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The UK's new National Security and Investment regime takes shape – Part II

by **Becket McGrath**

The UK's new National Security and Investment Act 2021 (NSI Act) received Royal Assent on 29 April 2021.[1] As described in Part 1 of this article, the NSI Act implements a wholly new regime that will enable the UK Government to review a wide range of transactions for potential national security issues. Transactions involving the acquisition of control over, or of non-controlling investments in, entities active in certain specified sectors will be subject to mandatory notification and government approval before completion. Although we now know the final form of the Act, significant uncertainties remain over its purpose, operation and impact. More positively, the government has taken some sensible steps to narrow the Act's scope during its parliamentary passage.

Having considered the responses to its consultation on the initial list of these mandatory filing sectors,[2] the government confirmed on 2 March 2021[3] that it would retain all 17 sectors on the list, albeit with some important modifications. In particular, it has narrowed the "communications" definition so that entities are caught only if they operate a *public* electronic communications network or service and generate annual sales of at least £50 million. In addition, the sector previously known as "engineering biology" has been redefined and renamed "synthetic biology". Under this new definition, a number of activities that would otherwise be caught have been removed from the mandatory notification requirement, including clinical diagnostics, gene therapy, cell therapy and food production. To cite two more examples, "artificial intelligence" has been narrowed to cover only the use of AI for: (i) identification or tracking or objects, people or events; (ii) advanced robotics; and (iii) cyber security, while "cryptographic authentication" has been narrowed to cover research and development or production of products that employ cryptography and have authentication as a primary function.

While these and other refinements of definitions are certainly welcome, the overall scope of the regime remains broad and no sector has been removed altogether from the mandatory filing list. In addition, the definitions remain technically complex and difficult to interpret. For example, the draft definition of advanced materials now runs to 10 pages of tightly drafted text that includes a list of 45 "critical materials", from activated carbon to yttrium, for which the extraction, refinement, processing, production and end of life recovery is in scope. Fortunately, the government has indicated that it is open to further refinement of the sector definitions in the run-up to passing of the relevant Statutory Instrument that will finally set out the definitions in law.

At the same time as confirming the revised list of mandatory filing sectors, the government also published a number of policy papers to provide more clarity on the implementation and operation of the new regime. These included a revised draft Statement of Policy Intent, which sets out the factors that the Secretary of State will take into account when deciding whether to call in a transaction for detailed scrutiny. As first indicated in the original 2018 draft Statement of Policy Intent, the Secretary of State will take into account three types of risk: the target risk (whether the target is active in an area where national security risks are more likely); the trigger event risk (the type and level of control and how this could be used in practice); and the acquirer risk. While the last of these is described rather vaguely, as "the extent to which the acquirer raises national security concerns", more helpfully the policy statement goes on to note that, when assessing the acquirer risk, "the Secretary of State will consider the entity's affiliations to hostile parties, rather than the existence of a relationship with foreign states in principle, or their nationality".

The government has also published a draft form for notifying transactions. The form, which will be completed through an online portal, focuses on gathering basic information on the notified transaction and is mercifully shorter in scope than the forms specified under some other countries' FDI regimes. There will be no filing fee.

The government also confirmed on 2 March that it does not intend to use the option provided for by the NSI Act to implement a "white list" to exclude certain types of acquirer or acquisition from the mandatory notification requirement.

Rather, the government indicated that it intends to see how the regime beds down after commencement before deciding whether its scope needs to be narrowed in this way.

As a result, the Statutory Instruments implementing the NSI Act will initially be limited to those necessary for the commencement and operation of the regime, including more detailed specifications for the notification process. Drafts of the main SIs are expected to be published for consultation in May or June. Although the NSI Act is now the law of the land, statements by the Department for Business, Energy and Industrial Strategy (BEIS), which has primary responsibility for the new regime, indicate that full commencement of the regime will not occur until "towards the end of this year".

In the meantime, BEIS has already established a new Investment Security Unit (ISU) to handle notifications and coordinate reviews. The unit is now scaling up, to ensure that it will be ready to process the anticipated volume of notifications by the end of the year. In addition to recruiting new staff, BEIS staff that are currently involved in conducting national security reviews under the Enterprise Act are expected to have moved across to the new unit by the end of April. In individual cases, the ISU may draw on the relevant expertise of other government departments, including the Department for Digital, Culture, Media and Sport and the Ministry of Defence, as well as the Security Services.

It appears that the government's plan to delay commencement until the end of the year, notwithstanding its smooth passage through Parliament and enactment well before the summer recess, is primarily to ensure that the unit is first ready and fully able to process the expected high volume of applications promptly. On the other hand, the government is understood to be keen to minimise the period during which parties to in-flight deals have to take account of the impending arrival of a new regime, the precise timing and details of which remain to be defined.

The Lords made only limited amendments to the Bill and several were introduced to the Lords by the government itself. The most notable, which was introduced by the government at the Lords Report stage, was the removal of the mandatory filing requirement on an acquisition of 15 per cent of a target's shares or voting rights. This means that acquisitions will only become notifiable if the 25 per cent threshold is met, materially reducing the number of transactions that will be caught by the new mandatory filing regime.

Introducing this amendment, Lord Callanan noted that: "We have always sought to ensure that the mandatory regime is reasonable and proportionate, and this is an important change, which I believe businesses and investors alike will welcome [since] it will reduce the business burden and allow the investment security unit to focus on notifications and cases that will necessarily result in control being acquired".[4] This move suggests that the widespread concerns regarding the high volume of transactions that would be caught by the new regime had been noted by government.

The Government also introduced a number of more minor amendments in the Lords to expand the range of information on the operation of the regime to be provided to Parliament in the annual report by the Secretary of State,[5] as a means of heading off calls for more prescriptive statutory deadlines. As government amendments introduced in the Lords, these were duly accepted when the Bill returned to the Commons. The government suffered Lords defeats on two amendments that would have required publication in the Secretary of State's annual report on the regime of summaries of all decisions to make a final order and, to the extent that any confidential details had to redacted from such summaries on national security grounds, for those details to be provided to Parliament's Intelligence and Security Committee. The government's large Commons majority ensured that these amendments were duly overturned (by 106 votes) when the Bill returned to the Commons on 28 April. As a result, the NSI Act is essentially in the same form as when the Bill was first introduced in November.

While the parliamentary debates provide some useful insights into the motivations for the Bill and the operation of the new regime, they also reveal that fundamental tensions remain unresolved. When opening the debate at Commons Second Reading on 17 November 2020, the then Secretary of State for BEIS, Alok Sharma, stressed that, while the UK remained "very much open for business", this did not mean that it was "*open to exploitation*". As a result, "appropriate safeguards" were needed to protect the country from "hostile actors who are looking to disrupt our economic and wider security".[6] While emphasis on the need to achieve the right balance between these objectives has permeated the Bill's passage, there remains limited information on how the government will achieve it in practice. Indeed, the leitmotif throughout has been for the government to resist any amendments seeking to provide more detail in the Bill on important matters such as the meaning of national security or the precise timing of the review process. As a result, it remains the case that, in the words of the Liberal Democrat Spokesman for Business in the Lords, Lord Fox, the Bill "has been written as widely as possible to give the department as much leeway as possible in the event of stuff happening, stuff which is as yet undefined or is perhaps undefinable".[7]

Although the Labour opposition has expressed support for the Bill as "the right thing to do for our country", they have argued that it should actually go further and facilitate the consideration of a transaction's impact wider impact on public interest and industrial strategy objectives. For example, Labour Shadow Business Secretary Ed Miliband argued that experience under the current regime, including Kraft's controversial takeover of Cadbury in 2010, the potential takeover by Pfizer of AstraZeneca in 2014 and the current NVIDIA/ARM transaction, demonstrated there was insufficient ability to review foreign takeovers and attempted takeovers on wider economic grounds.

The government consistently resisted the temptation to widen the explicit scope of the regime, at least in their public statements, which have restated the narrow focus on national security, as assessed in a "non-political" and "quasi-judicial" manner by the Secretary of State. For example, the Secretary of State stressed during the Commons debate that the new powers "will be exclusively used on national security grounds", rather than "to intervene in business transactions for broader economic or public interest reasons, and we will not seek to interfere in deals on political grounds. They will not and cannot be used for wider economic tests".

This question of balance emerged again in debates in the House of Lords. At the Lords Committee stage, Lord Fox noted the "overwhelming concern from all sides of the House" regarding "how the [ISU] was to operate effectively without stifling innovation, scaring off capital and becoming a proxy for wider strategic considerations". He also observed that it seemed "almost punitively value-destroying to have a mandatory process".[8]

Returning to an analogy that has proved popular in discussions of the Bill, Liberal Democrat peer (and ex-corporate lawyer) Lord Clement Jones stressed that, while "we support the trawling process and its purpose … a large number of questions … need answering about the extent of the net, the size of the mesh, and which species will be taken on board and which discarded, and how long that will take". He went on to warn against the risk of "significant overnotification of irrelevant transactions"[9] and "catching minnows".[10] Labour peer Baroness Hayter of Kentish Town observed that, while she also agreed on the central importance of national security, it was critical to strike the right "balance between security needs and the desire for economic growth, research, innovation and freedom to invest".[11]

The House of Lords debate has also highlighted one of the unusual aspects of the NSI Act, namely the fact that it applies to all acquisitions that are within its scope, regardless of the nationality of the investor. Unlike other national investment screening regimes that have been recently introduced, many of which have been cited by ministers as precedents during the process leading up to the NSI Act, the new UK regime is therefore not a *foreign* direct investment screening mechanism as such and will also catch purely domestic transactions.

Addressing this aspect directly in response to a proposed amendment that would have removed acquisitions by UK owned and controlled entities from the regime, Conservative peer Lord Lansley noted that "the purpose of the legislation is to address national security risks; it is not to screen foreign investments in the UK". Including UK acquirers, Lord Lansley went on, ensures that the UK adheres to the principle of non-discrimination (as required by the World Trade Organization), while recognising the fact that, as far as national security is concerned, "not all foreigners are hostile, and not all those who are hostile are foreigners".[12] His fellow Conservative peer and Parliamentary Under-Secretary of State for BEIS Lord Callanan noted that the "mandatory notification regime is based on the risks posed by acquisitions of target entities due to those entities' activities, rather than the risks posed by the acquirers. [Since] an acquirer's nationality cannot tell the Secretary of State everything he needs to know about that acquirer's intent … excluding purely on the basis of nationality could create a loophole to exploit".[13]

The government's overall approach was neatly summarised by the Conservative Minister of State Lord Grimstone, who observed that such a broad and admittedly complex regime was required because "some of the hostile actors that we are trying to prevent acquiring sensitive matter are extremely sophisticated and wily". As a result, the government has consistently stressed that even the most minute loopholes need to be avoided. In return, the government has committed to process notifications as quickly as possible, with Lord Grimstone noting that it should be possible to clear notifications quickly, especially where it is self-evident that there are no national security issues, meaning that the 30 working day limit is "a deadline, not a target".[14]

Even though the NSI Act is now in its final form, it remains unclear what precisely the new regime is for. The policy behind the NSI Act is predicated on the base assumption that transactions involving investments in UK companies and assets are currently taking place that threaten UK national security but which either go unnoticed or cannot be challenged by the government using its existing (and newly expanded) powers. As noted above, the government's response has been to create an extremely broad review regime to catch every transaction that could conceivably affect national security, on the express premise that only a very small percentage of reviewed transactions will turn out to raise real concerns justifying intervention.

Although the origins of the NSI Act are the 2016 review of the rules governing foreign investments in critical UK infrastructure, as noted above the new regime will catch investments by any entity (including UK controlled companies) across significant parts of the UK economy. While the Government have resisted pressure to extend the range of issues that can be considered under the new regime beyond national security, they have also refused to define what is captured by this term. Experience in other countries suggests that national security can be a highly flexible concept, if need be.

It is notable that the NSI Act originated from the industrial strategy agenda of the previous Conservative government under Prime Minster Theresa May, and the selection of some of the mandatory notification sectors arguably reflects this. The Act has survived the Johnson government's explicit abandonment of that agenda and the departure of the Secretary of State who was most associated with it. It is nevertheless hard to resist the suspicion that this Government, or its successors, will use the extensive tools provided by this regime to increase its general oversight of the economy and tighten its controls over a wide range of foreign investments for wider industrial strategy and public policy ends.

As far as the identification of the investors that will encounter most difficulty is concerned, the 2018 draft Statement of Policy Intent emphasised the need to prevent investments in sensitive areas by "hostile actors" that may be engaged in "terrorism related activity or cyber warfare", such as sabotage of sensitive sites or espionage. Although the revised 2021 draft Statement of Policy Intent contains broader examples of the situations in which control over technology could be used in a manner that could harm national security, it maintains the focus on identifying acquisitions by "hostile actors". These are (rather vaguely) described as acquirers that "are hostile to the UK's national security, or when they owe allegiance to hostile states or organisations", rather than investors from foreign countries that may not be geopolitical allies to the UK. Indeed, the new Statement of Policy Intent states specifically that "the National Security and Investment regime does not regard state-owned entities, sovereign wealth funds – or other entities affiliated with foreign states – as being inherently more likely to pose a national security risk".

Notwithstanding these statements, one suspects that most cases are likely to require consideration of the risk associated with acquisitions by investors that are not hostile actors at the time of the transaction but could become so in the future, were the geopolitical context to change. Or, more accurately, it may be difficult to establish the extent to which an investor may be linked to a government that may be viewed as a strategic rival now but could become hostile at an undefined future date. Recent experience[15] indicates that investments in sensitive sectors by Chinese entities, in particular, will face an uphill struggle.

Where politically sensitive transactions are allowed to proceed, remedies are likely to be imposed to ensure existing security levels are maintained, to protect domestic technology, to ensure local control over sensitive activities and to ensure local production in the UK. Recent undertakings have also specified that a proportion of management must be British nationals and that a suitable UK presence and employee base is maintained, even where this is not directly linked to a need to protect sensitive technologies.

On the other hand, the UK remains publicly committed to attracting inward investment from China, alongside other countries. As is the case for the regime as a whole, it will be a challenge for the government to strike the right balance between attracting and deterring Chinese investors and for advisers to advise accordingly.

It must also be borne in mind that the risk factors set out above will only be relevant when the government is determining whether to call in a transaction for a detailed review. There is no discretion as to whether a notifiable transaction must be notified. The government's Impact Assessment for the NSI Act estimates that between 1,000 and 1,830 notifications will be made each year, of which between 70 and 95 will be called in and about 10 will result in remedies.

It is unclear how this estimate was arrived at. Experience of legal advisers suggests that the number will be higher, potentially significantly so. Indeed, speaking in the House of Lords, the President of the Confederation of British Industry referred to concerns that there could be up to 10,000 notifications annually.

In practical terms, the difference between an investor simply being able to proceed with making an investment in a company, on the one hand, and having to undertake a mandatory notification of that acquisition and wait for approval before completing the transaction, or face fines, imprisonment and a void transaction if they do not, on the other, is enormous. All transactions involving entities that are potentially within one of the mandatory notification sectors will need to be carefully assessed to establish whether a notification is required. The severe consequence of getting this assessment wrong will mean that parties will inevitably err on the side of filing. As a result, while it remains to be seen how many filings the ISU will have to deal with when it goes live, it is likely to be a very large number. Whether the cost and disruption incurred by this is proportionate to identifying and remedying the estimated 10 problematic transactions requiring remedies is an open question.

As we await sight of the implementing Statutory Instruments, draft guidance and ultimately commencement of the regime, the implementation and expansion of screening regimes by other countries offers a taste of what is to come. Investors are finding that even the most innocuous of transactions can trigger mandatory filing obligations in several countries, simply through the presence of local sales subsidiaries. While this is not uncommon in merger control, that at least involves competition reviews by independent regulators that operate according to shared economic principles, within a framework that facilitates coordination between authorities. With foreign investment reviews, one is ultimately dealing with politicians, together with their officials and members of the Security Services. As a result, processes and decision-making are inherently less transparent.

Unfortunately, notwithstanding the welcome extension of the matters to be covered in the annual report noted above, the UK's new national security regime appears set to reduce transparency, compared with the current regime. Whereas intervention notices issued under the current regime are published, ministers have indicated that call-in notices will not be. Instead, only aggregated data will be made publicly available. While this is presumably intended to protect investors from what may ultimately be unmerited speculation over transactions, it will also make it harder to establish why transactions are being called in and hence to advise investors on risk. Reduced transparency may also make it easier for ministers to extract concessions from investors that go beyond national security concerns, which the recent precedents noted above indicate is likely.

Government ministers have admittedly demonstrated an awareness of the need to ensure that the notification process is as light touch and rapid as possible. They have also repeatedly referred to the need for government to strike a balance between protecting national security and not deterring inward investment. Where that balance is to be drawn on individual transactions remains to be seen, however, especially in an environment where there will be continued political pressure on the government to "protect" UK businesses from what may be unwelcome attention from foreign buyers.[16] Whatever the protestations of ministers and officials to the contrary, it seems unlikely that the regime will maintain a narrow defence and security focused interpretation of national security in practice. While this would perhaps be understandable in the present geopolitical climate, such a development will place an even higher premium on transparency of decision-making, given the disruptive impact of political uncertainty on deal execution. Whatever the eventual outcome, it will certainly be an interesting period for investors in the UK and their advisers.

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Endnotes

1. The full text of the NSI Act, as enacted, is available at: https://www.legislation.gov.uk/ukpga/2021/25/pdfs/ukpga_20210025_en.pdf.
2. *National Security and Investment: Sectors in Scope of the Mandatory Regime – Consultation on secondary legislation to define the sectors subject to mandatory notification in the National Security and Investment Bill* available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935774/nsi-consultation.pdf.
3. See *National Security and Investment: Sectors in Scope of the Mandatory Regime – Government response to the consultation on mandatory notification in specific sectors under the National Security and Investment Bill* – available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/965784/nsi-scope-of-mandatory-regime-gov-response.pdf.
4. Lords Hansard, 15 April 2021, column 1465.
5. NSI Act, section 61.
6. Hansard, 17 November 2020, column 205.
7. Lords Hansard, 15 April 2021, column 1499.
8. Lords Hansard, 2 March, column 349.
9. Ibid, column 337.
10. Lords Hansard, 9 March, column 649.
11. Lords Hansard, 2 March, column 315.
12. Lords Hansard, 9 March, column 589.
13. Ibid., column 593.
14. Lords Hansard, 6 March 2021, column 616.
15. It is notable that both of the recent transactions that were abandoned following national security public interest interventions (*Gardner Aerospace/Impcross* and *Aerostar/Mettis*) involved Chinese buyers. In contrast, the two transactions that were permitted to proceed (*AI Convoy Bidco/Cobham* and *Connect Bidco/Inmarsat*) involved international bidding consortia.
16. As noted in a recent FT opinion piece by Helen Thomas, *"citing national security concerns has become part of the M&A defence playbook"* – see *Whether it's football or chips, let's be upfront about our national interests*, FT 20 April 2021, available at: https://www.ft.com/content/48701370-6428-4340-910f-4440ae538bec.