Evidence submitted to the National Security and Investment Consultation by Dr. Ashley Thomas Lenihan*

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KEY MESSAGES

Many states are overhauling their national security review processes for foreign investment in light of the recognition that other countries may seek to use such investments to their advantage. Indeed, the struggle for power among states may increasingly be played out in the economic realm, as some states try to use the market – and companies over which they have control or influence – to gain economic and even military power through foreign investment.[1]

Overall, the UK government's approach to the reform of its powers in relation to national security and investment, as outlined in its July 2018 White Paper, is both welcome and comprehensive. If properly implemented, with some minor tweaks, it should create a robust and transparent mechanism for the screening of foreign investment in order to protect national security, without jeopardising the UK's well-earned reputation for openness to foreign investment and ease of doing business.

The White Paper presents a clear understanding by government of the recurring, new, and emerging threats to national security. It also presents a heartening recognition of the distinction between national security and the national interest or public security, combined with a desire for transparency and proportionality that should be praised.

With this in mind, and on the basis of research of best practice in this area, this submission makes the following *overarching recommendations*. Detailed responses are provided to the individual consultation questions in the pages that follow.

Overarching Recommendations:

1. The list of trigger events should be restated in simpler terms and without thresholds, to avoid being over-complicated or self-limiting.
2. Acquisition thresholds should, instead, be provided as 'guidance' in the Statement of Policy Intent, with lower thresholds suggested for acquisitions by foreign government controlled or influenced investors.
3. There should be greater transparency and institutionalisation of the *organisational* processes behind the regime, including clarity about how monitoring will be conducted and the actors that will feed into the screening and review process.
4. It is recommended that a review panel, constituted of representatives from relevant statutory and regulatory bodies and government departments, is formed to report to and assist the Senior Minister and his team. Proper investment will be required to achieve this.
5. And finally, ***there should be no time limit on retro-active government intervention into foreign investment transactions for national security purposes.***

[1] Lenihan, A. T. (2018). *Balancing Power without Weapons: State Intervention into Cross-Border Mergers and Acquisitions*. Cambridge University Press: Cambridge (https://doi.org/10.1017/9781316855430), p. 282.

RESPONSE TO INDIVIDUAL CONSULTATION QUESTIONS

1. What are your views about the proposed tests for trigger events that could be called in for scrutiny if they met the call-in test?

It is particularly important, and welcome, that trigger events include the acquisition of influence or control over both *entities* and *assets*. Many recent cases highlight the need to recognize that allowing a foreign entity to gain control over both physical and intangible assets can, under certain circumstances, pose a significant national security threat – whether because of the nature of the asset itself, or the ability of that asset to be used as a platform for espionage, disruptive activities, or leverage.

In February 2011, for example, the Committee on Foreign Investment in the United States (CFIUS) retroactively forced ***Huawei*** to divest computing technology assets it had acquired from ***3Leaf*** in May 2010 over national security concerns.[2] Huawei argued that it had not believed it needed to file with CFIUS because the assets were purchased as part of a bankruptcy sale. But the attributes of these assets (including patents with intellectual property around innovative server technology) were clearly of concern to the US government, especially given the close reported ties of Huawei to the Chinese military.[3] There are also many reported instances globally of foreign investment in land assets for the purposes of espionage. In September 2012, for example, President Obama issued a Presidential Order for ***Ralls***, an entity owned by Chinese nationals, to divest its acquisition of four physical wind farm sites on national security grounds, because the sites were located in close proximity to restricted air space used to test drones in Oregon.[4] In 2015, the Australian government also cited national security concerns when it blocked the purchase of the Kidman & Company land portfolio from foreign investors (rumoured to include investors from both Canada and China), in part due to the fact that half of one of the cattle stations included in the Kidman portfolio lay inside the 'Woomera Prohibited Area' used for weapons testing.[5]

The delineation of the proposed test for trigger events in the White Paper is, however, over-complicated and self-limiting. The government rightly specifies that a trigger event should be an acquisition (or further acquisition) that results in significant foreign influence and control over an entity or an asset (trigger events 1, 3, and 5). This formulation provides investors with a simple rule, while ensuring the government has the lee-way it requires to review and screen a myriad of potential cases and transaction structures, as the need arises. The additional inclusion of formal acquisition 'thresholds' for review on top of this is redundant, with the potential to create confusion where it was intended to provide clarification.

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[2] See: Jackson, J. K. (2016). The Committee on Foreign Investment in the United States (CRS Report No. RL33388). Washington, DC: Congressional Research Service (February 19); and Raice, S. and A. Dowell (2011). Huawei Drops US Deal Amid Opposition. *Wall Street Journal*, February 21.

[3] See: Raice, S. (2010) Small Deal Brings Scrutiny to Huawei. *Wall Street Journal*, November 18; and Domain-B (November 19 2010). US government questions Huwaei on 'sneak' 3Leaf Systems acquisition news, https://www.domain-b.com/infotech/itnews/20101119_systems_acquisition_oneView.html.

[4] See: Crooks, E. 2012. Obama Blocks Chinese Wind Farm Plan. *Financial Times*, September 28; and Obama, President B. H. 2012. Order Signed by the President regarding the Acquisition of Four US Wind Farm Project Companies by Ralls Corporation. White House, press release, September 28.

[5] Australian Treasurer (2015). Statement on Decision to Prevent Sale of S. Kidman & Co. Limited. Statement by the Honorable Scott Morrison MP, Treasurer of Australia, media release, November 19; and Thomas, G. and S. Lilly (2016). Australia's New Foreign Investment Regime. Perth: Norton Rose Fullbright (June).

In other words, the list of trigger events could simply be restated as:

- *The acquisition of significant influence or control over an entity or asset*
- *Further acquisitions of significant influence or control over an entity or asset*

The Statement of Policy Intent could then be amended to include acquisition thresholds as suggested 'guidelines' for voluntary notifications. In other words, the acquisition thresholds – of 25% for an entity and 50% for an asset, currently delineated as trigger events 2 and 4 – could be offered as general guidance for acquiring entities seeking to determine whether their acquisition is *likely* to be considered by the government to result in significant ownership or control. It should be clarified that over these thresholds, the likelihood of foreign influence and control may be assumed, but it is also possible that the government will call-in a transaction if influence and control is gained over an asset or entity through acquisitions that fall below these thresholds. As discussed below, the government may wish to provide lower acquisition thresholds as guidance for what might be considered a 'trigger event' that would be 'called-in', for when the acquirer is controlled or influenced by a foreign government. In any case, it should be made clear that an assessment of the details of each transaction will need to be made in their totality, and on a case-by-case basis, regardless of threshold guidelines.

If the government does choose, however, to move forward with the inclusion of acquisition thresholds within its delineation of trigger events, then it should strongly consider the inclusion of lower acquisition thresholds for certain types of acquirers, such as State-Owned Enterprises (SOEs) and Sovereign Wealth Funds (SWFs). SOEs by definition have a closer relationship with their national governments than other foreign entities, and in some cases are directed to make purchases on the open market intended to enhance their country's power and position within the international system. SWFs, more often behave as innocuous market actors or even institutional investors, but may in some circumstances be considered to have political motivations for their acquisitions and investment strategies.[6] As part of its wider 'going out' strategy, for example, the Chinese government encourages outward foreign investment it believes might help its country to 'mitigate the domestic shortage of natural resources' or gain access to 'internationally advanced technologies' – and this is often achieved either through SOEs or SWFs directly, or with their help through the provision of deal financing.[7] For these and other reasons, foreign investment review regimes across the globe usually take a more stringent approach to such investors. Australia and Russia, for example, use lower acquisition thresholds for 'government-controlled investors' (GCIs), and the United States requires that acquisitions made by such investors automatically undergo lengthy investigations by CFIUS.[8]

3. What are your views about the content of the draft statement of policy intent published alongside this document?

[Please see response to consultation question #1.]

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[6] Lenihan. *Balancing Power without Weapons*, p. 260-261; and Lenihan, A. T. (2014). Sovereign Wealth Funds and the Acquisition of Power. *New Political Economy* 19 (2), https://www.tandfonline.com/doi/abs/10.1080/13563467.2013.779650.

[7] See: Lenihan. *Balancing Power without Weapons*, p. 289; and UNCTAD (2006). World Investment Report 2006 – FDI from Developing and Transition Economies: Implications for Development. Geneva: United Nations, p. 210.

[8] Wehrlé, F. and J. Pohl (2016). Investment Policies Related to National Security: A Survey of Country Practices. OECD Working Papers on International Investment (2016/02). Paris: OECD Publishing (June 14). http://dx.doi.org/10.1787/5jlwrrf038nx-en, pp. 25-26.

4. Does the proposed notification process provide sufficient predictability and transparency? If not, what changes to the proposed regime would deliver this?

While the intent of the government to create a predictable and transparent process for investors should be lauded, the proposed regime raises two areas of concern.

First, while the *notification process* is transparent, the *institutional processes and organisation* that will underlay and support the UK's new foreign investment review regime are not. Transparency is needed about more than just what constitutes a trigger event or the legal test for 'call-ins.' The key to creating a regime that is trusted by investors – and which results in the least amount of friction and tension with other states in the event of the need for government intervention into a (proposed) transaction – is the perception surrounding the overall levels of ***institutionalisation*** of the foreign investment screening regime.[9] This is important, because if the government's decision concerning a particular trigger event becomes the subject of public or international debate, a reputation for an institutionalised and predictable process can help deflect and defend against potential criticism that the decision might have been political-motivated or rooted solely in economic nationalism (i.e. – without a sufficient or true national security concern). Moreover, countries with highly institutionalised processes are generally more likely to be able to successfully mitigate national security concerns where possible, and low levels of regime institutionalisation are associated with lower overall levels of cross-border deals in sectors associated with national security.[10]

The institutionalisation of a foreign investment regime takes time. The regime must demonstrate consistency of application of transparent legal processes for review, screening, and assessment, as is clearly intended in the White Paper. But the regime must also demonstrate transparency, and some level of basic consistency, around what actors are involved in the overall process, and the roles that they will play within that process. **For this reason, there needs to be a clearer and more detailed public explanation of the composition of the review body/team in the proposed UK regime under the Senior Minister in charge**, and a clarification of the lines of authority under the 'Senior Minister' making the final decision about a particular trigger event (see answer to question 11 for further discussion of this). This does not need to mean named individuals, but it must be clear to the outsider what government departments are (at least usually) involved in the screening and review process, and where points of (informal and formal) contact may be appropriately made to seek information and clarifications.

Second, it is important to note that while transparency of *process* and *regime* are desirable from both a national and investor perspective, public transparency about the *details of the individual cases* that are called-in for review by government are not desirable at the early stage in the review process currently proposed. In paragraph 5.23, and 7.43-7.45 of the White Paper, it is stated that as soon as a trigger event has been called in, the government will publish their reason for doing so, interim restrictions where relevant, and the timescales for further assessment. From the researcher's perspective, this would be a gold-mine of information that would be deeply welcomed. However, from the perspective of the economy, business, and the country as a whole, it would be better if the government were able to hold off publishing such details until *after* a decision has been made in relation to the transaction. Indeed, 'while providing as much information as possible to

[9] Lenihan, Balancing Power without Weapons, pp. 52–3, 201—3, 214.

[10] Lenihan, Balancing Power without Weapons, pp. 52-53, 214. For a detailed comparison of levels of institutionalisation in the US, versus the Chinese and Russian, foreign investment review regimes, see pp. 200-210.

concerned parties, most countries … take measures to safeguard commercially sensitive information (including, at times, the fact that a review is taking place) and to protect security-related information.'[11] In the US, for example, there are stringent legal confidentiality requirements to which CFIUS must adhere surrounding the parties related to the transaction, their filings and any proprietary information included therein, and even the fact that their transaction is under review – with some exceptions added under recent amendments to the process (made under FINSA in 2007 and FIRRMA in 2018), for example, to allow for information sharing among US government authorities relevant to the review process and even allied governments in some cases.[12]

In many countries, allowing the parties involved to decide whether or not to make public discloses about their involvement in a foreign investment and national security review process – after their own internal assessment of the risks to their deal – appears to be an important aspect of encouraging voluntary notification and early engagement with government, as well as confidence in the process. Otherwise, it creates unnecessary pressure on both the government and the parties involved in the transaction, at a very early stage in the process. Premature release of the details of transactions under review may also invite more than public debate, it can also invite public **dissent and/or politicization** of a transaction review at an early stage in the process. Politicization of foreign investment reviews are particularly troublesome, as undue pressure can be placed on elected officials to veto or heavily mitigate a transaction in instances where it may not actually be necessary to satisfy national security. This type of miscalculation can have negative and unintended consequences beyond its potential impact on future foreign direct investment. It can even lead to 'overbalancing' against the power of another country, resulting in costly short- and medium-term diplomatic consequences in relation to the host state of the foreign investor involved.[13]

For this reason, it is recommended to publish details about the scrutiny of a transaction only after its review has concluded and if it has been vetoed or mitigated, in addition to the publication of high-level statistics related to the regime through annual reporting. This would be in-line with best practice across countries that have formalised regimes for screening foreign investment on the basis of national security. For example, in a 2016 survey of 17 such countries, Wehrlé and Pohl found that:

> 'some 70% of them make public, in one form or another, their decisions to block or otherwise restrict proposed investment. In some cases, information about the outcome of the review is systematically provided (e.g. Austria, Japan, Korea, New Zealand, UK, and the US); in other cases, decisions are sometimes disclosed, albeit not systematically (e.g. Australia, Canada, Germany, Russian Federation), for instance on the occasion of meetings with journalists. By contrast, the number of countries that provide an annual report has not increased during the past seven years. Like in 2008, only Australia and the United States provide publicly available reports.'[14]

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[11] OECD (2008). Accountability for Security-Related Investment Policies, http://www.oecd.org/investment/investment-policy/41772143.pdf.

[12] See: Jackson, J. K. (2018). The Committee on Foreign Investment in the United States (CRS Report No. RL33388). Washington, DC: Congressional Research Service (July 3), https://fas.org/sgp/crs/natsec/RL33388.pdf; and https://www.whitecase.com/publications/alert/cfius-reform-becomes-law-what-firrma-means-industry.

[13] Lenihan, *Balancing Power without Weapons*, pp. 22–4, 62, 93, 97, 158, 163–6, 182, 185, 292–4, 300.

[14] Wehrlé, F. and J. Pohl, Investment Policies Related to National Security, pp. 35-36. It should be noted that since the publication of their report, more countries do appear to be publishing high-level statistics on an informal basis (such as Canada and Russia), but these can be difficult to find.

Post-review details of individual transactions in these, and many other countries, are often only made public when a transaction is vetoed or heavily mitigated – or if there was an earlier leak that the transaction was under review – and sometimes disclosures are not even that systematic.[15]

Publication of high-level statistics about foreign investment review screenings through annual reports, and the publication of high-level details concerning transactions after they have been vetoed or mitigated, can help investors to get a better sense of which transactions may be considered national security risks, and help build confidence in the transparency and institutionalisation of the regime among foreign investors and governments.[16]

5. What are your views about the proposed legal test for the exercise of the call-in power? Does it provide sufficient clarity about how it would operate?

While the proposed legal test for the exercise of the call-in power is sufficiently clear about how it would operate, there is a key change that must be made to the call-in power itself. At the moment, the White Paper states that if the Senior Minister intervenes retroactively, i.e. 'after a trigger event has taken place, they must do so as soon as reasonably practicable after becoming aware and (in any event) within a prescribed period,' which is currently suggested to be up to six months. This must be changed.

In order to protect national security, there should be NO time limit on retroactive intervention. And if there must be a proscribed time period for retroactive review, it must be significantly longer than six months. The concern is that parties choose not to notify government, provide false documentation, or fail to provide the necessary information for an accurate decision to be made, allowing a trigger event of significant national security concern to go under the radar. Indeed, the only way a time limit on retroactive intervention could potentially work is if the government had real-time registry of every foreign acquisition of an entity or asset in (or affecting) the UK, that would need to go far beyond the proposed Register of Beneficial Ownership, and which would need to be constantly monitored and analysed. The government may also need to consider what happens if circumstances materially change during or just after a trigger event, in such a way that the national security implications of a transaction are changed – for example, due to changes in national circumstance such as shortages, supply chain disruptions, or even Brexit.

The importance of not setting a time-limit for retroactive review cannot be overstated. Real examples exist – even in the most institutionalized systems – of the need for retroactive decisions long after an event has taken place. For example:

- ***Sequoia Voting Systems (United States) / Smartmatic (Venezuala)***
  In the United States, CFIUS began discussions in July 2006 to open a retroactive review of a March 2005 takeover of the US voting machines firm **Sequoia Voting Systems** by a Venezuelan software company, **Smartmatic**, because of fears that Smartmatic might have

[15] For legal requirements on disclosure by country see Table 7 of Wehrlé, F. and J. Pohl, Investment Policies Related to National Security, pp. 36-37. Though, as noted above, countries like Canada and even Russia are now disclosing high level statistics in their annual reports – even when these are not legally mandated.

[16] Lenihan, Balancing Power without Weapons; Wehrlé, F. and J. Pohl, Investment Policies Related to National Security; and OECD (2009). Guidelines for Recipient Country Investment Policies Relating to National Security: Recommendation Adopted by the OECD Council. Paris: OECD Investment Division. www.oecd.org/daf/inv/investment-policy/43384486.pdf.

ties to the Venezuelan government of Hugo Chávez.[17] Smartmatic sold Sequoia to its American management, in order to avoid having to undergo a full investigation by CFIUS, by November 2007 – over two years after the initial 'trigger event' because it had not been aware of the transaction when it occurred.[18] (O'Shaughnessy 2007; Smartmatic 2007).

- ***3Leaf Systems (United States) / Huawei (China)***
  As mentioned above, CFIUS retroactively forced Huawei to divest assets in February 2011 that it had acquired from 3Leaf in May 2010 – almost a year later – due to significant national security concerns.[19] Huawei argued that it did not believe it needed to file with CFIUS because the assets purchased were part of a bankruptcy sale, in which they had only acquired some of the assets including patents and personnel.[20] However, the IP involved in the patents were of clear concern, and – again – CFIUS was not aware of the transaction at the time.

These examples are striking, because the US possesses the budgetary and physical capacity to monitor foreign investment for threats to national security, and has multiple government agencies feeding into the CFIUS process – yet even CFIUS missed two cases of clear concern for well over a year, with the parties involved choosing to forego voluntary notification, and CFIUS only learning of these transactions later through apparent happenstance. **National security cannot be confined to a proscribed time period, and neither should the ability for the Senior Minister to conduct retroactive reviews.**

This raises the issue of how, under the proposed voluntary-notification regime, foreign investments will be monitored to ensure that those transactions of concern to national security can be reliably identified and called-in by the Senior Minister. The government cannot rely on public debate or third parties to flag trigger events of concern, but rather will need to create a systematic way to monitor foreign acquisitions of entities and assets in order to assess their national security implications. The proposed Register of Beneficial Ownership in relation to UK land, and existing reporting requirements for entities concerning People with Significant Control (PSC) in their organisations, are an excellent start. Yet, these will not be sufficient on their own to track the 'harder to monitor' changes in ownership – for example of sensitive intellectual property that might reside in the bankrupt assets of former military or government contractors, or of innovative artificial intelligence technology with national security implications in a non-public start-up company. To even begin to map a comprehensive picture of the foreign investment landscape in the UK as it relates to all aspects of national security, **the UK will need to invest in monitoring processes and teams across its government departments, while still striving to be transparent about how monitoring is conducted and who is feeding into the process assessing foreign acquisitions for their national security implications.**

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[17] For further details see: Golden, T. (2006) U.S. Investigates Voting Machines' Venezuela Ties. *The New York Times*, October 29, https://www.nytimes.com/2006/10/29/washington/29ballot.html.

[18] See: Smartmatic. 2007. Smartmatic Announces the Sale of its Subsidiary Sequoia Voting Systems. Smartmatic, press release, November 8. ; and O'Shaughnessy, M. 2007. Smartmatic Announces Sale of Sequoia Voting Systems. Office of Representative Carolyn B. Malone, US House of Representatives, press release, November 8.

[19] See: Jackson, J. K. (2016). The Committee on Foreign Investment in the United States (CRS Report No. RL33388). Washington, DC: Congressional Research Service (February 19); and Raice, S. and A. Dowell (2011). Huawei Drops US Deal Amid Opposition. *Wall Street Journal*, February 21.

[20] See: Raice, S. (2010) Small Deal Brings Scrutiny to Huawei. *Wall Street Journal*, November 18; and Domain-B (November 19 2010). US government questions Huwaei on 'sneak' 3Leaf Systems acquisition news, https://www.domain-b.com/infotech/itnews/20101119_systems_acquisition_oneView.html.

7. What are your views about the proposed remedies available to the Senior Minister in order to protect national security risks raised by a trigger event?

[See answer to question #5 concerning retroactive reviews.]

11. What are your views about the proposed manner in which the new regime will interact with the UK competition regime, EU legislation and other statutory processes?

There are many questions that remain about the exact nature and composition of the review body/team working for or under the direction of the 'Senior Minister'. As discussed above in response to consultation questions 4 and 5 above, such clarity is important not only for the transparency of the regime, but also for public and investor perceptions of its institutionalization over time, and for delineating how it will interact with other statutory processes.

For example: Will there be a team or panel that reports or makes recommendations to the Senior Minister? Who will monitor foreign investments, and how? What government departments will be involved in the monitoring and screening processes respectively? Will this information be public? Will it be adaptive (i.e. – would the government later be able to bring expertise as needed in areas it might not originally expect, for example in areas like food security)? Will the review team or Senior Minister receive automatic feed-in from other statutory and regulatory regimes, or will this occur on a case by case basis?

One recommendation would be to create a **review panel** comprised of representatives from relevant statutory and regulatory regimes, that could report to or make recommendations to the Senior Minister and his team in regard to a particular transaction. This would require a **clear and transparent structure** with the expectation of **feed-in reporting** from its members (which could range from the CMA regarding competition and the Ministry of Defence concerning security, to the Department for Environment, Food and Rural Affairs regarding food security). Dedicated representatives from other government bodies could assist with monitoring in their sectors, provide sector-specific expertise, and help address any differences or discrepancies between their institution's statutory or regulatory action in a particular case, and the ultimate national security determination and remedy sought by the Senior Minister. It would also help to have internal set of processes for the notification of a transaction with security risks to the Senior Minister in charge, by those with whom he or his office may not normally have contact.

Such organisational processes are an important issue, because **proper capacity and investment is required** for an undertaking of this scale. *Otherwise the likelihood of missing a transaction with national security implications in a voluntary notification scheme is quite high.* In other words, a two or three-person team under a senior minister, without clear channels of feed-in from the relevant departments or the proper monitoring capabilities and assets, will struggle to identify transactions that pose a risk. This is especially true in regards to potential retroactive reviews and identifications of 'non-notifications' of a transaction that poses a security risk in a voluntary regime. It is also important for investor confidence in any such regime that companies have a clear idea of touch points within government where informal guidance can be sought concerning whether or not a transaction should be notified to, and discussed with, government. Finally, as mentioned above, the institutionalisation and transparency of such organisational processes, helps build confidence in the regime among foreign investors and states, helping to minimise the impact of vetoed and

mitigated transactions on international relations, and to encourage desirable foreign investment over the long term.