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# National Security & Investment Act

Don't let your investment round get caught by the broad scope of the **National Security & Investment Act**

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# The National Security & Investment Act

## What is the legislation?

The National Security and Investment Act 2021 gives governmental regulatory bodies powers to investigate investments into UK companies, which they believe may have "national security" implications.

National security might seem like a high bar and not something that will apply to your business. But, tread carefully because the legislation's scope is broad enough to catch **a large number of UK equity financing transactions**.

The Act grants a governmental body, the Investment Security Unit, which sits in the Cabinet Office, the power to call in certain transactions to assess whether the transaction might create a national security risk. In FY22/23, 866 notifications were received by the ISU, and 65 of those were called in for further assessment.

"National security" is not defined by the Act or the Government and is kept purposefully vague so that the Government can flex its approach. This flexibility isn't, however, ideal for working out whether or not your investment round will be called in!

Furthermore, although the Act only comes into force from 4 January 2022, it allows the Government to go back to 12 November 2020 and call in transactions that have already completed. So it's important to be aware of the requirements of the Act right away.

## How do I know if I'll have a problem?

Firstly, the rules will only apply if any person or entity acquires a new level of control over your company. The main criteria for assessing this control are:

1. a party's shareholding stake or voting rights meet or cross certain thresholds (see thresholds below);
2. irrespective of voting rights, a party acquires rights that allow them to pass or block resolutions governing the affairs of your company; or
3. a party becomes able to materially influence the policy of your company (e.g. gaining a right to appoint a director, if that appointment enables the appointor to influence the strategic direction of the company).

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It is worth noting that some of this will depend just as much on the practicalities as on the legals. Not every investor director will be in a position to "influence the strategic direction of the company" in the way envisaged by the Government. But, the way other investor directors operate in practice (or even how much they are listened to!) could arguably give them more sway over the company's actions.

It is also worth noting that the Government has marked certain sectors as important to the UK economy and therefore particularly susceptible to national security risks. There are 17 of these sectors in all, ranging from Transport to Cryptographic Authentications, and including a number of sectors with a broad tech focus and a fairly wide remit – such as Synthetic Biology, AI, and Communications, amongst others. A full list is available here, with detailed definitions of each sector. We'll refer to these below as the 'key sectors'.

While it is obvious with some key sectors (Nuclear, Military etc) where a business might fall within scope (Defence, for example, received more than twice the proportion of notifications than the next largest area of the economy in FY 22/23) other sectors (such as Communications, Synthetic Biology etc) could conceivably encompass many businesses.

It may seem obvious that the development of a games console might not be of national security interest, given that Computing Hardware is a key sector, a gaming business with an upcoming financing round may need to comply with the Act.

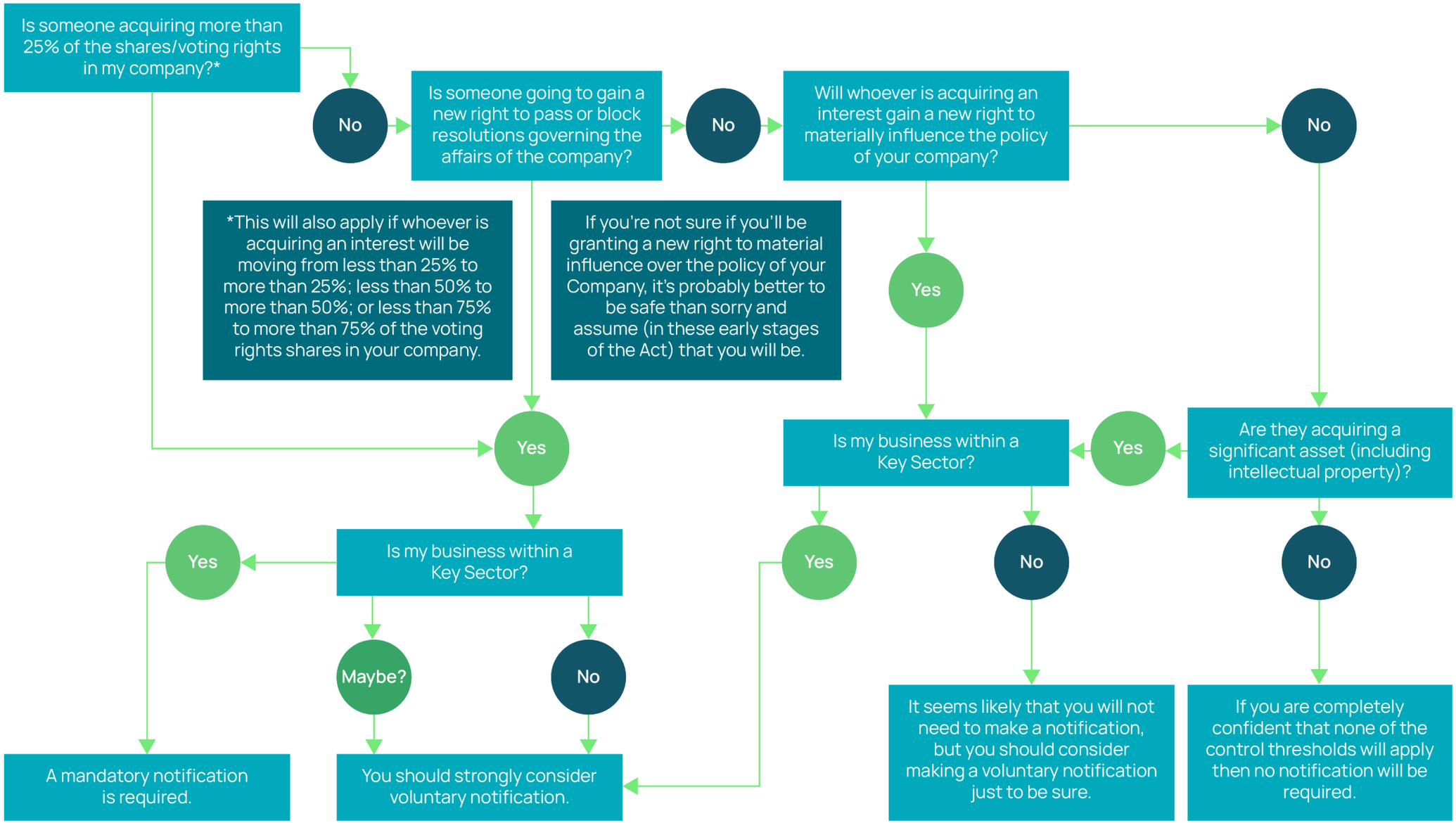
If your business operates in a key sector and control of your business changes or updates as per points one and two above, then your business is very likely to be subject to the Act.

Regardless of being in a key sector or not, the Government can call in any transaction where it feels that control of your company may have changed and there may be any form of national security risk. In FY22/23, 10 call-in notices were issued for non-notified acquisitions, thus the ISU are being relatively pro-active in monitoring transactions.

**The flowchart on page four summarises what you need to consider.**

"...the Government can call in any transaction where it feels that control of your company may have changed and there may be any form of national security risk."

## Will I need to make a notification under the Act?



## What do I need to do to comply with the Act?

### There are two options:

For complete certainty, any transaction involving a change of control as mentioned above would need to be voluntarily notified to the ISU within the Cabinet Office.

If you and your investors are completely comfortable that there is no possible national security risk, you could simply complete the investment and hope for the best.

Note that the SoS can call in a transaction for review up to five years after it has taken place, but no longer than six months after the Government first became aware of it – so if the completed investment has been widely publicised and more than six months have passed then you should be clear (though the Government's "awareness" of transactions hasn't yet been tested in this way).

**However**, businesses who fall within any of the key sectors will need to make a mandatory notification to the ISU in the cases of change of control points 1 (shareholding and/or voting rights above threshold) and /or 2 (able to pass or block resolutions) above.

Businesses in a key sector that don't fall into the above (e.g. where an investment may result in some other influence being granted to the investor, or involves the sale of an important asset) should strongly consider making a voluntary notification.

The SoS has claimed that they will review all notifications within 30 working days (six weeks) of receipt. In FY22/23, all 766 mandatory and voluntary notifications and retrospective validations were indeed reviewed and parties were notified of the outcome within the 30 working day period.

This gives some comfort that the majority of acquisitions which are notified can proceed without being called in.

However, in some transactions, the 30 working day period and potential further 45 working day additional review period may be critical to the viability of a financing, so it is important to make an application, if required, as soon as possible. In FY22/23, 25 notified acquisitions of the 65 which were called in proceeded to the additional period (another 45 working days) within the reporting period.

Note that the main obligations under the Act actually apply to the investors, not to the company itself. So it is primarily the investors who will need to ensure compliance (though there are plenty of reasons you should also play a part – see below).

## What are the repercussions of failing to comply?

### Non-mandatory

If it was not mandatory to notify the ISU, but the SoS later calls in the transaction and decide that it has resulted in a national security risk, then they are likely to impose conditions.

The exact conditions will vary based on the circumstances, but market experience from conditions imposed by the Competition and Markets Authority demonstrates that these can be difficult and costly to implement – particularly if the investment has already completed. In a worst case scenario, BEIS could seek to block a transaction (or in the case of BEIS taking retroactive action, for the transaction to be '"unwound'").

"In a worst case scenario, the Secretary of State could seek to block a transaction."

## Mandatory

If a transaction falls within the scope of the mandatory notification scheme and does not receive SoS approval, the relevant investor commits an offence and may be imprisoned and/or suffer a significant fine. In FY22/23, 671 of the 866 notifications received were mandatory.

Importantly, the relevant transaction would automatically be considered void. This means that, despite having signed paperwork and received funds, the investment would be deemed never to have legally happened and would need to be unwound.

In fact, the requirements of the Act mean that it will no longer be legally possible to complete an investment round requiring mandatory notification, without having received formal clearance from the SoS.

## If all obligations are on investors, why should I be concerned about this?

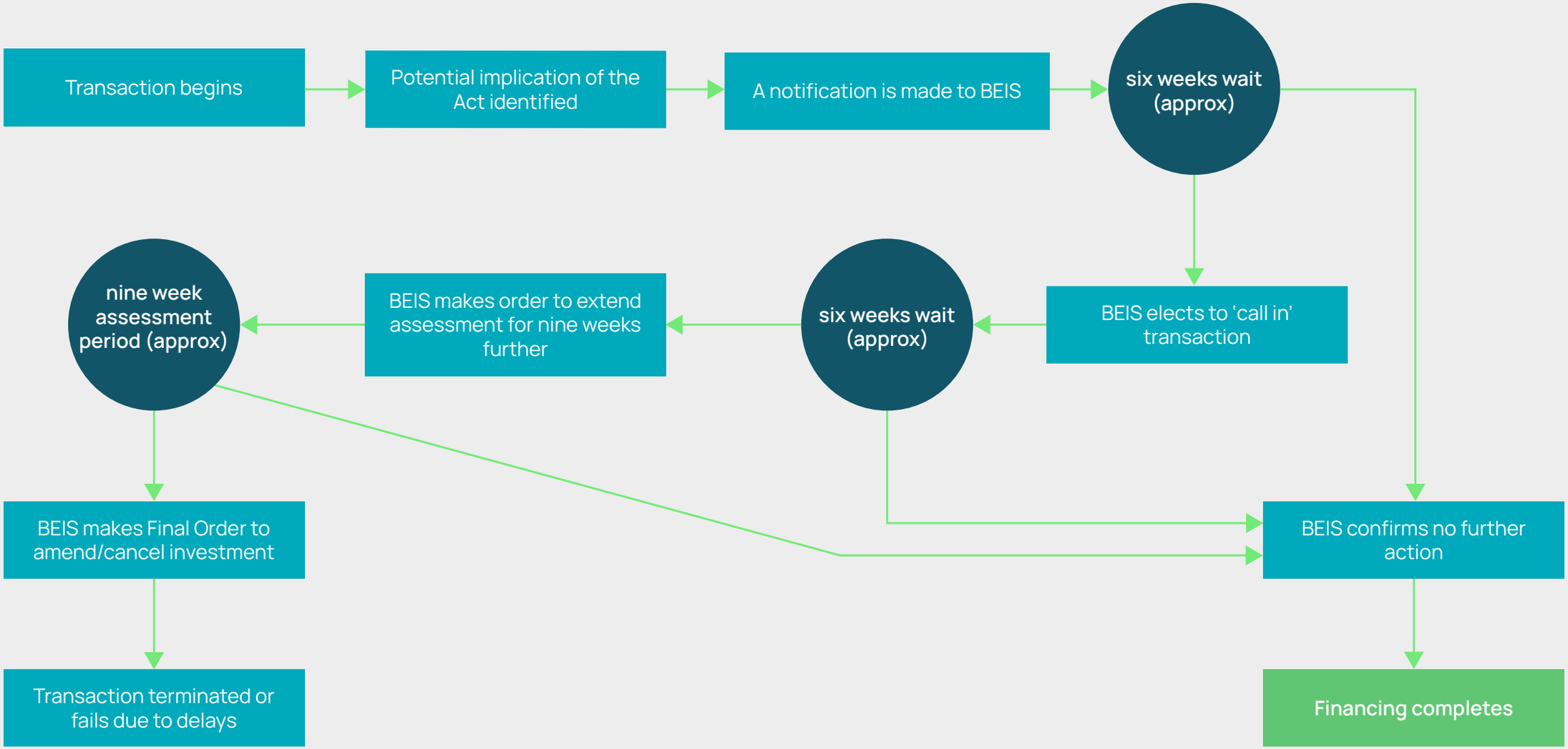
The Act will likely have implications for (i) the certainty of transactions (e.g. will investors be dissuaded by the potential for SoS scrutiny?), and (ii) the timeline for an investment round. Timing in particular can be of critical importance for funding rounds, as businesses often need to secure investment in order to pay their suppliers, fund staff salaries, continue in operation, etc.

A need to notify a Government Department will ultimately lead to transactions taking longer than expected, and there will be additional costs involved to make sure any notification is made properly and in good order.

**To help you, we've created a flowchart on page seven that sets out a possible timeline for a voluntary notification on what would be a standard transaction. In FY22/23, the Government took on average 27 working days to decide whether to call in an acquisition based on a voluntary notification, and 28 working days for mandatory notifications.**

"...the requirements of the Act mean that it will no longer be legally possible to complete an investment round requiring mandatory notification, without having received formal clearance from the Secretary of State."

## A sample timeline for a notification



In addition to timing risks, note that some investors may seek to pass on the risk of any breach of the Act to the company / its founders. New warranties may be requested, which look to make the founders liable.

Practically speaking, investors are going to need the help of founders to fully understand their business and make an appropriate notification to the ISU if required.

The due diligence process that you may be familiar with is likely to be updated to include provisions that are relevant for the purposes of the Act (e.g. you will be asked to confirm if you consider yourself to fall within a key sector). We've updated our standard due diligence enquiries to include the questions likely to be raised.

A problem for your investors is ultimately also a problem for you.

## FAQs

### Will the Act only affect investment from foreign investors?

The terms of the Act as drafted apply to both foreign and domestic investments, so it will affect all transactions that result in a change of a degree of control as set out in the Act.

### What if I have completed an investment round prior to 4 January 2022 (when the Act came into force)?

The Act will grant the SoS powers to scrutinise investments from 12 November 2020 onwards. Therefore, if you have secured any equity financing in the period from 12 November 2020, such investment remains at risk of being 'called-in' by the SoS and could be subject to scrutiny. It is important to note that a call-in notice must be given within six months of the SoS becoming aware of the acquisition, and cannot be given more than five years after the acquisition took place.

### How do I go about making a notification the ISU?

It is expected that an online portal will be established for the An online portal has been established for the purposes of making notifications to the ISU, and it is through this portal that communications will take place.

Ashfords has advised a large number of clients on compliance with the Act, and made a number of notifications to the ISU. For those who applied to the Future Fund scheme during the Coronavirus outbreak the portal notification process for the Act should be fairly familiar, as the process is very similar.

## Further information

A number of detailed guidance notes have been published by the Government including:

- A general guidance note
- Guidance on the use of 'call in' powers
- Mandatory notification sectors

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