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A New Foreign Investment Regime In The UK

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Those who track investment policy issues will have noticed an important theme emerging in recent years of Western economies evaluating their foreign investment regimes, in particular in light of the outflow from China into technology, infrastructure and natural resource assets. The U.K. is expected to adopt a new foreign investment regime and details of the government's consultation are awaited this month or early next year. Together with the potential impact of Brexit, which may lead to the European Commission having less power to intervene in U.K. mergers not involving the EU, this seems set to produce a foreign investment environment with more possibilities for political intervention. We set out below the existing powers in this area before discussing the potential reforms.


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Existing Powers

The Enterprise Act 2002

The Enterprise Act 2002 passed authority over the control of mergers and takeovers to the national competition authorities (currently the Competition and Markets Authority, or CMA). The CMA (and the European Commission for large-scale transactions with EU dimensions) assesses mergers according to their likely impact on competition, but the government can intervene in any merger investigation that could raise specific public-interest concerns.

Previously there was a wide public-interest test, but under the Enterprise Act 2002, the government (via a secretary of state) may only issue an "intervention notice" to commence an inquiry into a merger or acquisition on public-interest grounds where concerns exist as to: (1) national security; (2) the impact on newspapers and the media, e.g., the impact on plurality and the range, accuracy and quality of content (in this area, as in others as diverse as financial services and soccer, the relevant industry regulators also have powers to intervene that include ensuring that those holding licenses and authorizations remain fit and proper to do so); and (3) the stability of the U.K. financial system. The government can propose new public interest considerations, subject to parliamentary approval.

Where the competition aspects of a merger are subject to assessment by the European Commission, the EU Merger Regulation allows essentially the same grounds for intervention — "public security, plurality

of the media and prudential rules." Again, other public interest tests can be used, but these require notification to, and approval of, the European Commission. The commission has so far taken the position that any such notification should be in advance of and separate from any individual case.

To date, intervention notices have been issued in only a small number of deals involving the defense, media and financial sectors. The inquiry itself is administered in conjunction with the CMA, and and the government makes the final decision on whether or not to allow the merger to proceed and on what terms.

Golden Shares

Golden shares are usually nominal shares that can be used to protect companies from a takeover, allow the government to subject material business decisions to its prior consent, and limit the voting rights of any single shareholder to 15 percent. Golden shares were originally used in the U.K. during the wave of privatizations beginning in the late 1980s. The government held golden shares in many companies, but now retains a small number in defense industry contractors and suchlike, for example in NATS (involved in air traffic control). It appears that the government will press the refresh button on the golden-share concept, at least in relation to new nuclear build infrastructure.

One of the main restrictions on the government's ability to use golden shares is their prima facie incompatibility with EU law on the free movement of capital and the freedom of establishment within the EU. Only a small number of narrowly defined exceptions permit their use, such as reasons of public policy, public security, national security and defense. The European Commission has a relatively successful track record in opposing golden shares held by EU member states. In 2003, the EU General Court ruled that the U.K.'s golden share in BAA was an illegal restriction of the free movement of capital within the single market. The EU courts reached similar rulings in numerous related cases, including against Germany, Spain, France, Italy, Portugal and others.

Industry Act 1975

There is a specific power of intervention relating to entities wholly or mainly engaged in the manufacturing business that the government considers to have special importance to the U.K. If the government believes a change of control of such an entity would be contrary to the U.K.'s interests, a "prohibition order" can block the transaction or impose conditions. The government has never used this provision and numerous commentators question its compatibility with EU law.

The City Code on Takeovers and Mergers

The City Code on Takeovers and Mergers (backed by the Companies Act 2006) applies to mergers and acquisitions of U.K.-listed companies. In December 2014, government-inspired revisions to the code introduced a distinction between nonenforceable post-offer intention statements and enforceable post-offer undertakings given by an acquirer. The revisions introduced binding post-offer undertakings relating to certain courses of conduct to be taken, or not taken, relating to levels of investment, numbers of employees, and so forth. Importantly, they are not supposed to be dependent on the subjective judgment of the party to the offer or its directors. Thus, via the code, the government can frame the landscape and specifics of a deal.

Compliance with the undertakings can be monitored by written reports by the board and independent supervisors (similar to monitoring trustees who monitor compliance with a competition regulator's

conditions). Noncompliance may result in directions being given to the company and, potentially, disciplinary sanctions by the Panel on Takeovers and Mergers as well as court orders requiring compliance, although the panel has never sought enforcement by the court.

Reform

Recent Debate

In recent years there has been debate about introducing a broader public interest test and extending the scope of the ability of government to intervene. As with many other countries, the concerns in the U.K. stem in part from investment by foreign state-owned entities in the technology, infrastructure and natural resource areas. This was recently seen in September this year, when the U.K. government approved the construction of a nuclear power station at Hinkley Point. The French company EDF (in which the French government is a shareholder) and state-sponsored China General Nuclear each hold stakes in the project. The approval, which came after EDF gave assurances that it would not sell a controlling stake in the project without prior notice, was not without controversy.

Equally, the concerns stem from fears over jobs and technological know-how, as demonstrated by the attempted takeover by Pfizer of AstraZeneca in 2014, where the maintenance of the U.K.'s research and development capabilities was mooted as a potential ground for intervention.

That said, the recent acquisition of ARM, one of the U.K.'s leading hi-tech electronics companies, by Japan's Softbank was encouraged and supported by the government. Softbank gave post-offer undertakings (the first company to do so under the revised code) that included doubling the U.K. workforce within five years and maintaining ARM's headquarters in the U.K. for at least the next five years. It also gave post-offer intention statements relating to employees, management, places of business, and fixed assets. Similarly the recent (Nov. 24, 2016) announcement of the takeover of Skyscanner, a travel search business and one of the U.K.'s few so-called "unicorns," by Chinese rival Ctrip for £1.4 billion appeared to be welcomed by the government.

The ARM and Skyscanner transactions, however, shine a light on a further issue, which is that the government's concerns seem to go further than ensuring investments are beneficial to people in all "corners" of the country, but also to combat long-term productivity issues.

The government has said it plans to draw level with other major economies, suggesting it may consider importing a foreign investment control regime from elsewhere. The U.S., for example, has a highly structured and detailed review process for foreign investment into critical infrastructure, administered by the Committee on Foreign Investment in the United States. The government has not yet revealed what the structure for revision of foreign investment will be, for example through the existing CMA and secretary of state structure, or a new CFIUS-type structure.

Potential Reforms

Prior U.K. governments had contemplated an extended definition of a national- or public-interest test but had concluded that it would complicate the merger control process and deter potential acquirers. A clearer picture of the proposed reforms will emerge when the government publishes a green paper (a consultation document) at the end of the year with the aim of producing a white paper (setting out the government's proposals for future legislation) early in 2017. We set out some possibilities below.

Option 1: Strengthen the Existing Regime

The government has confirmed a review of the public-interest regime under the U.K. Enterprise Act 2002. To date, the government has only used "national security" grounds in relation to the defense sector. One option might be to clarify or to expand the sectors to which the grounds apply. The government has also suggested that it will expand use of golden shares by taking a share in all future nuclear projects, and it may also do so in future infrastructure projects. In an uncertain economic climate, with acquisitions sparked by falling asset prices, there would be an impetus to protect jobs and research and development capabilities in high-technology industries, e.g., the pharmaceutical and automotive industries. These arguments would run alongside those concerning expanding threats to national security.

Option 2: A New Regime

Above we referred to CFIUS, a U.S. government committee authorized to review transactions where a foreign person or entity may acquire control of a U.S. business or assets, in situations where this could, in any way, implicate U.S. national security interests or involve critical infrastructure. This process is additional to competition scrutiny by regulators such as the U.S. Department of Justice and the Federal Trade Commission. The review process is usually complete within 30 days, but in some circumstances is extended by a further 45 days, and if referred to the president, for a further 15 days. While the process is confidential, it can be time-consuming and costly, and CFIUS has broad discretion to consider a range of factors when assessing a foreign acquisition. CFIUS can block any transaction, or impose certain conditions on its approval, and its decisions are not subject to court review. It would be open to the U.K., of course, to develop its own version of CFIUS.

Further Considerations

The government's options are currently constrained (and may continue to be constrained) by EU rules on freedom of establishment and free movement of capital as mentioned above. The EU further requires that member states respect the exclusive decision-making power of the EU regarding foreign direct investment, EU competition law and the EU treaties generally. Irrespective of EU law, the U.K. would still be constrained by other trade rules, including World Trading Organization rules, other trade agreements, such as the Energy Charter Treaty, and bilateral investment treaties, which usually prohibit discrimination against foreign investors. Further, the government must consider the risks of creating economic distortions, of increasing economic uncertainty in a fragile environment, and of dissuading foreign investment in U.K. infrastructure and the U.K. economy as a whole. All that said, however, the government does appear determined to increase its ability to scrutinize foreign investment in the U.K. as part of its "industrial strategy," the details of which will be revealed over the next few months.

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