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## Defence Sub-Committee

### Oral evidence: Foreign Involvement in the Defence Supply Chain, HC 699

Monday 23 November 2020

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Members present: Richard Drax (Chair); Stuart Anderson; Sarah Atherton; Mr Tobias Ellwood.

Questions 44 - 95

#### Witnesses

I: Francis Tusa, Editor, Defence Analysis; Elisabeth Braw, Visiting Fellow, American Enterprise Institute; and Michael Formosa, Managing Partner, Renaissance Strategic Advisers.



## Examination of witnesses

Witnesses: Francis Tusa, Elisabeth Braw and Michael Formosa.

Q44 **Chair:** Welcome to the second session of the Sub-Committee of the Defence Committee. Today, we are continuing to look at the risks of hostile foreign involvement in the defence supply chain and the extent of Chinese ownership in sensitive UK industries with reference to specific examples. We will also look at whether Covid-19 increases the risk of hostile foreign involvement and whether the Government have done enough to protect industry, in addition to other matters.

Our three distinguished guests are: Francis Tusa, editor of Defence Analysis; Elisabeth Braw, visiting fellow, American Enterprise Institute; and Michael Formosa, managing partner, Renaissance Strategic Advisers.

Francis, can you tell us a little bit about yourself?

Q45 **Francis Tusa:** I set up Defence Analysis, a monthly newsletter, 23 years ago. It constantly looks at the background issues—not just the headlines but what is causing various things: defence budgets, the defence industry, mergers and acquisitions, and general strategic trends. Initially, it had an overwhelmingly UK focus, but more and more it has a European focus, and, I will admit, cherry-picks some of the global issues to see how they especially affect the UK and Europe.

Q46 **Chair:** Elisabeth?

**Elisabeth Braw:** I am a visiting fellow at the American Enterprise Institute where I focus on new national security threats. As we all know, the national security threats that are increasing the most are the ones directed against civil society. That includes hostile business practices, which is part of what this is about. How do we as liberal democracies keep our economies safe from predatory business practices? I was previously with RUSI in London, and in a previous life as a journalist, among other things, I was based in San Francisco reporting on technology.

Q47 **Chair:** Finally, Michael?

**Michael Formosa:** I am managing partner of Renaissance Strategic Advisers. We are a consultancy specialising exclusively in aerospace and defence. FDI strategies are a central focus as we work with companies all over the world looking to enter foreign markets, including the United Kingdom. We also do a lot of work in M&A with banks and private equity, much of which is cross-border.

**Chair:** Thank you very much indeed.

Q48 **Stuart Anderson:** It would be great if you could set out what you see as the risks of hostile foreign involvement in the defence supply chain. Elisabeth, could you start us off, please?



**Elisabeth Brow:** The way we are set up as liberal democracies is that innovation happens in the private sector at different levels. In the defence industry, it starts with the primes and trickles all the way down to start-ups. What is happening now and where it affects the defence industry is that China has two strategies. This is a problem that concerns mostly China, even though we should not say that China is the only perpetrator of any sort of aggressive acts.

China has two strategies under way that I think we should be concerned about. One is Made in China 2025, which is China's strategy for economic superpower status. The other is called military-civil fusion, which seeks to incorporate civilian innovation into the defence supply chain to improve its own defence industrial capabilities and, by extension, its own armed forces. Of course, it wants to be able to sell better military equipment to other countries essentially through its own defence industry.

The problem is that innovation in China is not as good or wide-ranging as it is here, so it concerns us when Chinese companies start investing in our companies to get access to our innovations, be they for civil or military use, for China's benefit and to our detriment.

Q49 **Stuart Anderson:** Francis, would you like to add anything to that?

**Francis Tusa:** Following on the policy of civil-military fusion, it is impossible to say, "This is a Chinese commercial aerospace company. This is a Chinese military aerospace company." The two are inextricably linked. One of the key mergers and acquisitions entities in China is AVIC, which is its defence aviation company. It is utter rubbish for anyone to say, "We felt happy that this company could buy a British commercial company because it is not defence." You cannot make that distinction. In everything China is doing, it believes that, if it gets commercial aerospace technology, it will end up in the defence sphere. The two are linked.

Q50 **Stuart Anderson:** You mentioned mergers and acquisitions. Michael, would you like to share your views?

**Michael Formosa:** Hostile foreign involvement is a risk to our sovereignty, freedom of action, our competitive advantage and critical IP, but it is also a threat to our ability to collaborate. The UK needs to consider collaborative alliances with foreign partners, especially on projects for which we have insufficient local demand. Tempest is an obvious example. We need our partners to trust our supply chain. It is also a threat to core security partnerships such as maintaining "Five Eyes" status. To be a serious partner, we need to ensure that our house is in order. This is the case with the Huawei situation regarding our ability to maintain tier 1 intelligence-sharing status with "Five Eyes". It also helps us when it comes to attracting inward foreign direct investment. We need to ensure that our house is in order and that our potential foreign inward investors trust the integrity of our supply chain.



**Elisabeth Braw:** This is a problem not just for the UK, but for potentially every liberal democracy. We are seeing exactly the same scenario in every developed country. Every developed country is at a loss about what to do. We need foreign investments; that is what makes our economy tick, but that money is supposed to benefit us and individual companies, not a country that is engaging in strategic competition with us.

Perhaps I may read something that was said at the previous inquiry that demonstrates what is happening. This was an inquiry conducted by the BEIS and Defence Committees two years ago. Alex Chisholm was then permanent secretary of BEIS. I think it was Martin Docherty-Hughes who asked him how many times the Government had intervened in mergers and acquisitions on national security grounds under the Enterprise Act 2002. Mr Chisholm said that it had happened only eight times. Then Richard Harrington MP, the Under-Secretary, said, "There have been eight interventions, but that has to be put into the context of literally thousands of M&A transactions. I do not think anyone can say that foreign investment in this country is anything other than welcome, and that will remain the case." That demonstrates the dilemma that we are in as liberal democracies. We need the money, but we need to limit the damage it can cause.

**Francis Tusa:** I want to follow up Elisabeth's and Michael's point. You referred to "supply chain". Perhaps this is the issue. The Chinese, and before them the Russians and Soviets, are not stupid enough to try to put in a bid to buy BAE Systems or Rolls-Royce. They know that every single alarm would go off. If you are to get a strategic advantage, industrially or technologically, you go not just one but probably two or three tiers down, and it is precisely the area where every Government Department—Ministry of Defence, BEIS or whatever—says, "We don't have the resources to check any of this." That is precisely why this is such an easy way to get in.

We have seen a report from the Henry Jackson Society that said that 110 companies had been bought by Chinese entities. If you had the resources, I suspect that a broader survey would reveal it was many hundreds, and the ripples out from that into defence, commercial aerospace and back again would probably shock people.

Q51 **Mr Ellwood:** Let us look back over the past 10 years. We are all very awake to what China is up to today, but, looking back on it, at what moment should we have had that wake-up point, or do you think we are still drifting?

**Elisabeth Braw:** Maybe the wake-up call should have been when China launched its Made in China 2025 plan, but it seemed so innocuous at the time. Which large country would not want to be an economic superpower? I do not think we realised that it would involve us losing assets for China to be able to handle that. In the past couple of years it has been so obvious that Chinese companies are buying up, as Francis said, not major companies—because all sorts of alarm bells would go



off—but smaller ones that are not household names, will not get coverage in the media and are not multi-billion-pound deals. For me, in 2018, it was clear that it was a question of China trying to undermine our ability to innovate; but it is a very blunt tool for legislators to legislate and impose restrictions. In hindsight, it is easy to blame legislators for not having done enough.

**Q52 Mr Ellwood:** We have just had an integrated review, the first step of which is confirmation by the Government that they are willing to invest additional funding on our defence posture. We are still waiting to hear where that money will go, what Britain stands for and what it means to be part of Global Britain. We will not see that until February. Would you like to see a sputnik moment when we label China for what it is and the geopolitical threat that it is turning out to be, not least because of its direction of travel and what it is doing with its investment in western companies?

**Michael Formosa:** We need to have a moment when we realise that the only way we can more effectively engineer, monitor and evaluate any takeover attempt—Chinese or otherwise—in this country is when we have an effective defence and security capability development plan from which should flow a very clear industrial strategy that highlights key technologies and capability areas that we want to keep sovereign, and on which we can birth an effective and comprehensive regulatory regime. Doing so would enable us to create not only the infrastructure necessary for all companies to go through when they are trying to access our markets but, if done correctly, empower specific Departments within Government, for example, to be very dynamic when it comes to evaluating potential deals and deals that have happened.

Francis talked about issues around the supply chain as we go down the tiers. We can look at the United States for examples of where Chinese concerns have come in to snatch up very small companies for just a few million dollars. In those cases the company runs out of cash and the Chinese concern can come in and basically pay for it, obviating the need for a specialised M&A adviser and legal counsel, but the United States has mechanisms by which to go out and actively monitor this activity and unwind it when necessary. I think the answer to that question really relies on the formation of a very well-thought-out and comprehensive framework from which a regulatory regime can be produced.

**Q53 Mr Ellwood:** Francis, what are your thoughts on this?

**Francis Tusa:** To take your last question first, are we drifting? Yes, because if the drift had stopped there would be in place legislation such as Michael referred to. Until there is legislation and the process to oversee takeovers, drift will continue.

As to the wake-up point, as regards the defence industry specifically in Britain, I would go back to a piece by Deborah Haynes of Sky News in June last year in which she highlighted the fact that a company called



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eXception PCB, a printed circuit board maker in Tewkesbury, the archetypal boring sub-system supplier, was gained by a Chinese defence aerospace company. It provides circuit boards for the engine control unit for the F35, the Typhoon fighter and the Meteor beyond-visual-range air-to-air missile. It is so far below the horizon that the MOD had no idea it had happened. That purchase was in 2013. Speaking subsequently to well-qualified electrical engineers, they said that printed circuit boards are really boring, but the company has to know what g-force that circuit board is due to take, and the voltages, power and temperature range. Quite frankly, if you gave an electrical engineer all that data, they would be able to start to reverse engineer the capabilities of the overall system. Again, it is not the Chinese buying Rolls-Royce, but they buy people who supply Rolls-Royce with its critical systems, and they start to reverse engineer those engines or, if it is BAE Systems, the fighters, the missiles and MBDA.

**Q54 Mr Ellwood:** The MOD did come back to say it had looked into this and there was no ability for the Chinese to influence it or no danger to the F35.

**Francis Tusa:** It had no idea what was going on. Talking to Deborah afterwards, an MOD team visited the company the day after the report to try to find out what was going on. The MOD traditionally says, "It's the supply chain; it's nothing to do with us." I am afraid I do not believe the MOD's assurances on that. There are so many other examples. The Henry Jackson Society points out other companies. The MOD does not monitor this.

Michael has talked about different Departments looking after this. Perhaps this is the problem in Britain. We should not have different Departments monitoring this. There needs to be a single point of focus, and it should not be about that Department's own interest but national security.

**Q55 Mr Ellwood:** As for that printed circuit board company, do you think there are still questions to be answered by the MOD?

**Francis Tusa:** I would hope that any potential issues about technology leakage have been sorted out, but the fact is that for six years it has been owned by a Chinese entity. You can go to the Zhengzhou air show or whatever. Elisabeth has referred to the combination of commercial and defence in one. The idea that there is a benign Chinese industrial interest in a company like that which does not leak into the military means that for six years who knows what has flowed across the internet back to China.

**Q56 Mr Ellwood:** The parent company is Shenzhen. The Gloucester-based company that prints the circuit boards would claim that there is a firewall between the two. You are saying it could still penetrate that.

**Francis Tusa:** No. What I am asking is: what has happened in the six years until the report came out? At the time the MOD was not monitoring



it; it had not paid any attention to it. How do we know? It is just an example. Bear in mind all the evidence is that you cannot separate commercial civilian defence technology and China actively says, "Get commercial technology in and we can migrate it on to the military." How do we know what has passed between the UK-based company and China? The MOD had no idea what was going on. When I heard its denials, it was a great example of bolting the stable door after the horse had gone. How many other deals have happened even in the past year where sub-system suppliers now have Chinese ownership and we do not know what is passing between the two countries?

**Q57 Mr Ellwood:** I am sorry to pursue this one, but, to flip it around, is there any evidence—Michael or Elisabeth, please jump in—that in the particular case of the circuit boards, or other cases to do with the F35, by reverse engineering we have seen this capability emerge or materialise in China? Francis, can you wrap that up, if you are aware of that?

**Francis Tusa:** If you have seen the number of prototype stealth aircraft coming out of China in the past five years, you are starting to see questions about technology leakage. At least two new Chinese air-to-air missiles have been seen recently. How many of these are viable? The pace of technology development inside China over the past five years has been pretty astounding. Whereas 10 or 15 years ago they may have been two generations behind the west, in a number of areas they have been catching up. The problem is that, until there is a proper audit, we do not know how much of this has come from Chinese companies buying up western sub-system suppliers and the technology leaking. I do not think there is the evidence base to say categorically that security has been in place to prevent technology leakage.

**Elisabeth Braw:** Not referring to that particular company, it is impossible to prevent intellectual property from crossing borders. Companies can promise that that will not happen and it can be put in writing, but there is no guarantee. There was a similar case in Sweden a couple of years ago where three phenomenal cutting-edge space start-ups were contacted by Chinese companies that wanted to buy their services and use their technology. That was prevented by Swedish export legislation. Not surprisingly, they then said, "In that case, we're buying the companies," which was what happened, and there were no restrictions on foreign acquisitions. Now these companies are Chinese-owned and there is absolutely no way anybody can guarantee that their technology and expertise is not going to China. In effect that is what is happening. With intellectual property, borders do not matter, and I think that is what we are seeing over and over again, as Francis has just described.

*Mr Ellwood took the Chair.*

**Q58 Sarah Atherton:** You have answered a lot of my questions. Can you confirm for me your experiences of direct examples of hostile ownership or acquisition of UK firms? We have been given conflicting information in



this Committee. As Francis said, the Henry Jackson Society has identified 115 companies acquired by Chinese-owned firms since 2010. We have heard about 38 defence companies owned by Asian companies, not necessarily Chinese ones, but the Sub-Committee has also been told by a number of witnesses that it is a perceived risk, not an actual one. What are your own experiences of this? Can we start with Michael, please?

**Michael Formosa:** It is a great question and we can spend hours evaluating and debating literally every takeover attempt. There is a handful of examples where there has been very significant discourse concerning the practicalities of acquisitions since they all deal squarely in the aerospace component field. SLMR, a Chinese concern, was permitted to acquire Gardner Aerospace in 2017. Gardner subsequently took over Northern Aerospace, but the Competition and Markets Authority allowed both. On the other hand, the CMA blocked Gardner's attempt to take over Impcross Ltd, also a components manufacturer. Aerostar, another example of a Chinese concern, walked away from attempting to acquire Mettis Aerospace only after the Business Secretary intervened directly using provisions of the Enterprise Act.

The point is that these are all reactive reviews happening outside the scope of a clear regulatory framework. A proper framework can detail whether or not these acquisitions are allowable before an appreciable amount of time, energy and effort are expended on them. We need to understand a range of key questions that relate to any would-be acquirer, whether they are companies or funds. Who are the owners or investors? Where is the fund coming from? What else is in each portfolio? How is the fund administered and regulated? What other tech do they own? In other words, what are the implications for the addition of the UK tech to its existing portfolio? We have seen examples of this in the United States with Russian firms buying up disparate pieces of technology that suddenly add up to a missile, or even hypersonic technology.

All of these questions go beyond the basics. This would help us form a full picture and anticipate not just the initial transaction but the implications of that acquisition down the road. I think we have the building blocks starting in this country in the interactive analysis tool created by the Defence Solutions Centre. On top of that, even if we approve an acquisition, we have to consider, as is done in the United States, the need for things like special security agreements, proxies and a whole set of export control orders that would complement the inward investment regime and enable us to keep more of a handle on IP.

I do not think we should adopt a simplified view of foreign acquisitions but rather judge each on its own merits, but we can do this only with frameworks that work in support of a clear strategy. That is why it is really important to get this right and not just think in broad terms about any particular country or investment.

Q59 **Sarah Atherton:** Why do you think this has been allowed to happen? We seem to be playing catch-up in this country. Why do you think we are



playing catch-up?

**Michael Formosa:** It is because we are an incredibly open FDI destination. We are No. 3 in the world behind the United States and Hong Kong. Obviously, there are a lot of question marks around Hong Kong and a lot of potential in thinking about a post-Brexit environment. We also have to bear in mind that only a few short years ago we were actively courting Chinese investment in this country as a matter of open policy. Right now we need to balance the notion of maintaining and growing our status as an attractive FDI destination, but we also have to be very practical about instituting the kinds of frameworks needed to maintain control of our own value chains.

**Francis Tusa:** I wholeheartedly back up Michael. The whole gamut of special security arrangements in the States is the type of regime the UK needs. You can look at the SSAs and say that the starting point or presumption in the United States, in most cases of acquisitions by overseas companies, is, "No. Now persuade us why yes." As for SSAs, for example if you were to look at the types of agreements that BAE Systems has in the United States—it is a major player, top 10 defence company—the US sub-divisions are almost completely cut away from the parent company. They are run by US boards and US people. The day-to-day management and control of the board in the UK is limited, and apparently we are a special relationship best ally, so a degree of institutional paranoia when it comes to takeovers and so forth is probably what we should have in the UK.

To come back to Elisabeth's point about the fact that China sees this fusion of commercial aerospace, military and the whole lot, the presumption has to be that any Chinese interest in a UK aerospace defence company, even quite low, is because it wants the military knowledge to improve its defence industry. Even if we may not have great examples of spies carrying briefcases full of documents on to a plane to get back to China, the presumption has to be, because it is stated Chinese policy, that this is what is happening.

**Elisabeth Braw:** I think a good illustration of that incredibly close relationship between Chinese businesses and the Government—it does not originate with the businesses; it is just a matter of legal obligation and policy—is what happened one or two weeks ago when Jack Ma was planning to take his company public. As we know, that would have been the world's largest and most valuable IPO. That IPO was scuttled by President Xi because he disliked something Jack Ma had said in his speech. This is an incredibly powerful company, but not powerful enough to be able to operate independently in China. If you think about all the other Chinese companies that may have wanted to have some sort of separation from the Government, it is just not possible.

It is dangerous to look simply at where the acquiring entity is based and then say, "If it is a Chinese company, we should look more closely at it; if it is based in the UK, an EU country and other allied countries, then it is



fine.” As we know, entities based in our countries can have significant links that we should be concerned about, even though they are registered here. In a previous life I worked in corporate investigations and learned to look at not just the acquiring entity but who ultimately owns it.

A good illustration of why that needs to be done happened in the US a couple of months ago. I do not know whether anybody here remembers the case of Grindr. It is the world’s largest gay dating app. Why do I mention a gay dating app on the Defence Select Sub-Committee? It was bought by a Chinese entity and then the US regulator realised that it might pose a national security risk because who knows what the Chinese Government may do with the data that Grindr has? Therefore, CFIUS, the regulator, forced the Chinese company to sell Grindr. It was sold to a US entity that turned out to be a completely newly-formed entity. It was even registered as a special purpose vehicle. That is linked very extensively to the original Chinese buyer, essentially the same individuals. That illustrates that, even though it is officially a completely American company based in Los Angeles, I think, the problem may not be solved through reversal of the acquisition and resale of Grindr.

**Q60 Stuart Anderson:** You have said that Chinese investment in defence supply chains is not just a problem for the UK but for many countries around the world. Francis, you said that they do not go for the primes but further down the supply chain. We are looking at this and identifying whether it is a major concern, but where do we sit compared with other countries? Do we have an excessive amount of attempts to invest in our defence supply chain compared with other countries, or are we relatively normal?

**Francis Tusa:** The starting position is that, because there has been no single point of focus in the UK as to who is responsible for checking this, if you put people up and ask what is going on, the answer would be, “We don’t really know.” Elisabeth has mentioned the Swedish Government checking on M&A. They are lucky because, with respect, it is a smaller industry and it is easier to keep track of who owns what. Who is really responsible for tracking who is buying what in the supply chain? Is it the MOD? Is it BEIS? Is it the Cabinet Office? There is no single point of responsibility, and that is the biggest problem.

I have seen more evidence—it has been accelerated by Covid, strangely—that France has a greater knowledge of its defence supply chain and thus which companies are at risk of collapse because of Covid-related problems, and it is actively trying to manage the supply chain. I do not detect any such work in the UK to end up in a position where the levers of the defence supply chain are understood so you can suddenly say, “That is a company that, if it collapses, will have implications downstream here, here and here.” I suspect the MOD would say—because it says it about most industrial matters—it is not its responsibility.

**Q61 Stuart Anderson:** Michael, would you concur with those points, or do you have anything else to add?



**Michael Formosa:** I would underline them by saying it is safe to say that Chinese companies, many of which work very closely with the Chinese government are literally investing everywhere around the globe. The belt and road initiative is a prime example. This is so in Europe, and Italy specifically, but moves by China in developed markets, especially in one as sophisticated as ours militarily, are different because they are about acquiring and mitigating our technological and operational advantages. These companies are well funded; they have a lot of deployable cash on hand. For instance, I spoke earlier about Gardner. We estimate that that company went for about 13 times EBITA for cash, where companies in this space would go for more like nine to 11 times.

Lastly to emphasise the point, we should consider the amount of activity in the United States. This is particularly remarkable given the fact that the US has very strict regulatory measures in place, at least in their current form, to block Chinese acquisitions of critical assets specifically. It is happening everywhere.

Q62 **Stuart Anderson:** I would be keen to look at where we can learn. Francis has given a great example of the US where the starting point is, "No; try to convince us." Elisabeth, outside the US, what are other countries doing to protect their industrial base, and where can we learn from them?

**Elisabeth Braw:** Germany is a good example. Its wake-up call was in 2016 when a company called KUKA, which is a pioneering industrial robot maker, was acquired by a Chinese company. At the time it was seen as the most vanilla acquisition ever, and then that company's activities began to focus on China. The CEO resigned and now it is a fully Chinese company. That set off alarm bells in Germany. The German Government strengthened their rules as to the level at which investments had to be approved by them. It went down from 25% to 10%. More recently, the German Government have expanded the number of areas where Government approval is required for investment. Ten per cent. is quite a low level.

In its most recent incarnation, German legislation has a very expansive definition of national security. Under the definition, the effect on national security does not have to be immediate but possible. It is a lower requirement. It does not mean that an acquisition is likely to have negative effects on national security. It is a much broader definition. If it can have an effect, that is when the Government will need to approve an acquisition or investment impact.

It is dangerous to focus on just investment and acquisitions. They are very easy to measure. We can read in any database which company has invested where. The biggest concern from my perspective is VC funding where entities invest in start-ups even before they are ready to be acquired, so it is at a very early point. It is extremely hard to track VC funding. You can read which VC funds fund which start-ups, but we have no idea who the limited partners are in VC entities that back start-ups.



That is my biggest concern. Innovation starts in early stage start-ups and that is where you can snap up the best ideas and you do not have to wait until the companies are a few years old to acquire them. If you get that knowledge early on, the home country still has it, but you can speed ahead and use it for your own purposes. I am sorry to expand on your question, Stuart. I just thought it important to mention that.

**Q63 Stuart Anderson:** That is very interesting. In a minute I will turn to Francis, who wants to follow on from that. Highlighting that point, when referring to seed rounds and series A and B investments, we are talking about hundreds of thousands to low millions. Is this a target people will be aiming for to get into the technology early, because if you invest in 100 seed rounds or start-ups, it will cost you a very small amount to get just one or two successful ones? Is that a key area that is or will be targeted?

**Elisabeth Braw:** It is already targeted. It is very difficult to measure and see where it is happening because VCs do not have to declare their limited partners. A couple of years ago there was a fantastic study by Reuters focusing on the US, but the situation is similar in the UK specifically with Cambridge-based research. Cambridge is the biggest and most significant hub of innovation in the UK. The Reuters investigation found that 20 VCs that have significant funding are connected to the Chinese Government. Twenty VC entities are operating in Silicon Valley. They operate there for the purpose of going round and finding the best ideas at a very early stage. As we all know, VCs operate by investing in lots of early-stage start-ups. Not all work out, but for the ones that do work out financially you are handsomely rewarded. Even with the ones that do not work out financially or commercially, you have a phenomenal wealth of ideas at your disposal as an early-stage investor.

The problem from my perspective is that in the UK we just do not know which entities they are investing in and which ideas they tap into. Maybe in a future session of the Committee it might be worth talking to Alex van Someren. He is the key man at least in the UK VC world, who would be able to tell you a lot more. However, this is something that every country, but specifically the UK and US because they are so strong on university-based innovation spin-offs, needs to address.

**Q64 Stuart Anderson:** Francis, did you want to add something to that?

**Francis Tusa:** Yes, and very much on the last part of Elisabeth's answer. Without being disparaging to universities, if you look at how the innovation train goes into defence, universities and so forth are at the bottom—not in a bad way—of the pyramid, and they feed up into the industrial supply chain. We all know—it has been highlighted—that Chinese participation in UK universities is massive, and it turns out to be quite massive in those universities that have specialised departments dealing in engineering, aerospace and the like. It can be incredibly cost-effective for Chinese universities—to come back to Elisabeth's point, the idea that they are separate from the state is just not the case—to buy



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their way into research and development in British universities and get access to complete intellectual property that they can then use themselves. If there is anyone tracking this inside Government, MI5 or whoever, they do not seem to have been able to make the security case that this involvement is not benign.

Q65 **Stuart Anderson:** Michael, do you want to make a final point before we move on?

**Michael Formosa:** If you look at a map of our aerospace and defence industrial base, you will notice that there are a lot of very large companies, not much in the middle, and then a lot of SMEs. SMEs are a huge priority in defence, especially the ones dealing in tech and cyber. The point is that there is not a critical mass of VC funding in this country that exists in, say, the US market. As a result, these companies are in a position where they are looking around for capital. We need to keep that in mind as we consider these issues.

*Richard Drax took the Chair.*

Q66 **Chair:** Francis, can I raise one question on the protection of our industrial base? Having spoken to Airbus very recently, it is very concerned about a number of things, not least Covid, the UK leaving the EU and the MOD's habit of dishing out contracts to other countries, albeit even friendly ones within the EU. Do you think the time has now come, bearing in mind the technology and all the things that we are worried about from China, when the Government should start to dish out contracts within the UK to build up our manufacturing base and retain all the expertise and skills we will need for fear of potentially losing it?

**Francis Tusa:** If you were to take at face value the words of the Prime Minister on Wednesday of last week, this is exactly what is going to happen. Although he talked about not wanting military capabilities to atrophy beyond rescue, you can take from a lot of his comments that, to do that, we will have to ensure that the defence industry retains and grows capabilities for the military capabilities to be retained. So, yes, I think there is a case. People say it is not affordable to do that type of thing for industry. It is not necessarily protectionism. I would point to the fact that France is doing particularly well, and Sweden manages to favour, wherever it can, its own defence industry and still get value for money.

Q67 **Mr Ellwood:** Francis, you mentioned universities. Are you suggesting that somehow we need an overt vetting process, or are you saying we should close our doors to Chinese students studying here? In practice, how do you see us managing this conundrum?

**Francis Tusa:** It will take a vast bureaucracy. This morning a journalist colleague told me, apropos my giving testimony here, that his wife, who was doing work at a university in the north-west, at a drinks party was introduced to a Chinese doctoral student who said that not only was she doing a PhD in aerospace studies but she was a colonel in the Chinese



security police. She was absolutely open about it. He thought, “Gosh! Should we be thinking about this and considering what this means?” The answer is yes. Quite frankly, if we are talking about national security, and if it means that certain universities that are dependent on Chinese students have to merge or go under, that might be the price.

Q68 **Mr Ellwood:** Initially, you are suggesting that this is something for our agencies to look at.

**Francis Tusa:** I would suggest this is more than “needs to be looked at”: it should be looked at. We are seeing more and more evidence that Chinese students are being monitored to see whether they go on protests against the Communist party and so forth. I do not think anyone believes there aren’t plants from the security services of the Chinese Government monitoring the students in this country. You have to ask whether, if they are doing degrees, postgraduate or whatever, connected with defence and aerospace-type fundamental research, a lot of that knowledge isn’t going back into the Chinese system.

Q69 **Mr Ellwood:** What percentage of Chinese students studying in the UK—I appreciate this is a ballpark calculation—do you suggest will be obliged to work with, or are voluntarily working with, the Chinese military authorities?

**Francis Tusa:** To go back to Elisabeth’s point, you cannot say that any Chinese company is divorced from the state. The Chinese Government provide a certain form of exit visa to allow people to study in Britain. If they are known to be studying aerospace topics, you have to come back to the question: why won’t there be an effort to tap their knowledge when they get back?

Q70 **Mr Ellwood:** I hear that; I understand that. What I am trying to work out is that, until there is a sizeable number, it is unlikely you will get anybody to take this because it is quite a bold, dramatic move to start providing a kitemark for those who may be here. It would certainly hit universities as well financially because of the scale of Chinese investment in adult education.

**Francis Tusa:** Fine, in which case we basically say we will take the money over national security and we are happy for British industry to suffer because of the money going to universities. This is the binary choice we are looking at. If national security is important, maybe one or two universities might not survive.

Q71 **Mr Ellwood:** Venturing away from China, having focused a lot on it, should we as a Committee be conscious or aware of any other states that are potential IP threats to the UK, or should we focus on just China?

**Elisabeth Braw:** At the moment it is primarily China simply because it has the capital and ambition to improve its position. It is already strong. As long as our societies are open, it is possible for any country that develops these ambitions to tap into our resources as well.



To add to what Francis said earlier, a US Senate released a report recently on exactly this. The goal for the number of scientists involved in China's Thousand Talents programme was originally 2,000; as of 2017, 7,000 were estimated to have been recruited. That is a significant number, but it is important to point out that, with China or any other country, one does not need to scrutinise every foreign student who is studying aerospace engineering, because that is basic knowledge at bachelor's degree or even masters level. The real intellectual property is at the PhD and postdoc levels where you conduct research, some of which at a number of universities is funded by the armed forces and is sensitive research. It is not a matter of us needing to investigate every foreign student from a non-EU or non-"Five Eyes" country.

**Michael Formosa:** In a way, by talking about countries other than China we are getting to the real crux of the question. I would go further. An appropriate regulatory regime should consider would-be acquirers on the basis of not only the country of origin but elements like the basis of the entity itself, in terms of which sectors it is involved in and which sectors it is touching; the nature of its ownership; and the basis of the specific individuals in key positions of authority in those organisations. Let us decide what is strategic to us, what is important, what should be prioritised and why, and then assess it on a case-by-case, country-by-country, entity-by-entity and individual-by-individual basis, but this is very difficult to do reactively. We need a clear strategy from which to perform these tasks.

Q72 **Sarah Atherton:** This Committee has heard in evidence that, while defence industries have remained quite resilient during Covid, adjacent industries like civil and commercial aerospace have suffered considerably. To what extent has this exposed the sector to greater involvement by hostile foreign involvement?

**Michael Formosa:** Covid is definitely exposing companies, particularly on the civil side of aerospace, to greater risk. Back in March, at the beginning of the crisis, we were very cognisant of the desire on the part of PE, for instance, to understand which assets specifically, in whatever country—not just the UK—would become distressed in the short term because of Covid but are fundamentally good bets in terms of investment for the long term. Specific examples would be the civil part of aerospace, but the chatter really tailed off in light of Government intervention.

Here, in the UK, on the defence side, we made sure that payments were put through at pace, but Governments on the continent really intervened to prop up the commercial side of aviation. This is giving the OEMs room to rationalise their value chains on the basis of projected production schedules, so the industry will in time right-size. On the other hand, for how long can Government afford to intervene? It is going to experience significant fiscal stress eventually. We have been hearing about that in the news all weekend. Right now interest rates and inflation are low, but we cannot guarantee that this situation will continue. Let us develop a



strategy that clearly defines what is hostile, because PE involvement is a very important part of the solution here since it will and can take critical parts of our supply chain and keep it liquid.

**Q73 Sarah Atherton:** Do you think the UK Government could have done more—I am thinking sector-specific here—to support the civil aerospace industry to reduce any risk going forward from hostile takeovers or involvement?

**Michael Formosa:** On the civil side, let us look at France and Germany. Not only have their defence and interior ministries sped up acquisition, but, in the case of France, I believe it was about €15 billion in bail-out, which took the form of loan forgiveness and financing. About half of that went to Air France, but the balance was aimed at the OEMs like Safran, Airbus and Thales, where the Government invested in a fund with the proviso that the OEMs would follow suit and specifically help small businesses in the supply chain and invest in greener tech. The Germans did something similar with about a €10 billion bail-out. Their five-year plan for military procurement was pulled forward. A lot of 2024-25 money was pulled back into 2021-22.

**Q74 Sarah Atherton:** Francis, would you like to add anything?

**Francis Tusa:** Looking at the approach with Covid effects, France very quickly set up an interministerial team to look at the supply chain with industry for defence and aerospace, to highlight which companies were at risk of collapse, especially if they had key roles in the defence supply chain, and, if so, what could be done to rescue them. This keeps on running, and I suspect you will find it is going to be a feature of how they manage their defence supply chains for the foreseeable future. It is not just Covid that affects this.

There was an example from MBDA, the missile manufacturer, which found out that a relatively key supplier was literally a father and a son, and if one of them died it would probably stop trading. That would have affected the production of two types of missiles. It is amazing quite how small the key players can often be, and you have to manage it actively. Just saying, which is the rule over here in the UK, "It is nothing to do with Government. It is for industry to sort out," no, it is not.

**Elisabeth Braw:** The companies that we talked about are quite large, and if they were to fail it is likely, given what Francis has just said, that the Government would step up and bail them out. The biggest concern is the SMEs, and especially the cutting-edge start-ups that have the technology and expertise that China, in particular, wants.

The EU Commissioner for Competition, Margrethe Vestager, recently proposed that the EU should have a fund for its member states that would be able to offer the VC funding that these start-ups would otherwise get from China. That model should be considered by the UK as well, for example, through expanding NCIF, which is a small operation at



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the moment. If it were to be expanded, the UK Government would be able to invest in those really vital companies before their expertise is lost to China. If you get lucky with start-ups, it is a good deal commercially. Nine out of 10 will be commercially unsuccessful, but one will be successful. It could even be a good deal for the taxpayer. In the meantime, the country would get to keep this really vital expertise and technology.

**Q75 Mr Ellwood:** We realise there is a massive challenge here. We now need to allow the politicians and the legislation to catch up. It has been said that France has a better system or structure. The United States has also been mentioned. We will come to the Bill shortly. In more generic terms, what do we need to do, given this advance? Is the first thing to recognise honestly that we should label China as a hostile competitor? Can we not move forward until we have that change of attitude?

**Michael Formosa:** Doing so is simplistic. As I keep banging on, we really need to develop a strategy and understand where certain types of foreign investment fit. You mentioned a comparison to other regimes. In the case of the French, it is a lot more intense and there is more critical mass. There are a number of actors involved in evaluating foreign acquisition and foreign direct investment: the Minister of the Armed Forces, the DGA and the Cabinet; there is an interministerial body and a mechanism related to the nuclear establishment. In addition to that, the EU passed additional FDI legislation.

On top of all of this, there is a lot of political influence of MPs who can also intervene. A pretty good example very recently was the would-be American acquisition of the French company Photonis. Teledyne attempted to buy Photonis and was, in essence, blocked by a group of MPs. This is still in process, but now the French Government are trying to work out a deal where they can retain 10% interest in the firm in exchange for lowering the price. My point is that, although this regulatory system is more intensive than something that we have, it is also very reactive, and it does not enable would-be acquirers and the invisible hand to operate as well.

If you are a potential foreign direct investor or acquirer, and you only know at the last minute that something will not be allowed by way of a veto, it makes the country less attractive as an FDI destination. We need to be very mindful of that. We have a lot going for us for the reasons that I have said, and we would have to go a long way to jeopardise that position. A piecemeal approach that is not very clear is against the commercial interests of firms that are trying to legitimately invest in this country.

**Q76 Mr Ellwood:** A lot of the western countries—the NATO countries—want to be able to have a common trading platform. There is a lot of talk of a D10 grouping of nations. Should there be more of a collective effort rather than each of us going through our own processes? There needs to be within Whitehall a scrutiny process to be able to do this work; that is a



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given. Ultimately, there must be a common set of standards. If somebody has done the homework and the United States feels happy to operate with a particular country clear of any connection with China, should we have to do the same due diligence again? A lot of duplication might be caused by that.

**Elisabeth Braw:** It would make a lot of sense if we had an EU CFIUS that the UK could join as well. It is a lot of administrative work, but it will be rewarded if and when we can avert the deals or transactions that we are talking about. It is something that every single NATO country and EU country has in common. I do not see how anybody could oppose sharing this administrative and intelligence effort, even though the intelligence would be at quite a rudimentary level.

Another thing that might be useful is already under way. NATO is thinking about creating a VC fund to support exactly the sort of innovation that we are talking about without every country having to create an individual VC fund to keep Chinese and other companies away that we do not want involved in the defence supply chain. That is particularly important because, at the moment, another strain of the public discussion is about how we invigorate innovation in the defence supply chain and how we keep up with the Chinese. We are not keeping up by letting our best ideas seep away. Now that key decision makers are in the process of encouraging the tech community to innovate more in the spirit of national security, it would make a lot of sense to support that with VC funding so they are not even tempted to take on funding from entities that we would deem unhelpful to our national security.

**Francis Tusa:** A problem shared is a problem solved. If, for the sake of argument, the State Department has said, "No, we do not want this company, wherever it is from, buying an American company," that is a very good starting point because it will have done all the due diligence. Equally, if the DGA or whichever authority had said, "No, we do not believe X is a proper entity to buy a French company," that is the type of evidence trail that should make you say, "If it is good enough for them, it is good enough for us."

From a UK point of view, the weakness at the moment is, who is responsible for industrial policy? The problem is this. We frequently see the desk officer at the Ministry of Defence saying, "Despite the prosperity agenda, despite the levelling up, I am just told to get the cheapest I can get. I am not asked any other thing. Cheap is what I am asked for," in which case, industrial matters go by the wayside. If you are going to do active, accurate management of the defence industry and supply chain—by the way, it not just defence; it is also commercial—you must have a single Ministry running it. You could well see a situation on that basis where the MOD wants to do X, and BEIS, or whoever it is, says, "I am sorry, we will not let you go down that path." That is what it is going to need. At the moment, there are too many people with fingers in the pie,



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and it allows everyone to say, "Well, it is not our responsibility. It's them. It's them. Ask them instead."

**Michael Formosa:** I will underline the fact that ultimately it is our responsibility, but we should be extremely cognisant of what other countries, particularly the United States, think in terms of these regulations. If we want to collaborate with foreign partners, we need to know exactly how they view their own supply chains and their own commercial activity. Without doing so, we run the risk of becoming a less desirable collaborative partner.

Q77 **Sarah Atherton:** We have already discussed how the UK is unique among western economies in not having some sort of foreign investment legislation. We do not have as yet a stand-alone foreign investment screening process. Francis, why do you think that is?

**Francis Tusa:** Sorry, I missed that. I just had a domestic intervention there.

Q78 **Sarah Atherton:** We have already discussed and identified that the UK is unique. We do not have any stand-alone foreign investment screening process. Why do you think that is?

**Francis Tusa:** It goes back to the fundamental issue of the belief that, if you are going to be open to investment, that almost precludes oversight, and anything that is seen to hinder direct investment and so forth makes you less attractive so let's just forget about it. Looking back to the early part of the 2010s, saying Britain should actively court China may well have led to the UK being far too open and not looking at issues of the defence and aerospace supply chain, which other countries have still managed to keep within their grasp.

Q79 **Sarah Atherton:** Elisabeth, would you like to add anything?

**Elisabeth Braw:** I will emphasise what Francis said about the cultural aspect. The UK is such a fervent believer in global trading and open borders. I should add that the UK is not the only country that has had very limited investment screening. For example, Sweden has had none. That is a quite significant problem. At least the UK had the Enterprise Act. Parliament is now trying to pass legislation very quickly because the Government's version will take much longer. In all these cases where there have been quite permissive environments, it goes back to the idea that history has ended and that we can trade on equal terms, but the realisation, not least as a result of Covid, is that one major power does not play fair, and that has sped up the recognition that we need scrutiny of investments.

Q80 **Sarah Atherton:** You mentioned Sweden. Why is Sweden suddenly doing it post-haste right now?

**Elisabeth Braw:** For many years, like the UK, it believed very strongly in complete openness. You will see, for example, that the Swedish



Government's approach to the defence industry is that they put everything on EU-wide tender, as you are supposed to do, while France uses an escape clause all the time. Swedish Governments of different political persuasions believed in the globalised market and in other countries' willingness to play by the rules. Cases like those three takeovers of the cutting-edge start-ups in space research were a wake-up call that it does not work. You can believe in the globalised market all you want, but if you lose your best companies, for your own self-preservation you need to do something.

Government proposals take a lot longer than they probably should, so that proposal is taking quite long and it is supposed to be finalised next year. In the meantime, a great number of parliamentarians thought they should speed up the process by proposing their own version, which is what is under way at the moment.

**Q81 Sarah Atherton:** Michael, how does the UK compare with its allies on the ease with which there could be foreign investment in defence?

**Michael Formosa:** It is all to do with the fundamental characteristic that we are an open FDI environment and that we actively court foreign direct investment in our industries. In addition to that, we are at pains to create a very even playing field. It is impossible to even talk about UK defence without giving a lot of airtime to the very significant contribution by international firms. Firms like Thales and Leonardo are very much a part of the fabric of our defence productive capability, as are some of the large American firms. Lockheed Martin is the largest traded defence company in the world, and it is a very important partner to the MOD.

We have gone a long way to demonstrate quite clearly that we can build developmental and productive capability on the basis of having a very open, inward investment environment. That has been a success of the UK. Other countries that are less open protect their industry in the short term, but they basically impinge on capability development in the longer term in a military sense. There are trade-offs here. We need to think about proper planning, of which regulations should be a part, and we should proceed accordingly. We should understand the challenges that we are up against as to the need to collaborate more with international partners, and we need to leverage the fact that we are so international and use that to our advantage. The only way that we are going to protect ourselves is in developing that strategy and associated regulatory regime. We talked about that a few times. Francis mentioned it and so did I.

We need to understand in a very clear-eyed way, even in cases where we are approving the investment, where the lines need to be drawn regarding the operational angles of the formed UK entity, what that means in terms of management and security status of individuals in key areas, and finally we need to consider a range of export control laws that we can use to guard our IP. In the National Security and Investment Bill, there was an impact analysis on the application of regulations. The impact assessment suggested that similar regimes in other countries did



not play a major role in investment decisions. This is all to do with the fact that we are one of the largest defence producers and users in the world, we are fundamentally an attractive market, and would-be acquirers and investors are going to remain interested in us.

**Sarah Atherton:** There is a fine balancing act to be had. I wonder whether we are going to find it in the National Security and Investment Bill.

Q82 **Stuart Anderson:** We will look at the National Security and Investment Bill. It is very far-reaching—far more so than what was proposed in the July 2018 White Paper. Do you think this reflects a trend towards greater protectionism in the UK or across the world?

**Elisabeth Braw:** I do not think it can be described as protectionism, but it can be described as protecting the economy. Protectionism is about putting up unnecessary walls because you think your companies cannot compete internationally. This is about protecting our own very best brain output and technological output. As you say, it is quite a bit more activist than the version a couple of years ago. I noticed in particular the different percentages whereby companies have to report an impending acquisition or major investment.

It is very much in line with what other countries are doing, as we discussed earlier. Germany already has quite restrictive rules and so far it does not seem to be causing any bottlenecks. The UK is very much in line with other countries. In particular, in the past year, there has been enormous legislative activity around Europe on this. The US has CFIUS and the relatively recent FIRRMA Act.

Q83 **Stuart Anderson:** Michael, would you like to come in on that point?

**Michael Formosa:** This is not necessarily about protectionism. This is about how important FDI is as part of the equation, especially in a post-Brexit paradigm. For defence, this is about a realisation of the vulnerability of the Aerospace & Defence supply chain that has become more globalised and more entwined with commercial industry, especially in key areas that we are prioritising for the future like cyber, AI and quantum computing. Regulatory regimes can complement healthy commercial activity. We need FDI, but we need guide rails as well.

Q84 **Stuart Anderson:** Francis, would you like to come in on that?

**Francis Tusa:** I agree with Michael. Even with perceived changes in the scope of the Act, the UK is catching other people up. It has been, arguably, too laissez-faire especially in the defence industry as to who can do what, and you could question what has happened with the buy-out of Cobham. The UK is finally waking up to the fact that defence is not a free market. It is not like buying cars or something. It is a very special and globally—generally speaking—closed market. We cannot treat it as if it is the automotive industry. We have to have the regulations in place. My concern is that without a very clear executive lead—a Ministry



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responsible for managing this—we can have as many Acts as we like, but it will fail.

Q85 **Stuart Anderson:** Where do you think that responsibility would lie? Which Ministry? Which Department?

**Francis Tusa:** If we look at defence, it should probably be with BEIS, because on current performance, over the last decade, the Ministry of Defence does not understand industrial matters generally. You could say that any policy it has had has been “Make America Great Again”.

**Elisabeth Braw:** BEIS makes complete sense because national security is not just about the armed forces and their equipment. I will give a couple of recent examples in the UK from the past few months. Two biotech companies received Chinese funding, one a 10% stake and one series C funding, both from Tencent, which is a Chinese entertainment giant. We might ask what that has to do with national security. Biotech is one of the key areas within Made in China 2025. It is a comprehensive plan to out-compete us. If we were to isolate the defence supply chain and scrutiny of investments within the MOD unit and other Departments looking at other areas, we would miss that comprehensive view. It is a long way of saying I agree with Francis.

Q86 **Stuart Anderson:** Michael, do you want to add on that point?

**Michael Formosa:** I also agree with Francis. It needs to be centralised in a way because it gets very complicated very quickly. How far down the supply chain do we need to look? Fundamentally, even with the scoping of a very comprehensive regulatory regime, it can never be about simply following the rules and trying to point to them every time we are faced with a tricky issue. It is about being dynamic. I talked about a couple of examples in the United States in some CFIUS-related activities that we have seen there. I would add to that. There is another example that is bandied around all the time where a foreign firm bought a concern on a piece of land that sat alongside a military test range.

In other words, the regime needs to be incredibly proactive and dynamic, and include a range of expertise in order to effectively monitor these situations that are moving very quickly. This is legal advice, technologists, the military, people with a military background, bankers with an understanding of the business cycle, commercial and businesspeople, et cetera. It is going to be awfully difficult to patchwork all of this together without some kind of clear centralisation.

**Elisabeth Braw:** Finland recently passed legislation that introduces scrutiny of real estate investments after the Finns found that Russians had bought a suspicious amount of land near armed forces facilities. Like most countries, they had completely open doors for investments. That is changing, not with regard to SMEs but with real estate. That is worth bearing in mind as well.

Q87 **Stuart Anderson:** You have all highlighted a very important point. It has



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to be owned within a Department. Let us put BEIS to one side. If the Bill is brought forward and comes into legislation, how effective will it be if it is not owned by a single Department, let alone BEIS? Let us say MOD-BEIS.

**Francis Tusa:** If it is not owned, it will fall between the cracks, because if you have not given a certain Department responsibility, but it is scattered across Whitehall, there will not be any critical mass and everyone will be able to slope shoulders.

Q88 **Sarah Atherton:** If BEIS is to be the lead on this Bill, if enacted, what role do you think the MOD or the Secretary of State for Defence should have?

**Francis Tusa:** They can make representations to BEIS. If they want to pursue some form of co-operation or similar, which would be seen to go against British national interest, they can make a representation. I will just come back to the fact that the MOD's record in industrial policy has been pretty bad over the past couple of decades. Especially as regards defence and industrial matters, I really would not trust them to make the right decision. They will take short-term decisions based on literally just price. That is not necessarily in the interests of the country.

Q89 **Mr Ellwood:** Michael, do you want to come in?

**Michael Formosa:** MOD and DSTL need to be expert advisers on key tech areas that we need to protect. Going back into the collaboration opportunity, they also need to take the lead regarding how other countries structure their regulatory regimes and use those mechanisms to understand those regimes. Also, contributing to the discussion around frameworks of how to organise collaborations would be another role that the MOD could play.

Q90 **Mr Ellwood:** There are 17 key sectors in there. We are trying to get our heads around where this Bill will go. Do you think that it is going to be sufficiently broad to deal with all the sectors and areas that we need? Have you had a chance to look at the background to it? Are you content with what you see?

**Elisabeth Braw:** From the way things stand today, it is a comprehensive list. The risk for people like us is that, if we start thinking of everything as national security, it becomes almost a suffocating exercise. It is comprehensive and in line with what other countries are doing and the areas they are including.

**Francis Tusa:** I would pick up on Michael's comment. The whole area is moving so fast, you must have an Administration that is able to adapt. I agree with Elisabeth: you could say everything is national security. That just makes it unwieldy. However, you have to recognise that the thing you have never considered actually happens, and you then have to have a Ministry, a body, that can understand that it has to change to meet the new environment. If we consider how technology has changed over the



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past 20 years, something tells me that an Act covering this 20 years ago would now almost certainly, definitely, not be fit for purpose. Flexibility is the key.

**Michael Formosa:** It is implicit in everything that I have said. This is a good start. This is a good element, but it needs to be an element of a much more widely considered strategy and regime.

**Mr Ellwood:** We will have to wait and see where things go. We will find out very soon.

Q91 **Sarah Atherton:** You have probably just answered the question I was going to pose. How do you think international defence investors will view this Bill? Will there be issues for friendly investors, or will we see lower foreign investment as a result? Do you have any thoughts on that?

**Michael Formosa:** The introduction of regulations where there were none before or even the increase of regulatory burden is always going to apply somewhat of a handbrake to the invisible hand. But who are the regulations really pointed at, considering our discussion today? Most of our inward FDI in defence at least has been from Europe and the United States. Moreover, I would say that it is the attractiveness of the market that counts the most. We are the most attractive defence market across Europe and even beyond.

With last week's announcement, we have just made additional and very significant commitment, and this makes us even more attractive, especially, hopefully, in high tech and developmental areas. FDI is likely to rise on the back of this. Allies and embedded players like the Europeans and American companies are likely to solidify and increase their investments here. Moreover, I do not think that the Bill would necessarily slow inward portfolio investment. We have not really talked about that.

**Elisabeth Braw:** If we consider that most western companies, if not all of them, have considered some sort of subversive Chinese business activities, including intellectual property theft, the sort of companies that might be interested in investing will welcome these regulations because it means that they will be able to compete on some sort of more level playing field. I should not say among their own, because it is a very wide range of countries and companies that are not Chinese, but it is at least some sort of agreed standards of ethics and activities. That will be a benefit to the companies involved and will increase their interest in the UK.

Q92 **Sarah Atherton:** Francis, do you have anything to add?

**Francis Tusa:** I cannot add anything to what Michael or Elisabeth has said.

Q93 **Sarah Atherton:** Elisabeth, I will go back to the point you made about hostile investment in start-ups. Do you think this Bill addresses that



glaring gap in any shape or form?

**Elisabeth Braw:** It does not because it addresses investments and not early stage funding, which is a different form of investment. I hope that will be the next step after this Bill. This Bill is necessary because we have been concerned about investment and takeovers for some time. From my perspective, VC funding is absolutely the next step that needs to be addressed. It will be a bit trickier simply because it is much harder to measure. There are no databases where you can check and write a report about how much Chinese VC funding has gone into something. The mistake that we make is assuming that, if we plug this hole of Chinese investments, our technology and innovation will be safe. It will not, because it will have seeped out long before.

Q94 **Stuart Anderson:** As a supplementary point about the VCs and start-ups you raised earlier, which countries, if any, have legislation to deal with this matter?

**Elisabeth Braw:** I am not aware of any country that has been able to address it. It is also because it is such a new phenomenon. It is linked to the divide between tech and national security. The tech community has not been seen as a national security issue or connected to national security, which is why we have had too little innovation that would benefit the armed forces and wider national security. Countries are trying to change that, especially the US and the UK. I do not know any country that has been able to address it. In particular, the area to address is the fact that VCs can have limited partners that do not have to be registered or reported anywhere, so we do not know who they are.

Q95 **Mr Ellwood:** Do you think that the Government are moving fast enough? Do they now get it? Do you get the feeling that there is a recognition through this Bill that we are moving at the right pace and able to catch up with what is long overdue?

**Francis Tusa:** It is certainly a move in the right direction. We would all recognise that 2020 has seen events that have slowed down progress, administrative and otherwise, in a lot of areas because priorities have had to be focused specifically on Covid. The fact that the Bill is under way suggests that the progress is heading in the right direction at the very least, if I were to carp. Let us hope it keeps momentum.

**Michael Formosa:** I agree with Francis that it is certainly a step in the right direction. We need to make sure that it is fortified by understanding the contexts in which we are working so that we do not write up a set of Bills that we can point to but, rather, we maintain a very dynamic approach to a very complicated issue. Any time we merely write up some legislation and point to it as opposed to truly engaging the problem proactively is a risk. But this is obviously a very good start.

**Elisabeth Braw:** I completely agree with Francis and Michael. It seems to be part of this general wake-up call that has come post Covid where



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China revealed itself in the eyes of many to be a country that does not play fair and obfuscates.

One concern I have about the Bill is that it is not sufficiently clear how the Government are going to deal with companies that fail to report pending acquisitions, and how that is going to be followed up on, because it will require quite substantial administration considering the amount of M&As that go on all the time. Who is going to do it and how are we going to make sure that all the cases are identified, even those who may want to get out of it?

**Mr Ellwood:** Thank you. Chair, back to you.

**Chair:** Thank you very much indeed, Tobias. I apologise to all of you. I am afraid there was a technical hitch in the Chamber. The Prime Minister was there one minute and the next minute he disappeared as the broadband or something collapsed, so it all took much longer than I thought. I do apologise because I was away much longer than I thought.

I thank you all very much indeed for your contribution and for your time: Francis Tusa, editor of Defence Analysis; Elisabeth Braw, visiting fellow, American Enterprise Institute; and Michael Formosa, managing partner at Renaissance Strategic Advisers. I thank my colleagues too, particularly Tobias for chairing in my absence. I also thank Matthew Congreve, our Clerk, who has put it all together. With that, I conclude this session of our Sub-Committee.