
Mergers and the public interest: a wolf in sheep's clothing?

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Introduction and summary

The UK government is currently consulting on the most sweeping changes to UK merger law since the introduction of the Enterprise Act 2002 (EA02).² Under that legislation, the Competition and Markets Authority (CMA) can block a merger or takeover on the grounds that it will lead to a substantial lessening of competition. In addition, the EA02 gives limited power to government ministers to block mergers and takeovers on the grounds of national security and financial stability (a power exercised by the Secretary of State for BEIS), and on the grounds of media quality, plurality and standards (where the Secretary of State for DCMS is the decision maker).

The government proposes to extend its ability to intervene in mergers and takeovers to protect national security. The proposals also apply more broadly to certain investments, share purchases, loans, as well as other measures that may result in increased influence or control over a business. Although presented as benign technical changes to pursue an important public policy goal, the proposals amount to a wolf in sheep's clothing.

First, they would create an entirely new merger review regime which by-passes existing institutions, structures and the transparent processes that accompany them. Second, they greatly expand the number and types of transactions over which the government has the right to intervene. Third, while much of the language is around national security and the threat from foreign actors, they apply to any takeover, not just those involving foreign companies, and the concept of national security is not adequately defined. Fourth, while focussed on certain sectors of the economy, they would enable the government to intervene in any sector.

The government envisages examining 200 cases per year under the new regime. This would be a vast increase, considering it has used existing powers to intervene on national security grounds fewer than ten times since 2003. Although the consultation does not point to a single historic case where national security was impaired but where the government was unable to intervene, the consultation envisages that under the new regime 50 or so cases a year will need to be remedied or blocked to protect national security. By contrast, the CMA currently only remedies approximately 20 cases a year on competition grounds.

In addition to greatly expanding the size and scope of the government's interventions in the market, the changes are likely to have two further harmful effects.

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² Department for Business, Energy & Industrial Strategy, [National security and investment: proposed legislative reforms](#), July 2018.

First, they would introduce a much more restrictive approach towards foreign investment into the UK. This new approach was first set out in Prime Minister's Birmingham speech of July 2016,³ and its application seen almost immediately when the government extracted commitments from Softbank in relation to its acquisition of Arm.⁴

Second, the changes provide a mechanism by which the government can use the threat of a national security intervention to extract commitments related solely to continued economic activity in the UK, and not to national security. This is not a theoretical concern; the government has shown an increased appetite for doing so recently. In March 2018, the government extracted substantial commitments from Melrose in respect of its purchase of GKN.⁵ This takeover did not involve a foreign business and any impact on national security was at best limited. National security powers can and will be used to intervene for politically motivated reasons.

One of the main reasons the current merger regime is decided almost solely on competition grounds by an independent agency is to enable Ministers to avoid the siren cries of vested interests. In politics, the short-term interests of stakeholders who can see a direct negative effect, or an opportunity to extract rent, can often trump the longer-term interests of economic efficiency.

The costs of the economy of these changes will be myriad and substantial.

1. The direct costs to the taxpayer may exceed those of the CMA's current merger activity.
2. There will be direct costs to the companies whose investments are called in and challenged, and indirect costs in terms of delay and uncertainty.
3. There are additional costs for all firms contemplating investments and takeovers in terms of the unpredictability of the outcome. In situations where timing is of the essence, for example, this may in practice serve to exclude many foreign bidders.
4. Tighter scrutiny of foreign direct investment (FDI) is likely to reduce the value of UK assets.
5. There may be a harm to competition. FDI often increases competition because a foreign owner may have deeper pockets, better technology, or an expansion strategy that causes it to increase competition in domestic markets. In addition, if foreign buyers are excluded, it may result in more mergers that are domestically concentrating.
6. Many of the core sectors where intervention is most likely are also those where UK research and innovation are most intense, raising the risk of reduced business incentives because of uncertainty over potential investment.
7. The new regime will result in substantial additional rent-seeking activity in most merger situations, with private vested interests opportunistically seeking to benefit from any new merger or investment.
8. It will weaken the government's moral authority to challenge protectionist barriers to investment by UK firms in other countries, which may be more costly post-Brexit.
9. It sends a negative signal about the openness of the UK economy post-Brexit.

Ultimately, these proposals seem likely to undermine government policy in relation to productivity growth, innovation policy, and trade post-Brexit. A pathway will open. However seldom the current

³ Theresa May, [2016 Speech to Launch Leadership Campaign](#), July 2016.

⁴ London Stock Exchange, [Post-offer undertakings in relation to the acquisition of Arm Holdings plc by SoftBank Group Corp](#), October 2017.

⁵ Department for Business, Energy and Industrial Strategy, [Correspondence on the proposed GKN/Melrose takeover](#), March 2018.

government intends to use it, this pathway will end up a well-trodden route for lobbyists and other special interests to protect themselves from competition, to the cost of consumers and productivity growth across the country as a whole. These costs illustrate the good reasons why the current policy limits government intervention in the “public interest”.

The remainder of this paper provides a brief chronological account of the UK policy and legislative development over the past 15 years before going on to look at the application of the public interest test in practice. The paper then looks at developments since July 2016, the date that policy started to change.

UK policy and legislative background

For the past 30 years or so, merger control in the UK has been determined largely on competition grounds. Prior to the Enterprise Act 2002 (EA02), ministers could intervene in competition cases under a broad public interest test, but rarely did so, under a convention known as the “Tebbit” doctrine.⁶

EA02 depoliticised merger control and moved it from a public interest test to a new substantial lessening of competition (SLC) test to be applied by politically independent competition agencies, the Office of Fair Trading (OFT) and the Competition Commission (CC)⁷. EA02 limited public interest intervention by the Secretary of State for the Department of Trade and Industry (DTI)⁸ to two grounds, national security and media quality, plurality and standards.⁹ There was broad political support for all these changes.¹⁰

The political independence of the competition regime followed that of the Bank of England, and shared some of that rationale¹¹. The rationale for the competition changes were set out in the government’s 2001 White Paper, *A World Class Competition Regime*.¹² A key part of that rationale was a concern that the existing regime, despite the “Tebbit” doctrine, did not provide certainty to business. Those involved at the time testify to a great deal of wasteful lobbying by private vested interests that had little to do with the public interest.

EA02 did not repeal Section 13 of the Industry Act 1975, under which the Secretary of State can issue an order prohibiting a non-UK person from gaining control of manufacturing undertakings deemed to be of special importance to the UK. But this provision has not been used since EA02 came into force.

In 2008, a third significant public interest test, namely financial stability, was introduced to enable the Government to address the Lloyds/HBOS merger, which would otherwise have been delayed or blocked due to competition concerns. This was in the aftermath of the financial crisis and encountered little political controversy.

In 2010, following a controversy involving the then-Secretary of State for BIS, the application of the media quality, plurality and standards test was moved to the Secretary of State for Culture, Media and Sport (DCMS).

⁶ House of Commons Library, [Contested Mergers and Takeovers](#), July 2018. The exception to this was the “Lilley” doctrine in 1991. This was an attempt to allow interventions in takeovers involving state-owned foreign companies. The doctrine was abandoned shortly after its introduction.

⁷ These were merged in 2014 to form the Competition and Markets Authority (CMA).

⁸ The DTI became the Department Business, Enterprise and Regulatory Reform (BERR) from 2009, the Department for Business, Innovation and Skills (BIS) from 2010 and the Department of Business, Energy and Industrial Strategy (BEIS) from 2016.

⁹ The second [Communications Act 2003 amended the Enterprise Act 2002 to include media plurality](#). Media plurality includes considerations of both plurality and genuine commitment to broadcasting standards. See [Enterprise Act 2002, Section 58 \(2A, 2B and 2C\)](#).

¹⁰ See the account of the political debate in [Contested Mergers and Takeovers](#), July 2018.

¹¹ John Vickers, [Central banks and competition authorities: institutional comparisons and new concerns](#), November 2010.

¹² Department of Trade and Industry, [A World Class Competition Regime](#), July 2001.

The Enterprise and Regulatory Reform Act 2013 that merged the OFT and CC to create the CMA involved no change to the public interest test. The CMA now contains an independent panel system that replicates the previous functions of the CC.

In 2014, following concerns arising from the Cadbury/Craft and Pfizer/AstraZeneca matters (discussed below) that public commitments given by foreign companies taking over UK businesses were not enforceable, the Takeover Panel consulted on changes to post-offer undertakings and intention statements. These changes, which came into effect in early 2015, were an attempt to make promises made during a takeover (e.g., to protect jobs at a particular location) binding on the parties.¹³ Whether they will have much effect remains unclear.

Throughout this period, UK merger control operated in conjunction with the European Council Merger Regulation (ECMR). The ECMR applies a significant impediment to effective competition (SIEC) test that is, for practical purposes, identical to the UK's SLC test. The test is applied by the European Commission. As the relationship with the EU is not central to the issues in this paper, and as we do not know how ECMR will apply after Brexit, we do not address the relationship with the EU further in this paper.

Application of the public interest test in the UK (up to 2016)

As mentioned above, EA02 put UK merger policy on a politically independent footing, with final decisions made by the OFT and the CC (now the CMA), and reviewed by a specialist tribunal (the Competition Appeals Tribunal) and higher courts. EA02 ultimately included three narrow grounds for intervention by ministers in the public interest, national security and media quality, plurality and standards and financial stability. The processes around these public interest grounds are clear and transparent. Expert bodies and third party views are taken into account in a structured way, and fully reasoned decisions are published at each stage of the process. With some exceptions, the system appears to have worked well.

There have been fifteen public interest interventions since EA02 came into force. Nine of these involved issues of national security and five involved issues of media quality, plurality and standards. Lloyds/HBOS is the only case raising financial stability issues to date. To put this figure of one a year on average into perspective, the CMA considers between fifty and one hundred on competition grounds.

Lloyds/HBOS is unique as the only case where a merger that was potentially anti-competitive was explicitly¹⁴ allowed in the public interest. In all other cases, the public interest test has operated as an additional control whereby a merger that does not raise any competition concerns could be blocked or remedied because of separate public interest concerns.

Media quality, plurality and standards

When a merger may have an impact on media quality, plurality and standards, a public interest intervention notice (PIIN) can be made by the Secretary of State for DCMS. The CMA undertakes a Phase 1 competition assessment as normal, and there is an additional assessment by Ofcom, the media sector regulator. Ofcom submits its report with recommendations on media quality, plurality and standards to the Secretary of State, who then decides whether the merger requires further scrutiny on the public interest grounds. If it does, then the Secretary of State refers the case to the CMA to investigate the

¹³ Takeover Panel, [Public consultation paper: post-offer undertakings and intention statements](#), September 2014, and Takeover Panel, [Response statement by the Code Committee of the panel following the Consultation on PCP 2014/2](#), December 2014. A fuller account is in Norton Rose Fulbright, [Post-offer undertakings and intention statements – you will be held to what you say](#), January 2015.

¹⁴ See the discussion below on defence sector mergers where the same may have occurred.

public interest consideration in more depth.¹⁵ This happens regardless of whether the merger is found likely to harm competition.¹⁶

At Phase 2 the CMA considers the public interest test alongside any competition considerations and makes recommendations to the Secretary of State. The Secretary of State makes the final decision about whether the merger will act against the public interest and the appropriate remedies.

Since 2003, there have been five public interest notifications relating to media quality, plurality and standards. They are:

- Sky's acquisition of 17.9% of ITV in 2007.¹⁷ This case was referred to the CC on both competition and public interest grounds. The Secretary of State did not find a media concern and instead remedied it on competition grounds, requiring Sky to sell more than half of its stake. This decision was challenged in the courts but ultimately upheld by the Court of Appeal.
- News International's proposed purchase of Sky in 2010.¹⁸ The case was referred to the CC on public interest grounds, and later abandoned.¹⁹
- Global Radio's purchase of Guardian Media Group in 2012.²⁰ The CC remedied this case on competition grounds.
- 21st Century Fox's proposed purchase of Sky in 2017.²¹ This case was remedied on public interest grounds.
- Trinity Mirror's proposed purchase of Northern & Shell in 2018.²² This case was cleared.

This system has generally worked well for several reasons:

- The process is highly transparent, with clearly defined roles for the CMA and the Secretary of State and publication of reasoned decisions by both.
- The Phase 1 process involves a report from Ofcom, which is politically independent and expert in the substance of media quality, plurality and standards. Again, the report is published.
- The definition of the public interest consideration was set out clearly and in advance in DTI guidance. It has developed over time through decisional practice from CC and Ofcom's measurement framework.²³
- No case with anti-competitive effects has been overruled by the Secretary of State.

¹⁵ The Secretary of State can accept undertakings in lieu of a reference on public interest grounds. Although not ultimately adopted, undertakings were considered in News International/BSkyB.

¹⁶ In cases where there are no public interest concerns, the case reverts to a competition-only assessment and the CMA makes the ultimate decision. Where there are both competition and public interest concerns, it is the Secretary of State who makes a reference for an in-depth investigation on both competition and public interest grounds.

¹⁷ Department for Business, Innovation and Skills, [Acquisition by BSkyB plc of 17.9% of the share holding of ITV plc.](#), January 2009.

¹⁸ Department for Culture, Media and Sport, [Culture Secretary Jeremy Hunt's statement following consultation on the proposed merger](#), June 2011.

¹⁹ Competition Commission, [Acquisition by News Corporation of 60.9 per cent of the shares in British Sky Broadcasting Group Plc](#), July 2011.

²⁰ Department for Culture, Media and Sport, [Global Radio and Guardian Media Group Radio merger not to be considered on media plurality grounds](#), October 2012.

²¹ Competition and Markets Authority, [21st Century Fox / Sky merger inquiry](#), June 2018.

²² Competition and Markets Authority, [Trinity Mirror / Northern & Shell Media Group merger inquiry](#), June 2018.

²³ The [measurement framework set out by Ofcom](#) defines plurality as: (i) ensuring there is a diversity of viewpoints available and consumed across and within media enterprises; and (ii) preventing any one media owner or voice having too much influence over public opinion and the political agenda. The measurement framework does not have comprehensive quantitative measures for both of these points, but it includes contextual factors to assist Ofcom, the CMA and ultimately the Secretary of State to determine whether a merger may act against the public interest. This framework was not used in first two merger assessments set out above.

Despite some concerns about politicisation, it difficult to fault the operation of the public interest test in relation to media quality, plurality and standards.

Financial stability

Financial stability was not one of the original exceptions set out in EA02, but was introduced to counter the consequences of the 2008 financial crisis and permit the Lloyds/HBOS merger.²⁴ It has not been used since.

The OFT Phase 1 competition assessment found the merger was likely to lead to harm to competition.²⁵ The merger was allowed without further scrutiny to ensure financial stability, without being referred for a detailed Phase 2 investigation.²⁶ The case was unusual in two respects: first, that competition concerns were overruled in the public interest; and, second, that this was done at Phase 1 rather than Phase 2.

The OFT's role in assessing the public interest considerations at Phase 1 was limited to providing a summary of views from the tripartite authorities (namely HM Treasury, Bank of England and Financial Services Authority), all of whom recommended the merger be cleared on the grounds of financial stability.

John Vickers has argued²⁷ that there was no trade-off between competition and financial stability at the time this decision was made, and that both factors should have weighed against allowing the merger. The acquisition of HBOS gravely worsened the position of Lloyds, and in 2009 the Government made a £17 billion capital injection into Lloyds and ended up with 43.5% of the enlarged banks. In Vickers's words,

“Relaxation of competition law was not a good way to help financial stability in this case, and as the subsequent problems of LBG [Lloyds Banking Group] have shown, it may have worsened it.”

It may be expected that any future use of this public interest consideration will be limited. It may even be used in the opposite direction by blocking or remedying a financial services merger on financial stability grounds even if it did not raise competition concerns.

National security

Currently, when the Secretary of State for BEIS issues an intervention notice in respect of a merger on national security grounds, the CMA investigates public interest issues alongside any competition issues, and submits a report to the Secretary of State. There is no separate independent regulator akin to Ofcom or the Financial Conduct Authority or Prudential Regulatory Authority considering public interest issues, but the CMA may receive views from the relevant ministerial department before it submits its report to the Secretary of State.

Unlike media quality, plurality and standards, but similar to financial stability, any such views are internal to the CMA process and summarised by it in its report, and do not constitute a separate published report to the Secretary of State.

²⁴ House of Commons Library, [The Lloyds-TSB and HBOS Merger: Competition Issues](#), December 2008.

²⁵ Office of Fair Trading, [Anticipated acquisition by Lloyds TSB plc of HBOS plc](#), October 2008.

²⁶ Department of Business, Enterprise and Regulatory Reform, [Final decision of the Secretary of State in the proposed Lloyds TSB merger with HBOS](#), October 2008.

²⁷ John Vickers, [Central banks and competition authorities: institutional comparisons and new concerns](#), November 2010.

There have been nine formal public interest interventions on national security grounds since 2003. No case has identified competition concerns at Phase 1, and there have been no Phase 2 cases as any national security issues have been resolved at Phase 1.

In some cases, the government may affect a merger outcome without using a public interest intervention, as when the Government is also the main buyer in any affected markets. For example, in Babcock/Devonport²⁸, a merger involving submarine servicing and dockyards, the OFT concluded that the two companies were the only credible competitors but cleared the merger on the basis that the Ministry of Defence, as the buyer of these services, submitted that there would be no adverse effect on competition. Such an outcome may be closer to that in Lloyds/HBOS where public interest trumps competition concerns, although less transparently because it happens within the Phase 1 process and does not involve the Secretary of State formally overruling the competition decision.

Other cases

Any discussion of public interest interventions would not be complete without consideration of those cases where public intervention was demanded but did not happen. In other words, are there gaps within the current system?

Over the past decade, a number of cases generated a degree of political concern that resulted in calls or threats to expand the public interest regime. It is noteworthy that none of these related to national security.

Kraft's 2010 acquisition of Cadbury was cleared by the European Commission conditional on Cadbury's divestment of its Polish and Romanian chocolate businesses, and the Commission found no competition concerns in the UK.²⁹ In its takeover proposal, Kraft stated that it believed it could reverse the pending closure of Cadbury's factory at Somerdale. But one week after the takeover had been finalised it announced that it would continue with the closure after all.³⁰

The episode led to concerns that the British government was not equipped to block 'predatory' takeovers³¹ and resulted in calls to widen the public interest test. It also started a process of examining how to make pre-takeover statements binding under the Takeover Code.

No action was taken during this takeover in the UK, but it influenced the government's actions during Pfizer's attempted £69bn takeover of AstraZeneca in 2014, when the Secretary of State for BIS threatened to expand the public interest test to protect the UK's scientific research base (though ultimately this did not happen). This would have required approval from Parliament and recognition from the European Commission that it was consistent with EU law. Pfizer made commitments about keeping R&D staff in the UK, which under the Takeover Code (by this time revised post Kraft/Cadbury) would in general have been legally binding.³²

In any event, AstraZeneca's board rejected the takeover and, despite some speculation since that Pfizer would launch another bid, none has been made. The bid attracted significant political debate and media attention and has shaped thinking about foreign takeovers since then, particularly the fear that foreign takeovers of British firms are motivated by acquiring intellectual property and closing domestic production. This view of foreign takeovers as being vehicles for 'asset stripping' is an important development in the subsequent evolution of the politics of the public interest test.

²⁸ Office of Fair Trading, [Completed acquisition by Babcock International Group plc of Devonport Management Limited](#), August 2007.

²⁹ European Commission, [Commission clears proposed acquisition of Cadbury by Kraft Foods, subject to conditions](#), January 2010.

³⁰ House of Commons, [Mergers, acquisitions and takeovers: the takeover of Cadbury by Kraft](#), April 2010.

³¹ Financial Times, [Kraft case showed limits to UK's power to intervene](#), February 2017.

³² The exception would be if there were a "material change of circumstances", which could have effectively acted as an escape clause in this case. See [Slaughter and May \(May 2014\)](#) for further detail.

Policy and practice since 2016

The Birmingham speech and its aftermath

The most significant turning point since 2003 was Theresa May's speech given at the launch of her campaign for the leadership of the Conservative Party in July 2016, in which she promised to reform competition law to make "markets work better for people", naming big utility firms and banks as companies that might be abusing concentrated markets and vowing to "do something about it":

"Because as we saw when Cadbury's – that great Birmingham company – was bought by Kraft, or when AstraZeneca was almost sold to Pfizer, transient shareholders – who are mostly companies investing other people's money – are not the only people with an interest when firms are sold or close. ... [Two] years ago the Government almost allowed AstraZeneca to be sold to Pfizer, the US company with a track record of asset stripping and whose self-confessed attraction to the deal was to avoid tax. A proper industrial strategy wouldn't automatically stop the sale of British firms to foreign ones, but it should be capable of stepping in to defend a sector that is as important as pharmaceuticals is to Britain."³³

This was a clear shift in policy towards a more interventionist approach. Throughout the previous two decades the UK had been a staunch opponent of such interventions by other EU governments, and an advocate of politically independent merger policy.

As recently as 2013, for example, the Government rejected a recommendation by the Heseltine review to do more to consider foreign takeovers "to ensure [the UK's] long term industrial capabilities are given proper consideration."³⁴ Similarly, under then Prime Minister David Cameron, the UK Government stated that its position was neutral at the prospect of Pfizer acquiring AstraZeneca, amid calls from the then opposition leader Ed Miliband for a public interest test inquiry and for more guarantees for UK jobs and research.³⁵

Now, the soon-to-be Prime Minister was advocating an entirely different, highly political approach.

Shortly after, the Government delayed giving final approval to EDF Hinkley Point C to examine whether Chinese investment in a civil nuclear plant raised a national security issue. The investment was cleared to proceed after an agreement in principle with EDF that the government would be able to stop the sale of EDF's controlling stake prior to completion, and would retain its ability to intervene in a sale after completion.³⁶ The government also announced that in future it would take a special share in all future nuclear projects to prevent significant stakes being sold without the government's consent, and that it would review the public interest regime as it related to national security.

SoftBank's takeover of Arm in September 2016 was the first significant merger under the new Prime Minister. Following discussions with the UK Government, including the Prime Minister and the Chancellor, Softbank committed to keep Arm's UK headquarters and double its UK-based staff.³⁷ It offered these commitments under the Takeover Panel's new Code. The commitments did not relate to national security but instead to continuing economic activities in the UK.

³³ Theresa May, [2016 Speech to Launch Leadership Campaign](#), July 2016.

³⁴ The Heseltine report "No stone unturned" makes a series of 89 recommendations in aspects of government policy that affect economic growth. The Government response sets out the reason for rejecting in HM Treasury, [Government's response to the Heseltine review](#), March 2013.

³⁵ BBC News, [Pfizer's AstraZeneca bid: Miliband wants 'national interest' probe](#), May 2014.

³⁶ Department for Business, Energy & Industrial Strategy, [Government confirms Hinkley Point C project following new agreement in principle with EDF](#), September 2016.

³⁷ Financial Times, [SoftBank to acquire UK's Arm Holdings for £24.3bn](#), July 2016.

Both of these matters, following so quickly after the Birmingham speech, indicated a far more interventionist and sceptical approach to foreign investment in UK companies. But while concerns over Hinkley Point appeared to relate to genuine fears about a foreign state-owned actor in the nuclear sector, with Softbank the primary concern was economic activity in the UK and there is no discernible national security issue.

In April 2017, the Secretary of State issued a public interest intervention notice in respect of the acquisition of Sepura by Chinese-based Hytera Communications Corporation, a merger between firms producing the telecoms systems used by the emergency services.³⁸ Unusually, the Home Office made representations to the Secretary of State, and not the CMA, owing to sensitive national security-related matters.

The merger did not raise competition concerns but did raise national security concerns.³⁹ Undertakings were secured to provide assurance that sensitive information and technology would be protected, and to ensure the maintenance of UK capabilities in servicing and maintaining radio devices used by emergency services in the UK.⁴⁰ The undertakings included Sepura employing a British citizen with Security Check clearance to oversee compliance, and to appoint a British citizen with Security Check clearance to Sepura's board of directors.

Melrose's takeover of GKN

Melrose's takeover of GKN in 2018 represents the most significant shift since 2016 towards a new, more interventionist regime. This was a hostile acquisition, resisted by GKN. Calls for the government to intervene came from the Unite trade union whose opposition on national security grounds included many other concerns.⁴¹ Unite sought assurances on "job security and investment", accused Melrose of having a "short-term, profit-first business model" and said "any last vestige of a manufacturing strategy will be in tatters".⁴² It referred back to Kraft, saying, "eight years on from the takeover of Cadbury, businesses in this country are still too easily able to be destabilised by short-term profit-hunters".

These calls were echoed by Daily Mail journalist Alex Brummer, who wrote a series of articles warning that allowing GKN to be taken over would devastate GKN: that "engineering skills built up over generations at GKN's Redditch base in the heart of the Midlands could be lost" to Melrose's "ability to slice and dice companies and sell them off to the highest bidder".⁴³ The former Trade Secretary, Michael Heseltine, said that "No other country of our sort would have allowed this to happen."⁴⁴ The Guardian wrote that the Business Secretary should intervene "to signal a return to Mrs May's vision" of radical action on corporate takeovers, and, though its concerns were about jobs, investment and GKN's pension fund, noted that an intervention on national security grounds was "plausible".⁴⁵

The House of Commons Business, Energy and Industrial Strategy Committee took evidence on the issue. While there was questioning on national security, there was also considerable concern with other issues such as employment, pensions, and long-term investment. The national security issues were unclear. For example, Jos Sclater, Group Financial Director of GKN said "We are not highly integrated into UK Government defence contracts directly" and "I would say our US military presence is a lot more significant than our UK presence".⁴⁶ According to the Financial Times, at the time of the takeover bid

³⁸ Department for Business, Energy & Industrial Strategy, [Proposed acquisition of Sepura plc by Hytera Communications Corporation Ltd: decision notice](#), May 2017.

³⁹ Competition and Markets Authority, [Hytera-Sepura](#), May 2017.

⁴⁰ Department for Business, Energy & Industrial Strategy, [Decision by Secretary of State](#), May 2017.

⁴¹ Unite the Union, [Melrose bid for GKN 'a threat to US national security', warns Unite](#), February 2018.

⁴² Unite the Union, [Unite on Melrose bid for GKN: Government last minute move 'too little, too late' - and assurances may not even be enforceable](#), March 2018.

⁴³ Alex Brummer, [If GKN is taken over, Britain may as well forget being a major engineering nation \(not that rapacious hedge funds would give a damn\)](#), March 2018.

⁴⁴ Financial Times, [UK defence secretary weighs GKN-Melrose review](#), March 2018.

⁴⁵ The Guardian, [The Guardian view on hostile takeovers: creating value for bankers](#), February 2018.

⁴⁶ Business, Energy and Industrial Strategy Committee, [Oral evidence: The Future of GKN, HC 844](#), March 2018.

“defence makes up a relatively small part of GKN’s overall engineering business and the company does not feature among the top 50 suppliers to the MoD”.⁴⁷

The Secretary of State did not intervene on national security but did obtain commitments. The Financial Times reported that the commitments went beyond those enabled in the Takeover Code and involved a novel ‘deed of undertaking’. The same report revealed that there had been no grounds for national security intervention.

The letter setting out the undertakings revealed that they concerned factors that did not relate to national security.⁴⁸ The list of commitments offered by Melrose included:

- *Operating as a UK business, headquartered and listed in the UK.*
- *Maintaining a UK workforce and respecting the existing employment rights of that UK workforce, as well as closely engaging with their representatives.*
- *Continuing to pay tax as a UK taxpayer.*
- *Continuing to invest in research and development programmes, such as eDrive and the Wing of the Future, which are crucial to our industrial strategy.*
- *Investing in the training and development of the workforce, including in apprenticeships.*
- *Treating suppliers well, including prompt payment for suppliers.*
- *Making arrangements for current and future pensioners which are to the satisfaction of trustees and the independent pensions regulator.*

In addition, Melrose “had agreed to give ministers ‘early visibility’ on any prospective buyers” and agreed to “meet ministers every six months to update the government on its ownership of GKN”.

The Melrose/GKN case is of concern for several reasons.

First, it shows the power of vested interests to influence the outcome of a merger once the possibility for political intervention is present, even under the current very limited public interest test. Many of the commitments such as those relating to prompt payment and pensions simply require Melrose to abide by existing law, and appear to be designed to appease those calling for intervention. Even if intervention does not happen, much harm is done by wasteful rent-seeking. The new test will - on the government’s own estimation - mean 50 times the number of opportunities per year for this to happen.

Second, other commitments that constrain Melrose’s future commercial behaviour show how such intervention may damage economic productivity. Takeovers play a crucial role in disciplining poor performance of top managers in target firms.⁴⁹ By restricting the freedom of the new owner to implement change, the intervention may limit any upside benefit in this case, and may cause other positive takeovers not to happen. But the most damaging productivity impact arises from the longer-term impact on the reduced incentives for top manager performance because of the greater protection afforded by such interventions. Indeed, it may incentive poorly performing managers to put more effort on political rent-seeking than improving the performance of their businesses.

Third, the case illustrates the way in which the threat of a national security intervention can be used to extract concessions unrelated to national security, including in a case where national security was not in fact at risk.

Fourth, the case illustrates that the extra intervention envisaged in the Prime Minister’s Birmingham speech goes deeper than “the sale of British firms to foreign ones”, but includes UK firms buying other

⁴⁷ Financial Times, [Clark clears Melrose Industries’ £8bn GKN takeover](#), April 2018.

⁴⁸ Department for Business, Energy and Industrial Strategy, [Letter from Greg Clark MP to Simon Peckham](#), March 2018.

⁴⁹ Kenneth J Martin and John J McConnell, [Corporate Performance, Corporate Takeovers, and Management Turnover](#), June 1991, and Ugur Lel and Darius P Miller, [Does takeover activity cause managerial discipline? Evidence from international M&A laws](#), July 2012.

UK firms. In giving life to her concerns about “transient shareholders – who are mostly companies investing other people’s money”, “asset stripping” and tax avoidance, it shows that the concerns also go beyond national security.

Gardner/Northern Aerospace

On Friday 8 June 2018, Better Capital announced the sale of Northern Aerospace to Gardner Aerospace (a subsidiary of Shaanxi Ligeance Mineral Resources). Both companies manufacture structural assemblies and other parts for the aerospace industry. The case raised no competition concerns.

On 17 June 2018, the Secretary of State issued a public interest intervention notice on national security grounds and referred the matter to the CMA, with a Phase 1 deadline of 13 July 2018.⁵⁰ In a highly unusual step, given the UK does not operate a suspensory merger regime, but reflecting the activation of the national security public interest regime, the CMA issued an order that prevented the parties from completing the transaction prior to the conclusion of the merger review. As the completion date agreed by the parties fell within the CMA’s statutory merger review timeframe, this led to press reports⁵¹ that the deal had collapsed, and criticism of the way the case was handled.⁵² On 19 July 2018, the Secretary of State announced⁵³ he had cleared the deal as “there are no national security grounds for referring the merger for a Phase 2 investigation”, and the deal was revived and completed the following week.⁵⁴

Notwithstanding the fact that the sale ultimately went ahead, this case illustrates the possibility that an unexpected public interest intervention has the potential to scupper a deal completely, especially where transactions are sensitive to uncertainty and delay. It illustrates that even a short intervention that leads to no action may not be a costless process.

Proposed changes to the national security public interest test

The October 2017 consultation

In October 2017, the Government embarked on changes to the public interest test and proposed both detailed short-term reforms and consulted on possible long-term options.⁵⁵

The short-term reforms were prefaced as being about foreign investment in the UK. The proposal was to lower the thresholds for intervention under the EA02 from £70m turnover to £1m for takeovers involving:

- the military use and dual use (civilian and military) sector; and
- parts of the advanced technology sector such as quantum computing.

This consultation did not ask for views on whether the change should be made or were proportionate to the risks, but instead focused the responses on the mechanism for doing it and the costs and benefits of different procedures for identifying potentially problematic investments. The summary that was released following the end of that consultation acknowledged that that many submissions from legal

⁵⁰ This case was called in under changes introduced following the October 2017 consultation on changes to the national security public interest test. See the discussion below.

⁵¹ Daily Telegraph, [Better Capital ditches aerospace sale to Chinese after Government intervenes on national security grounds](#), July 2018.

⁵² Daily Telegraph, [Better Capital boss Jon Moulton hits out at Government for scuppering Northern Aerospace deal](#), July 2018.

⁵³ Department for Business, Energy & Industrial Strategy, [Proposed acquisition of Northern Aerospace Limited by Gardner Aerospace Holdings Limited: decision notice](#), July 2018.

⁵⁴ Caixin Global, [Crash Reports Premature, as Chinese Purchase of British Airplane-Parts Maker Takes Off](#), July 2018.

⁵⁵ Department for Business, Energy & Industrial Strategy, [Consultation: National security and infrastructure investment review](#), July 2018.

and advisory firms described the proposed approach as “disproportionate” or “inappropriate”, but noted that the government disagreed with the respondents.⁵⁶

Following that consultation, the Government introduced new, lower, thresholds for national security mergers for firms involved in three sectors:⁵⁷

- The development or production of items for military use (including “dual use” items that have both civilian and military applications);
- The design and maintenance of aspects of computing hardware; and
- The development and production of quantum technology.

In relation to the longer-term reforms, the Government said it intended “to make more substantive changes to how it scrutinises the national security implications of foreign investment”. This resulted in a second consultation in July 2018, which concluded in October 2018.⁵⁸

The July 2018 consultation

This consultation proposes sweeping changes to UK merger law which would dramatically extend the ability of the Government to intervene in mergers.

- It would introduce a new public interest power for the Secretary of State to intervene on grounds of national security, to replace the existing provision.
- It would remove the CMA from the process, with matters instead being handled by (what would presumably be a new unit within) BEIS.
- In the event of a difference between the CMA and the Secretary of State, the Secretary of State’s determination would be final. The consultation openly admits the possibility that an anti-competitive merger could be permitted on national security grounds.
- It envisages the calling in of 200 cases a year, with more detailed scrutiny of 100 and remedies or prohibition for 50⁵⁹. Initial screening decisions would take 15 (extendable to 30) days and the 100 cases subject to detailed scrutiny would be determined within an additional 30 (extendable to 75) days.
- While the proposal sets out a set of core infrastructure sectors (civil nuclear, communications, defence, energy and transport) where cases are most likely, the Secretary of State will be able to call in a merger in any part of the economy.
- The proposals cover a broader set of activities than mergers and acquisitions, including certain investments, loans, and acquisitions of intellectual property rights, including copyright and patent rights, and physical property.

To reiterate, the government has intervened to examine national security concerns in fewer than one case per year on average (eight formal cases) since 2003, and now proposes to do so one hundred times

⁵⁶ Department for Business, Energy & Industrial Strategy, [National security and infrastructure investment review: Summary of responses to the Government’s consultation on long-term reform proposals](#), July 2018.

⁵⁷ The first case called in under these proposals was the Gardner Aerospace purchase of Northern Aerospace, discussed above.

⁵⁸ Department for Business, Energy & Industrial Strategy, [National security and investment: proposed legislative reforms](#), July 2018.

⁵⁹ This is despite a statement in the Executive Summary of the October 2017 Consultation that “The expectation is that the need to act would be relatively rare.”

per year. It will be about twice the caseload of the competition regime which examines about 70 cases and remedies or blocks fewer than 25.

The reason for the vastly increased number of interventions is due to the increase in the number of “core areas” that the government has defined as having the potential to provide a risk to national security.⁶⁰ These include:

- some parts of national infrastructure sectors – civil nuclear, communications, defence, energy, and transport;
- some advanced technologies:
 - advanced materials and manufacturing science;
 - artificial intelligence and machine learning;
 - autonomous robotic systems;
 - computing hardware;
 - cryptographic technology;
 - nanotechnologies;
 - networking and data communication;
 - quantum technology; and
 - synthetic biology;
- critical direct suppliers to the government and the emergency services; and
- military and dual-use technologies.

The government considers that there are other key parts of the economy where national security risks are more likely to arise compared to the wider economy as a whole:

- critical suppliers who directly and indirectly supply the core areas;
- those parts of the national infrastructure sectors not in the core areas; and
- those advanced technologies not in the core areas.

The new process has the potential to cause a number of difficulties for merging parties. Firstly, uncertainty about both the length of time and outcome from the processes has the potential to cause a significant chilling effect on M&A activity. Even where a case is ultimately considered benign, the increased processes can hurt deals, as seen in the Northern Aerospace deal.

The government's proposals contain a particularly important potential wolf in sheep's clothing. It says that only five “core areas” of national infrastructure will be subject to the public interest test – civil nuclear, communications, defence, energy and transport. But the regime will not be legally restricted to

⁶⁰ Department of Business, Energy and Industrial Strategy, [National Security and Investment: Draft Statutory Statement of Policy Intent](#), July 2018.

these areas. Rather the proposals note that national security risks could arise in *any* national infrastructure sector – including industries like finance, food or health.

Two of the three national security risks highlighted are extremely broad. Along with espionage, they are “the ability to corrupt processes or systems”, and “the ability to exploit an investment to dictate or alter services or investment decisions or in other geopolitical or commercial negotiations”.⁶¹ The broadness of these risks gives substantial discretionary power to the government, and creates substantial uncertainty for would-be investors. In addition, as the process is not yet established, there will be significant uncertainty about how it will be applied.

The rationale

The justification provided for these changes starts with the general statement that “Any Government’s first duty is to protect national security”.⁶² It sets out that the Government has assessed that national security risks are increasing, stating “we need to be alert to the risk that having ownership or control of critical businesses or infrastructure could provide opportunities to undertake espionage, sabotage or exert inappropriate leverage”. There is a clear focus on the higher risk from foreign actors. Further justification relates to the comparison with other countries’ provision, suggesting that the current UK provisions are weaker and that several countries are “modernising” their regimes.

This paper does not take issue with the need to protect national security. Rather, it takes issue with several aspects of the justification for the proposed changes.

First, the case for such dramatic change is not clearly made. As has already been noted, none of the documents identifies - even in the most general terms - a historic case in the UK where national security was threatened and the government was unable to intervene. Hinkley Point C, which prompted the government to review the public interest test, was cleared with minimal conditions that the government’s proposals go far beyond.

Second, if the threat is so great as to result in a fifty to one hundred-fold increase in the number of interventions to protect national security every year, it raises the question as to the stock of existing investments by foreign actors. Since many of these would have triggered an investigation when they went through, and are still in the hands of those foreign owners, does the government’s logic not imply that these historic transactions may be a threat to national security?

Third, the government does not discuss alternatives to addressing this threat, such as strengthening the UK’s existing security and intelligence services. Nor is there any questioning of when or why investment would be an effective means to harm Britain’s national security. Foreign investors in UK infrastructure bear considerable risk of policy change. Foreign investment appears to be a particularly costly way of attacking another country’s security, as it would risk losing the value of the investment.

Fourth, the references to other countries are not compelling. There is no overall assessment of how their controls fit into their wider national security apparatus, so comparability with that is not possible. There is limited information on the number of cases, but what there is suggests lower levels of activity than the UK plans. For example, the October consultation paper states that the government of Australia required one divestment in 2014-15 which “related to a property purchased by a foreign-owned company”. And despite referring to the modernisation of other countries’ provisions, no information is given on that.

⁶¹ Department for Business, Energy & Industrial Strategy, [Consultation: National security and infrastructure investment review](#), July 2018.

⁶² Department for Business, Energy & Industrial Strategy, [National security and investment: proposed legislative reforms](#), July 2018.

There is no reference to the domestic criticism in those countries of such provisions having protectionist intent.⁶³ Indeed, it is ironic that the UK now points to France as an example to follow, given the scepticism in the UK when in 2005 the French government pledged to defend Danone from a proposed acquisition by PepsiCo in “the interests of France”.⁶⁴

Fifth, the government does not set out clearly why the current framework is not adequate, especially given the revisions to thresholds in certain sectors in June of this year, and the recent changes to the Takeover Code. Nor is there any reference to the provision in Section 13 of the Industry Act of 1975, still on the statute book, which enables the Secretary of State to issue an order prohibiting a non-UK person from gaining control of manufacturing undertakings deemed to be of special importance to the UK.

Sixth, the definition of “inappropriate leverage” defined as the “ability to exploit an investment to dictate or alter services or investment decisions or in other geopolitical or commercial negotiations”, is very broad.⁶⁵

Other parts of the document suggest that the changes may, in part, be motivated to enable intervention to deal with issues that are wider than national security. For example, the consultation paper states, “A further area of concern in takeovers is where Government has provided funding to industry, for example for research and development, to support innovation and growth of cutting-edge industries and solutions”.

The costs

These proposals will be hugely costly to the UK economy.

First, there will be substantial direct costs for the government associated with examining over two hundred matters per annum, monitoring investments that are not notified, and screening, evaluating and determining them. Given the volume of cases, this cost may exceed that of the CMA's merger activity. As there are no plans to charge fees to parties, these costs will be borne by the taxpayer.

Second, there will be costs to business affected. These include the direct costs to the companies whose investments are called in and challenged, and indirect costs in terms of delay and uncertainty.

Third, there is the cost of uncertainty and possible delay for all firms contemplating investments and takeovers. Given fifty or so cases a year are expected to be remedied or prohibited, many companies may not invest in the first place due to uncertainty about the outcome. Delay to the completion an investment can be costly both because the target asset value can depreciate during the process, and because it postpones the benefits of the investment. In some situations where an asset is being sold by auction, some otherwise attractive bidders may be excluded because the buyer fears an intervention.

Fourth, tighter scrutiny of foreign investment is likely to reduce the value of UK assets. How significant this effect is will depend on the extent to which intervention is targeted at foreign entities.

Fifth, competition in the UK may be adversely affected. Foreign owners often have deeper pockets, better technology, or an expansion strategy that cause them to increase competition in domestic markets. To the extent that foreign buyers are excluded, it may favour domestic competitors in

⁶³ For example, “Australian governments have unfortunately trivialised the concept of the national interest by associating it with foreign investment decisions that have often been more about domestic politics and protectionism.” [Sydney Morning Herald, August 2018](#) and “the current US administration has an expanded definition of national security that now includes economic security for US industries” [BCF commentary, September 2018](#).

⁶⁴ Financial Times, [French pledge to defend Danone](#), July 2005.

⁶⁵ Department for Business, Energy & Industrial Strategy, [National security and investment: proposed legislative reforms](#), July 2018.

purchasing companies that are for sale. It allows the Secretary of State to permit a merger that the CMA has determined would be anticompetitive.

Sixth, the policy may lie in conflict the government's industrial strategy, and particularly its policy to promote innovation within the UK. Many of the core sectors where intervention is most likely are also those where UK research and innovation are most intense. UK policy toward R&D is strongly geared towards encouraging foreign firms to invest in UK-based facilities that translate research done in UK universities into practical innovation that can be deployed and diffused in business.

Seventh, the new policy will result in substantial additional rent-seeking activity in many merger situations. Private vested interests will be quick to seek intervention and, as seen with Melrose/GKN, keen to extract extra concessions where intervention does occur. Even where no intervention actually occurs, the rent-seeking may still happen and rent-seeking is economically wasteful. As John Kay has written, rent-seeking is:

“the accumulation of a fortune not by creating wealth through serving customers better but by the appropriation of such wealth after it has already been created by other people. Both are routes to personal enrichment and the tension between them has been a dominant theme of economic history. Whenever the balance shifts too far in favour of appropriation over creation, we see entrepreneurial talent diverted to unproductive activity, an accelerating cycle in which political power and economic power reinforce each other – until others become envious of the proceeds of appropriation, and the resentment of the oppressed undermines the legitimacy of the regime. Political and economic instability are an inevitable consequence.”⁶⁶

Eighth, it will weaken the government's moral authority to challenge protectionist barriers to investment by UK firms in other countries. The consultation acknowledges that UK FDI abroad is significant⁶⁷. Since 2003, the UK has been world-leading in keeping politics out of merger control. The clear limits on when intervention can happen, combined with an extremely transparent process, put the UK in a strong position to challenge protectionism in other countries. With the proposed national security changes, it will become far more difficult for the UK to champion the case of UK businesses whose investment outside of the UK is being challenged or opposed for political reasons. This may weaken the hand of the UK's trade department post-Brexit.

Finally, it sends a negative signal about the openness of the UK economy post-Brexit. By focusing on foreign investment, and taking such an expansive view of what takeovers should be subject to remedies, the government is signalling that it views foreign investment as, at best, a much greater risk than at any time in recent history, and at worst a challenge to the sort of economy it wishes to create. This is not compatible with the notion of Britain as a global free trading nation.

Conclusion

In his foreword to the green paper published in October 2017, the Business Secretary wrote that the “proposals are not in any way designed or intended to limit market access for any individual countries, nor are they related to the degree of market access the UK is able to enjoy abroad.”⁶⁸ Whatever his own intentions are, this is not a reliable safeguard. Even putting aside the government's own track record, the current Business Secretary cannot bind the hands of any future Business Secretary, in this or any other administration.

⁶⁶ John Kay, [The monumental folly of rent seeking](#), November 2012.

⁶⁷ “In 2017, foreign companies spent £35 billion acquiring 254 UK companies, while UK companies spent £77 billion acquiring 150 overseas companies” para 1.21 of the October Consultation.

⁶⁸ Department for Business, Energy & Industrial Strategy, [Consultation: National security and infrastructure investment review](#), July 2018.

The 2001 White Paper which led to EA02 was published with huge aplomb. Making competition policy politically independent was seen as central to UK productivity growth. The 2018 proposals, which will unwind much of the political independence of the UK merger regime are, by contrast, being consulted on quietly. The changes are being explicitly presented as innocuous, well-intentioned and technical responses to a national security question, rather than as the sweeping radical changes that they in fact are.

This is not how such a huge shift in policy should be undertaken. The government should consider the harms that are likely to arise from giving itself such sweeping powers, and at the very least re-open the consultation to give a fair hearing to arguments on all sides.