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UK Government Proposes New Regime for Acquisitions That Have National Security Implications

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On 24 July 2018, the UK government published details of its proposed new regime for the scrutiny of foreign investments that may have national security implications. The details are contained in the **National Security and Investment White Paper** (the "White Paper") and a **draft Statutory Statement of Policy Intent** (the "Draft Statement") (together, the "Proposals"). The Proposals build on the government's National Security and Infrastructure Investment Review Green Paper published in October 2017, which led to the introduction of "short term" reforms in June 2018 (the "June Reforms"). Those reforms, which would be replaced by the Proposals, gave the government greater powers to screen mergers on national security grounds where the target is involved in the production of military or dual-use technologies or certain types of "advanced technology" (see **here** for our Client Briefing).

The Proposals would create an entirely new regime that would apply to a much wider range of transactions, including the acquisition of assets that do not amount to an enterprise, and would extend to all sectors of the economy. The only material limiting factor would be that the government must have a "reasonable suspicion" that a transaction may pose a risk to national security before it can launch an investigation. Unlike the current regime, there would be no need for the transaction to reach a particular turnover or share of supply threshold. Although there would be no mandatory filing requirement, parties are encouraged to make voluntary notifications to the government if they believe a transaction might raise national security concerns. Based on the estimate in the White Paper that as many as 200 transactions will be notified in this manner each year, the government clearly expects the regime to have a major impact. For comparison, a total of 62 transactions were reviewed under the UK's regular merger control regime in the year 2017/2018.

The Proposals are now subject to consultation until 16 October 2018.

Affected transactions

The government proposes to introduce legislation to expand the range of transactions that it can review for potential national security concerns to include:

- the acquisition of more than 25% of the votes or shares in an entity;
- the acquisition of significant influence or control over an entity;
- the acquisition of further significant influence or control over an entity beyond the above thresholds;
- the acquisition of more than 50% of an asset; and
- the acquisition of significant influence or control over an asset.

"Asset" is broadly defined to include real and personal property, contractual rights and intellectual property. Property situated outside the UK that meets a UK nexus test would also be caught. It is important to note that the test goes far beyond a business acquisition structured as the sale of assets and could catch the acquisition of a single asset, such as a piece of land or a patent. Whilst the government acknowledges that the proposed legal test for asset acquisitions is broad, it also notes that the power to

review such transactions is intended as a backstop to prevent circumvention of the regime. Nevertheless, the government's initial analysis estimates that around a quarter of total notifications (approximately 50) would concern asset acquisitions, half of which would need to be called-in (approximately 25) and around half of those (approximately 12) would be subject to remedies. The methodology behind these figures is not explained in the Proposals.

In the case of entities, "significant influence or control" would cover a person (natural or legal) that can direct the activities of an entity or ensure that an entity generally adopts the activities that they desire. Simply being appointed to a company's board as a director would not generally be sufficient to meet this threshold. In respect of assets, the definition would cover a person that has absolute decision rights over the operation of the asset.

National security concerns

In assessing whether a transaction (referred to in the Proposals as a "trigger event") raises national security concerns, the Draft Statement identifies three risk factors that will be taken into account when determining whether to call in the transaction for closer scrutiny:

- **Target risk:** The acquisition of control over entities and assets within certain areas of the economy will be more likely to pose a national security risk than in others. These are defined as "core areas" and include businesses involved in national infrastructure (which includes civil nuclear, defence, communications, energy and transport), certain advanced technologies (which include artificial intelligence and machine learning, computer hardware and nanotechnologies), critical direct suppliers to the government and emergency sectors, and military and dual-use technologies. Suppliers to operators in core areas are also higher risk;
- **Trigger event risk:** This is the risk that the acquisition may give the acquirer the means or ability to undermine the UK's national security, for example through disruption, espionage or inappropriate leverage; and
- **Acquirer risk:** This is the risk that the acquirer may seek to use its control over the entity or asset to undermine national security, i.e. that it may be a so-called "hostile party". The definition of "hostile parties" includes states that "seek to undermine UK national security through a range of traditional and non-traditional means" ("hostile states") and parties acting on behalf of a hostile state or affiliated to a hostile state ("hostile actors"). While the Proposals contain very limited detail on this issue, rather worryingly the Draft Statement indicates that "foreign nationality could prove to be a national security risk factor" since foreign nationals "may feel an allegiance or loyalty to their home country" and hence be motivated to undertake activity contrary to the UK's national security. What this means in practice remains to be seen.

Notification process

The government proposes a voluntary notification regime, under which parties may notify transactions that might be viewed as raising national security concerns. Informal discussions with officials would be available to help parties decide whether or not to notify. Following notification, the government would have 15 working days (extendable by a further 15 working days in complex cases) to decide whether to call in the transaction for a full national security assessment.

A Senior Minister (i.e., a Secretary of State, the Chancellor or the Prime Minister) would be able to "call in" a transaction if he or she has a reasonable suspicion that, due to the nature of the activities of the entity involved or the nature of the asset (or its location, in the case of land), the transaction may pose a risk to UK national security.

Once a transaction has been called in, it must not be completed until the government has finished its assessment. In respect of transactions that have already completed, the government would have a prescribed period (potentially up to six months after the transaction has taken place) to call it in. Once called in, the government would have 30 working days to make its assessment, extendable by a further 45 working days where a more detailed analysis of the risk and remedies is required.

Outcomes and remedies

Following the assessment, the responsible Senior Minister may approve the transaction unconditionally, approve it subject to remedies or, where there is no remedy to address or mitigate the risk to national security, he or she will have the power to block or unwind it.

The proposed legislation will include an indicative but non-exhaustive list of the types of remedies that could be imposed, including behavioural and structural remedies. The only limitation is that any remedies must be "necessary and proportionate" to protect national security. The responsible Senior Minister will also have to consult affected parties, and consider their representations, before imposing remedies.

The government's initial estimates indicate that around half of the transactions called in for a full national security assessment are likely to be approved without the imposition of remedies.

Sanctions for non-compliance

To incentivise compliance and punish breaches, the government is proposing to introduce severe sanctions for non-compliance. Sanctions include a maximum custodial sentence of five years for most offences, as well as civil financial penalties (up to 10% of a business's worldwide turnover or, for an individual, up to 10% of their total income or £500,000, whichever is higher) and director disqualification for up to 15 years.

Judicial oversight

A specific appeals process will be created for the regime, with decisions subject to appeal before the High Court, based on judicial review principles (which focus on the legality of a decision, rather than whether it was correct). In order to prevent the public disclosure of information harmful to national security, the government may request Closed Material Proceedings.

Impact on existing merger control and EU rules

As noted earlier, the Proposals would replace the entire existing national security public interest regime for mergers, including the June Reforms. Once the proposed legislation is enacted, a transaction's impact on competition may fall to be assessed by the UK Competition and Markets Authority (the "CMA"), while at the same time being assessed by government ministers for national security risks under the new regime. The proposed legislation will therefore establish a new procedure to govern this interaction.

The government will also work with the Takeover Panel to consider how the proposed reforms would interact with the City Code on Takeovers and Mergers.

The proposed reforms will also need to work alongside the EU Merger Regulation, so long as the UK is bound by it. While Member States are allowed to review the impact on national security of transactions that are subject to a competition review by the European Commission, they cannot discriminate against companies or individuals from other Member States on grounds of their nationality. This will constrain the government's ability to take action against acquisitions by companies or individuals from other Member States, until such a time as the EU Treaties no longer apply to the UK (which is uncertain at the time of writing, but likely to be either 29 March 2019 or 31 December 2020).

Additionally, the government's proposals will need to work alongside the Commission's proposed EU-wide foreign direct investment screening regulation as long as it applies to the UK. This provides a cooperation mechanism between Member States for such reviews, including a requirement that Member States share information on their screening activity.

Similarities with the CFIUS regime

Interestingly, many features of the Proposals appear similar to those of the regime for the review of transactions that have national security implications by the inter-agency Committee on Foreign Investment in the United States (the "CFIUS"). The CFIUS regime is similarly based on voluntary filings. Using its extensive powers, CFIUS reviews transactions of all sizes both before and after closing as part of its broad remit to vet foreign acquisitions that may affect national security or critical infrastructure. If CFIUS establishes that a transaction poses a risk, the parties are required to implement mitigations or, as is often the case, abandon the deal. Ultimately, the US President may exercise a veto power to block a deal, no questions asked.

When the original CFIUS regime was adopted in 1975, the definition of "national security" was narrowly interpreted to cover businesses and assets that were directly linked to the defence and security industries. Over time, the definition has been materially broadened and expanded by US Presidents (often to political ends) to cover foreign deals that could cause significant outsourcing of jobs, the sharing of sensitive technologies, or impairment of critical infrastructure.

President Trump has used CFIUS' powers several times. For example, in March 2017, President Trump blocked a proposed acquisition of a US semiconductor company by Infineon Technologies of Germany. President Obama also used CFIUS, including in one instance to unwind a $2 million acquisition by China's Huawei of 3Leaf, a US server technology company.

Conclusion

The Proposals mark a step change in the level of governmental scrutiny of foreign acquisitions of UK companies and assets. Whereas typically only one transaction a year has been subject to a national security review under the current regime, the government anticipates that around 200 notifications would be made each year under the new regime, of which 100 are likely to raise national security concerns and 50 would require remedies. Fortunately, the Proposals will require ministers to review transactions on national security grounds alone, rather than applying a broader 'public interest' test for acquisitions that could lead to deals being challenged simply because they involve a foreign acquirer.

The main impact of the proposed reforms is likely to be the introduction of a degree of uncertainty and potential delay for transactions that come within its scope. This can be seen from a recent example of a transaction that was caught by the June Reforms. Just days after the June Reforms came into force, the government intervened in the proposed acquisition of Northern Aerospace (a manufacturer of civil aerospace components) by Gardner Aerospace (a subsidiary of China's Shaanxi Ligeance Mineral Resources) on national security grounds. This intervention delayed the closing of the transaction by approximately 30 days. At the conclusion of the review, the Secretary of State for Business, Energy and Industrial Strategy announced that he no longer had any national security concerns, following the receipt of "further representations direct from the Ministry of Defence".

Ultimately, the Proposals reveal that the government is walking a tightrope. On the one hand, it is seeking to address legitimate concerns that acquisitions by foreign investors have the potential to expose the country to national security threats and their potential consequences. In particular, the technology sector is an increasingly important part of the nation's security infrastructure and, at the same time, a sector in which the UK has a growing number of attractive acquisition targets. On the other hand, the government clearly recognises that the UK needs to continue to encourage foreign investment and to maintain an open trading environment, which is particularly important as the security provided by the UK's membership of the EU draws to an end. Whether it can maintain this delicate balance remains to be seen.

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