holdings, connected persons and those sharing a "common purpose".

The Government would also be able to intervene if a buyer already meets the 25% threshold or already has significant influence or control, if the buyer increases its interest beyond certain shareholding thresholds or acquires new or additional rights (e.g. board appointment rights).

Acquisitions of more than 50% of an asset, or of significant influence or control over an asset

The proposed definition of an asset is broad, encompassing:

- real and personal property (within or outside the UK, subject to the test for UK nexus described below), including land, buildings or other physical assets such as infrastructure sites and equipment;
- contractual rights; and
- intellectual property, comprising patents (including pending patents), registered designs, copyright, design rights, database rights and any rights under the law of a country or territory outside the UK which corresponds with these rights.

However, the Government does not intend that the power would be used in relation to ordinary business or consumer transactions and is inviting views on how the call-in test could be structured to reflect this.

The test for significant influence or control over an asset would be applied consistently with the test for significant influence or control over an entity. Preferential access to an asset would not, in itself, be considered to amount to significant influence or control. However, the acquisition of a licence related to an asset (including IP) would be reviewable if it provides the licensee with the means of using or manipulating the asset in question.

New projects and loans

The tests outlined above for acquisitions of interests in entities or assets would mean that qualifying interests in new projects would be reviewable, even if they do not, at the time of the investment, amount to functioning businesses.

They could also catch loans, where an asset with national security significance is collateral for the loan. Such loans would become reviewable only at the point in time where the lender actually acquires ownership or significant influence or control over the collateral, which will not usually be until an event of default has led to seizure of the relevant asset. However, an agreement to extend a loan or an act of default on such a loan could trigger a review in certain limited circumstances, e.g. where unusual loan clauses require sensitive, non-commercial data to be provided to the lender or where, following a default, a lender demands that their representative attends board meetings.

NO THRESHOLDS BUT REQUIREMENT FOR A UK NEXUS

There will be no thresholds. A qualifying acquisition of an interest in any entity or asset will be reviewable, no matter how small and irrespective of the volume of UK turnover of the relevant business or value of the relevant assets.

However, the Government is proposing to incorporate a requirement for a UK nexus into the regime. This would allow intervention in transactions involving investments in entities, assets or legal rights (e.g. IP) outside the UK only where the Government is satisfied that:

- the non-UK entity carries on activities in the UK or supplies goods or services to persons in the UK; or
- the non-UK asset or right is used in connection with activities taking place in the UK or the supply of goods or services to persons in the UK.

In practice, the combination of no thresholds and an expansive test for UK nexus means that the Government will have powers to call in an extraordinarily wide scope of extra-territorial transactions. For instance, the licensing of IP by one Asian entity to another could fall within the scope of the regime if that IP is used to manufacture goods that are sold in the UK.

A VOLUNTARY REGIME

Contrary to a suggestion in the 2017 green paper that mandatory filing might be required for some transactions, the white paper does not envisage such requirements, or an automatic prohibition on closing a reviewable transaction. However, the Government would have power to call in a transaction for review, if it has a reasonable suspicion that the transaction meets the tests described above and that it may give rise to national security concerns. If the Government calls in a transaction that has not yet completed, a prohibition on closing would become applicable at that point.

For transactions that have already completed, the white paper proposes that the Government's call in power would be exercisable up to six months after the relevant transaction has taken place. The Government would have powers to impose interim restrictions on such deals, such as a prohibition on the release or sharing of specific information or a prohibition on access to specified sites by individuals.

Breach of a prohibition on closing or of an interim measure would attract civil penalties of up to 10% of group worldwide turnover (or 10% of total income for individuals, subject to a £500,000 cap) or criminal penalties of unlimited fines and/or imprisonment for up to five years.

THE REVIEW PROCESS

Transactions may become subject to review when they are called in by the Government, which will devote resources to monitoring markets for transactions raising potential national security concerns. However, parties to a potentially affected transaction will be able to notify the Government in order to obtain comfort that their transactions will either not be called in for review or, if it is, that the transaction will not be subject to prohibition, or to any remedies that would undermine the commercial rationale for the transaction. The Government intends to specify the information that would be required for such a filing.

Parties would also be able to engage the Government through informal discussions to establish whether the Government may have national security concerns in relation to a specific transaction, but in the absence of formal

notification this would not result in a binding clearance decision preventing the transaction from being called in at a later date.

Following submission of a complete notification, the Government would have a fixed period (anticipated to be 15 working days, extendable to 30) within which to decide whether to call in the transaction. If it decides to do so, it would have 30 working days to review the transaction for national security concerns, which may be extended by a further 45 working days (or more, if agreed by the parties). It is envisaged that the Government will have information gathering powers comparable to those that currently exist under the merger control regime.

The key decision maker under the national security regime would be a Cabinet-level minister, which may include any of the Secretaries of State, the Chancellor or the Prime Minister.

The proposed regime would be entirely separate from the UK merger control regime and national security considerations would be removed from the scope of "public interest considerations" that can be taken into account in the context of merger control reviews under the Enterprise Act 2002, such that the Competition and Markets Authority (CMA) would no longer have any formal role in the national security screening regime. The lower merger control thresholds that were recently introduced for transactions involving targets with military/dual use and certain advanced technology activities (see our June 2018 briefing) would be reversed.

Where a transaction is reviewed under both of the national security regime (by the Government) and the merger control regime (by the CMA), it is envisaged that the Government would have the power to require the CMA to pause its competition assessment pending the outcome of the national security assessment. The Government would also have the power to vary any remedy previously-imposed by the CMA where it is considered to be inconsistent with the interests of national security, or to decide that a merger should be permitted to proceed on national security grounds, notwithstanding a decision by the CMA to prohibit it on competition grounds. The Government is also considering whether similar arrangements ought to be put in place with respect to decisions of other sector regulators such as Ofcom, Ofwat, the Office for Nuclear Regulation and the UK Civil Aviation Authority.

If the Government concludes that a transaction poses a national security risk, it will be able to impose such remedies as it reasonably considers necessary and proportionate to prevent or mitigate that risk. These may include structural remedies (e.g. divestment), behavioural remedies or outright prohibition or unwinding of a transaction. The Government proposes to provide a legislative list of indicative remedies that it may decide to impose as a condition of clearance, such as obligations:

- to restrict access to sites, information or technologies;
- to allow only personnel with appropriate UK security clearances to have access to confidential information or to be involved in the management of the business;
- not to transfer certain IP rights;
- to maintain certain supply relationships; or
- to be subject to supervision, monitoring or periodic reporting.

To date, the majority of remedies imposed in cases raising national security issues have been behavioural.

Breaches of obligations imposed as a result of a remedy or prohibition would be subject to the same civil or criminal penalties as breaches of a prohibition on closing or interim measures (see above). Any decision to impose remedies or to prohibit a transaction would be subject to judicial review before the High Court.

HOW NATIONAL SECURITY WILL BE ASSESSED

A draft "Statutory Statement of Policy Intent" accompanying the white paper (the Draft Statement) outlines three categories of risk that the Government will assess, which are described in more detail below: target risk, trigger event risk and acquirer risk.

In assessing these risks, the Draft Statement indicates that the Government will be guided by the following key principles:

- that any interventions around national security should be necessary, proportionate, even-handed and will not impose arbitrary restrictions on corporate transactions or other activities; and
- that any interventions are not designed or intended to limit market access for any individual countries or to undermine the UK's commitment to being open for business and welcoming foreign direct investment.

Target risk

The 'target risk' is that the target entity or asset is such that the acquisition of control over it may pose a risk to the UK's national security, due to the nature of the target's activities or the nature of the target itself. Such risks are considered by the Government most likely to arise if the target is active in certain "core" areas, including:

- some parts of certain national infrastructure sectors, such as communications, civil nuclear, defence, energy and transport;
- some advanced technologies, such as artificial intelligence and machine learning, autonomous robotic systems, computing hardware, cryptographic technology, materials and manufacturing science, nanotechnologies, networking/data communication, quantum technology and synthetic biology;
- critical direct suppliers to the Government and emergency services sectors; and
- military and dual-use technologies, with a focus on the development or production of goods on certain export control lists.

Concerns are also more likely to arise (but less likely than for the core areas) where the target is:

- a critical supplier that directly or indirectly supplies the core areas;
- active in those parts of the national infrastructure sectors not in the core areas (e.g. finance, food, water, chemicals or space); and
- active in other advanced technologies not in the core areas.

Outside these areas, the Government considers that national security concerns less likely to arise, but notes that geopolitical, national security or technological changes may change its assessment. In addition, acquisition of

certain land may pose a national security risk if it is located in close proximity to a sensitive site.

The Draft Statement sets out a number of useful illustrative examples of relevant factors in assessing target risks, including whether an asset or entity:

- could be used to cause a national emergency (threatening serious damage to human welfare);
- is integral to UK defence capabilities;
- could be manipulated or controlled remotely to cause detriment or harm, e.g. because it produces commonplace technological components used in many household products which could be controlled or manipulated remotely;
- could be manipulated or controlled remotely to extract sensitive information, e.g. by building in 'listening' devices into household or business electronics such as TVs or computers; or
- contains sensitive information, or information relating to a large proportion of the population (e.g., healthcare databases) that could be used to cause targeted harm to sections or individuals within the population.

Trigger event risk

Assessment of this risk focuses on the degree to which the relevant transaction gives the acquirer the practical means or ability to use the entity or asset to undermine national security, e.g. by giving the acquirer:

- a greater opportunity to undertake disruptive or destructive actions or to magnify the impact of such action, e.g. by allowing the acquirer to bring, or to threaten to bring, the production of certain goods or the provision of certain services to a standstill;
- an increased ability and opportunity to undertake espionage activities, e.g. by access to information; or
- the ability to exploit the acquisition to dictate or alter services or investment decisions or use ownership or control as inappropriate leverage in other negotiations, e.g. to extort or coerce the Government to change its position on other geopolitical priorities.

Acquirer risk

This involves the consideration of the risk that the acquirer may seek to use the entities or assets to undermine national security. While the Government considers that most buyers pose no national security risks, some may be hostile to the UK's national security. However, the Draft Statement does not identify the States or actors that the Government considers to be potentially hostile.

In addition, while the Draft Statement emphasises that the vast majority of foreign nationals pose no national security risk and make a positive contribution to the UK, foreign nationality may make it comparatively more likely that an acquirer poses such risks, even if they are not considered hostile. While less likely, even UK nationals and businesses may, in the Government's view, pose national security risks, for example if they have a hostile motive towards the UK.

Acquirer risk will be assessed on a case-by-case basis, taking into account all those with direct or indirect control over the acquiring entity and its track

record in relation to other acquisitions or holdings or, for individuals, any criminal record and information related to their affiliations.

NEXT STEPS

The Government is consulting on the proposed reforms, with a deadline for responses of 16 October 2018. The Government will then use the responses to the White Paper to refine its proposals ahead of the introduction of primary legislation "when Parliamentary time allows".

IMPLICATIONS

The Government expects that there would be around 200 notifications each year under the new regime and that around 100 transactions would be called in for review. Consequently, the national security regime would affect significantly more transactions than the existing merger control regime, under which around 60 transactions are reviewed each year and the existing regime for screening mergers for national security concerns, which catches only one or two transactions a year.

The proposed regime would combine extremely broad jurisdiction (a wide scope of qualifying transactions, no thresholds and extensive extraterritorial reach), an automatic prohibition on closing for transactions that are called in (with criminal penalties for breach) and highly subjective and vague criteria for assessing whether national security risks may arise. This would cause significant difficulties in planning transactions affecting the UK; not just for mergers, acquisitions and joint ventures, but also certain financing arrangements, licensing or transfer of IP and real estate deals.

In particular, while the Draft Statement gives an unusual amount of detail on the factors that the Government will consider when assessing national security, it offers little indication of which acquirers will be considered to pose risks and would also give the Government a wide discretion to raise putative national security concerns in scenarios that are not described in the Draft Statement's illustrative examples. For instance, the Government recently (under the existing national security regime) sought commitments from the British business Melrose in respect of its takeover of GKN on the basis that the 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. There is nothing in the draft Statement that would obviously prevent the Government from doing so under the new regime.

Accordingly, while the white paper emphasises that the Government intends for the UK to remain open to foreign investment and that its proposals have been designed with the sole aim of addressing legitimate national security concerns, there is a risk that the regime could become a Trojan horse for other, undisclosed considerations to be taken into account by this or future Governments, such as protectionism of national champions or a merger's impact on employment. Whether that is the case may ultimately depend on the willingness of the courts to scrutinise the strength of national security justifications that are relied upon by the Government.

CONTACTS

Alex Nourry
Partner

T +44 (0)207 006 8001
E alex.nourry
@cliffordchance.com

Jenine Hulsmann
Partner

T +44 (0)207 006 8216
E jenine.hulsmann
@cliffordchance.com

Nelson Jung
Partner

T +44 (0)207 006 6675
E nelson.jung
@cliffordchance.com

Greg Olsen
Partner

T +44 (0)207 006 2327
E greg.olsen
@cliffordchance.com