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THE UK NATIONAL SECURITY AND INVESTMENT ACT: WHAT IS THE IMPACT?

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The UK government, like many others around the world, is focusing on the perceived threat of hostile investors owning or controlling critical businesses or infrastructure and, as a result, enacted the National Security and Investment Act (NSI) in May 2021. When the regime becomes effective later this year, it will give the UK government very broad powers to block inward investment on national security grounds. In this briefing we assess the impact of the new Act on a wide variety of investments and financing transactions.

What's in the Act?

- The Act will introduce a hybrid regime and the powers under this legislation are extensive.
- Certain investments in entities active in 17 sensitive sectors will require mandatory filings and government approval before they can complete.
- There are serious consequences of a failure to file a mandatory transaction – including imprisonment of up to five years for individuals and/or fines of up to 5% of the group worldwide turnover of the investor, or £10 million (whichever is higher) – and transactions that close in breach of the prohibition will be legally void.
- A very wide scope of transactions (investments in both entities and assets) can be called in for review, such that there may be situations where a voluntary filing could be warranted.
- The government has the right to call in deals for review up to five years after completion, but this can be shortened to six months if the government is proactively informed of the deal.
- The government has issued a draft Statement of Policy Intent which says that it is most likely to call in a transaction for review if the target is active in one of the 17 sensitive sectors, or if the target has activities relating to infrastructure for water, food, chemicals, health or finance.
- Acquisitions of real estate that is a sensitive site, or is located near a sensitive site, will have a higher risk of being reviewed.
- Whether the review follows a mandatory or voluntary filing, the government will have the power to block/unwind deals and can impose remedies.
- This Bill will not merely cover deals which are signed or closed after the new law comes into effect. It has retroactive effect so that any deal which has closed after 12 November 2020 can be called in for review by the government.

The UK government says that the UK, and UK businesses, "face continued and broad-ranging activity from those who seek to compromise our national security and that of our allies. Such behaviour left unchecked can leave the UK vulnerable to disruption, unfair leverage, and espionage. It is crucial that the government is able to fully combat these threats coming from ever more determined overseas actors."
The Act follows steps taken by other governments, including the US, Australia, France and Germany, to introduce or extend laws focusing on national security issues.

Dan Harrison, a Clifford Chance Knowledge Director specialising in antitrust, says that the introduction of the Act is due to the fact that the UK government feels that the existing regime has not allowed it to intervene in some transactions that might raise national security issues.

"The UK has had a public interest regime in its current incarnation for nearly 20 years, but the government could only intervene on national security grounds in deals that fell within the scope of the merger control regime (and under the jurisdiction of the UK Competition and Markets Authority (CMA)) and investments in the defence sector. This has only been used 12 times since 2002, most recently in the case of US tech giant Nvidia attempting to buy UK chip designer, ARM, " he says.

The new regime will go much further, in three main ways:

- It will extend to investments that do not meet the merger control thresholds.
- It will catch investments in "bare" assets that do not amount to a business.
- It will impose mandatory filing requirements.

Is the UK playing catch-up?

What the UK is introducing will in many ways be familiar to international investors, as the US and Australia already have mandatory filing requirements. Chandralekha Ghosh, a senior associate in Clifford Chance's antitrust team, says: "A number of European jurisdictions, such as France and Germany, have also steadily expanded the scope of their mandatory filing regimes in recent years, due to the impact of the COVID-19 pandemic and the advent of the EU Foreign Investment Screening Regulation. So, in some ways, the UK is just catching up with its international peers."

However, the UK regime will go further than comparable regimes in other countries as the Act has much wider extraterritorial reach. Most other regimes apply only to investments in domestic companies or assets. The UK regime does not need a UK entity or UK-based asset as long as the foreign entity is active in the UK (potentially through exports) or if the foreign asset is used in connection with activities in the UK. "This is a national security regime, not a foreign investment regime, so it's not just investments by foreign investors that are caught – UK investors are too. There are some other regimes that do that, but it's relatively unusual," says Ghosh.

In addition, intragroup transactions are caught. So, internal restructurings involving group companies that directly or indirectly own an entity active in a sensitive sector in the UK could trigger a mandatory filing obligation, even if those group companies are outside the UK. That could lead to possible criminal penalties, fines and invalidity of the transaction if that requirement is not spotted by the legal team. "Again, the UK would not be the only country to do that – intragroup transactions can be caught by the CFIUS regime in the US, for example – but it is unusual. This has been challenged in consultations but the Government hasn't yet given a very good reason for why it thinks mandatory filing is necessary in those circumstances," she says.

What types of investment are caught?

Investments in an entity that is active in a sensitive sector are only subject to mandatory notification if they cross certain specified share thresholds – 25%, 50% and 75% – taking into account any existing interests; or they give the investor voting rights that enable it to veto any class of shareholder resolution governing the affairs of the entity. When the legislation was first published, it included a threshold of 15% but the Government decided to remove it. "This will be a big relief for those investors that typically take a shareholding of less than 25%," says Ghosh.

Deals that are not subject to mandatory filing can be called in for a review on the same basis, but also if there is an acquisition of material influence. Material influence is a concept that is used in the merger control regime and is very broad and flexible. It can catch contractual veto rights over a range of decisions relating to the target's business, as well as relatively low shareholdings especially if accompanied by a board seat. For example, in Amazon/Deliveroo, a 16% interest, combined with a right to appoint a director and observer on Deliveroo's board and certain other factors, was considered enough by the CMA.

For investments in assets, the trigger event arises if the investor is able to use or direct the use of the asset. Assets are defined very broadly – land and tangible moveable property – as well as a broad range of IP "ideas, information or techniques that have industrial, commercial or other economic value."

In general, the definitions of the 17 sensitive sectors (which are still in draft) are also quite broad, which allows a range of investments to be caught. This can be difficult to navigate for investors in infrastructure or the tech sectors, in particular.

The definitions of sensitive sectors

The government definitions of the sensitive sectors determine which investments are to be subject to mandatory filing and also which sectors are most at risk of being called in, even if they don't have to be notified.

"In a very broad sense, the UK is adopting a similar approach to that already taken in many jurisdictions, including the US, France and Germany," says Mark Fisher, a senior associate in Clifford Chance's Telecoms, Media and Technology team. "Technology does not live in a vacuum and so these reforms would bring welcome alignment and recognition of foreign investment principles. The difficulty, of course, when it comes to technology, is its prevalence and society's reliance upon it – and this is very much the case across all the mandatory sectors."

The Advanced Materials sector, for example, mainly focuses on research and development or production of advanced materials, but it also includes software/data technology which is used to support those activities. The Military and Dual-Use Goods sector covers (as well as the goods themselves) the "holding of information" in relation to such goods, including software. "And so in many areas the impact of this may well be felt by technology suppliers in some fairly obscure ways," says Fisher. "Technology is ultimately just a tool and the use of a tool isn't always as intended." For example, something quite complex and ambitious, such as Advanced Robotics, may start with very significant uses involving considerable national security concerns and sensitivities – such as those targeted by this regime – before being used in much more benign ways. "In fairness, the government has recognised this to an extent with some of the updated definitions and refocus of the likes of AI to a short list of higher risk applications," he says.

The opposite also applies in that technology used in benign ways may be so repurposed as to give rise to genuine national security concerns. "Of course, lack of national security concerns and practical limitations will mean that these theoretical examples will never be looked at – which is reminiscent perhaps of the fanfare surrounding GDPR in 2018. The concern, though, is that this will have a mid to long-term chilling effect on innovative development and use of technology – an ice age rather than a bout of seasonal flu. This will be something the government will no doubt be wary of as the decision-making policy and its machinery settles into place."

What about the communications sector?

The original proposal from the government was extremely concerning for many, as it covered all electronic communications networks and services. However, recent clarification that the focus will be on public communications networks and services only has been welcomed. Likewise, the reference to the Network and Information Systems Regulations in the context of defining an 'essential service' provides far greater clarity.

One of the concerns here was the previous inclusion in scope of private data centres. It is important to note, however, that the Data Infrastructure definition still covers entities that house and support data infrastructure, but the government is working on sorting out this discrepancy. The caveat here is the direction of travel of the telecoms industry towards technology-driven infrastructure – so, where there was once a clear delineation between communications 'point of presence' (PoPs) from private data centres – with the virtualisation of telecoms infrastructure and deployment of generic data centre servers, this distinction is disappearing.

"Even with these revised definitions and scope in place, I would expect to see the scope of the regime expand over time as technological innovations result in a greater footprint of what would be deemed to be communications infrastructure," says Fisher.

There would also be a knock-on impact for real estate, with properties previously containing out-of-scope private data centres now concerned if these servers are processing the 'public electronic communications network.' The Government is still looking at the role of 'mere hosts', with further clarification expected before this becomes law.

The impact on real estate and infrastructure

The Communications and Data Infrastructure definitions have been helpfully narrowed from a real estate perspective. Although the draft definitions are still catching up in places, the intention is now to focus on entities operating in those sectors and not the owners of land which passively hosts equipment. "The expectation is that landowners whose property passively hosts communications equipment and property investors owning data centres should not ordinarily be caught. In other good news for real estate investors, the other sector definition which initially included them – Critical Suppliers to Government – no longer includes landlords of Government-occupied buildings," says Lindsay Mann, a senior associate knowledge lawyer in Clifford Chance's real estate team.

The definitions of sensitive sectors are also heavily weighted towards infrastructure and the energy sector. "There is a lot of focus on the energy sector because it is currently amongst the most dynamic in the UK as the country attempts to meet its clean energy generation and energy efficiency targets. It is important that in describing the parts of the sector which fall within the ambit of the Bill, a balance is struck between scrutinising transactions involving critical infrastructure and avoiding blocking capital," says Praveen Jagadish, a senior associate in Clifford Chance's finance practice.

Following consultation on the sensitive sector definitions, it is now clear that retail electricity suppliers will not fall within the scope. The UK Department for Business, Energy & Industrial Strategy (BEIS) has recognised that these are often technology and trading businesses and not infrastructure owners. "This is helpful because creating a market with a diverse range of retail electricity suppliers has long been a policy goal and their inclusion within the ambit of the Bill may have placed unattractive burdens on investors," says Jagadish.

There have been similar helpful clarifications in relation to transport. In the maritime sector, the definitions focus on cargo infrastructure and previous references to bringing small passenger terminals in scope have been removed. In relation to airports, the passenger number and cargo thresholds to be satisfied in order to bring airports within scope are now measured as of 2018 to take into account the drastic effects of COVID-19.

Mandatory filing

The scope of the mandatory filing requirements – only acquisitions of voting rights in entities that pass certain thresholds or confer veto rights over a class of resolutions – means that many transactions involving a sensitive sector will not be required to be notified.

In particular, investments in real estate can be called in for review, but are not themselves subject to mandatory filing. "Direct real estate investments – buying the property itself – are asset transactions. So, purchasers of land and or buildings don't need to worry about the mandatory regime. Even though real estate acquisitions are also commonly structured as indirect transactions – buying the property-owning entity rather than the asset – it is unlikely that the property-owning entity will fall within one of the sensitive sector definitions so mandatory filings are unlikely to be needed on these either," says Mann.

In terms of finance arrangements, making a loan will not trigger a mandatory notification because the loan is not of itself a "notifiable acquisition" of shares or voting rights. The risk of mandatory filings really only comes into play when lenders take security over the shares of entities in a borrower group that has activities in a sensitive sector. In those cases, the Act should have no impact on lenders at the outset of the financing transaction because the granting of security does not typically result in the lenders having legal title over those shares. The situation changes if the lenders enforce their security over shares and acquire legal title to the shares. That would constitute a trigger event under the bill, and if the relevant entity is engaged in a sensitive sector the mandatory filing requirements will apply.

Government call-ins and voluntary filings

Transactions that aren't subject to mandatory filing could still be called in by the government and subjected to remedies. In assessing whether national security risks arise, the government will consider trigger risk, target risk and acquirer risk. Trigger risk is all about what control rights the investor will have. For the acquirer risk, the Government says that there will be a high risk of a call-in if an investor owes allegiance to a hostile state or organisation. "However, the deals we've seen being called in under the current public interest intervention regime on national security grounds suggest that risk assessments should really be focusing on what the target does, not where the investor is from. For example, Nvidia/ARM was called in – the investor is American, and a couple of years ago we advised on the acquisition of the satellite company Inmarsat by a consortium of investors that included Canadian pension funds and US private equity houses, which was also called. In 2018, there was even a threat to carry out a national security review into the acquisition of the engineering firm GKN by the British investor Melrose," says Ghosh.

So, when assessing risk, the focus should be on what the target does and whether it is active in any of the 17 sensitive sectors or critical infrastructure for food, water, chemicals and healthcare, and whether it has land proximate to sensitive sites. The Government can call in investments in any sector if it thinks there are national security issues, and the concept of national security can be fluid. Investors need to always consider whether the investment is likely to be of political interest for other reasons.

Parties can protect against the risk of a later call-in by making a voluntary filing to obtain clearance. If companies decide to make a voluntary filing, the review period is 30 working days from the date on which the Government accepts that the filing is complete, during which the government will decide whether to open an in-depth review (this takes another 30 to 75 working days). The review period is the same for mandatory filings.

Voluntary filing on real estate transactions

Voluntary filing, rather than mandatory filing, will be the bigger focus for most real estate deals and will need to be considered both on direct acquisitions of property (buying the land itself) and on indirect acquisition of property (buying a property-owning entity) where a mandatory filing is not triggered. Then, as with any other sector, the underlying question is whether the transaction poses a national security risk.

There is general guidance in the draft Statement of Policy Intent around assessing the trigger risk, target risk and acquirer risk and, in relation to land specifically, there is a very limited amount of additional guidance. This says there is a concern about land which is itself a sensitive site, or which is proximate to a sensitive site and that the intended use of the land may also be taken into account. "An example of what this might look like in practice – albeit an extreme example – is land next to a sensitive military facility capable of use for espionage" says Mann.

'Sensitive' and 'proximate' are the key terms here, but it isn't possible to be definitive about what they mean. In terms of sensitivity, the guidance highlights critical national infrastructure and government buildings as 'sensitive' and also gives the military facility example. "There is nothing to stop a call-in outside of this if there is a perceived national security risk. The key to this is to look at the 17 sensitive sectors and if you are buying land which is critical to how the business operates or could be used to disrupt the business or steal sensitive information from it, then it could start looking a lot like something which is considered 'sensitive'," she says. In these situations parties may seek the comfort of a voluntary filing – "for example, buying a specialist facility used by a tenant manufacturing components for military aircraft. Especially where the buyer will have rights under the manufacturer's lease to access sensitive operational equipment or stock."

In terms of 'proximate,' there is currently no guidance. "It's very possible we won't get any because it will likely be fact dependent. For example, if the sensitive site is one where the risk is use as a base for espionage, then lines of sight are as important as distance." says Mann.

Identifying sensitive sites which present a national security risk is going to be the key from the real estate perspective. There have been calls from various stakeholders for a register of sensitive sites to help with this. "Such a register risks creating a target list for terrorists which brings its own national security concerns. So I think, on balance, it's unlikely to happen," says Mann. Lawyers don't typically inspect properties so are not going to be able to identify that the property is next door to a sensitive site unless it is obvious from the paperwork. But those that do visit should look out for any obvious giveaways (something like Ministry of Defence signs on the building next door). Some of the search providers who currently provide details of things such as HS2, tube lines and utilities, may expand those searches to cover any critical infrastructure. "Until we have more information, defensive filings are likely to be considered if acquiring property near major infrastructure such as train stations, power stations, ports, airports. Or near military installations, or in an area with a high density of government-occupied buildings such as Westminster and Whitehall," says Mann. The risk which will remain difficult to mitigate is the unknown, secret sensitive sites.

Voluntary filings on financing transactions

Loan arrangements won't be subject to mandatory filing obligations, but the call-in power is very broad and an entity gaining the capacity to materially influence the policy of another entity is said to control the second entity under the Act. "Could positive and negative covenants granted to the lenders under loan documents, and restrictions imposed in security documents, be sufficient to pass that "capacity to materially influence" threshold? Possibly, says Praveen Jagadish. Share security could fall within the mandatory filing regime at the point of enforcement, but not at the outset when security is taken.

A similar analysis applies to asset-level security over moveable property or certain types of IP of the borrower, but in the context of the voluntary filing regime. Taking security should not trigger a consequence under the Act at the outset because the lenders will typically not be able to direct or control the use of those assets. However, that changes on enforcement, so if the underlying asset has a sensitive purpose or could be said to pose a national security risk, the lenders will need to consider a voluntary filing at or prior to enforcement, assuming enforcement results in control over the asset.

The Competition and Markets Authority says loans can confer material influence; for example, if a lender could threaten to withdraw loan facilities if a particular policy is not pursued, or where loan covenants confer veto rights on the lender that go further than necessary to protect its investment. However, in the 40 or so years in which that test has been applied there hasn't really been a case in which a loan agreement, on its own, was found to confer material influence. "Loans don't generally give rise to competition issues, so it is perhaps not surprising that they haven't been found by the CMA to give rise to material influence under the merger control regime. The question is, whether there is something about the national security context which means that the Government might apply the material influence test to loans more than the CMA has done. And, in that respect, it is interesting that Opposition MPs have pushed to expand the scope of the Bill to cover situations in which a lender becomes the holder of more than 25% of its total debt. So there does seem to be a perception among at least some politicians that loan arrangements can give rise to national security issues," says Jagadish.

The government has said that the overwhelming majority of loans are expected to pose no national security concerns, including loans to borrowers engaged in sensitive activities. It has also said that in the rare circumstances where they do pose concerns, the Secretary of State generally only expects to intervene when an actual acquisition of control will take place (for example, a lender seizing collateral).

It is likely to be very rare that a loan will give rise to a call-in risk at the outset of a transaction. However, for security it's more complicated, as there isn't a mechanism to obtain legal certainty. Pre-clearance of share security via a voluntary notice at the inception of the financing is not possible because at that point enforcement would not be "in contemplation". A voluntary notification seeking clearance could be made once circumstances have arisen that are capable of leading to enforcement (i.e. an event of default has occurred). This has the potential to delay enforcement whilst clearance is sought. "It might be possible to obtain non-binding informal guidance from BEIS when taking the security as to the likelihood of a call-in if the security is exercised, but this does not eliminate the risk entirely. Moreover, we would expect BEIS to discourage or limit requests for case-by-case guidance over time in order to avoid a flood of those requests," says Jagadish.

Impact on current deals

Mandatory filing requirements apply to deals that close after the regime commences, which the Government says will be by the end of 2021, but it could be as early as Q3. For deals which could potentially fall within the broad definitions of sensitive sectors, the SPA needs to account for this uncertainty even if there are no apparent substantive concerns. SPAs therefore include conditions precedent requiring a mandatory national security filing and government approval should the regime commence before closing. If a mandatory filing has to be made, there can be a knock-on effect on timing – investors need to assess the risks of a delayed completion and allow extended long-stop dates. The government will also have a retroactive call-in right for transactions which closed after 12 November 2020. Investors need to assess the post-completion risk of being called in or any remedies based on the target activities (target risk) as well as the acquirer risk and trigger risk.

"BEIS is open to consultation as to call-in risk. On a number of completed or soon to be completed deals, we have contacted BEIS with details of the transaction and have received informal feedback from BEIS that it is unlikely to call it in for review. This is not binding but gives a level of comfort to investors. The communication with BEIS will also reduce the limitation period for call in from five years to six months."

Where an acquisition is being debt financed and the lenders are looking to the acquired business to put the borrower in funds to service the debt, the lenders will have a strong interest in ensuring that the acquisition cannot be voided under the Act. They may therefore make mandatory or voluntary clearance a condition precedent to the loan or check that it is a condition under the acquisition agreement which cannot be waived without lender consent.

Lenders may also seek a specific mandatory prepayment trigger such that if clearance is not achieved and the acquisition is then voided or called in, the borrower would be under an immediate obligation to repay. "And whilst the market is still developing on this point, legal opinions which cover the enforceability of security will almost certainly include a qualification around the possibility that clearance will need to be sought before enforcement," says Jagadish.

What's next?

The legislation has been enacted, but will not be brought into force until later this year. In the meantime, the government has turned its attention to the various pieces of secondary legislation and guidance that need to be put in place to make the regime operational, woth the first batch of guidance expected to be published in July. In this respect, there is ongoing engagement between business associations and the government regarding the definitions of sensitive sectors and clarity around treatment of customary minority protection rights and extra-territorial transactions. In the longer term, potential exemptions for certain categories of investment/investors may be developed. For the moment, however, there is an option to notify and obtain clearance for transactions that are taking place now, even though they will be at risk of a call-in when the regime is in force. "It is likely that the informal guidance route will need to be used frequently now for transactions that are at risk of a call-in, but cannot delay closing until the regime is in force,," says Ghosh.

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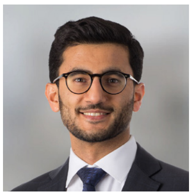

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