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Foreign Investment Regime Reforms in the UK

March 23, 2018

Litigation and Investigations

On March 15, 2018, the Government introduced legislation to Parliament that would strengthen the state's ability to scrutinise the national security implications of foreign investment in cutting-edge technology sectors. As anticipated in proposals published in October 2017, the main change is that the Government will be able to scrutinise transactions in those industries where the target's UK turnover is £1 million or more. For these industries, this is a significant change to the current turnover threshold of £70 million[1].

In December 2016, we commented on potential changes to the foreign investment regime in the UK. Since then, as well as heavy press and Parliamentary Select Committee interest, the Government has introduced staged proposals for reform. The first stage is now in the form of Statutory Instruments to amend the existing Enterprise Act 2002.

Below we provide a brief overview of: (i) the new industrial strategy announced by the UK government in November 2017; (ii) the short-term and long-term proposals to amend the foreign investment regime in the Government Green Paper of October 2017 -- and the amendments put before Parliament on 15 March; (iii) proposals from the Takeover Panel from September 2017 and implemented in January 2018; (iv) increased Parliamentary activity more generally; and (v) EU-wide proposals from the European Commission in September 2017 in the form of a proposed draft regulation on the screening of foreign investment in the EU.

Summary of Background and Principal Developments

As with other countries, the focus on what methods are available to screen foreign investment has Chinese state-owned or state-backed entities' activities uppermost in mind. In the UK, this is in part a result of deals such as Hinkley Point C, estimated to provide, once running, 7% of the projected UK generation needs for 60 years, and investments in UK technology companies. Indeed, it seems fair to say that the UK is alone among Western economies to be quite so open to foreign investment, and even more so to investment by foreign governments.

While Western economies may be genuinely concerned with preventing the control of sensitive and critical assets by foreign state actors, this is evidently an area ripe for political grand

[1] While this also has implications for the threshold for intervention on competition grounds, this article does review those, aside from noting the Government's view that competition scrutiny will not be materially affected in practice.

gestures and in which protectionism can find its practical expression. To that end, the Government has been keen to reassure businesses and investors that these reforms are solely focused on national security issues of genuine public interest rather than protectionism.

The principal development is that the government has put forward short-term and long-term proposals for reform of the Enterprise Act 2002. The short-term proposals -- now formalised in rules subject to Parliament's approval -- intend to amend thresholds for intervention, by both the Competition and Markets Authority ("**CMA**") and the Government on national security grounds[2], in transactions in the advanced technology and dual-use sectors, in particular the reduction of the target's UK turnover threshold from £70 million to £1 million, and where the target has a lower turnover but supplies at least 25% of the relevant goods or services in the UK market.

The long-term proposals show that the UK (on all sides of the political spectrum) has still not decided what to do in order to balance openness (in particular with Brexit in mind) and national security interests. At present, there is a sense that the 'mind' is dictating the imperative of ensuring the UK is seen as open to foreign investment but the 'heart' wants to move towards a more actively interventionist regime.

Government Industrial Strategy

In November 2017, the Government unveiled its "*industrial strategy*" to transform the economy and, in particular, address the perceived issues (as set out in our 2016 article) of lack of productivity, shortfalls in R&D investments, a lack of ability for firms to find the funding to grow from SME status into large companies, and short-termism.

The industrial strategy is to build "*the world's most innovative economy*" and, aside from expected gains for individuals and communities, this is expected to include: (i) a major upgrade to the UK's infrastructure; and (ii) an intent that the UK be the best place to start and grow a business. Both of these last two targets will require openness to foreign investment and participation in the UK economy. Indeed, the Government stated, "*Building on our strengths, the strategy ensures we remain one of the world's most open economies by:*

- welcoming investment from overseas
- participating in global supply chains
- buying and selling goods and services from all over the world
- continuing our active participation in the international community."

Following on from this, sector deals are to be agreed, and so far there have been such deals in the life sciences (in December 2017) and automotive sectors (in January 2018), with one to come in agriculture (concerning agri-tech), where investment targets (e.g., with respect to infrastructure and supply chains) are agreed and commitments given between the Government and the private and charitable sectors.

[2] We understand that in theory these could also apply to the ability of the Government to intervene on the grounds of financial stability or media plurality, but in practice, given the sectors targeted, these are not expected to be affected by the changes.

Government Green Paper

Following the July 2017 Queen's Speech, the Department for Business, Energy and Industrial Strategy ("**BEIS**") issued a Green Paper on October 17, 2017. This was focused on proposals for developing the UK's regime for screening and intervening in transactions with national security concerns. The specific concerns centred around critical national businesses and infrastructure, and potentially inappropriate levels of influence and control by foreign state entities over those assets.

By way of recap, the UK operates a voluntary (rather than mandatory) merger notification regime. Above certain high thresholds (the target having annual turnover of more than £70 million and/or the merger resulting in 25% or more market share): (i) the CMA is able to scrutinise a transaction for its effects on competition; and (ii) the Government may intervene in the public interest, essentially in cases of national security, financial stability and media plurality. The voluntary nature of the regime does not mean that transactions escape scrutiny, because the market or CMA's dedicated Mergers Intelligence Committee will generally be aware of proposed transactions. As those transactions can be unwound, frozen or subject to intervention (e.g. by ordering disposals), in practice parties do notify if they consider that the merger is likely to raise the possibility of competition or public interest concerns.

Short-term Proposals

The Government proposed amendments to be made to the turnover threshold and share of supply tests in the advanced technology and military and dual-use sectors. These have now been formalised, laid before Parliament, and are discussed further below

Long-term Proposals

The Government believes that the UK foreign investment regime is less well developed generally than the regimes of the four other nations it looked at (the U.S., Australia, Canada and France) and it also believes that its powers are too limited in certain areas. The conclusion drawn was that the UK regime is inconsistent, too reliant on voluntary notification, and potentially too uncertain for business.

While this suggests a more interventionist regime, the government also wants the UK to be perceived as remaining open for business, in particular with Brexit looming. The Green Paper's broad themes are whether: (i) to expand the 'call-in' powers to allow the Government to scrutinise a broader range of transactions for national security concerns within a voluntary notification regime; and/or (ii) to introduce a mandatory notification regime for foreign investment into the provision of a focused set of 'essential functions' in key parts of the economy. These are not mutually exclusive and, indeed, one can expect the outcome to be a mix of both. In essence, we can envisage a regime where the power to intervene is strengthened, more questions are asked and information requested than before, but intervention will remain relatively rare.

Aside from these two themes, proposals have been made in specific areas. For example, the Green Paper includes proposals for introducing measures allowing the clawback of government funding for R&D, where a company that has received funding has been taken over and would not have been eligible for such funding.

Increase the government's 'call in' powers

This would expand the government's 'call-in' power and increase its abilities to scrutinise more transactions for national security concerns.

The suggestion is that the Secretary of State[3] would be able to intervene on national security grounds if there was a reasonable belief that national security risks had been raised by the acquisition of "*significant influence or control*" (in essence, the acquisition of more than 25% of a company's shares or votes) over "*any UK business entity by any investor (either domestic or foreign)*".

Introduction of a Mandatory Regime

There is a proposal for a mandatory notification regime for foreign investment (involving the acquisition of significant influence or control) in the provision of "*essential functions*". Initially, this would involve 13 sectors including civil nuclear, communications, defence, energy, transport, as well as the military and dual-use, and advanced technology sectors. Some sectors that could be considered vital are not proposed to be included for now, being chemicals, financial services, food, health, space and water. The list is not exhaustive and it is anticipated that mandatory notification may also be required in *ad hoc* situations where critical services or national infrastructure are involved.

Process and Timing

The Green Paper's consultation periods ended in November 2017 for the short term proposals, and January 2018 for the long term proposals. The BEIS has reviewed responses to the short-term proposals culminating in its March 15, 2018 recommendations (see below). The BEIS is currently reviewing responses to the consultation on long term proposals and has stated that it will set out its proposals in a White Paper later this year[4].

In terms of how the reforms will be implemented in practice, the CMA will continue to be separate from the national security scrutiny side. The government has established the Investment Security group ("**ISG**"), a forum of relevant Government departments and agencies, chaired by the Deputy National Security Adviser, that will consider the implications of foreign investment for national security and give the government advice on such investment. The ISG is there to ensure consistency and coordination in the approach to scrutinising transactions. The formalisation of such a committee indicates an anticipation of increased activity in this area.

[3] In the case of national security, this would be following a consultation with a number of government departments, most notably the Ministry of Defence and the Business, Energy and Industrial department.

[4] A Green Paper is normally intended to stimulate discussion, reviewing potential courses of action and proposals for new laws and regimes, while a White Paper is the precursor to draft legislation being introduced into, and debated in, Parliament.

Changes Introduced on March 15, 2018

On March 15 this year, the BEIS released its response (to the consultation on the short-term proposals), draft non-Statutory guidance, and confirmed its intention to introduce two corresponding Statutory Instruments.

These are the Enterprise Act 2002 (Share of Supply Test) (Amendment) Order 2018, an "affirmative statutory instrument"[5] concerning the share of supply test, and the Enterprise Act 2002 (Turnover Test) (Amendment) Order 2018, a "negative statutory instrument"[6] concerning the turnover thresholds. The first was laid before Parliament on March 15, and if passed, the second will be submitted for approval. Subject to Parliamentary approval, both are expected to become effective in the coming weeks, and to apply to mergers concluded after that date.

The Government documents released on March 15, 2018 stated that it expected an additional five to 29 transactions a year would be affected by these changes, of which one to six might require a Public Intervention Notice that would more closely and formally examine the transaction[7].

Affected Sectors

The revised tests apply only to transactions in three areas of the economy: (i) the development or production of items for military or military and civilian use (known as "dual use", examples of which might be drones or seabed mapping); (ii) the design and maintenance of aspects of computing hardware; and (iii) the development and production of quantum technology. It includes research, development, design, manufacture and the supply of services in those sectors. These three areas are to be defined through an amendment to the definition of a "relevant enterprise", pursuant to a new section 23A to the Enterprise Act 2002.

Military and dual-use

Under the proposed section 23A the "military and dual use" sector will be defined as enterprises involved in the development and production of "restricted goods", being those specified in the "relevant export control legislation", meaning:

> "(a) Schedules 2 and 3 to the Export Control Order 2008;
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> (b) the Schedule to the Export of Radioactive Sources (Control) Order 2006;
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> (c) Annex I to Council Regulation (EC) No. 428/2009."

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[5] This type of Statutory Instrument requires approval from both Houses of Parliament. However, Parliament can accept or reject a Statutory Instrument but cannot amend it.

[6] This type of Statutory Instrument does not require Parliamentary approval and become law on a fixed date absent objections within 40 days. It can be annulled by a resolution of either House of Parliament.

[7] As explained in our December 2016 article, this leads to a Phase 1 Report from the CMA, potentially a Phase 2 Report after which the Government can accept undertakings, make orders to remedy, mitigate or prevent adverse effects, or block the transaction. All these stages are subject to judicial review, i.e., Court scrutiny of whether the Government acted in a reasonable and lawful manner.

The concern was that a number of smaller niche companies, including some without defence contracts, have increasingly been designing and producing such items and they fall outside the existing regime for scrutiny. There will be detailed guidance alongside the new provisions. The government proposes the use of some of the Strategic Export Control Lists to determine the scope of what goods, and therefore what businesses, will be caught in this category. While Strategic Export Control Lists are updated from time to time, updates will not automatically update across to the amended merger thresholds. Instead, periodic secondary legislation will be brought in to reflect changes.

Computer hardware

The definition of "multi-purpose computing hardware" has been refined following the consultation, and will encompasses enterprises whose activities consist in or include under the proposed section 23A:

> "(c) owning, creating or supplying intellectual property relating to the functional capability of -
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> > (i) computer processing units;
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> > (ii) the instruction set architecture for such units;
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> > (iii) computer code that provides low level control for such units;
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> (d) designing, maintaining or providing support for the secure provisioning of management of -
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> > (i) roots of trust8 of computer processing units;
> >
> > (ii) computer code that provides low level control for such units."

Quantum-based technology

The definition of "quantum-based technology" in the proposals has also been refined following the consultation[9]. Under the proposed section 23A(e), (f) and (g), this will now encompass enterprises involved in "research into", "developing or producing anything designed for use in", or "supplying services employing":

> > "(i) quantum computing or simulation;
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> > (ii) quantum imaging, sensing, timing or navigation;
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> > (iii) quantum communications; or
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> > (iv) quantum resistant cryptography."

As alluded to above, this definition includes the creation of intellectual property for these areas, through use of the terms research and development.

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[8] According to the proposed definition, this means "*(a) means hardware, firmware, or software components that are inherently trusted to perform critical security functions; and (b) includes cryptographic key material bound to a device that can identify the device or verify a digital signature to authenticate a remote entity*".

[9] Most of the terms used (e.g. "quantum computing" and "quantum imaging") have, in turn, their own definition. For ease of review, these are not set out here but can be found in the draft Statutory Instrument.

Amended Thresholds Relating to the Turnover and Share of Supply Tests

For the above three areas, the UK turnover threshold, applicable to the target, will reduce from £70 million to £1 million. Even if the turnover threshold is not met, for only these three areas, the new lower share of supply test will apply: i.e., the target must have a share of supply of 25% or more of relevant goods or services in the UK, as will the existing share of supply test (that the merger leads to an increase in the merging parties' share of supply to 25% or more).

The draft guidance that will be finalised and issued alongside the Statutory Instruments will attempt to assist companies to assess whether they fall within the new regime, as well as an explanation of the process of assessment and review, and a realistic assessment of how long it would take to reach a decision.

The Takeover Panel

In our previous article, we gave an overview of applicable Takeover Panel rules, and in particular the recent introduction into the Takeover Code (which determines the process and timing of mergers and acquisitions related to London Stock Exchange-listed companies) of specific and precise post-offer undertakings and intentions to be agreed with the Takeover Panel. In September 2017, the Takeover Panel issued proposals for further reform and the proposed amendments came into force on January 8, 2018.

The main aims were to obtain better information provision, more time for scrutiny and to provide for better monitoring of post-offer undertakings and intentions given by acquiring companies. Of particular relevance for foreign investment is that more stringent requirements have been introduced on offerors, at the front-end and afterwards, to give some reassurance that assets, knowledge and operations will not simply be stripped and moved out of the UK, and employees terminated.

At the front-end, offerors have to make specific statements of intention with regard to R&D functions, with regard to any material change in the balance of skills and functions of the employees and management, and with regard to the location of the company HQ. Afterwards, there is a requirement for companies to report on post-offer undertakings (which are susceptible to a higher degree of monitoring and, potentially, independent supervision) and intention statements, and to report to the public if they digress from these within 12 months.

Parliamentary Scrutiny

Parliamentary Select Committees that shadow governmental departments (such as the Treasury Committee, the Business, Energy and Industrial Strategy Committee, the Work and Pensions Committee and the Culture, Media and Sports Committee) have had an increased profile and activity since 2010. These committees can take evidence in hearings, and request information in correspondence. Their powers are wide-ranging and generally unchallenged or criticised and, when used and steered properly, they can be highly effective in scrutiny.

With regard to takeover and investment activity, the relevant committees can take evidence from executives (from bidder and target, as well as other involved parties, such as workers' union and pensions regulators) on subjects as wide-ranging as how the company will be run, assurances on long-term intentions, undertakings to be given to the Takeover Panel (if involving a listed company), how any bid will be funded[10], national security impacts, pensions scheme assurances, relations with unions, potential impacts on jobs, research and development, supply chains and -- as is common in the last few minutes of any committee hearing -- awkward questions on executive remuneration.

Developments at EU Level

In early 2017 Germany, France and Italy called for EU-level intervention in the screening of foreign investments. This followed the general tightening of foreign investment regimes more generally in defence and critical infrastructure, on top of public order and security, (as set out in our prior article) primarily directed at Chinese investment.

Proposals were put forward in September 2017 for a new EU-wide regulation aimed at harmonising the screening of foreign direct investments, increasing cooperation, and increasing collaboration on intervention in transactions involving state-subsidised companies taking investments in sensitive areas.

Currently around half of EU Member States have specific rules and procedures in place. In broad terms, for those with systems in place, there will be a requirement to report annually to the European Commission on the screening of foreign investment and, for those with no systems, a report to the European Commission on foreign investment taking place in their country. Aside from these cooperation and information mechanisms, there are two, more interventionist, proposals for: (i) a EU-wide framework for screening of foreign direct investments by Member States on grounds of security or public order; and (ii) European Commission screening.

As to the EU-wide framework, the idea is to put in place a harmonised structure with some base principles of transparency, equal treatment and adequate redress. As noted by most headlines on this topic, this will also include a requirement to inform the European Commission and Member States of foreign investment that could raise "*security and public order*" concerns. These will be widely interpreted and will include (non-exhaustively) effects on critical infrastructure[11], critical technologies[12], on the security of supply of critical inputs (e.g. raw and primary products) and effects on access to, or the ability to control, sensitive information.

As to the European Commission screening, the idea is that where foreign investment could affect (on security or public order grounds) a project of EU interest, the European Commission can conduct a security review of the investment and give a non-binding opinion to the relevant EU country. Examples given include projects and programmes in the R&D, space, transport, energy and telecoms sectors.

[10] We would note that these committees' focus on funding, leverage and long-term holding is of particular relevance to private equity funds.

[11] This would include energy, transport, communications, data storage, space, financial infrastructure, sensitive facilities.

[12] This would include artificial intelligence, robotics, semiconductors, dual use, cybersecurity, space, nuclear technology.

While there had been calls for a mutuality regime, whereby, for example, foreign investors from countries that provided for certain restrictions on foreign investment (such as the requirement to establish joint ventures with a local partner or IP transfers) should face those same restrictions in the EU, the EU proposals do not go so far as to introduce mutuality.

The European Commission said that it would set up a coordination group on inward direct foreign investment to cover all issues under the scope of the proposed screening Regulation, but that it will also be a forum for wider discussions. Its broad remit will include identifying sectors and assets that have strategic implications from a security, public order and/or control of critical assets point of view at national level, cross-border level or at European level. It will discuss issues of common concern, such as subsidies and other practices by third countries facilitating strategic acquisitions. The group will be chaired by the Commission and composed of representatives of all Member States. This would seem to be a cross-between the Committee on Foreign Investment in the U.S. (known as CFIUS) and the UK's ISG, with a policy remit as well as a transactional advisory remit.

The European Commission will also carry out an in-depth analysis of foreign direct investment flows into the EU by the end of 2018. This will focus on strategic sectors (such as energy, space, transport) and assets (key technologies, critical infrastructure, sensitive data) whose control may raise concerns for security, or public order reasons, and will have particular regard to investments by state-owned or state-backed entities.

Conclusions

The failure of the Conservative Party to gain a majority in May 2017 was expected to dampen the appetite for changes to the UK's regime for screening foreign investment. However, it does seem there is cross-party support for more studied and strategic intervention. It seems clear that notification obligations will increase, in a wider range of sectors, affecting a wider range of transactions, both as to type of control gained and as to size. The short term proposals outlined above, now introduced to Parliament, testify to that.

Against that, the Government's industrial strategy, Brexit concerns, and the direction which the EU may be taking towards a wider arsenal of interventionist tools, may mean an emphasis in the UK to rare intervention, so as to preserve the UK's reputation as being relaxed about, and open to, foreign investment.

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