

REGULATORY INTELLIGENCE

UK foreign direct investment in a post-COVID-19, post-Brexit world

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Unprecedented economic disruption caused by the COVID-19 pandemic has seen a significant uptick in Chinese state-backed investment in distressed assets worldwide. In recent weeks, this has fueled long-standing frustration with the UK government's deficient powers of intervention in foreign investments involving sensitive infrastructure and technology critical to national security.

In this context, we discuss proposals under the National Security and Investment Bill 2019-20 to strengthen the government's powers of intervention where foreign investments pose a national security risk.

COVID-19 has pushed national security to the top of the UK government's legislative agenda, but China is not the only state that some UK politicians perceive to be potentially hostile to its national security. As such, where foreign investors are, or may be involved in deals concerning UK entities or assets (including those based overseas), the market should expect heightened regulatory scrutiny.

The UK's financial services industry attracts some of the highest levels of foreign direct investment globally, and also facilitates much of the country's domestic deal activity. As such, the government has identified the sector as vulnerable to potential misuse by hostile actors. Looking to the rest of 2020 and beyond, dealmakers should therefore prepare for the impact of these measures on future corporate activity.

Background to UK proposals*The bill*

The bill, announced in December 2019, has been in the making since 2016 when Theresa May's government approved the construction of the new Hinkley Point C nuclear power plant. Due to the controversy surrounding Chinese involvement, the then UK government launched a wider review into national security concerns surrounding UK foreign direct investment. This resulted in the UK government publishing a green paper in October 2017, which revealed the government's limited intervention powers under the Enterprise Act 2002. A white paper followed in July 2018 proposing detailed legislative reforms. A draft of the bill is likely to be published in the coming weeks, and we expect the text to align closely with the white paper.

Inquiry into foreign asset stripping

On April 8, 2020, the UK parliament's Foreign Affairs Select Committee (FAC) launched an emergency inquiry into potential asset stripping of UK companies. The move followed an aborted boardroom takeover of Imagination Technologies (Imagination), a semiconductor and software design company by one of Imagination's shareholders, a Chinese state-owned venture fund, China Reform Holdings. In the light of Imagination, the FAC is keen to strengthen the Foreign & Commonwealth Office's (FCO) power to intervene in foreign takeovers where there is a national security risk and has called for written evidence submissions on what these powers might look like (with submissions to be made by June 30, 2020).

Global supply chain dependence

National security concerns are also prompting lawmakers to push for further measures beyond foreign investment screening. On May 14, 2020 Conservative think tank, the Henry Jackson Society, published a report indicating that the supply chains of all members of the Five Eyes alliance are strategically dependent on China for imports of goods with applications in critical national infrastructure. The report brings into sharp focus the growing level of discontent during the COVID-19 pandemic with supply chains that are overly reliant on potentially hostile states.

Immediately following its publication, 23 UK MPs proposed several new measures to reduce the UK's strategic dependence on perceived hostile states. These measures include the introduction of a UK "Entity List" banning dealings with certain bad actors, potential import restrictions on dependent products, as well as closer Five Eyes cooperation.

Screening mechanism and risk assessment

The review mechanism under the Enterprise Act 2002 sits within the merger control regime and is not specifically tailored to national security concerns. The National Security and Investment Bill will introduce an independent review mechanism for foreign investments outside the merger control regime and will result in a significant increase in both the number of transactions subject to review and the nature of the government's intervention powers.

The following are key elements of the proposed screening mechanism:



Unlike the Enterprise Act 2002, the review is not contingent on market share or turnover thresholds.

The statutory test for intervention will have two limbs. To intervene, the government will need to have: (i) reasonable grounds for suspecting that a trigger event has taken place or is in progress or contemplation; and (ii) reasonable suspicion that the trigger event may give rise to a risk to national security.

The "trigger events" that would enable the government to scrutinise acquisitions are: (i) the acquisition of more than 25% of the votes or shares in an entity; (ii) the acquisition of "significant influence" or control over an entity; (iii) the acquisition of further significant influence or control over an entity beyond the above thresholds; (iv) the acquisition of more than 50% of an asset; or (v) the acquisition of significant influence or control over an asset. Transactions will also need to have a "UK-nexus", meaning that foreign targets may be subject to review if they carry on activities in the UK, or supply goods or services to UK persons. The government has also identified the use of debt instruments and other financial products as a means of asserting control over entities and assets, or as a way of bypassing scrutiny through contrived deal structures.

Parties will need to decide whether to submit a voluntary notification to the government. This decision should be based on a risk assessment considering whether: (i) the target could be used to undermine national security (termed "target risk"); (ii) the trigger event could give someone the means to undermine national security (termed "Trigger Event Risk"); and (iii) if the acquirer would have the potential to use the target to undermine national security (termed "acquirer risk"). This will involve a relatively detailed assessment of the transaction and the nature of national security risks presented by the same based on input from various departments in what essentially is a "black box".

If a voluntary notification is submitted, the government will have up to six weeks to decide whether to "call-in" the transaction for a full national security assessment. This decision will be based on the three-pronged risk assessment set out above.

A full national security assessment could take up to 15 weeks, with potential for extension if required.

The government could clear, block, approve the transaction with conditions or even unwind a transaction if it has occurred within the last six months. Interim restrictions could also be imposed during the review, the most common of which is likely to be a stay on completion pending the review's outcome.

Takeaways

We expect the bill to come into force around Q1 2021, but it could be sooner than this. In future, national security considerations will be a key part of deal strategy, in particular for financial institutions supporting overseas acquirers. It should not be handled as an afterthought. In particular, overseas investors and their advisors looking to invest in potentially sensitive UK entities and assets should prepare for this to have a significant impact on deal timelines, with a substantive risk assessment required in the initial stages of all "trigger event" transactions.

There are substantive parallels between the national security interest at the heart of the review and foreign policy processes such as export licensing for military/export controlled goods and/or designation under sanctions laws which call for specialist advice.

Reports suggest the proposed measures are likely to be strengthened further, with possible mandatory notifications of trigger events backed by the threat of criminal sanctions. In light of the Imagination case, we also consider it likely that the timeline for potential intervention may be extended from six to twelve months post-acquisition.

Post-Brexit, the UK will have even more flexibility to introduce targeted national security measures. These could include revisions to the UK's export and import licensing framework, the introduction of a UK "Entity List", and a greater focus on national security in the UK government's agenda than in previous years.

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