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 UK is now considering, and is expected to adopt, a new foreign investment regime that will give the Government greater powers of intervention.

A recent investment in a nuclear power station building project, known as Hinkley Point, involving entities owned or part-owned by France and China, appears to have cemented the issue. When the new Government approved the project, subject to certain conditions about future investors, it also stated that it would review the tools available to it to intervene in such matters, with an eye principally on national security. There have been many deals since then, some of which are referred to below. Most recent is the sale, reported on December 8, 2016, of a controlling stake in a major UK gas distribution network to a Chinese-Australian consortium, stated by the *Financial Times* to be one of the biggest British infrastructure deals in recent history.

The UK Government has indicated that in late 2016 / early 2017 it plans to consult on the reform of existing powers and that it would do this by revising the definition of “public interest” contained in the Enterprise Act 2002, an Act originally more directed at mergers and acquisitions than investment in new infrastructure projects. This, together with the potential impact of Brexit, which may lead to the European Commission having less power to intervene in UK mergers not involving the EU, seems set to produce a foreign investment environment with more possibilities for political intervention. We set out below some of the background to the current debate and the Government’s existing powers in this area before discussing the potential reforms.

Background

A New “Industrial Strategy”

On September 15, 2016, the UK 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 (“CGN”) 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. The Government said that it would take a special share in all future nuclear build projects to ensure that significant stakes cannot be sold without its consent. It further stated:

> “There will be reforms to the Government’s approach to the ownership and control of critical infrastructure to ensure that the full implications of foreign ownership are scrutinised for the purposes of national security. This will include a review of the

> public interest regime in the Enterprise Act 2002 and the introduction of a cross-cutting national security requirement for continuing Government approval of the ownership and control of critical infrastructure."

The Government's consultation and revision will take place under the auspices of a new "industrial strategy" (to be developed by the newly-established Department for Business, Energy and Industrial Strategy ("BEIS")) under which the Government is set to obtain a wider ability to intervene, not only in new infrastructure projects but also in mergers and acquisitions, and not only on grounds of national security but quite probably on broader grounds of public interest.

With regard to national security, a wider and more forceful approach may develop to cover an expanding range of threats such as cybercrime, cyber terrorism, and data breaches that tangle with national security concerns.

Regarding broader grounds of public interest, it is notable that Prime Minister Theresa May criticised two prior M&A deals; the acquisition of Cadbury by Kraft and the attempted acquisition of AstraZeneca by Pfizer, questioning why the Government did not have the ability to intervene in such deals to ensure the protection of jobs, research and development, and, more generally, strategically important sectors. In a recent speech to the Confederation of British Industry on November 21, 2016 the Prime Minister lauded recent investment announcements by Nissan, Softbank and U.S. tech companies among others, and this was repeated by the Chancellor in his Autumn Statement on November 23, 2016. It seems that the Government's concerns are to ensure not only that investments are encouraged but that "*those investments benefit people in every corner of the country*." However, in order to fit with the Government's objective of showing that "*Britain is open for business*" it does seem that any new regime may need to be balanced with an eye, particularly post-Brexit, to maintaining an open economy that welcomes foreign investment with low levels of political intervention.

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 ("CFIUS"). 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.

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 ("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: (i) national security; (ii) 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 licences and authorisations remain fit and proper to do so); and (iii) the stability of the UK financial system. The Government can propose new public interest considerations, subject to Parliamentary approval. This was indeed how ground (iii) was created, which allowed the Government to intervene to allow, despite competition concerns, the acquisition of HBOS by Lloyds TSB following the global financial crisis of 2008.

Where the competition aspects of a merger are subject to assessment by the European Commission, then 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 defence, media, and financial sectors. The inquiry itself is administered in conjunction with the CMA and can involve the relevant company making binding statements with regard to its future conduct, 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%. Golden shares were originally used in the UK during the wave of privatisations beginning in the late 1980s. The Government held golden shares in many companies, but now retains a small number in defence 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 defence. 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 UK'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 UK. If the Government believes a change of control of such an entity would be contrary to the UK'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 UK-listed companies. In December 2014, Government-inspired revisions to the Code introduced a distinction between non-enforceable 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). Non-compliance 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. While the UK has always seemed open to foreign investment, from the U.S. ownership of financial institutions post "Big-Bang", to Japanese, German and Indian ownership of the automotive industry, there have been queries as to whether the UK regime is robust enough in defending the national interest.

In most Western countries there exist fairly wide grounds for intervention in the public interest and these are used, sometimes controversially. France introduced new rules in 2014 requiring Governmental approval of foreign investment in energy, transport, water, health or telecoms, in addition to sectors more linked to national defence. This year Australia blocked the acquisition of part of the Kidman estate as well as the acquisition of Ausgrid by different Chinese consortia, the German government withdrew approval for a €670m Chinese-backed acquisition of Aixtron SE, a chipmaker, on security grounds, and President Obama recently blocked the Chinese-backed acquisition of Aixtron SE's U.S. business on December 2, 2016 (see our related Alert).

As with many other countries, the concerns in the UK stem in part from investment by foreign state-owned entities in the technology, infrastructure and natural resource areas (for example Hinkley Point itself, as well as the potential takeover of Centrica by Gazprom in 2006) as these are seen to pose national security concerns. For an overview of the new U.S. Administration's potential approach to these issues, please see our related Alert.

Equally, the concerns stem from fears over jobs and technological know-how, as demonstrated by the takeover of Cadbury by Kraft in 2010 (and the consequent controversial

closure of a Cadbury facility in the UK) and the attempted takeover by Pfizer of AstraZeneca in 2014. During Pfizer's attempted takeover of AstraZeneca, the maintenance of the UK's research and development capabilities was mooted as a potential ground for intervention, although no decision was taken. Indeed on July 11, 2016 Theresa May stated:

> "Because as we saw when Cadbury's – that great Birmingham company – was bought by Kraft, or when AstraZeneca was almost sold to Pfizer, transient shareholders – who are mostly companies investing other people's money – are not the only people with an interest when firms are sold or close. Workers have a stake, local communities have a stake, and often the whole country has a stake."

That said, the recent acquisition of ARM, one of the UK's leading hi-tech electronics companies, by Japan's Softbank was encouraged and supported by the Government, though not without criticism. Softbank gave post-offer undertakings (the first company to do so under the revised Code) that included doubling the UK workforce within 5 years and maintaining ARM's headquarters in the UK for at least the next 5 years. It also gave post-offer intention statements relating to employees, management, places of business and fixed assets. Similarly the recent (November 24, 2016) announcement of the takeover of Skyscanner, a travel search business and one of the UK's few so-called "unicorns", by Chinese rival Ctrip for £1.4bn 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 appears to believe that an issue in this field is that successful British businesses are being sold rather than expanding. On November 21, 2016 the Prime Minister said it was a problem that, "*too frequently fast-growing firms can't get the patient long-term capital investment they require, and have to sell-out to overseas investors to access the finance they need*", and on November 23, 2016 the Chancellor spoke of tackling "*the longstanding problem of our fastest growing technology firms being snapped up by bigger companies, rather than growing to scale*" and announced additional Government funds to address this.

In turn, this demonstration of the state directing money towards certain sectors as well as the apparent desire to protect certain sectors from foreign takeovers and investment has caused concern. The CMA itself submitted, in October this year, to the BEIS enquiry that the proposals to revise the definition of "public interest" could decrease objectivity and certainty and some, such as Ian Forrester QC (a UK judge at the General Court in Luxembourg), have commented that it would be "*unfortunate*" if the UK moved to politicise its competition rules following Brexit.

Potential Reforms

Prior UK 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. There is now, however, what appears to be a cross-party consensus that some sectors are strategic and deserve special attention and / or support. The Government is presumably looking to widen the definition of public interest in order to increase the number of grounds on which it can intervene. 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 UK Enterprise Act 2002. To date, the Government has only used “national security” grounds in relation to the defence sector. A method 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 R&D 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 authorised 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 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 UK, 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 UK 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, increasing economic uncertainty in a fragile environment, and of dissuading foreign investment in UK infrastructure and the UK economy as a whole. All that said, however, the Government does appear determined to increase its ability to scrutinise foreign investment in the UK as part of its “industrial strategy”, the details of which will be revealed over the next few months.

Covington’s Experience

Covington has the preeminent practice representing parties before CFIUS and in matters requiring the mitigation of foreign ownership, control, or influence over U.S. government contractors. Our representations have included the leading transactions and most complex CFIUS reviews in the aerospace/defence, software/IT, telecommunications, energy, transportation, chemicals, infrastructure, and finance sectors. As the UK forms proposals on the future foreign investment landscape, Covington is uniquely situated to leverage the capabilities of its CFIUS practice alongside its leading public policy, European litigation, and

corporate practices, including a team of world-leading policy makers and diplomats to assist stakeholders through the reform process.

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