European and UK Critical Raw Materials (CRM) Supply Chains – "National Security" Considerations

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In the three preceding articles in this series on non-Chinese rare earth elements (REE) to permanent magnets supply chains (NCSC) (available here) we outlined western governments' responses to China's dominance of the REE sector, their focus on the development of resilient NCSC to meet the demand for permanent magnets for their industrial ecosystems, including EV and wind turbine industries and some of the challenges to that resilience.

In this article we consider the impact of the national security aspects of the foreign investment policies of the UK and the EU on NCSC.

The United Kingdom - The National Security and Investment Act (NS&I)

The UK Government is reforming the UK's foreign investment control regime by introducing specific legislation for the "making of orders in connection with national security risks arising from the acquisition of control over certain types of entities and assets and for connected purposes".

The NS&I provides for a regime of notices to be given in circumstances where a person gains or extends control over certain entities ("qualifying entities") or assets ("qualifying assets"). These events or circumstances are referred to as "trigger events".

Qualifying entity

The NS&I applies to any entity, whether or not a legal person, that is not an individual, and includes a company, a limited liability partnership, any other body corporate, a partnership, an unincorporated association and a trust.

A trigger event occurs when a person acquires a right or interest in, or in relation to, a qualifying entity and as a result:

- the percentage of shares or voting rights held by the person increases from 25% or less to more than 25%, from 50% or less to more than 50% or from less than 75% to 75% or more (Share Control);
- voting rights are acquired that enable the person to secure or prevent the passage of any class of resolution governing the affairs of that entity (Resolution Control); or
- the acquisition enables the person materially to influence the policy of that entity (Influence Control).

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Qualifying asset

Land, tangible moveable property, and "ideas, information or techniques which have industrial, commercial or other economic value" are qualifying assets.

A trigger event occurs when a person acquires a right or interest in, or in relation to, a qualifying asset and as a result the person is able to use that asset, or use it to a greater extent than prior to the acquisition, or to direct or control how that asset is used, or direct or control how it is used to a greater extent than prior to the acquisition.

Call-in notice

If the Secretary of State (Minister) reasonably suspects a trigger event has occurred or is in progress or in contemplation and which has, or may give rise to, a risk of national security the Minister may give a call-in notice to the acquirer, the qualifying entity (if the trigger event relates to it) and such other persons considered appropriate.

The NS&I once enacted will apply to any trigger event that has taken place since 12 November 2020. Where a trigger event takes place between 12 November 2020 and the commencement date of the NS&I Act in relation to a qualifying entity or qualifying asset, and the event has given rise to or may give rise to a risk to national security, a call-in notice may be given if the Minister became aware of the trigger event before commencement date of the Act, within 6 months of the commencement date and if the Minister subsequently became aware, a call-in notice may be given within 6 months of becoming aware and in any event within 5 years of the commencement date.

Voluntary notice

If a trigger event has occurred, or is in progress or in contemplation, the seller, acquirer or the qualifying entity concerned may give a voluntary notice to the Minister. The form and content of a voluntary notice will be prescribed by regulation.

In response to a voluntary notice, the Minister must either give a call-in notice or notify the parties that no further action will be taken.

Mandatory notice - notifiable acquisitions

If the qualifying entity is of a "specified description" a Share Control or Resolution Control trigger event (but not an Influence Control event) is a "notifiable acquisition" and before control is gained the acquirer must give a mandatory notice to the Minister. The form and content of a mandatory notice will be prescribed by regulation. In response to a mandatory notice the Minister must either give a call-in notice or a validation notice.

The term "specified description" when applied to a qualifying entity refers to 17 specified sectors of the economy. One such sector is "Advanced Materials". A qualifying entity which carries on activities in relation to "magnets utilising rare earth element-lean or element-free permanent magnetic material" or the "extraction, refinement, processing, production and end

of life recovery" of 45 elements, including all 17 REE, will be one of a specified description and accordingly, a trigger event in the nature of Share Control or Resolution Control affecting that entity (of whatever value) will require a mandatory notice to be given before Share Control of Resolution Control is gained.

If completion of a notifiable acquisition occurs without Ministerial approval, the acquisition is void and the parties to it will face heavy penalties (including fines of up to £10 million or 5% of the offender's annual revenue (whichever is higher) and/or prison sentences of up to five years. The acquisition itself will be subject to indefinite exposure to Ministerial review.

Gaining of control of a qualifying asset is not a notifiable acquisition.

The EU – The EU FDI Screening Regulation

Since 11 October 2020, EU Regulation 2019/452 of 19 March 2019 has established a framework for the screening of foreign direct investments into the Union. While leaving to Member States the responsibility of establishing and operating screening procedures for foreign investments, it provides for a cooperation mechanism between the EU Commission and the Member States on all "foreign direct investments" from third countries into the EU, whether falling within the scope of national screening mechanisms or not, "when such investments are likely to affect security or public order". EU Regulation 2019/452 is not "retained law" and so has no application to the UK following Brexit.

National screening mechanisms are currently in force in 18 Member States, but the Commission encourages Member States that do not have one (or that have one which does not cover all relevant transactions) to consider "other available options" when a foreign "acquisition or control of a particular business, infrastructure or technology would create a risk to security or public order in the EU".

Even though the final decision lies with the Member States, the EU Cooperation Mechanism can influence the measures to be applied to qualifying investments, notably when the investment affects a project or programs of Union interest. It is also to be stressed that this mechanism allows Member States and the Commission to provide comments and opinions on a qualifying investment, even when no national screening mechanism is applied.

Qualifying investments

The FDI Screening Regulation covers all foreign direct investments from third countries, i.e. those investments "which establish or maintain lasting and direct links between investors from third countries including State entities, and undertakings carrying out an economic activity in a Member State". The only exclusions are portfolio investments, which do not confer on the investor effective influence over management and control of the company. However, the Commission recognizes that, when such investments represent an acquisition of at least a qualified shareholding that confers certain rights to the shareholder or connected shareholders under national company law (e.g. 5%), they might be of relevance in terms of security and public order.

Such foreign direct investment must furthermore be likely to affect security or public order. Included as a factor for consideration of a threat to security or public order, are investments that have potential effects on the "supply of critical inputs, including energy and raw materials".

EU Cooperation Mechanism

When a foreign direct investment in a Member State is undergoing a national screening process, other Member States and the Commission may provide timely comments and opinions on the investment that will be integrated within the review process of the host Member State.

When a foreign direct investment is not undergoing a national screening process, another Member State (if it considers the investment is likely to affect its security or public order) and the Commission (if it considers the investment is likely to affect security or public order in more than one Member State) may nevertheless provide comments and opinions within 15 months after the investment has been completed, which may lead to the adoption of applicable measures by the host Member State.

In both cases, the host Member State must give "due consideration" to the provided comments and opinions.

Investments likely to affect a project or programme of Union interest

When the foreign direct investment is likely to affect projects or programmes of Union interest, the host Member State shall take "utmost account" of the Commission's opinion and provide an explanation to the Commission if its opinion is not followed.

In this particular circumstance, the Commission may also recommend in its opinion specific actions to the Member State where the investment takes place.

The projects or programmes of Union interest are listed in the Annex to the Regulation and are regularly updated. They relevantly include the EU Research and Innovation programme Horizon. Processing and exploitation of critical raw materials, including REE, will be a dedicated Horizon R&I project in 2021, as planned for in the Critical Raw Materials Action Plan of the Commission of September 2020.

UK – the risk of national security

The NS&I does not define the term "national security".

A Statement of Policy Intent (SPI) approved by both Houses of Parliament will set out how the Minister expects to exercise the power to give a call-in notice.

The current draft SPI identifies the three risk factors that will be considered:

- target risk – the nature of the target and whether it is in an area of the economy where the government considers security risks are more likely to arise;

- trigger event risk – the type and level of control being acquired and how this could be used in practice; and
- acquirer risk – the extent to which the acquirer raises national security concerns.

Advanced Materials are identified in the SPI as a core activity of the economy "where risks are most likely to arise and where the call-in power is therefore most likely to be used".

The EU – affecting security or public order

The FDI Screening Regulation does not provide a harmonized definition of security or public order. However, it provides a list of factors that may be taken into consideration by Member States or the Commission when assessing whether a foreign direct investment is likely to affect security or public order. These factors relevantly include the sector of activity of the target (including the "supply of critical inputs") and the risks related to the acquirer (such as its direct or indirect control or significant funding by a third country's government, past activities affecting security or public order and the risk of engaging in illegal or criminal activities).

The NS&I and its application to a UK NCSC

None of the trigger events are value related.

Share Control is identified in the NS&I by specific percentages and Resolution Control is readily identifiable by reference to the law and/or constitution of the relevant qualifying entity.

Influence Control will depend upon the particular facts and circumstances. The CMA's views in the context of mergers may be relevant – "The ability to exercise material influence is the lowest level of control that may give rise to a relevant merger situation. When making its assessment, the CMA focuses on the acquirer's ability materially to influence policy relevant to the behaviour of the target entity in the marketplace. The policy of the target in this context means the management of its business, and thus includes the strategic direction of a company and its ability to define and achieve its commercial objectives". [CMA "Mergers: Guidance on the CMA's jurisdiction and procedure" – December 2020].

A UK NCSC will operate in a "core activity" of the UK economy. Accordingly, any trigger event of whatever value within the NCSC whether in relation to an entity or asset (as defined) may justify the Minister's decision to issue a call-in notice.

In addition, a Share Control or a Resolution Control trigger event in a UK NCSC may be a notifiable acquisition requiring a mandatory notice and Ministerial approval prior to completion, otherwise it will be void and the parties to it exposed to criminal proceedings.

The NS&I uses the term "right or interest in, or in relation to", an entity or an asset in defining the trigger events - Share Control, Resolution Control, Influence Control and Asset Control.
Clause 10 and Schedule I of the NS&I describe the circumstances in which a person is to be treated as holding or acquiring an interest or right.

Where two or more persons share a "common purpose" in relation to an entity or an asset, each is to be treated as holding the combined interests or rights of both or all of them. Instances of a common purpose in relation to an entity or an asset include cases in which the persons co-ordinate their influence on the activities, operations, governance or strategy of the entity or on the way the asset is used.

Where interests or rights are the subject of a "joint arrangement" between parties, each of them is treated as holding the combined interests or rights of both of them. An arrangement is one that the parties "will exercise all or substantially all the rights conferred by their respective rights or interests jointly in a way that is pre-determined by the arrangement" and includes any scheme, agreement or understanding whether or not it is legally enforceable and any convention, custom or practice, provided there is "some degree of stability" about it.

An interest or right held indirectly by a person through a majority stake in another entity is treated as held by the person. Persons who are "connected" (eg as group undertakings or by family relationships) are each to be treated as holding the combined interests or rights of both or all of them.

Whether the occurrence of a trigger event in a UK NCSC has consequences will require careful analysis:

Step 1: Does the trigger event apply to an entity? The NS&I only applies to "qualifying entities". If the relevant NCSC entity is formed or recognised under a foreign law, it will nevertheless be a qualifying entity provided it carries on activities in the UK or supplies of goods or services to persons in the UK;

Step 2: Does the trigger event apply to assets? The NS&I only applies to "qualifying assets". Land, tangible moveable property, and "ideas, information or techniques which have industrial, commercial or other economic value" located outside the UK will nevertheless be qualifying assets if used in connection with activities carried on in the UK or the supply of goods or services to persons in the UK;

Step 3: Is the qualifying entity also one of a "specified description"? Clause 6 of the NS&I allows the Minister to make notifiable acquisition regulations and provides that "a description of a qualifying entity that is specified must include a provision that the entity carries on activities in the UK which are of a "specified" description, whether or not it also carries on other activities". Accordingly, in the context of a NCSC, an entity formed or recognised outside of the UK will not be of a specified description unless it carries on the activities of a specified description in the UK i.e. relevantly in connection with a NCSC, activities in relation to "magnets utilising rare earth element-lean or element-free permanent magnetic material" or the "extraction, refinement, processing, production and end of life recovery" of 45 elements, including REE;

Step 4: If the trigger event is in relation to the qualifying entity of a specified description, is the event a Share Control or Resolution Control trigger event? If so, a mandatory notice will be required; and

Step 5: if:

- the entity is a qualifying entity of a specified description, but the trigger event is an Influence Control and not a Share Control or Resolution Control (i.e. no mandatory notice is required);

- the entity is qualifying entity, but not one of a "specified description"; or

- the acquisition is an Asset Control trigger event,

should a voluntary notice be given or is it likely that a call-in notice will be given? Where the parties to a UK NCSC are satisfied that a mandatory notice is not required, prudence (and common sense) would suggest that a voluntary notice should be given because of the high-risk level of the sector (i.e. the so-called "target risk" identified in the SPI) even if the other two identified risk factors (trigger event and acquirer risk) are assessed as low.

Clause 6 of the NS&I gives the Minister a wide discretion to make notifiable acquisition regulations which can specify the circumstances in which a notifiable acquisition takes place, including provisions about the circumstances in which gaining control of a qualifying asset of a specified description is a notifiable acquisition where the asset is used in connection with activities carried on in the UK which are of a specified description. The potential exists therefore for control transactions affecting non-UK entities conducting mining or processing of REE outside of the UK or their non-UK assets to be designated as "notifiable acquisitions" and brought within the compulsory notification scheme of the NS&I.

The form and content of mandatory and voluntary notices will be prescribed by regulation. Parties to a UK NCSC should expect that compliance will require a high degree of disclosure of all the relevant economic and control circumstances of the NCSC and the particular acquisition. The NS&I gives the Minister wide powers to require the provision of information and examine witnesses.

The EU FDI Screening Regulation and its application to an EU NCSC

As is the case with the NS&I, qualifying investments under the EU FDI Screening Regulation are not value related.

The Commission acknowledges that "the [FDI Screening] Regulation […] is not subject to any thresholds" and that "The need to screen a transaction may indeed be independent from the value of the transaction itself", as "Small start-ups, for instance, may have a relatively limited value but may be of strategic important on issues like research or technology".

An EU NCSC will qualify as a "supply of critical inputs" to the EU economy. Accordingly, any qualifying investment of whatever value may justify the intervention of the European Commission, in combination with or in addition to the application of any relevant national FDI legislation.

A point of difference with the UK's NS&I is that, to trigger FDI screening within the EU, the investment should in principle involve an entity established within the EU. Indeed, even though the FDI Screening Regulation does not pose it as a condition and only refers to an undertaking "carrying on an economic activity in a Member State", EU national screening mechanisms, on which the FDI Screening Regulation very much relies, generally only apply to investments involving, even indirectly, national target companies (it is notably so in France, Germany, Austria, Spain). Hence, EU FDI screening will in principle not apply to those entities of the NCSC which are established outside of the EU with no affiliates within the EU.

That being said, if a transaction concerns an extra-EU entity but is likely to significantly affect the security of the REE supply into the EU, the scope of the FDI Screening Regulation would in principle allow the Commission to issue opinions to the Member States recommending that they find "other available options" to intervene in the transaction.

Whether a qualifying investment in an EU NCSC will have consequences will firstly require an enquiry into whether the NCSC entity concerned is established, or has established a subsidiary, within the EU.

If so, the next step is to establish whether any national screening mechanism applies pursuant to a national law. If so, the relevant national rules will apply and will automatically trigger the EU Cooperation Mechanism, by which the Commission and any other Member States may provide opinions and comments. If not, the Commission or any Member States may raise opinions or comments to other relevant Member States within 15 months of the completion of the investment.

A key consideration will be whether the NCSC entity participates in projects or programs of Union interest. In this case, increased scrutiny can be expected from the Commission which may request specific actions to be undertaken.

UK NCSC and the proposed EU ESG legislation

In the third of this series of articles we focused on the EU's proposed mandatory ESG due diligence law and in that context considered how parties to an EU NCSC could "regularly verify that sub-contractors and suppliers comply with their obligations" to carry out ESG policies that are in line with the due diligence strategy, noting that a joint venture structure may be appropriate with respect to the management and oversight of the ESG obligations of a NCSC and the management of reporting and disclosure compliance obligations.

As we have seen, the CMA considers "material influence" in the context of mergers as very a low bar. The creation of Influence Control throughout the NCSC may be unavoidable through the operation of clause 10 and Schedule 1 of the NS&I:

- a "common purpose" may be established through provisions which ensure that the activities, operations, governance or strategy of each link in the NCSC meet not only all applicable regulatory requirements, but also the ESG expectations of supportive government agencies, investors and financiers, customers and the market in general;

- "joint arrangements" may be established through arrangements that require at least prior consultation amongst parties before one party is able to exercise a right of rejection of product from its immediate supplier or in an extreme case termination of the contract with the supplier, whether or not such an arrangement was legally enforceable; and

- acquisition of rights and interests may be deemed to occur through indirect holdings and connected persons.

The development of a UK NCSC into its final form may be a link-by-link process with upstream and downstream parties joining at different times. As each link is joined to another link (or links) so acquisitions of rights or interests in, or in relation to, a qualifying entity or a qualifying asset may occur (including through the application of clause 10 and Schedule 1) requiring at each stage an internal investigation to identify what, if any, Share Control, Resolution Control, Influence Control or Asset Control has or is likely to occur, identifying who was or will be the acquirer, which other parties may be deemed to have the same interests or rights by virtue of a common purpose, joint arrangement, indirect holding or connected person relationship and what national security risk factors may applicable. And, critically, whether a notifiable acquisition is likely to occur requiring a mandatory notice and Ministerial approval before Share Control or Resolution Control is gained.

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