National interest screening: a growing challenge for international transactions?

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"The national security elements of the UK merger control system have been perceived as relatively liberal up to now, so there is an argument that the proposed reforms would close the gap with the regimes in France, Germany, the U.S. and Australia – but the change to a more interventionist regime is likely to cause some deal friction."

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Introduction

The proliferation of merger control regimes around the world – and the resulting need to consider potential notification requirements in multiple jurisdictions – poses an increasing burden for businesses seeking to make international mergers and acquisitions. A further regulatory dimension is now coming into play when planning cross-border transactions: screening by relevant authorities for compatibility with the national interest.

Scrutiny of foreign investments to assess their compatibility with the national interest is by no means new: countries such as Australia and the U.S. have had well-established screening mechanisms for many years. However, in recent years, governments around the world, while continuing to welcome the benefits brought by such investment in terms of jobs and economic growth, have shown a growing sensitivity towards its potential risks. These risks are commonly framed in terms of national security, though wider economic policy issues may also be at play (and the distinction between the two is not always clear-cut). At the same time, many governments are taking an increasingly broad view of the sectors which should be regarded as strategically important and in which new investment may give rise to national interest concerns. In doing so, they are going well beyond the traditional focus of intervention in the defence sector, with high-tech industries and critical infrastructure now frequently coming under the spotlight.

As we discuss below, governments have a wide range of tools to address such concerns and, in recent years, have shown themselves willing to use them by intervening in a variety of transactions. More significantly for the long term though, governments are also reconsidering whether those existing tools are fit for purpose, often concluding that they need to be strengthened, including by expanding their sectoral reach, strengthening investigatory and enforcement powers and moving towards systems requiring mandatory notification of certain transactions. Likewise, a number of countries without specific mechanisms for screening foreign investment have moved to plug the gap. The UK is a particularly interesting example, as it moves to replace rarely-used powers that are linked closely to the competition merger control regime with a standalone security screening regime of remarkably broad scope. Others are likely to follow, especially in light of moves at the EU level to encourage and co-ordinate national security screening through EU-wide legislation.

As a result, companies looking to invest in businesses or assets operating in strategically sensitive sectors can expect more complex and potentially multi-agency regulatory approval processes, involving distinct timelines, information requirements and – potentially – remedies. Within this, national interest reviews have the potential to be more political and less predictable than competition-focused proceedings, given the relative lack of transparency around national security concerns and the involvement of senior politicians in the decision-making process. A careful and holistic analysis of the national interest screening landscape will therefore be increasingly important for investors in developing their regulatory clearance strategies and allocating execution risk appropriately.

National interest screening – a mixed picture

Governments have many different tools available to them to seek to manage perceived risks to the national interest arising from corporate transactions. In the most extreme instances some states employ outright prohibitions or heavy limitations on investment in certain sectors.

China is an important example of this, where certain sectors feature on a 'Negative List' prohibiting foreign investment, although as we discuss below, some of these restrictions are being eased to allow greater market access to foreign investors. Other tools may include licensing regimes, shareholdings with special powers attached to them in strategic companies (often referred to as "golden shares"), and terms in contracts with government contractors (eg change of control or special confidentiality provisions).

Our analysis focuses on "screening mechanisms", which allow a formal review of transactions to determine whether they raise concerns by reference to national interests other than competition. These differ significantly from country to country. Beyond the specific detail of the process (timings, responsible authority, information requirements etc), some key areas of distinction include the following:

(i) **Sectoral coverage**: in some countries, screening mechanisms apply only in defined sectors (see, for example, the discussion of the French and Italian regimes later). In others, powers apply across the whole economy, wherever a relevant concern may arise: as discussed below, the UK is currently in the process of introducing a regime along these lines. Generally, the issue of which sectors should be covered is important in the design of screening mechanisms: on the one hand, limiting the scope of application may provide investors with greater certainty in planning deals; on the other, there appears to be an increasing sense that concerns can arise from investments in a wide range of sectors, and that defining these too narrowly – or at all – may unduly fetter government action to address threats to the national interest.

(ii) **Substantive test**: the breadth of the issues considered in screening can vary. In some cases, mechanisms focus specifically on national security. This is the case in the U.S. where the operational mandate of the Committee on Foreign Investment in the United States (**CFIUS**) is to look at transactions that could result in control of a U.S. business by a foreign person, in order to determine the effect of such transactions on national security. In other instances, the regimes cover public interest more generally; for example in Australia, where the Foreign Investment Review Board (**FIRB**) examines foreign investment proposals under the Foreign Acquisitions and Takeovers Act 1975 (**FATA**) and makes recommendations to the Australian Treasurer as to whether those proposals are in Australia's national interest.

"...there appears to be an increasing sense that concerns can arise from investments in a wide range of sectors..."

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(iii) **Mandatory or voluntary notification**: some jurisdictions require certain categories of transaction to be notified to the relevant authority for review, while others leave this decision to the parties (albeit under the threat of a transaction that is not notified being 'called in' – potentially leading to the imposition of remedies or even the unwinding of the transaction after it has completed). The well-established CFIUS regime has historically operated a voluntary notification process (although recent changes currently being piloted require mandatory notification of certain transactions (discussed further below)), while the Australian FIRB review can involve mandatory notification (depending on deal dynamics). This is an interesting contrast with the competition merger control regime administered by the Australian Competition and Consumer Commission (**ACCC**), where notification is voluntary, and companies may need to consider whether the fact that a FIRB notification must be made shifts the balance in favour of engaging with the ACCC as well as FIRB will typically consult with other government agencies as part of its national interest assessment.

(iv) **Relationship with competition review**: there is often a clear separation between investment screening and competition-focused merger control proceedings. However, in some jurisdictions, wider public interest considerations are assessed in the same process as competition issues. An example of this is South Africa, where the competition authority routinely takes into account wider social and industrial policy considerations, such as the effects of a transaction on employment, in deciding whether it may proceed.

The UK provides another illustration of an interlinked approach. The substantive test applied by the UK authority, the Competition and Markets Authority (**CMA**), in standard merger control proceedings is purely competition-based: whether a transaction will lead to a 'substantial lessening of competition'. However, the relevant legislation, the Enterprise Act 2002 (**EA 2002**), allows for a cabinet-level minister (the Secretary of State) to intervene in transactions that are subject to the CMA's jurisdiction where they raise certain specified public interest considerations, relating to national security, the plurality of the media and the stability of the UK financial system. In these instances, a Phase I public interest review is conducted in parallel with a review by the CMA to determine whether the transaction meets the relevant jurisdictional criteria and whether it gives rise to competition concerns.[1] The Secretary of State then decides whether to clear the transaction, accept undertakings, or refer it for an in-depth Phase II review by the CMA covering both public interest and (if applicable) competition issues, following which the Secretary of State takes a final decision on whether the transaction operates against the public interest and, if so, what remedies are required. The Secretary of State is bound by the CMA's findings on competition issues and jurisdiction, but can take a different view on the public interest. As noted below, following the UK government's White Paper, this is set to change with merger control and investment screening reviews being undertaken separately.

[1] In national security cases, the public interest review is led by officials at the Department for Business, Energy and Industrial Strategy (**BEIS**), with input from other relevant departments such as the Ministry of Defence and Home Office; whereas in media cases, the communications regulator Ofcom takes a leading role, providing advice to the Secretary of State for Digital, Culture, Media and Sport.

Intervention in practice

Whatever form the screening mechanism in a particular jurisdiction takes, it is increasingly clear that the prospect of screening is not a theoretical concern for investors. While governments continue to welcome foreign investment, there is clear evidence that they are willing to intervene where a potential risk to relevant national interests is identified. Recent prohibitions of high-profile transactions in the U.S. have attracted much attention, but relevant authorities around the globe have been flexing their muscles, by intervening in sectors that might not historically have raised concerns, or by frustrating acquisitions altogether.

The U.S. – sensitivities towards Chinese technology investment

The U.S. has a highly active foreign investment regime and with the extension of CFIUS' powers through the Foreign Investment Risk Review Modernisation Act (**FIRRMA**), this is likely to continue.

In recent years, there has been a trend (continuing under the Trump administration) of increased scrutiny of Chinese buyers making acquisitions in the technology sector, with a number of transactions blocked following a CFIUS review, including Canyon Bridge Capital's acquisition of Lattice Semiconductor, Hubei Xinyan's acquisition of Xcerra Corporation, and Ant Financial's plans to acquire MoneyGram.

The Ant Financial transaction illustrates the breadth of CFIUS' reach. This was a financial services transaction, involving the proposed acquisition by an online payments firm affiliated with the Chinese e-commerce giant Alibaba, of an American money transfer firm. Its prohibition in January 2018 reflected concerns that the transaction would have given a foreign investor access to sensitive personal data of U.S. citizens, data that might have been exploited in a way that threatened national security (a concern that has been codified by FIRRMA, as we discuss below).

Another recent case of particular interest is the widely-reported Broadcom / Qualcomm transaction. Unlike the transactions noted above, this did not involve a Chinese acquirer – rather, Broadcom was headquartered in Singapore and in fact had announced plans to move its headquarters to the U.S., a move which President Trump had previously praised as *"very very special and very important."* Despite this, the transaction was frustrated by similar sensitivities around the position of the U.S. relative to China in high-tech industries, with President Trump signing an order blocking the transaction in March 2018. An important contributing factor was the concern that Qualcomm's research spending would be eroded under Broadcom's ownership, risking the U.S. losing its position as a market leader in semiconductors to Chinese competitors. This illustrates how wider political and socio-economic concerns can play into investment screening decisions.

Germany – first-ever precautionary order prohibiting an acquisition

In August 2018, the German government for the first time ever issued a precautionary order prohibiting a foreign investor from acquiring a German business. This involved the proposed acquisition by a Chinese investor, Yantai Taihai, of a German mechanical engineering firm, Leifeld Metal Spinning AG, a technology leader with regard to supplies for the aircraft, aerospace and nuclear industry, with a turnover of around EUR40 million.

Although Yantai Taihai had recently (in January 2018) been cleared to acquire another German engineering firm (Duisburg Tubes Production AG, a company developing and producing precise tubes for the nuclear industry), its proposed acquisition of Leifeld attracted an in-depth review. Ultimately, the German government indicated its intention to block the transaction on national security grounds and, a few hours before the government was due to discuss the intended prohibition, Yantai Taihai abandoned the transaction. Despite this, the government adopted a precautionary decision prohibiting completion of the transaction in any event.

This case reflects the political environment in Germany, where control over foreign investment has become a hot topic and the government appears to have felt the need to demonstrate strength through the strict application of its screening rules. As we discuss below, the government had previously also introduced significant reforms to strengthen the screening rules. The Leifeld case demonstrates the need for investors to analyse these carefully in planning their transactions.

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UK – first national security intervention outside the military context

As described above, in the UK, the principal tool for regulating investments that may raise national security concerns is the Secretary of State's powers of intervention under the EA 2002, which runs in parallel with the competition review, and in which the Secretary of State is the ultimate decision-maker.

This power has been exercised infrequently, with only eight interventions on national security grounds since the EA 2002 came into force. Until 2017, the Secretary of State had intervened only in relation to transactions in the defence sector, involving companies with capabilities relating to military equipment used by the UK armed forces. On each of these six occasions the transaction was ultimately cleared following a Phase I review because of undertakings given by the parties, typically relating to the protection of classified information and/or the preservation of key strategic capabilities in the UK.

However, in April 2017, the Secretary of State issued an intervention notice in relation to the proposed acquisition by Chinese communications company Hytera Communications Limited (**Hytera**) of Sepura plc (**Sepura**). Unlike in previous cases, the Secretary of State's concerns related not to the supply of equipment to the UK armed forces, but to the civil emergency services.

Specifically, Sepura was an important supplier of mobile radio systems for use in the emergency services' communications infrastructure. The UK's interior ministry, the Home Office, raised concerns that the change of ownership over Sepura could put the protection of sensitive information and technology at risk, thereby prejudicing the operation of the emergency services and other agencies, with wider implications for national security. The Home Office was also concerned that Hytera might discontinue repair and maintenance services for the relevant equipment, or require devices to be sent abroad for repair (which would raise unacceptable security risks).

To remedy these concerns and avoid the transaction being referred for an in-depth Phase II review by the CMA, the parties offered undertakings. The proposed undertakings required them to implement enhanced controls to protect sensitive information and technology from unauthorised access, to permit audits by the UK authorities, and to continue providing maintenance and repair services for the relevant devices for as long as required by the UK authorities. On advice from the Home Office, the Secretary of State accepted the undertakings and cleared the transaction on 12 May 2017.

The transaction also attracted scrutiny under Germany's foreign investment rules. Following completion of the transaction, Germany entered into negotiations with Hytera, aiming at the execution of a contract covering security-related aspects of Sepura's German business. Under the contract, Sepura entities that supply the mobile radio systems to the German emergency services are required to remain distinct entities within the Hytera group and continue with the development and supply of those products independently.

Australia – a rare rejection of a foreign takeover bid

In November 2018, the Australian government formally rejected Hong Kong-listed Cheung Kong Infrastructure's AUD13 billion takeover offer for APA Group, which owns 15,000km of natural gas pipelines and supplies about half the gas used in Australia. This was on the basis that the proposed takeover *"would result in a single foreign company group having sole ownership and control over Australia's most significant gas transmission business."* The case illustrates the broader remit of FIRB in advising the Treasurer, compared with the merger control regime administered by the ACCC (which had conditionally approved the transaction in September), and highlights the increased regulatory uncertainty where national interest considerations are in play.

Although one of only six major public foreign investment proposals officially blocked since 2000, it is clear that the Australian government is increasingly sensitive to foreign investment in critical national infrastructure. (We also note that this figure does not reflect deals where the parties have withdrawn their applications to avoid a formal negative decision.)

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Reviewing the existing regulatory toolkit

As well as making use of existing powers, governments have been reviewing whether these tools are sufficient to protect the national interest in the changing technological and investment landscape.

In the U.S., across much of Europe and in Australia, significant reforms have already been made to strengthen existing powers. Meanwhile, in China, despite the general trend towards greater openness to foreign investment, preserving national security and the national interest remains a top priority, with a new law coming into effect in 2017 to protect critical information infrastructure (the **Cybersecurity Law**).

The U.S. – expansion of CFIUS' reach

On 13 August 2018, Congress expanded the authority of the U.S. Treasury Department's CFIUS to review certain transactions resulting in non-U.S. control of U.S. assets, businesses or technologies. The new FIRRMA legislation formally expands CFIUS' review authority in a number of ways, the most significant of which include expanding the definition of 'covered transactions' to catch: investment in critical technology, critical infrastructure and sensitive personal data maintenance; changes in foreign investors' existing rights; real estate transactions; and transactions that are designed to evade or circumnavigate reviews by CFIUS.

Although FIRRMA, which largely codifies CFIUS' practices over the past several years, will take around 18 months to be fully enacted, 10 November 2018 saw the creation of a new pilot program which requires mandatory short-form transaction declarations to be submitted for transactions involving 'critical technology' eg certain agents and toxins and specially designed nuclear equipment (previously, all CFIUS filings were essentially voluntary). The pilot program will remain in effect until 2 June 2020 or until CFIUS publishes a final rule that could further expand the range of industries and technologies covered. Theoretically, the mandatory declaration provides a potential 30-day shortcut for parties to avoid the more lengthy formal CFIUS review and investigation process. However, it remains to be seen whether the program will deliver on its promises or instead add an additional step into an already burdensome formal CFIUS filing.

UK – moves to enhance national security scrutiny of military, dual-use goods and advanced technology sectors

In its 2015 National Security Strategy and Strategic Defence and Security Review, the UK government emphasised the importance of foreign investment to the UK economy and, at the same time, of acting quickly to address any national security concerns it may raise: *"Foreign investment is crucial to our prosperity and the UK welcomes it... Where any national security concerns may arise, the Government will quickly assess the risks and mitigation to provide greater certainty for investors."*

Building on this, in October 2017 the government published a consultation paper (the **Green Paper**) heralding far-reaching reforms of national security investment review in the UK. In explaining the need for reform, the paper highlighted new security challenges arising from greater interconnectivity of nations, greater flows of capital and new technologies; the UK's continued need to attract investment in its national infrastructure; and the mismatch between the substantial and relatively consistent approaches to scrutinising foreign investment of a number of other major economies (such as Australia, Canada, France and the U.S.) and the more limited and inconsistent powers available to the UK government.

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Much of the Green Paper concerned proposals for the introduction of a long-term mechanism for screening investments for national security concerns, decoupled from the existing competition focused regime under the EA 2002, which have since been firmed up in a White Paper published in July 2018 (as discussed below). However, the Green Paper identified a "pressing gap" in the UK's national security defences, requiring "rapid action" to fill it.

Under the existing EA 2002 regime, the Secretary of State can prohibit or impose public interest remedies only on transactions that fall within the merger control jurisdiction of the CMA (or would do so were it not that the European Commission has exclusive jurisdiction under the EU Merger Regulation), or fall into a narrow residual category of "special merger situations", which includes transactions involving "relevant government contractors" (ie a government contractor that has been notified by the Secretary of State of information, documents or other articles relating to defence and of a confidential nature which the contractor or its employees may hold in connection with its role). The CMA's merger control jurisdiction under the EA 2002, in turn, catches transactions where either the target has UK turnover exceeding GBP70m (the **turnover test**) or the parties overlap in, and together supply or acquire 25% or more of goods or services of any description in the UK or a substantial part of it (the **share of supply test**). The share of supply test leaves the UK authorities substantial discretion in its application, and it is also noteworthy that in order to *initiate* a public interest review, the Secretary of State need only have "reasonable grounds for suspecting" that either of these two tests "may" be met (whether it is in fact met will then be assessed by the CMA as part of the review). Moreover, mergers involving defence contractors are likely to be caught by the "special merger situation" noted above.

The UK government's concerns about the adequacy of these tests were essentially three-fold. First, not all businesses that design or produce items with national security implications hold confidential defence material and therefore are "relevant government contractors" – in particular, businesses may produce "dual-use" items primarily intended for civilian use but with potential military applications, or may be active in non-military advanced technology sectors with cyber-security implications. Second, technological developments mean that small companies with niche, highly specialised activities may nonetheless hold information or items creating significant national security risks, but without meeting the standard turnover test. Third, national security issues can arise even where the acquirer is not active in the same area as the target – in these cases, the standard share of supply test would also not be met.

To plug these perceived gaps, the Green Paper proposed amending the turnover and share of supply tests in mergers involving the military and dual-use sector and parts of the advanced technology sector, to capture:

(a) a target with UK-based turnover of over GBP1m (rather than GBP70m as is the case now); and/or

(b) a target with a 25% or more share of supply (ie with no need for the merger to give rise to an increase in that share of supply), or where the merger/acquisition meets the current test of creating or enhancing a share of supply of 25% or more.

Following consultation, the government brought these changes into effect in June 2018. The sectors in which the lower thresholds apply are: (i) the military and dual-use sector, defined by reference to the UK's Strategic Export Control Lists; (ii) computer processing units and firmware; and (iii) certain areas of quantum-based technology.

These changes are intended as a 'short-term' interim measure, which could be implemented through secondary legislation, while more far-reaching 'long-term' reforms introducing a bespoke screening mechanism are consulted on and primary legislation passed through Parliament (as we discuss below). Once that regime is in effect, the changes to the thresholds will be reversed.

The new thresholds were applied in short order. On 17 June 2018, the Secretary of State issued an intervention notice in relation to the proposed acquisition of Northern Aerospace Limited by Gardner Aerospace Holdings Limited, both active in the manufacture of structural assemblies and parts for the aerospace industry. Gardner is a wholly-owned subsidiary of Shaanxi Ligeance Mineral Resources, a Chinese company listed on the Shenzhen stock exchange. Following the intervention notice, the CMA took the unusual step of issuing an order that prohibited the transaction from closing and, on advice from the Ministry of Defence, subsequently declined a request from the parties for a derogation to permit closing (the CMA routinely issues orders to prevent integration while it reviews a *completed* merger, but only exceptionally adopts orders in respect of anticipated mergers and, even then, these generally will not prevent closing). This led to the transaction missing its target completion date and subsequently lapsing, a matter that attracted some sharply-worded media criticism of the UK authorities from the sellers. However, the parties decided to revive the deal and on 19 July, the Secretary of State announced that the transaction did not raise public interest issues. Following competition clearance from the CMA the next day, the parties were able to announce completion of the transaction on 24 July.

"Italy's focus on high-tech is consistent with reforms in other jurisdictions, such as the UK."

Italy – "golden powers" extended to new high-tech sectors

Historically, Italy retained "golden shares" in certain companies operating in sectors of national interest such as defence, energy and public services, based on privatisation legislation first passed in 1994. The powers granted by these shares ranged from the right to block the acquisition of a significant shareholding in the company, to the right to appoint members of their management bodies.

Changes to this regime were forced by rulings of the European Commission and European Court of Justice, which found that it contravened EU rules on freedom of establishment and free movement of capital (with the vague nature of the powers and the extent of the discretion afforded to the Italian State giving rise to particular concern).

In order to bring the Italian approach to investment controls in line with EU rules and strengthen its approach, Italy passed new legislation in March 2012. As enacted, this legislation required mandatory notification of transactions involving companies in the defence and national security sector or strategic assets in the communication, energy and transport sectors. The Italian government may then decide whether to exercise its so-called "golden powers."

The "golden powers" permit the Italian government to prohibit the acquisition of a shareholding altogether; to impose specific conditions on the acquisition; and to block the adoption of shareholder and board resolutions on a range of matters, including: mergers and demergers; the transfer of a business, branch or subsidiary; the transfer of the company's registered office abroad; the change of the company's corporate purpose; and the winding-up of the company.

In December 2017, new legislation expanded the scope of the "golden powers" regime to catch a range of new sectors – including data storage and management, financial infrastructure, artificial intelligence, robotics, semiconductors, dual-use technologies, space and nuclear technologies. This focus on high-tech is consistent with reforms in other jurisdictions, such as the UK.

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Germany – significant strengthening of foreign investment reviews with mandatory notification and longer review periods

In Germany, the introduction of stricter controls on foreign investment was driven up the political agenda by high-profile M&A transactions involving Chinese investors in 2016: the takeover of Germany's iconic robotics specialist KUKA by Midea Group; and the attempted takeover of Aixtron, an engineering business producing machinery for the manufacture of semiconductors, by Fujian Grand Chip (which was ultimately blocked by President Obama following a review by CFIUS).

In July 2017, the German government adopted amendments to its foreign investment control legislation, the Foreign Trade Regulation (**FTR**). Under the FTR, the Ministry of Economic Affairs (the **Ministry**) has the power to review investments made by non-European investors whereby the investor directly or indirectly acquires more than a certain percentage (see below) of the voting rights in a German business. The FTR provides for two review regimes: a specific defence and cryptography regime; and a general cross-sector regime applying in all other sectors. The former also applies to European (but non-German) investors.

The reforms to the cross-sector regime clarified its scope of application with a non-exhaustive list of examples of sensitive businesses, with a particular focus on critical infrastructure, and brought in an anti-circumvention rule. Most significantly, it introduced mandatory notification of investments in critical infrastructure (notification had hitherto been mandatory only in the defence sector) and significantly extended the period within which the Ministry can commence an own-initiative review. Prior to the July 2017 reforms, the Ministry could start screening an acquisition only within three months of signing, whether or not it became aware of the transaction. Under the new regime, the Ministry can start screening a transaction at any time up to five years from signing, provided that it does so within three months of becoming aware of it. The result is that unless parties notify a transaction to the Ministry,
they will have legal certainty no earlier than five years after signing (strikingly longer than the six- and fifteen-month periods envisaged under the UK and EU reforms discussed later). The reforms also introduced broader information gathering powers and extended the period for the Ministry to screen a transaction following receipt of complete documentation, from two to four months (since the Ministry determines whether the file is complete, the process may in reality take longer).

The 2017 reforms also strengthened the sector-specific regime (where notification was already mandatory), extending the review period from one to three months, enhancing information-gathering powers and introducing an anti-circumvention rule, under which it is an indication of circumvention where a domestic purchaser has either no significant business activities or no permanent presence in the form of premises, personnel or equipment in Germany (except for its holding in the target company).

Until recently, both the defence and cryptography and cross-sector regimes applied to the direct or indirect acquisition of 25% or more of the voting rights in a German business. However, in a further reform adopted on 19 December 2018, the German government has lowered these thresholds to 10% for both the defence and cryptography sector and cases involving critical infrastructure. At the same time, the government broadened the definition of "critical infrastructure" to include media businesses.

France – proposals for wider sectoral screening and stronger sanctions

France is also in the process of amending its existing legislative framework with the upcoming PACTE Law, which is expected to be adopted in early 2019. The bill, the 'Action Plan for Business Growth and Transformation', covers a wide range of matters but, in relation to investment screening, will expand the scope of such screening to apply to additional strategic sectors. It will also amend the sanctions available to the French government where a relevant transaction is implemented prior to approval, and provide for annual public general (anonymised) statistics on the investment reviews conducted. A decree entering into force on 1 January 2019 has already extended the scope of the existing screening to new sectors including data storage, robotics, space, semi-conductors and 3D printing.

Australia – focus on critical national infrastructure

As described above, Australia has a well-established screening regime under legislation passed in 1975. However, the government has recently strengthened the protection of national critical infrastructure, with the new Critical Infrastructure Centre and the Security of Critical Infrastructure Act 2018 coming into effect. This shift in focus is as a result of increased sensitivity around the protection of infrastructure that is deemed essential for maintaining Australia's national interests such as telecoms, water, electricity, port and gas assets.

China – progressively relaxing the rules but preserving national security and interests remains a top priority

The situation in China represents an interesting comparison with the developments described above. As noted above, a number of Chinese outbound M&A deals have been frustrated through foreign investment screening mechanisms in recent years, perhaps connected to the geo-political tensions currently playing a significant role in M&A deals around the globe. Despite this, opening up its internal market to international trade still appears to be firmly on the agenda for China, with a number of reforms to its foreign investment regulatory framework being proposed or recently introduced. However, at the same time, the national security and wide policy implications of foreign investment remain an important focus.

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All foreign investments are currently monitored by public authorities to ensure compliance with national industrial policy objectives. The Foreign Investment Catalogue divides foreign investment projects into four categories: encouraged, permitted, restricted, and prohibited investments. This classification allows the Chinese government to direct foreign investment by implementing preferential treatment and regulatory measures in a structured manner. Depending on the category, different incentives (such as simpler approval procedures) or restrictions (eg on the maximum participation foreign investors may maintain in a foreign-invested company) apply. More recently, the restricted and prohibited investment categories were combined into a National Negative List, in an effort to streamline the foreign investment regulatory framework. Foreign investment projects falling within a sector included on the National Negative List are subject to a formal approval process whilst those falling outside generally follow an *ex post* simplified filing process.

On 28 June 2018, the National Development and Reform Commission (**NDRC**) and the Ministry of Commerce (**MOFCOM**) announced significant amendments to the National Negative List, which came into effect on 28 July 2018. The updated National Negative List further opens up the market for foreign investment in certain sectors, in an effort to stimulate greater competition in China's domestic market. Importantly, it includes a raft of measures designed to liberalise and open up previously restricted sectors including finance, automotive, mining, infrastructure, energy and resources, and agriculture (in addition to the new policies enacted at the national level, some sector regulators have also taken action to liberalise foreign investment restrictions including the People's Bank of China (**PBOC**) which, in April 2018, announced plans to further open up access to foreign investors to the financial sector).

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However, despite China's efforts to open up its economy to foreign investors, sensitive mergers with or acquisitions of Chinese assets can (and will) be subject to screening on grounds of national interest (the State Council brought in a security review regime in 2011). The screening mechanism applies to a wide variety of transactions, including those involving assets related to the military industry, or national defence and security, or key industries including significant agricultural products, energy and resources, infrastructure, transportation services, core technologies and important equipment manufacturing.

Whilst the criteria for application of the screening mechanism lack clarity, a filing with MOFCOM is mandatory and clearance needs to be obtained before a reviewable transaction can be closed. The transaction will be assessed by reference to its potential to impact national security. As is the case with a number of other jurisdictions, national security is a broad concept, in this case encompassing the preservation of the domestic production capabilities, the stable operation of the national economy, the basic social order, and even the domestic R&D capacity in relation to critical technologies. It is a concept that provides MOFCOM with a wide discretion when it comes to controlling foreign investment within its own borders.

In the absence of official data on, for instance, the number of filings or average duration of the process, it is difficult to assess how much of an impediment to foreign investment the security review mechanism is. In practice, that mechanism typically appears to foreign investors as a 'black box' and it is not unusual for reviews to last considerably longer than foreseen in the law. Because of the wide discretion retained by the Chinese government, predicting how the process will go, both in terms of outcome and timing, is still particularly challenging.

National security scrutiny of foreign investment in China has recently been tightened through the adoption of the Cybersecurity Law, which came into effect in 2017. The Cybersecurity Law places greater demands on the protection of critical information infrastructure and significantly extends the need to obtain security certification.

Overall, one thing that can be said with certainty is that, notwithstanding the liberalising trends described above, foreign investors must continue to pay close attention to Chinese national security and national interest considerations when operating in China.

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Switching on new screens

Most significantly for businesses, governments in some jurisdictions are fundamentally changing their approach to investment screening: either by introducing screening mechanisms where none exist, or by completely replacing existing mechanisms no longer thought fit for purpose.

The EU presents a particularly complex picture in this respect, due to the delicate balance between, on the one hand, the EU's competencies in commercial policy and interest in safeguarding Union-level projects and addressing cross-border impacts of foreign investment and, on the other, Member States' freedom of action in protecting core national interests. Here, we see new mechanisms being brought in at a national level, such as in the UK and Hungary, and measures at EU level to encourage this and co-ordinate national action.

Action at national level – the UK's long-term plans for investment screening

As discussed above, in October 2017, the UK government published proposals for both short and long-term reforms to its approach to investment screening. Shortly after the new merger thresholds discussed above came into force as a stop-gap measure, in July 2018, the government published a White Paper setting out its long-term plans. The White Paper confirms the government's intention to proceed with a voluntary notification regime backed by a call-in power, rather than requiring mandatory notification. This will replace the existing EA 2002 national security powers, including the short-term reforms described above. While the absence of mandatory notification is likely to be welcomed by many businesses, the incredibly far-reaching scope of the new powers is likely to be a concern. Indeed, John Fingleton, a former head of the UK's previous competition authority, the Office of Fair Trading, has argued that the planned regime is a *"wolf in sheep's clothing"* that, what are presented as *"innocuous, well-intentioned and technical responses to a national security question"* in fact amount to *"sweeping, radical changes"* that will *"unwind much of the political independence of the UK merger regime."*[2]

In summary, the government will be able to intervene in transactions in "any sector", and "regardless of the parties' revenues or market share." The only limit is that the transaction must give rise to a so-called "trigger event" – defined as the acquisition of a certain percentage of ownership or degree of control (see below for details). Another notable feature is that a trigger event can arise from the acquisition of a bare asset such as IP or land, a new project, or even from the making of a loan.

Under the White Paper proposals, a trigger event would include any investment or activity involving the direct or indirect acquisition of:

(a) more than 25% of an entity's shares or votes;

(b) "significant influence or control" over an entity; or

(c) further acquisitions of significant influence or control over any entity beyond the above thresholds (including the acquisition of over 50% or 75% of shares/votes, or new or additional rights eg board appointment rights). In effect, this means the UK government will be able to intervene where future acquisition/control thresholds are met even where it decided not to call-in a transaction following an initial trigger event(s).

"While the absence of mandatory notification is likely to be welcomed by many businesses, the incredibly far-reaching scope of the new powers is likely to be a concern."

[2] John Fingleton, 'Mergers and the public interest: a wolf in sheep's clothing', October 2018.

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In relation to the purchase of assets, the trigger events are the acquisition of:

(a) more than 50% of the asset; or

(b) significant influence or control over the asset (ie absolute decision rights over the operation of the asset or ensuring the asset is being operated in the desired way).

Perhaps regrettably, the government has chosen to use a *sui generis* concept of "significant influence or control" to set the bounds of the regime, rather than the more familiar concept of "material influence" used in merger control under the EA 2002, or even that of "significant influence or control" used for certain purposes under UK company law. Because the White Paper makes clear that the concept used in the national security regime is intended to be broader than in either merger control or company law, it renders the approach adopted by authorities under this existing legislation of little precedential value.

While the government intends to provide some guidance on the meaning of "significant influence or control" for these purposes (see below), it is unclear what "gap" transactions the government believes will be covered that the existing concept of "material influence" would not capture. A change of approach would be welcome in order to bring greater certainty for investors.

Where a transaction giving rise to a "trigger event" is not notified voluntarily, the government will be able to call it in for review. This power will be exercisable where the Cabinet-level minister responsible for taking decisions under the regime (for these purposes, referred to as the 'Senior Minister'): (i) has reasonable grounds for suspecting that it is or may be the case that a trigger event is in progress or contemplation; and (ii) has a reasonable suspicion that, due to the nature of the activities of the entity involved in the trigger event or the nature of the asset involved in the trigger event (or its location in the case of land), the trigger event may give rise to a risk to national security. The White Paper proposes that a transaction could be called in up to six months following completion (compared with four months under existing merger control rules). Unlike transactions called in for review on competition grounds by the CMA, the call-in will automatically prevent completion until approval is granted.

"...the call-in will automatically prevent completion until approval is granted."

"While parties and their advisers may derive some assistance from the Statement, any comfort is likely to be quite limited, since it largely consists of "indicative and non-exhaustive examples"..."

As a counter weight to the extraordinarily broad nature of its proposed powers, the government has placed considerable emphasis on the fact that it will publish a so-called "Statutory Statement of Policy Intent" (the **Statement**), a draft of which was published alongside the White Paper. The draft Statement is relatively detailed, and runs to just under 60 pages. The Statement provides some guidance on the meaning of "significant influence or control" and on the factors bearing on the likelihood that the government will intervene in a transaction. At its core is a tripartite risk assessment:

(a) **The target risk** – could the entity or asset subject to the trigger event be used to undermine the UK's national security? The Statement notes that this is more likely to be the case in "core areas" of the economy, eg certain parts of national infrastructure (listed as civil nuclear, defence, communications, energy and transport), certain advanced technologies, critical suppliers of the government and emergency services, and dual-use technologies. "Critical suppliers" of these core areas are also more likely to raise national security risks.

(b) **The trigger event risk** – does the trigger event give someone the means to use the entity/asset to undermine the UK's national security, eg through disruption, espionage or inappropriate leverage?

(c) **The acquirer risk** – might the person acquiring control over the target use this control to undermine national security? Here, "hostile states and other hostile parties" are most likely to pose a national security risk. While the regime covers both domestic and foreign investors, the Statement indicates that foreign states and foreign nationals are more likely to raise issues than UK-based acquirers.

While parties and their advisers may derive some assistance from the Statement, any comfort is likely to be relatively limited, since it largely consists of "indicative and non-exhaustive" examples of where concerns are more likely to arise, and makes explicit that the government retains the power to intervene in transactions in any sector of the economy where it considers that concerns may arise.

There is also a tension between this tripartite risk-assessment and the legal test for intervention described above. The second limb of that test requires that the Senior Minister has a reasonable suspicion that the trigger event may give rise to a national security concern *due to the nature of the activities of the target entity* (or its nature, in the case of an asset, or its location, in the case of land) – ie it apparently focuses on the "target risk". But under the Statement, the Senior Minister must, in deciding whether this limb of the test is met, carry out three risk assessments – the target risk, trigger event risk and acquirer risk assessments – which are wider than the statutory test and do not fit neatly with it. It would seem preferable for the second limb of the test for intervention to refer expressly to these three elements, rather than the "nature" of the activities or asset.

The White Paper envisages the following review process:

(a) Where a transaction is notified voluntarily, the Senior Minister will decide whether to call it in for a full review within 15 working days (extendable to 30 working days).

(b) Where a transaction is called in for review (either following voluntary notification or on the government's own initiative), the full national security assessment will take up to 30 working days in standard cases.

(c) This 30-working day period may be extended by a further 45 working days where a national security risk has been identified but the case requires more detailed scrutiny to ascertain the extent of the risk and/or the appropriate remedies. Further extensions will be possible with the agreement of the parties or if information requests are not complied with.

(d) At the end of the review, the Senior Minister will clear the transaction, clear it subject to conditions, or prohibit/order it to be unwound.

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While the basic 30-working day period may not seem unreasonable, businesses may be concerned that, overall, the process could become very lengthy. The 45-working day extension envisaged is a considerable one (150% of the standard review period) and it would be undesirable for the government to employ it other than in exceptional circumstances (or, where an extension is needed, to use the full 45 working days by default). Perhaps most concerning, the White Paper envisages that the clock will be paused where the government requests information – including from third parties. While the White Paper suggests that the Senior Minister may "un-pause" the clock where he or she concludes that another party's delay is unduly harming the acquiring party's interest, we consider that third parties could – and in all likelihood *would* – nevertheless seek to 'game the system' in order to derail a time-critical transaction.

The White Paper contains an indicative but non-exhaustive list of the types of conditions that may be imposed, which may be either structural, eg not acquiring control over a particular division or asset, or behavioural, eg limiting access to certain sites or information to those with appropriate security clearances. Conditions will be backed by civil and criminal penalties, including up to five years in prison in certain circumstances.

Given the scope of the powers, the automatic prohibition on completing transactions subject to review, and the possibility of transactions being called in for up to six months following completion, many businesses are likely to feel compelled to notify transactions notwithstanding the voluntary nature of the regime. The government itself expects around 200 notifications a year (a figure we believe is likely to be an under-estimate if the proposals are enacted in their present form). This compares with 62 deals reviewed by the CMA in total (including on competition grounds alone) in FY17/18.

Beyond the obvious impact on deal timetables, businesses are likely to be concerned by the appetite for interventionism shown in the White Paper.

The government's stated expectation is that of the 200 notified transactions each year, around 100 will receive a full national security review (there were nine in-depth reviews by the CMA in competition cases in FY17/18). This is a striking increase compared with the *eight* transactions reviewed on national security grounds in more than *15 years* under the EA 2002. Even more worryingly for businesses, the government expects to impose conditions on 50 transactions a year – contrast this with just 14 remedies imposed by the CMA in competition cases in FY17/18. The implications of these figures drew stinging criticism from another distinguished former regulator, Sir John Vickers (Director-General of the Office of Fair Trading until 2005), who reportedly submitted to the consultation on the White Paper that *"any doubt that the approach is disproportionate is dispelled by the remarkable number of projected cases"* and that *"It is very hard to believe that their number [referring to national security cases] has risen over the past 15 years to such a huge extent as is implied."*[3]

Assuming the proposals are enacted without substantial change, much remains to be seen as to how they operate in practice. Procedurally, a key issue is that the government has not yet provided clarity as to who will conduct reviews under the new regime, or whether they will be co-ordinated by a single department rather than being handled by individual departments depending on the sector concerned. While input from multiple departments may be required in certain cases, it would seem preferable for reasons of efficiency and consistency for all reviews to be led by the same, single team. Whichever department is given responsibility – and early indications are that it is likely to be the Department for Business, Energy and Industrial Strategy (rather than eg the Ministry of Defence) – it will need to find appropriate merger control expertise.

In terms of substance, it will be interesting to see whether the government's estimates of the numbers of deals requiring remedies proves accurate – the implication that under the current regime around 49 transactions raising material national security concerns have "slipped through the net" each year is a striking one, to say the least – and, if so, what the nature of the remedies imposed actually is.

[3] Quoted in the Financial Times, 15 November 2018: "Plan to tighten UK takeover rules are disproportionate."

Action at national level – Hungary introduces a new investment screening regime

On 2 October 2018, the Hungarian Parliament adopted a new law, which will require ministerial approval for foreign investment into specific sectors. The law applies to transactions that have closed, or will close, after 1 January 2019. Whether or not a certain transaction is subject to the new vetting regime depends on a number of factors, in particular:

(a) whether it relates to certain sensitive sectors;

(b) whether the relevant transaction qualifies as a triggering event; and

(c) whether the investor qualifies as a foreign investor.

There is currently no legislation in place in Hungary that allows for a systematic review of foreign investments and the mechanism used is limited and unsophisticated. The new legislation aims to address this gap, enabling the screening of acquisitions by entities registered outside the EU, EEA or Switzerland in certain sensitive sectors (such as defence, financial services and energy) where the entity is carrying out certain sensitive activities. Perhaps not as wide-reaching as regimes in other jurisdictions, this is the first step for Hungary towards greater scrutiny of acquisitions that may be detrimental to national security or public policy. This move is in line with, and possibly driven by, the wider proposals at an EU level.

"...the picture across the EU is a varied one, with around half of EU Member States having formal foreign investment screening mechanisms and significant variation in scope and process between them."

EU action – a new regulation to co-ordinate national level screening

In addition to the measures taken by individual EU Member States to introduce or strengthen investment screening mechanisms, change is underway at the EU level.

Reviewing foreign investment has to date been left to individual Member States (other than limited EU-level restrictions on foreign ownership in specific areas, including air carriers and gas and electricity transmissions system operators). EU rules on free movement of capital and freedom of establishment permit Member States to take measures to protect interests such as public security, and the EU Merger Regulation similarly recognises the right of Member States to act to protect legitimate interests in respect of transactions of which the competition aspects are subject to the Commission's exclusive jurisdiction. Accordingly, the picture across the EU is a varied one, with around half of EU Member States having formal foreign investment screening mechanisms and significant variation in scope and process between them.

The idea of EU-level action in this area is a controversial one, given the potential for intrusion on core national interests and prerogatives. However, in September 2017, the European Commission published a legislative package proposing a new EU regulation in this area, asserting that "the European dimension of foreign direct investment is obvious" in light of links with the EU Internal Market, potential knock-on impacts from investment in one Member State for the security or public order of another, and the existence of EU programmes requiring protection, such as the Galileo satellite navigation system. Interestingly, the package was presented as an "enabling framework" designed to confirm that Member States may operate screening mechanisms for foreign investment, notwithstanding the EU's exclusive competence in the area of the EU's common commercial policy.

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Importantly, in light of political sensitivities, the Commission's proposal did not seek to require Member States to introduce screening mechanisms, or introduce an EU-level one analogous to the Commission's role under the EU Merger Regulation. Instead, it proposed a framework for communication and collaboration between Member States, basic procedural requirements for screening mechanisms, and a role for the Commission in addressing "opinions" to Member States on planned foreign investment which they would be free not to follow (although in cases involving projects of "Union interest" such as the Galileo system, they would be required to "take utmost account" of the opinion and explain any departure from it).

Over the past year, the proposal has worked its way through the EU's legislative system, with various amendments proposed by the Parliament. On 20 November 2018, the Parliament, Council and Commission announced that they had reached agreement on an approach. The regulation will enter into force once formally approved by the Parliament and the Council under their respective procedures, but its requirements will not apply until 18 months after it enters into force.

Overall the regulation is in line with the Commission's proposal – ie it seeks to co-ordinate national foreign investment mechanisms rather than replace them with an EU-level mechanism, and Member States will remain free to decide whether to introduce such mechanisms. However, at the Parliament's instigation, the final text will include stronger tools to co-ordinate and apply 'peer pressure' to other Member States in the operation of their screening systems. Notably, if at least one-third of Member States request it, the Commission will scrutinise and issue an opinion on planned investment in another EU country, with that country's government required to give due consideration to this. A review could be initiated up to 15 months after an investment is made (but only in respect of investments made after the regulation enters into force).

At a minimum, the regulation seems likely to increase the risk that an investment will be scrutinised by Member States that already operate foreign investment screening mechanisms, and may result in review timelines being extended to accommodate comments from other Member States and the Commission under the envisaged co-operation mechanisms. In the longer term, the regulation may also encourage other Member States to introduce their own mechanisms, in line with the Commission's presentation of it as an "enabling measure".

"Overall the regulation ...seeks to co-ordinate national foreign investment mechanisms rather than replace them with an EU-level mechanism..."

"...the regulation seems likely to increase the risk that an investment will be scrutinised ...and may result in review timelines being extended to accommodate comments from other Member States and the Commission..."

Implications for businesses – complexity, uncertainty and risk

As investment screening regimes become more widespread and expand their reach, businesses will need to navigate increased complexity, uncertainty and risk in executing transactions, in an increasingly broad range of economic sectors and jurisdictions.

(i) **Complexity**: the proliferation of investment screening mechanisms adds another dimension to the regulatory scrutiny of transactions, on top of competition-focused merger review. This means companies will need to deal with more regulators, potentially in a wider range of jurisdictions, each following their own processes and with their own information requirements.

(ii) **Uncertainty**: whenever a new regulatory regime is introduced, there will inevitably be uncertainty about how it will operate in practice – both in terms of process and substantive outcomes – until a significant body of precedent has accumulated. However, the uncertainty raised by investment screening regimes risks continuing into the longer term. Investment screening decisions in many regimes are taken by senior politicians and, as such, are always likely to be susceptible to political considerations. Moreover, such decisions may involve highly sensitive issues, such as national security, making it difficult for governments to be as transparent about their reasons for action as competition authorities are in standard merger control proceedings.

(iii) **Risk**: fundamentally, the introduction of investment screening rules provides another source of regulatory risk for parties to a transaction. A transaction that raises no competition concerns may nonetheless face the imposition of substantial remedies or outright prohibition on other grounds, including national security (as many of the cases discussed above illustrate). Because investment screening processes in some jurisdictions can be initiated months after completion, such concerns could potentially require the unwinding of a completed transaction.

Moreover, the combination of investment screening and competition rules may make it more difficult to craft remedies suitable to address the authorities' concerns. For example, divesting part of the parties' overlapping businesses to a foreign sovereign wealth fund with no existing investments in that area might be a clear-cut solution to competition concerns, but might itself raise national security concerns in some circumstances. While some countries seem alive to these difficulties (for example, the UK reforms propose that the Senior Minister overseeing a national review would ultimately be able to overrule remedies proposed by the CMA to address competition concerns), we can still see significant scope for practical issues to arise.

Despite these challenges, it should remain rare for transactions to be frustrated altogether by investment screening processes. Foreign investment remains attractive around the world as a means of promoting growth and employment, and governments introducing or overhauling screening regimes have often been at pains to emphasise that their economies remain open to foreign investors. However, parties will need to pay close attention to investment screening processes in planning their transactions, conducting due diligence and negotiating risk allocation provisions in transaction documents, given these processes' potentially significant impact on deal timetables, value creation (if remedies are required) and ultimately, the chances of the transaction being able to proceed.

"...parties will need to pay close attention to investment screening processes in planning their transactions..."

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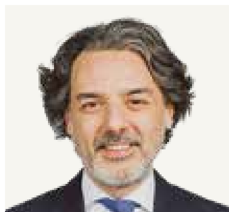

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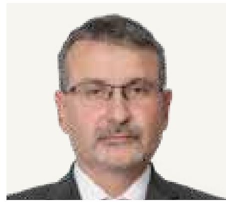

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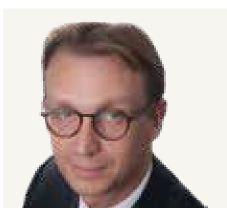

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