International Trade Alert

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Attempted Imagination Coup Triggers UK Push for More National Security Blocking Powers on Foreign Asset Stripping

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Key Points

- On April 21, 2020, Imagination Technologies, a U.K. based company producing graphics processing units used in 11 billion devices globally, was summoned to answer questions by MPs in relation to national security concerns. Lawmakers were alerted to the potential risk to U.K. critical digital infrastructure when a Chinese state-owned investor attempted a boardroom coup of Imagination in early April.
- In recent years, Chinese state investment has sparked growing unease. This unease is not U.K. specific; a number of Western countries have cited concerns with Huawei's 5G infrastructure and the European Union competition chief has warned that the COVID-19 pandemic leaves EU companies vulnerable to Chinese takeovers. The U.K. government has bemoaned its deficient intervention powers in relation to foreign takeovers since September 2016, when Theresa May suggested that the U.K. might develop a more politically interventionist approach to merger control.
- The Imagination coup shines a spotlight on U.K. government plans to significantly widen the net for activities that may be subject to government scrutiny on national security grounds. The new review mechanism would exist separately to the merger control regime, covering acquisitions of U.K. assets and entities in any sector, regardless of turnover or market share.

1. Background

In December 2019, the U.K. government announced the National Security and Investment Bill 2019-20 (the "Bill"), which is based largely on the 2018 White Paper published by the May government. The Bill will grant the U.K. government stronger and wider powers of intervention. However, recent events concerning Imagination suggest these powers need to go further still. In particular, the attempted Imagination takeover may prove an important launching pad for the U.K. government to push for greater blocking powers long after a foreign takeover has completed.

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On April 8, 2020, the U.K. parliament's Foreign Affairs Select Committee (FAC) launched an emergency inquiry into potential asset stripping of U.K. companies. The move followed an aborted boardroom takeover of Imagination, a semiconductor and software design company, which counts Apple and Samsung as key clients, by Chinese state-owned venture fund, China Reform Holdings. China Reform had planned to install four directors on to the board of Imagination, but subsequently abandoned the proposal. In November 2017, Canyon Bridge, a U.S. based private equity firm owned by China Reform, acquired Imagination for £550 million and delisted it from the London Stock Exchange. Recently reports have emerged that Imagination plans to appoint a number of non-executive directors with no connection to Canyon, in an effort to quell concerns about Chinese influence.

In a letter addressed to the Prime Minister on April 3, 2020, the chair of the FAC, Tom Tugendhat, indicated that the U.K. government initially approved Canyon's acquisition of Imagination in 2017 on the basis (i) that Canyon was licensed and regulated by U.S. law and (ii) of assurances that China Reform would remain a passive investor. Canyon has since re-domiciled from the U.S. to the Cayman Islands.

The current government guidance on foreign acquisitions and mergers was described in the April 3 letter as "vague" and the FAC called for assurances that "a stronger legal framework will be put in place for scrutinizing and handling foreign investments that could pose a threat to our national security." The FAC is keen to strengthen the Foreign and 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 May 29, 2020). Tugendhat commented that although combatting the novel coronavirus was the government's top priority, "we must not allow those who would seek to benefit financially or politically from this grave distraction the means to do so." The FAC will focus on what safeguards are required in the forthcoming Bill to ensure that the FCO has a full role in the decision-making process in relation to interventions.

2. Existing Regulatory Regime in the U.K.

(a) The Enterprise Act 2002

The U.K. government currently has limited powers to intervene in takeovers on national security grounds. Under the Enterprise Act 2002 ("EA 2002"), the Secretary of State may intervene on grounds of national security where a "relevant merger situation" occurs. This will be the case where either: (i) the business being acquired has a U.K. turnover of more than £70 million; or (ii) the merger creates a group with a share of supply greater than 25 percent in the U.K.

If the business being acquired is active in the production of items for military or dual-use items, the design and maintenance of aspects of computing hardware or the development or the production of quantum technology, the turnover threshold under (i) above is lowered to £1 million. Current intervention options range from offering approval subject to conditions, which often take the form of "post-offer undertakings," to an outright block of a deal.

(b) The Takeover Code

The Takeover Panel monitors and enforces "post-offer undertakings." Post-offer undertakings are legally binding commitments made with respect to the future of the

business being acquired in order to assuage public interest concerns. These typically address concerns about maintaining a U.K. presence and are binding for the time-period specified in the undertaking. Sanctions for breaching undertakings include obtaining a court order to seek compliance as well as reporting the offender to the Financial Conduct Authority, which may issue fines or prevent the company from operating.

3. National Security and Investment Bill

(a) Legislative Intent

The U.K. government's most recent U.K. national security risk assessment revealed that the U.K. faces continued and broad-ranging hostile activity from foreign actors, which is only likely to increase in the future. This includes human, technical and cyber operations designed to compromise the government, government-held information and critical national infrastructure; attempts to influence government policy covertly; and operations to steal sensitive commercial information and disrupt the private sector.

Whilst the U.K. government has a mature approach to protecting national security overall, it lacks effective statutory powers in relation to the ownership and control of businesses and other entities that could be used to undermine national security. It is important to recognize that national security concerns are not the same as those captured by the existing "public interest" or the "national interest" tests in the context of U.K. merger control review. As such, the proposed Bill intends to remove the national security considerations from the existing U.K. competition assessment process to create an independent review mechanism.

Whilst it will often be the case that both the competition and national security reviews will run in parallel, the proposed Bill seeks to decouple both reviews in that **national security assessments will occur when the relevant competition review thresholds are not met**, given that acquisitions could trigger national security concerns in any sector, regardless of turnover or market share.

(b) Trigger Events

The proposed "trigger events" that would enable the government to scrutinize acquisitions are: (i) the acquisition of more than 25 percent 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 percent of an asset; and (v) the acquisition of significant influence or control over an asset.

The Bill's measures on the acquisition or transfer of control over sensitive assets are designed to ensure that hostile parties cannot circumvent regulatory oversight by acquiring ownership or control of an asset, rather than the company that owns the asset. The government has positioned this power as a "backstop" and has explained that it expects to use it sparingly. That said, the breadth of the controls would suddenly see a huge number of acquisitions potentially falling within scope of the new legislation.

(c) Voluntary Notification

The new system will encourage parties to make a voluntary notification to the government where a transaction may give rise to national security issues. To decide

whether to complete a full assessment, a senior minister would conduct a screening review. The government expects that there to be around 200 notifications a year, half of which would be subject to a full assessment. In comparison to the handful of transactions reviewed under the EA 2002 on a yearly basis, this system would likely result in a significantly higher number of interventions. The government would also be given the power to "call in" transactions for further scrutiny for a specified period, expected to be around six months. An assessment would trigger an automatic stay on the transaction and interim restrictions could be imposed, including a prohibition on releasing information or on granting site access to certain individuals.

(d) Risk Assessment

A draft statement of policy intent accompanied the 2018 White Paper, setting out three key risk factors the senior minister would have a duty to consider in determining whether a trigger event gives rise to a reasonable suspicion that the it poses a risk to national security in order for the government to utilize its "call in" powers to scrutinize further a transaction.

- First, there would be an assessment of whether the target entity or asset being acquired might pose a national security risk (the "target risk"), which may be more likely in certain core areas and sectors. These are identified as certain national infrastructure sectors (i.e., civil nuclear, communications, transport, defense and energy), advanced, military and dual-use technologies and critical direct suppliers to the government and emergency services. A number of illustrative examples are given of the types of entities and assets more likely to raise national security concerns; for example those integral to U.K. defense capabilities or that could be used to cause an emergency in the U.K.
- Whether the relevant trigger event might enable the acquirer to undermine U.K. national security through disruption, espionage or inappropriate leverage (the "trigger event risk") will also be considered. This assessment would be outcomes focused; honing in on the ability of a hostile party to: (i) corrupt processes or systems, (ii) obtain unauthorized access to information or contribute to the proliferation of weapons or (iii) exploit an investment to dictate or alter services or investment decisions or geopolitical or commercial negotiations.
- Finally, there would be an assessment of the risk the acquirer may use the entities or assets to undermine U.K. national security. A non-exhaustive indicative list of types of acquirer that are more likely to pose a national security risk is provided in the draft and includes other states that are hostile to the U.K.'s national security ("hostile states") and parties acting on their behalf ("hostile actors").

(e) Available Remedies

In the event that a trigger event raises national security concerns, the government would have the following remedies available to it: (i) imposing interim restrictions during the statutory assessment period, (ii) imposing conditions of approval for the trigger event to proceed, (iii) blocking the trigger event and (iv) unwinding a trigger event.

Whereas under the EA 2002 ministers were permitted to accept post-offer undertakings as a condition of approval, the Bill would grant much wider powers of intervention allowing for the imposition of any remedies considered necessary to protect national security.

Whilst the government expects to engage with the concerned parties and welcomes input on acceptable remedies, the final decision on the form and detail of any remedy would be the government's alone. Conditions will typically be imposed on the acquirer and/or the asset or entity being acquired, but under the Bill the government would have the power to impose conditions on any party. The White Paper states that an exhaustive list of conditions would "unacceptably limit" the government's ability to protect national security, and so an indicative but non-exhaustive list of the types of conditions which might be imposed are included in Annex B. The indicative list includes conditions related to the structure of transactions, physical security measures and the appointment of monitors. Once the government determines that a trigger event can proceed subject to certain conditions, an approval notice would be published with high-level details about any conditions attached to that approval. The Bill would also provide the government with strengthened powers to monitor compliance by serving information-gathering notices and compelling the relevant party to unwind the trigger event in the event that a condition is breached.

Sanctions for failure to comply would be a criminal offence liable to unlimited fines or up to five years imprisonment, or civil financial penalties up to 10 percent of worldwide turnover.

4. Takeaways

The U.K. government was keen to stress in the Queens Speech that the Bill will align its powers of scrutiny with its "Five Eyes" intelligence partners, being Australia, Canada, New Zealand and the U.S., as well as Germany and Japan. The Bill certainly already goes far beyond the EU framework for screening foreign direct investments, which does not grant any veto rights to the European Commission to intervene in transactions.

The Bill will undoubtedly result in a much higher number of government interventions in foreign investments based on national security. In particular, the intended controls on the disposition of assets represent a major expansion of the activities that may be subject to government scrutiny in comparison to the current position. Taking the review mechanism outside the merger control regime will also mean that even transactions that do not meet relevant competition review thresholds may be liable to a national security assessment.

However, the Bill in its current form would still fail to capture instances like the Imagination takeover, which occurred long after Canyon's acquisition in 2017. We anticipate that the current FAC inquiry will seek to ensure that the U.K. government's new intervention powers under the Bill can be invoked not only at the point of investment, but also post-acquisition when investor activities pose a threat to national security. The current system of post-offer undertakings under the Takeover Code is clearly insufficient to hold state party investors to account post-investment. In this respect, proposals to increase the government's flexibility to determine conditions of approval and compel the unwinding of a trigger event where a condition has been breached are welcome developments.

The current U.K. parliament's FAC inquiry and the vulnerability of U.K. digital infrastructure, such as that produced by Imagination, to overseas control will likely prove an important impetus to focus minds on passing the Bill sooner rather than later.

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