Post-Brexit M&A in the UK and Europe

8 February 2021

Introduction

Many post-Brexit changes will play out in the years ahead in the M&A arena. This In Depth explores several significant recent developments: the UK's and EU's new rules on investment review, the impact of Brexit on UK and EU merger control, as well as the consequences for investment protection, the loss of financial services "passporting" rights and changes to UK law resulting from Brexit.

Foreign Direct Investment

UK National Security and Investment Bill

In November 2020, the UK government published the National Security and Investment Bill (the "Bill") as a comprehensive overhaul of the UK's foreign investment regime. Our previous note on the Bill provides more detail.

The UK has always had a national investment screening process that operated through its merger control regime. However, very few investments were in practice challenged, and the UK often promoted its economy as "open for business". The Bill introduces a number of important changes. The UK has beefed up its capacity to review filings, including by moving case oversight to a dedicated unit within the UK Department for Business Energy and Industrial Strategy in place of the Competition and Market Authority (the "CMA"). The government's ability to intervene in transactions will not be limited by a minimum turnover or share of supply threshold and the UK's jurisdiction will apply broadly where the target carries on activities in or supplies to the UK. The Bill also proposes a hybrid system of both mandatory and voluntary notifications. In short:

- **mandatory notification** required when a purchaser acquires:
  - 15% or more of the votes or shares or control;
  - of an entity with a UK nexus;
  - that operates in one of 17 "sensitive" sectors.
- **voluntary notification** recommended when a purchaser acquires:
  - control;
  - over an asset or an entity that has a UK nexus; and
  - the transaction is of interest from a national security perspective.

The 17 sensitive sectors that require mandatory notification include communications, data infrastructure and energy. The scope of the sectors was previously subject to consultation, with the results expected to be published in the coming weeks. Still, the Bill will apply retrospectively to transactions signed after 12 November 2020. Transactions that require a mandatory notification are void until they receive approval, with potential fines of up to 5% of global turnover or £10 million (whichever is greater) for non-compliance. Transactions that are not notified under the voluntary regime can be "called in" by the UK government for up to five years post-completion.

The proposed changes to the UK's foreign investment regime are not directly related to Brexit, having been contemplated and evolved over a number of years. Instead, the Bill reflects a global trend towards increased regulation of foreign investment. That trend was exacerbated by the ongoing pandemic, as national governments became concerned about opportunistic acquisitions of critical (often health-related) assets. The new regime will, however, be an important part of the UK's regulatory toolkit for the future and will be independent of the EU-wide framework that became operational last October.

In order for the UK to remain an attractive destination for inbound investment post-Brexit, the UK government will need to ensure that the new regime is applied proportionately and efficiently. The Impact Assessment accompanying the Bill estimates that the regime may require between 1,000 and 1,830 notifications per year. The UK government has tried to ease concerns relating to this number by releasing statements insisting on proportionality of application and introducing relatively short review periods of up to 30 working days. The real impact of the Bill will only be known once it enters into law, which is expected in the first half of 2021.

European Developments

In October 2020, the EU Regulation for an EU-wide foreign investment screening framework became operational. The framework does not establish a standalone EU-wide FDI screening regime managed by the European Commission (the "Commission") nor does it require Member States to implement their own FDI screening regimes. However, to the extent a Member State does introduce a regime, the framework provides for a set of minimum requirements that should be adopted. Perhaps most importantly, the new framework allows EU Member States and the "Commission to cooperate and coordinate when reviewing inward foreign direct investment affecting security and public order". Under the framework, if a Member State receives a foreign investment notification, it must communicate this to all other Member States and to the Commission.

Whilst it remains to be seen if the framework results in a more coherent EU approach to foreign investment, there are early signs that it will, noting the creation by the Commission of the role of "Chief Trade Enforcement Officer" to ensure that actions are guided by EU policy objectives and the publication of annual reports on the implementation of the regulation, based on information submitted by the Member States to the Commission.

This recent development is part of an ongoing global trend towards a tougher stance on inward investment, demonstrated by a number of EU Member States having recently announced new restrictions on foreign investment (including Poland and Hungary) or that they intend to do so (including Belgium, Ireland and Sweden). It has become more important than ever to consider potential national foreign investment restrictions across the EU, given that Member States will cooperate on notifications received. This will not only add complexity but also potentially significant delay to transactions, factoring in consultation with the Commission and other Member States (any of whom can ask for additional information about the transaction), with some reviews taking up to six months to complete. It remains to be seen how cross-border transactions requiring multiple filings will be dealt with and how "politicized" this may become, with different states taking different views in relation to a given deal.

Merger Control

Post-Brexit, a number of changes will now apply to UK and EU merger control. Investors considering investing in the UK and EU will need to consider the following changes.

The UK Will No Longer Be Part of the EU's "One-Stop Shop"

Transactions that are subject to the EU Merger Regulation only also require filings in individual Member States in a small number of cases. The Commission therefore acts as a "one-stop shop" which allows parties to avoid having to make multiple filings across the EU. The Commission will continue to have exclusive responsibility over merger filings that were initiated prior to 31 December 2020. However, now that the UK has left the EU, the UK is outside of the "one-stop shop" arrangement and UK approval will be a separate requirement for transactions that were not initiated by the Commission prior to Brexit. The CMA has been preparing for this for some time and, just six days post-Brexit, issued an invitation to comment on the proposed acquisition of Arm Limited by NVIDIA Corporation, a US-based chip designer and producer, which previously would have come exclusively under the Commission's jurisdiction.

European merger filings will also be effected by Brexit, as UK turnover will also no longer be relevant in assessing whether the merger control thresholds are met at the EU level (which remains the same post-Brexit), which may result in a reduction in the number of cases notified to the Commission. Although the decline in notifications is predicted to be relatively small, acquisitions where a significant portion of the EU turnover is generated in the UK may therefore no longer need to be notified to the Commission.

An Increase in UK Merger Control Filings

As the UK is no longer covered by the "one-stop shop", a number of deals that would have been reviewed only by the Commission will now go through a parallel investigation by the CMA. According to its December 2020 merger control guidance, the CMA will continue to take account of review proceedings in other jurisdictions, and the CMA may not open an investigation in respect of transactions where remedies in other jurisdictions would likely cover the UK; for example, if the relevant target's markets are wider than national in scope. Despite this, the CMA has estimated that, post-Brexit, there will be approximately 30-50 more transactions notified in the UK annually.

Although the UK merger control regime is technically voluntary, the CMA has been taking an increasingly proactive and interventionist approach in looking for deals that may meet the thresholds and routinely asking questions about transactions that are not filed. The significant increase in its merger caseload could have a negative impact on timing of reviews. The UK government has promised to increase funding for the CMA, which may help to ease the burden, but it remains to be seen whether this will be sufficient to avoid delays to what can be an already lengthy process.

Inter-Agency Cooperation

Post-Brexit, the CMA will also cease to be part of the European Competition Network (the "ECN"). The ECN provides for a strong institutional framework for cooperation between the Commission and national competition authorities. This involves sharing information on developments, including whether a case proceeds to a Phase 2 investigation, and exchanging views. The updated CMA merger control guidance confirms that the CMA will, as standard, ask merger parties whether they intend to notify the transaction elsewhere and, if so, will typically ask for a confidentiality waiver to allow the CMA to contact the other relevant competition authorities to discuss and share information as appropriate. There also remains the possibility that the Commission will enter into a formal bilateral agreement with the CMA to enhance cooperation in competition matters.

Brexit's Impact on Protection of Investments

Following the entry into force of the EU-UK trade and cooperation agreement (the "Treaty") on 1 January 2021, EU investors investing in the UK (and vice versa) are faced with a significant reduction in legal protection against discriminatory practices by the relevant host state in relation to investments they make in that state, including expropriation without compensation, lack of due process, adoption of discriminatory legislation, or actions or restrictions on transfer of capital.

Until the end of the Brexit implementation period (in December 2020), investors were protected by EU law, which expressly forbids or tightly regulates most types of discriminatory behaviour by host governments. Additionally, investors could challenge discriminatory behaviour directly in the courts of the discriminating Member State and, if necessary, in the European courts.

This protection is not replicated in the Treaty. The Treaty only includes an undertaking by each party to provide investors from the other party with "treatment no less favourable than that [accorded] in like situations, to [their] own investors…[or those of a third country]". This level of protection falls far short of what is normally found in bilateral investment treaties entered into by the EU or the UK. Standard protections, including fair and equitable treatment and full protection and security of investments or prohibitions against expropriation (whether direct or indirect), are absent from the Treaty.

Additionally, "investor" is defined narrowly, covering only entities "engaged in substantive business". This means that special purpose vehicles used, for example, in private equity structures will not benefit from this protection. Lastly, investors

themselves have no right of direct recourse against the host state if it does not comply with the investment protection section of the Treaty.

In recent years, the EU is seeking to move towards a new generation of investment protection and investor-state dispute resolution ("ISDS") mechanisms in its treaties with third countries. The model for this new generation of investment protection and ISDS mechanisms seems to be the one included in the EU-Canada Comprehensive and Economic Trade Agreement ("CETA"). However, it is notable that the investment protection and ISDS provisions included in the Treaty fall far short of those in CETA.

A potential, if partial, solution is to structure a transaction so that it falls within the scope of treaties that contain investment protection provisions. Both the UK and individual EU Member States have a highly developed network of bilateral investment treaties and are signatories to multilateral treaties with investment protection provisions (*e.g.*, the Energy Charter Treaty). In most cases, these treaties cover indirect investments (*e.g.*, investments effected indirectly through a subsidiary). EU investors wishing to acquire a target in the UK (or vice versa) should, if possible, structure their acquisitions so as to take advantage of a treaty that affords them, and their investment, the right investment protections. While this will not always be possible and will not replicate the level of protection afforded by EU law, it is a pragmatic solution to a potentially genuine problem.

Loss of the Financial Services Passport for UK Private Equity Firms and (Re)Insurers

From 1 January 2021, UK firms lost their financial services "passports" to access EU clients and markets. In financial services terms, the EU-UK Treaty amounted to a "hard Brexit", because it included no new terms for mutual access to each other's markets. The two sides will endeavour to agree by March 2021 on a new Memorandum of Understanding for a framework for regulatory cooperation on financial services. There is little current indication whether this will result in a new basis for mutual market access in financial service terms—see our separate note on the Treaty.

The passport allowed UK private equity firms, frequently authorised under the EU Markets in Financial Instruments Directive ("MiFID") or the EU Alternative Investment Fund Managers Directive ("AIFMD"), to conduct M&A-related activities on a "cross-border" basis in the EU. With the loss of the passport, there are two key uncertainties. Firstly, the circumstances in which a firm is taken to provide a service on a cross-border basis, which broadly means any provision of services in or to a client in a jurisdiction, other than from a permanent branch office in that jurisdiction. Secondly, whether M&A-related activities that a private equity firm conducts on a cross-border

basis amount to an activity that is regulated in a jurisdiction, with EU states providing different interpretations to broad concepts in MiFID.

Whilst there is some lack of clarity, UK private equity firms pursuing a range of deal-related activities (due diligence, structuring and negotiation) in the EU have not generally considered that such activities qualify as regulated activities in most EU states. Some UK private equity firms have EU offices licensed under MiFID or AIFMD, and there is some move to involve an EU-based staff member to "chaperone" deals that are conducted from the UK, although this has not become the norm.

In connection with other financial institutions, particularly the (re)insurance industry, the loss of the passport is equally challenging. Initially, there were, and to some extent there remains, concerns about the conduct of existing insurance policies with European policyholders, particularly the settling of existing policies with such policyholders.

Some hope has been placed on a potential "equivalence" decision from the EU in connection with financial services. However, for the (re)insurance industry, any equivalence decision will be limited to three defined areas: (i) reinsurance, (ii) solvency calculation and (iii) group supervision. This is not sufficient to plug the hole left by the passport.

Many (re)insurers spent the time between the Brexit vote in 2016 and 31 December 2020 preparing for a "hard Brexit"—the vast majority transferred their European liabilities to regulated subsidiaries in Europe through a court mechanism known as a Part VII transfer. Their preparations are standing them in good stead following the current uncertainties.

AIFMD Anti-Asset Stripping Rules

The AIFMD regulates many private equity firms in the UK and EU. Whilst the UK will continue to apply the UK rules implementing the AIFMD, there are some changes to the UK's jurisdiction that may leave some regulatory gaps. For example, any fund marketed in the EU since 2014 (when the AIFMD became fully effective) must comply with certain notification and "anti-asset stripping" rules (relating to restrictions on distributions) when it invests in larger EU-based portfolio companies. Because the revised UK implementing rules treat other EU countries as "third countries" from this year onwards, these obligations will, to the extent that they apply to a non-EU fund manager, only apply when an investment is made into a UK company. Conversely, EU rules will only apply when an investment is made into an EU company.

Whilst this is a logical consequence of the separation of the UK and the EU into distinct jurisdictions, it gives rise to gaps in coverage and supervision. For instance, if the FCA will, from 1 January 2021, only concern itself with activities that UK firms conduct in the UK, it is unclear how EU competent authorities will have any recourse to UK firms that marketed their funds under the passport before Brexit, and how those EU regulators could enforce the rules that firms have previously accepted. The treatment of the acquisition of groups comprising both UK and EU companies by a firm in scope of AIFMD is also unclear, given the potential application of two sets of rules.

AIF Co-investment Structures

Private equity sponsors that form co-investment structures and wish to attract EU co-investors will need to continue to consider whether those structures amount to "alternative investment funds" ("AIFs") that are governed by AIFMD, and subject to restrictions on marketing in the EU. Our separate note on the Treaty covers the impact of Brexit on marketing AIFs, including private equity funds, in the EU.

Notifications of Ultimate Beneficial Ownership

The UK implemented the EU's Fifth Money Laundering Directive in January 2020. In the M&A context, the changes to the anti-money laundering framework include new requirements relating to the obligation of UK and EU companies to hold information on their ultimate beneficial owners (broadly, individuals who hold, directly or indirectly, 25% or more of the ownership interests of the company) and the obligation on Member States to hold this information in a central register, which is accessible to both competent authorities and the general public. The UK had already established a publicly accessible central register of beneficial ownership of UK companies, and will not likely roll back any of these obligations in light of Brexit.

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Please do not hesitate to contact us with any questions.

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