

UK Government Proposes Greater Intervention in National Security and Infrastructure Mergers

October 24, 2017

On October 17, 2017, the UK Government published legislative proposals that would give it greater powers to intervene in mergers that raise national security considerations or involve national infrastructure. In the short-term, any transaction involving a party active in the manufacture or design of products for military use or in the “advanced technology” sector could face review on public interest grounds where the target’s UK turnover exceeded £1 million. In the longer-term, an even wider set of transactions – including bare asset sales and investments in new projects – could be scrutinised on national security grounds and be subject to mandatory notification to the UK Government before being allowed to proceed.

On becoming Prime Minister in July 2016, Theresa May called for the UK to introduce “a proper industrial strategy to get the whole economy firing.”¹ Referring to the attempted acquisition of AstraZeneca by Pfizer, she argued that UK law should be changed to allow the Government to defend sectors that are important to the economy. Those comments were seen in the context of Brexit, which is likely to allow the UK greater freedom to determine its own merger policy, and the debate surrounding foreign investment in the Hinkley Point nuclear power station.

The latest proposals, published for consultation in the form of a legislative Green Paper, are narrower in scope; they are limited to mergers raising questions of national security or control of national infrastructure. These terms are nevertheless defined broadly and have the potential to capture transactions that have only a tangential relationship to national security. The proposals could also result in the introduction of a mandatory merger review regime in the UK for the first time, as well as a new test of “significant influence or control.”

This Alert Memorandum summarises the proposals and the potential extent of their application.

¹ See <http://www.theresa2016.co.uk/we-can-make-britain-a-country-that-works-for-everyone>

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

LONDON

Maurits Dolmans
+44 20 7614 2343
mdolmans@cgsh.com

Nicholas Levy
+44 20 7614 2243
nlevy@cgsh.com

Romano Subiotto QC
+44 20 7614 2296
rsubiotto@cgsh.com

Paul Gilbert
+44 20 7614 2335
pgilbert@cgsh.com

David R. Little
+44 20 7614 2338
drlittle@cgsh.com

John Messent
+44 20 7614 2377
jmessent@cgsh.com



Background

Merger review in the UK is largely free from political interference. One of the objectives of the Enterprise Act 2002 (EA 2002) was to remove Ministers from the decision-making process in UK merger cases, with decisions taken by expert authorities on competition grounds alone. The Government retained the right to intervene in only a small subset of cases, falling into one of three categories.

- **Public interest cases.** Public interests are defined in the EA 2002 as national security, plurality of the media, and stability of the UK financial system, although the Secretary of State has the power to add other considerations by making an order that must be approved by Parliament.
- **Special public interest cases.** Special public interest cases are mergers that do not meet the UK's merger jurisdiction tests, but which may still be investigated on public interest (but not competition) grounds. They are limited to mergers involving "government contractors" holding confidential information relating to defence and certain mergers in the newspaper and broadcasting sectors.
- **EU Mergers.** Certain mergers reviewable by the European Commission under the EU Merger Regulation can also be reviewed on public interest grounds at national level. Under the EU Merger Regulation, Member States may take "appropriate measures" to protect public security, the plurality of the media, and prudential rules. Any other public interests must be approved by the European Commission on a case-by-case basis.

To date, the Government has intervened in only 12 cases under these powers, seven on grounds of national security.

In the event that the UK leaves the European Union, it is likely to have greater freedom to determine its own merger policy. In particular, the UK could intervene in cases that fall within the scope of the

EU Merger Regulation on a wider range of public interest grounds than is currently permitted.²

In addition to merger control, the Government can exercise powers to limit or revoke the licences of firms operating in regulated sectors on a change of control and, in some limited circumstances, has specific statutory powers allowing it to intervene in transactions.

- Under the Industry Act 1975, the Secretary of State can issue an order prohibiting a non-UK person from gaining control of manufacturing undertakings deemed to be of special importance to the UK. The Government has never used this provision and, in the case of a merger falling within the EU Merger Regulation, any prohibition would have to be agreed by the European Commission under Article 21(4) of the Regulation.
- Under the Water Industry Act 1991, the Competition and Markets Authority (CMA) can prohibit a merger if it is likely to prejudice Ofwat's ability to make comparisons for the purpose of carrying out its statutory functions (such as setting price controls on regulated water enterprises and other regulatory functions).³

In extreme cases, the Government can take emergency measures under the Civil Contingencies Act 2004 to address actual or threatened emergencies (e.g., serious threats to human welfare resulting from disruption to the supply of money, food, water, energy or fuel, or a threat to communication or transport systems).

Motivation for the Green Paper

The Green Paper introduces proposals for addressing perceived deficiencies in the current regime. It sets out the Government's proposals for reforming the

² See Cleary Gottlieb Alert Memorandum "[Industrial Strategy Post-Brexit: The UK's Power To Block Mergers On Public Interest Grounds](#)" July 2016.

³ The European Commission has recognised the UK's legitimate interest under Article 21 of the EU Merger Regulation to apply the special water regime to ensure that Ofwat can continue to exercise its regulatory functions in a satisfactory manner.

UK regime in both the short-term and the longer-term. The short-term proposals would arguably be compatible with the EU Merger Regulation, whereas some aspects of the longer-term proposals could not be implemented before the UK left the European Union.

Despite Prime Minister May's 2016 call for wider powers to protect companies in important sectors of the UK economy, such as pharmaceuticals, the Green Paper is limited to the protection of national security (albeit widely defined).

The Green Paper argues, at some length, that the UK should continue to be one of the "top destinations" for foreign direct investment. It also stresses the benefits of foreign investment in upgrading, renewing and expanding national infrastructure.

The Green Paper nevertheless argues that foreign control of businesses involved in the defence sector or operating "critical national infrastructure" can raise national security concerns. Having reviewed the regimes in other developed economies (including, Australia, Canada, France, and the United States), the Green Paper states that the UK regime is less well developed than those of other countries. In particular, the Green Paper contends that the UK regime appears to be inconsistent (between different sectors and types of case), too reliant on voluntary powers, and potentially uncertain for business.

The Green Paper also notes recent proposals by the European Commission to introduce EU-wide Foreign Direct Investment Screening, which have more to do with ensuring consistent process across the EU than adding new substantive grounds for intervention.⁴ The EC's proposals are likely to be introduced after the date at which the UK is expected to leave the European Union.

The Green Paper sets out five principles and aims:

- To ensure the UK remains attractive to inward investment;
- To provide certainty and transparency wherever possible;
- To reflect national security concerns;

- To ensure a target scope for intervention wherever possible; and
- To ensure the new powers are proportionate.

The Government stresses that it would expect to intervene in only exceptional cases. It estimates that fewer than 100 transactions a year would fall within scope of the new rules and that "only a small proportion of these transactions" would likely be subject to conditions or blocked outright.

Short-Term Proposals

In the short-term, the Government proposes amending the jurisdictional thresholds for mergers in certain defined sectors. At present, mergers can be notified voluntarily or called in for review only if one of two jurisdictional thresholds is met:

- The target firm has UK turnover of more than £70 million; or
- As a result of the merger, the parties' combined UK share of supply or purchases of goods or services of the same type would increase to 25% or more.

Other than special public interest cases, the Government cannot intervene on public interest grounds unless the transaction qualifies for merger review. Under the Government's proposals, the merger thresholds would be reduced for transactions involving firms in one of two sectors that it considers could raise national security concerns: the military and dual use sector, and the advanced technology sector. Specifically, a merger in one of these sectors could be subject to review if the target's UK turnover exceeds £1 million (regardless of the share of supply). The Government acknowledges that, if it amends the provisions of the EA 2002 by statutory instrument in the way proposed, it would also extend the lower intervention thresholds to cases involving other public interest considerations (such as media plurality or financial stability). It intends to publish guidance explaining the types of cases in which it would use these additional powers.

The military and dual-use sector

The military and dual-use sector would include all firms involved in the design or production of military equipment, as well as products that could be

⁴ Details of the Commission's proposals can be found at: http://europa.eu/rapid/press-release_IP-17-3183_en.htm

used for military as well as civilian purposes (dual use). Although the Government is already able to intervene in some defence mergers as special public interest cases, not all firms involved in the design or production of military items are defence contractors or hold confidential defence material.

In relation to dual-use products, the Green Paper identifies risks from the acquisition of small businesses that design or produce items, or have technical expertise, with possible military applications. It argues that, with advances in technology, small businesses that undertake niche activities or highly specialised activities may hold information that is significant for national security. Today, the acquisition of a small business is likely to avoid scrutiny if the target's UK turnover is below £70 million and the merger does not create or enhance a UK share of supply of at least 25%.

To determine whether a firm falls within the military or dual-use sector in practice, the Government proposes to apply the revised thresholds to firms involved in the production of goods listed on the Strategic Export Control Lists, specifically the UK Military List, the UK Dual-Use List, the UK Radioactive Source List and the EU Dual-Use Lists. These lists identify products, software and technology that are considered to carry national security or human rights risks, and which cannot be exported from the UK without a licence from the Export Control Organisation.⁵

The advanced technology sector

The Government is concerned about national security risks (*e.g.*, the threat of cyber warfare) arising from the acquisition and use of new technologies, particularly those relating to advances in computing power and connectivity. It argues that technology advances are often driven by the creativity and energy of small businesses. While some of these technologies may fall within the proposed definition of dual-use products, others may not. The Green Paper therefore proposes to apply the lower intervention thresholds to the acquisition

of any business involved in “advanced technology.” Under the current proposals this would comprise:

- **Multi-purpose computing hardware.** “Enterprises that: (i) own or create intellectual property rights in the functional capability of multi-purpose computing hardware; or (ii) design, maintain or support the secure provisioning or management of roots of trust of multi-purpose computing hardware.”
- **Quantum-based technology.** “Enterprises that research, develop, design or manufacture goods for use in, or supply services based on, quantum computing or quantum communications technologies. This would include the creation of relevant intellectual property or components.”

The Green Paper does not provide details of how the Government intends to analyse public interest considerations under these proposals. It has, however, already established a cross-Government forum comprising different departments and agencies to consider the implications of foreign investment for national security and provide advice to Ministers. The Government also recognises a tension in wanting to provide as much clarity as possible in the review of transactions while still maintaining secrecy for national security reasons.

As with other UK mergers, it will be for parties to decide whether to notify a transaction voluntarily or risk the transaction being called in for review, including after completion.

The Government has invited comments on the short-term proposals by November 14, 2017.

Longer-Term Proposals

The Green Paper sets out two options for longer-term reform, either of which would enable a far higher degree of intervention than the existing regime:

- A voluntary regime, with an expanded power to “call-in” transactions, modelled on the existing EA 2002 power, which would allow the Government to scrutinise a broader range of transactions for national security

⁵ The Strategic Export Control Lists are published at: <https://www.gov.uk/guidance/uk-strategic-export-control-lists-the-consolidated-list-of-strategic-military-and-dual-use-items>

concerns, including new projects and bare asset sales; and

- As an alternative to or in combination with the above, a mandatory notification regime for foreign investment into the provision of a focused set of “essential functions,” for example the civil nuclear and defence sectors (including investment in new projects or specific businesses/assets).

As under the existing regime, the Government would be able to approve, impose conditions on or, *in extremis*, prevent or unwind a transaction.

Intervention would occur only when necessary and proportionate for national security reasons, and would be subject to procedural safeguards and judicial review.

Any national security review would be separate from the existing competition process, and there would be no amendments to the process relating to other public interest considerations (*i.e.*, financial stability and media plurality).

Deficiencies identified in the existing regime

The longer-term proposals aim to address four deficiencies identified in the existing regime:

- National security concerns can arise in relation to businesses/assets affecting national infrastructure, but powers to intervene in these sectors are inconsistent;
- National security risks may arise in transactions unrelated to competition issues, as well as in relation to new projects, proximate sites and sales of assets, to which the Enterprise Act 2002 does not apply;
- A voluntary system carries the risk that the Government may be unaware of transactions that raise national security concerns; and
- Under a voluntary system, businesses cannot be certain which transactions the Government will be interested in.

The Green Paper seeks “the best balance between the Government’s need to know and ability to act where needed, certainty for businesses and investors, and the burden placed on businesses in complying with the regime.”

Voluntary regime with expanded “call in” power

One of the options proposed in the Green Paper entails the retention of a purely voluntary regime, but with greater scope for “national security intervention” in the “acquisition of significant influence or control over any UK business entity by any investor (either domestic or foreign)” in any sector or “any other transaction that gives (directly or indirectly) significant influence or control over that company or over its assets or businesses in the UK.” Any acquisition of more than 25% of a company’s shares or voting rights would also qualify. Such powers might also extend to new projects and the sales of bare assets.

The Government could therefore intervene even if there were no relevant merger situation for competition law purposes. Only relevant merger situations would be subject to competition assessments, as under the existing regime.

To address concerns over uncertainty, the Green Paper proposes the publication of a list of indicative, but not exhaustive, means by which an investor can obtain significant influence or control (“such as an investor obtaining unrestricted access to sensitive sites or data”). The Green Paper also emphasises that the Government intends to intervene in only a “very small number of cases” and suggests that it might provide informal advice as to whether it has national security concerns in particular investments.

Mandatory notification regime

An alternative or additional option would be mandatory review for “all foreign investors in specified sectors [...] before the transaction could take legal effect.” A decision would be made within a “clear, short timeframe.”

A mandatory notification regime would apply to companies:

- Which undertake, or are crucial to the undertaking of, the essential functions that are critical to ensuring national security;
- Where foreign ownership or control poses a risk which there are no other reasonable means of adequately mitigating; and
- Where existing licensing or regulatory

regimes are insufficient.

Of the 13 sectors that comprise the UK's national infrastructure, there are five that the Government would be "strongly minded" to define as "essential functions, automatically bringing companies within the scope" of a mandatory regime:

- Civil Nuclear (*e.g.*, operation of reactors);
- Communications (*e.g.*, voice/data infrastructure, if impairment could deprive more than one million end users of network);
- Defence (companies with facilities on List X or issued with a Security Aspects Letter);
- Energy (*e.g.*, "Energy suppliers that provide energy to significant customer bases"); and
- Transport (*e.g.*, air traffic control services).

A mandatory regime would also apply to the manufacture of military and dual-use items and advanced technology, and might be expanded to cover "certain named individual businesses or assets." The Green Paper also suggests extending the regime to the acquisition of land that is in proximity to a national security-sensitive site where foreign ownership or control of such land, buildings or other fixed structures could give rise to a national security risk (*e.g.*, from espionage or sabotage).

The consultation closes on January 9, 2018.

Comment

The short-term changes will require relatively little adjustment to the present regime, although the definition of "advanced technology" in the Green Paper is potentially broad.

As explained above, the short-term proposals could extend the lower intervention thresholds to other public interest considerations (such as media plurality or financial stability). The Government proposes publishing guidance explaining the types of cases in which it intends to use these additional powers. It is unclear why this could not be achieved in the legislation implementing the changes, which would provide greater legal certainty.

The longer-term measures, on the other hand, could lead to a significantly more complex environment, less certainty, and an increased scope for political

involvement in mergers. Debate will likely focus on the breadth and precision with which the Government defines the types of transaction and the sectors to which the regime will apply, as well as the merits of voluntary and mandatory regimes.

The possibility of mandatory notification for certain transactions not only risks undermining some of the flexibility of the current voluntary regime, but its workability will depend on firms being able to determine in advance, with sufficient certainty, whether any given transaction should be notified.

If the proposals proceed, there will inevitably have to be a balance between the Government's retaining the ability to intervene whenever it perceives a potential national security risk, and the need to provide certainty for business and proportionality in the burdens imposed by the regime. The Government recognises the latter two considerations throughout the Green Paper, but asserts that "national security must be prioritised in its decision-making."

The Green Paper explains that national security review under the proposed longer-term reform would be separate from the CMA's assessment of competition and other public interest considerations (*i.e.*, financial stability and media plurality). The Paper does not, however, specify whether national security review would fall to the CMA, existing regulators, or a new body. It may be preferable for any review of national security elements to be separate from a competition review; investigating public interest is a different exercise from investigating whether a transaction may result in a substantial lessening of competition.

Ultimately, whether national security review is conducted under a voluntary or mandatory regime, the principal concern for investors will be whether there is a clear and objective basis on which to determine whether intervention is likely (and, if so, what form of intervention may be anticipated in any given case).

...

CLEARY GOTTlieb