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WHITE PAPER

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Key Lessons from UK National Security and Investment Regime's First Year

Since the United Kingdom implemented the National Security and Investment Act in January 2022 ("NSI Regime"), there has been a significant increase in state intervention in, and review of, business transactions in the United Kingdom, including for international transactions involving targets with limited activities in the United Kingdom.

Although the NSI Regime is often described as the United Kingdom's foreign direct investment law, it is limited neither to transactions involving foreign entities (like CFIUS in the United States), nor to direct investments. Indeed, the coverage of the NSI Regime is broader than transactions that might ordinarily be considered "investments" because it may require a filing for certain license agreements, financing arrangements, and insolvency proceedings, among others. Instead, the NSI Regime is a broad investment control regulation.

Over the last year, the UK government has extensively deployed its new powers, reviewing many hundreds of mandatory notifications, calling in dozens of deals for detailed national security assessments, imposing conditions on nine transactions, and prohibiting three. Some of the matters that have attracted the most attention from the UK government are those you would expect—deals in the defense and national security sectors. However, other deals—including one in which the UK government imposed remedies involving an acquisition of an equity interest of just 12.1%—might come as a surprise to many businesses.

This *White Paper* provides an overview of the NSI Regime and lessons from transactions that have been called in over the last year. It also highlights implications for a range of specific client sectors that we have seen commonly arise since the introduction of the regime.

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OVERVIEW OF NSI REGIME

The NSI Regime introduced a mandatory and suspensory pre-closing notification requirement for acquisitions of corporate entities carrying on specified activities in any one of 17 UK industry sectors considered to be "sensitive." The NSI Regime also established a broad "call-in" power that authorizes the UK Secretary of State ("SoS") to intervene in acquisitions of both corporate entities and assets in any sector for which there is sufficient nexus to the United Kingdom. Where a transaction gives rise to risks of a potential call-in, parties can choose voluntarily to notify the SoS. The UK Department for Business, Energy and Industrial Strategy has also established a new regulatory team, the Investment Security Unit ("ISU")[1], to administer the NSI Regime.

The new regime applies to a wide range of corporate transactions, including:

- Minority investments above certain thresholds (including additional notification requirements for further increases in shareholdings or voting rights between thresholds);
- Acquisitions/gaining of voting rights above certain thresholds (even where no underlying equity is acquired);
- Acquisitions of interests in assets, including intellectual property rights (e.g., licensing agreements);
- Financing arrangements; and
- Internal corporate restructurings.

Unlike many foreign direct investment regulations, the United Kingdom's mandatory notification rules are agnostic as to the nationality of the acquirer. Therefore, even acquisitions by UK-headquartered companies of foreign entities with activities in the United Kingdom can be subject to notification requirements. However, the nationality of the acquirer is relevant to the ISU's analysis of national security risks.

The jurisdictional requirements of the NSI Regime can be met even if the target does not have a subsidiary or physical presence in the United Kingdom. Instead, the jurisdictional test will be met if:

- In the case of acquisitions of entities, the target carries on any activities in the United Kingdom or supplies goods or services to the United Kingdom; or
- In the case of assets, the asset is used in connection with activities carried on in the United Kingdom or used in connection with the supply of goods or services to people in the United Kingdom, even if the asset is located overseas.

There are significant consequences for noncompliance with the NSI Regime. If parties fail to make a necessary mandatory notification, the consummated transaction is deemed to be void as a matter of UK law. In some cases, parties can remedy such a mistake through a retrospective notification. The NSI Regime also features potential fines of up to 5% of worldwide turnover or £10 million (whichever is greater) and, in extreme cases, risk of imprisonment for up to five years for senior managers. No penalties have been issued to date, and in practice, we expect that the largest fines and criminal sanctions will be reserved for the most serious violations—for example, intentional non-filing or repeat offenders.

WHEN MANDATORY NOTIFICATIONS MIGHT BE REQUIRED

The NSI Regime introduces a mandatory notification requirement if:

- An acquisition gives rise to a "trigger event"; *and*
- The entity being acquired (or in which an interest is being acquired) carries on specified activities set out in the National Security and Investment Act 2021 (Notifiable Acquisition) (Specification of Qualifying Entities) Regulations 2021 (the "NSI Regulations") in the United Kingdom.

The following trigger events can give rise to a mandatory notification requirement:

- The acquisition of more than 25%, more than 50%, or 75% or more of the shares or voting rights in a target entity (including acquisitions that cause moves between the thresholds so multiple notifications may be required for an acquisition conducted in multiple stages); or
- The acquisition of voting rights enabling or preventing the passage of any class of resolution governing the affairs of the target entity.

The list of specified activities in the NSI Regulations is very detailed but falls within 17 broad sectors:

Figure 1: NSI Mandatory Notification Sectors

THE MANDATORY NOTIFICATION PROCESS

If a mandatory notification is required, it is unlawful to complete the transaction until the UK government has:

- Notified the acquirer that it will take no further action with respect to the transaction (which would occur at the conclusion of the initial review period);
- Issued a final notification after calling in the transaction for a national security assessment; or
- Issued a final order imposing conditions considered necessary for preventing, remedying, or mitigating the national security risk identified.

The SoS also has authority to issue an order prohibiting consummation of the transaction if the transaction gives rise to national security concerns that the parties cannot address through remedies.[2]

There are three stages to the review process:

Review Stage	Timing Implications
Formal Acceptance of Notification	When a party submits a notification, the statutory review period begins only after the ISU accepts the application as complete. ISU staff aims to accept notifications within five working days. In our experience, ISU typically accepts sufficiently comprehensive draft notifications that address likely areas of interest within 1-3 working days.
Initial Review Period	The SoS has up to 30 working days, approximately six weeks, from ISU acceptance of the filing to decide whether to “call in” a transaction for a national security assessment. While there is limited public visibility of the internal process followed, we understand from discussions with ISU staff that there are three phases to the Initial Review Period: • The ISU’s review of the notification; • TA “cross-community assessment” in which other government agencies relevant to the notification conduct their own review; and • TA period during which the ISU collates feedback from other government agencies, manages disagreements (if any), and prepares a paper for the SoS. The ISU may send information requests to the transacting parties and third parties such as customers during this period, but those requests do not delay the statutory deadline for the review.
National Security Assessment	If the SoS has called in a transaction for a national security assessment, they will have 30 additional working days to decide whether to clear the transaction (through the issuance of a final notification) or impose conditions (through the issuance of a final order). Information requests and attendance notices sent during this period pause the “statutory clock,” so it is important that parties respond to such requests quickly. The SoS can also unilaterally extend the statutory timeline by up to 45 working days, bringing the total review period to 75 working days, not including pauses related to ISU information requests. Any further extensions require an agreement with the acquirer.

THE CALL-IN POWER AND VOLUNTARY NOTIFICATIONS

If a transaction gives rise to a trigger event, the SoS may call in a transaction for a national security assessment even if the target entity does not carry on activities in the mandatory notification sectors, or if the acquisition is of an asset such as land or intellectual property rather than of a corporate entity. The SoS may conduct a review for up to five years after the transaction has closed or six months after the SoS becomes aware of the transaction.

The legislation does not set out the circumstances in which a transaction poses a risk to national security, consistent with longstanding UK government policy to provide itself with sufficiently flexible national security powers. However, the statute required the SoS to publish a statement setting forth the circumstances in which the call-in power is more likely to be exercised:

- Acquisitions of less than 25% of the equity or voting rights in targets with activities specified in the NSI Regulations (“NSI Specified Activities”) that still represent material influence (an additional trigger event that exists for the call-in power but not the mandatory notification regime);
- Acquisitions of interests in targets active in the broad 17 sector descriptions (e.g., artificial intelligence, civil nuclear, critical suppliers to government, etc.) that do not fall within the detailed NSI Specified Activities and so do not require mandatory notification;
- Acquisitions of assets (including interests in intellectual property and land) that are, or could be, used in connection with the NSI Specified Activities; and
- Acquisitions of assets or land that constitute sensitive sites or are proximate to those sites.

Although the SoS has stressed that the nationality of the acquirer is not an “inherent” risk factor,[3] the nationality of the

acquirer is nevertheless an important factor in the SoS' evaluation. Therefore, businesses entering into transactions involving entities linked to jurisdictions that the UK government considers hostile should carefully consider NSI risks.

In deals that may be a close call with respect to a filing or that create risk because of vague rules, and if national security risks could arise, parties may choose voluntarily to notify a transaction to avoid the risk of SoS intervention. As noted above, an SoS intervention could involve the SoS imposing conditions or requiring that the parties unwind the transaction. In addition, the SoS can issue interim orders preventing completion, imposing hold separate obligations, or limiting information exchange (among other possibilities) while it conducts its investigation.

If parties choose to make a voluntary notification, the same timeline applies as in the case for mandatory notifications, i.e., 30 working days for each initial review period and national security assessment (if called in), with the possibility of a 45-working-day extension. However, unlike for transactions that the SoS calls in, voluntary notifications are not subject to the automatic statutory obligation to suspend closing while the SoS' review is pending.

CONSEQUENCES OF NATIONAL SECURITY CONCERNS BEING IDENTIFIED

If the SoS determines that a transaction gives rise to national security concerns, it has wide powers to impose conditions on the transaction or, in more extreme cases, to block or unwind it. To date, the types of restrictions imposed have included:

- Restricting the sharing of information from target entities to the acquirer;
- Restricting the influence of the acquirer over appointments of key staff within the target;
- Prohibiting the acquirer from appointing representatives to the boards of certain target entities;
- Requiring the appointment of a UK government observer to the boards of certain target entities;
- Requiring the acquirer to notify the UK government if it transfers assets from certain target entities;
- Providing UK government agencies with rights of access (presumably above those available under their existing regulatory powers) to premises and information to audit compliance with security measures;
- Requiring the acquirer to maintain research, development, and manufacturing capabilities within the United Kingdom; or
- Requiring the acquirer to obtain UK government approval before entering into certain commercial contracts.

In addition to those final order conditions, the ISU may pressure businesses during the RFI process to provide informal assurances regarding matters such as maintenance of staff, capabilities in the United Kingdom, and continuation of supply to certain UK government customers. While those interactions may provide an opportunity to avoid final orders (and the potential penalties that can come from breaching those orders), before providing such assurances, businesses are well-advised to consider whether the requisite level of national security concerns exist to allow the SoS to issue final orders in any case.

IMPLICATIONS FOR SPECIFIC TRANSACTION TYPES

Minority Investments

The NSI Regime has significant implications for minority investors that might not trigger foreign direct investment ("FDI") requirements in other jurisdictions, particularly if those interests do not carry significant governance rights. As noted above, acquisitions of more than just 25% of the equity or voting rights in an entity carrying on specified activities in the United Kingdom will give rise to a mandatory notification. In addition, acquisitions of "material influence" over an entity that carries on any activities in the United Kingdom or supplies any goods or services to the United Kingdom are not subject to a mandatory notification requirement, but can be called in by the SoS for a national security review. The statute does not define "material influence," nor is the standard bounded by clear minimum equity or voting rights thresholds.

Those low thresholds already have led to enforcement actions for some minority investors. For example, in a recent matter involving a UAE-based investor in a British aerospace

manufacturer, the SoS took the view that the acquisition of just 12.1% of the equity in the target and a right to appoint one board member was sufficient to constitute material influence. That assertion of jurisdiction led to the SoS imposing conditions to address its national security concerns.

The United Kingdom's liberal jurisdictional rules have, in some instances, also made it more challenging for private equity funds and other investment managers to market and secure funding from investors reluctant to proceed if there is risk of an NSI Regime notification—even if there is little-to-no risk of substantive national security concerns arising. In some cases, investors purchased less equity or voting rights than they otherwise would have to ensure they fall below the mandatory 25% notification threshold.

Key Takeaways

- Investors considering investments in entities with any connection to the United Kingdom should consider potential NSI risks, particularly in acquisitions of more than 25% of the equity or voting rights of the entity. Parties also should evaluate the NSI risk with respect to acquisitions of smaller interests if the acquirer will receive the right to appoint board members or if there are other factors that might give rise to material influence.
- Investors should confirm whether target entities have complied with any previous NSI Regime notification requirements as part of due diligence, given the risk that prior transactions could be considered void as a matter of UK law if there was a failure to notify.
- Fund managers syndicating investments should assess FDI obligations early in the investment process, particularly given the risk that FDI considerations can have consequences for the composition of the syndication, depending on the willingness of potential investors to be subject to notification requirements.

Investments in the Defense and National Security Sectors

While few will be surprised that the defense and national security sectors are a particular focus of the NSI Regime, the scope of the defense sector definition within the NSI Regulations captures businesses engaging in a broad range of activities. Specifically, under the sector definition, a mandatory notification will be required if:

- The target is a government contractor that develops, produces, creates, applies, or carries out research in relation to goods or services, and those products are used for, or provided for, defense or national security purposes;
- The target is a subcontractor in a chain of subcontractors that begins with a government contractor; or
- The UK government has notified the target that it holds or may come into possession of classified material.

Given the broad sector definition, the NSI Regime may catch entire chains of subcontractors, some of which may provide inputs with little connection to military or defense applications. Indeed, ISU guidance counsels that acquisitions of subcontractors that provide goods or services without clear military applications (such as catering or cleaning) can give rise to mandatory notification obligations.

In practice, the ISU takes a particular interest in transactions involving entities active in defense supply chains. Although the SoS has not called in many transactions involving subcontractors with a remote connection to national security supply chain, the ISU may nevertheless request that businesses confirm—informally—that they intend to maintain operational capabilities in the United Kingdom during the initial review period.

Key Takeaways

- Investors should ensure that due diligence assessments consider not only direct customers, but also the entire supply chain if there is a possibility that the target supplies products or services, even indirectly, to government contractors in defense or national security.
- When a mandatory notification is required, investors should consider briefing the target's key UK Ministry of Defense contacts regarding the details of the transaction to identify and address potential concerns at the outset.

Investments in Real Estate

Investments in real estate (when part of a share deal rather than an asset deal) may give rise to mandatory notification

requirements in a range of circumstances, with the most common ones including if:

- The real estate is contracted for use by a government contractor that develops, produces, creates, applies, or carries out research in relation to goods or services that are used or provided for defense or national security purposes;
- The main purpose of the real estate asset is to host certain types of telecommunications equipment (e.g., data centers, cable landing stations, satellite ground stations); or
- The real estate includes transport infrastructure (e.g., ports, airports) meeting certain specified thresholds.

Investments in the types of assets described above would not require mandatory notification when structured as an asset deal. Given the potential timing and remedy implications of an NSI review, notification requirements can become a significant factor when considering deal structure, particularly if investors are reluctant to be involved in a notifiable transaction, as can be the case with some sovereign wealth and large pension funds.

However, as with all other asset types, the SoS can call in investments in real estate assets (regardless of transaction form), if those assets have sufficient nexus to the United Kingdom. The SoS also has raised the possibility of calling in acquisitions when land is either itself a sensitive site or located proximate to such a site, with such sites including critical national infrastructure sites and government buildings.

Key Takeaways

- When conducting due diligence, real estate investors need to consider whether existing tenants at the time of acquisition are carrying on activities that could mean changes in interests in the real estate and give rise to mandatory notification requirements, as the use of the land could make it sensitive.
- Investors should consider whether an asset deal might be preferable to a share deal in order to avoid mandatory notification obligations if the real estate assets are potentially connected to sensitive sectors.
- If real estate assets are used for sensitive purposes, or located close to such sites, the risk of the SoS calling in the transaction should be considered in the deal timeline and in the evaluation of potential investors and/or buyers.

Intellectual Property ("IP") Licenses

Although the acquisition of interests in assets such as IP are not subject to mandatory notification requirements, the SoS has authority to call in those transactions for a national security review. As a result, parties to transactions involving IP with some nexus to the United Kingdom now need to consider the risk of an NSI review, particularly if the IP relates to sensitive sectors. While the United Kingdom is not alone in applying FDI rules to acquisitions of interests in assets such as IP, the ISU is focused on national security risks associated with such transactions.

In July, the SoS intervened to prohibit the University of Manchester from granting a license for IP related to vision-sensing technology to a licensee in China. Businesses should be aware that the sale and licensing of sensitive IP is likely to attract increasing scrutiny going forward, and that in some cases, it may be advisable to make a voluntary notification to the SoS.

The SoS also can call in transactions that do not involve the transfer or sale of assets but merely the grant of a right or interest allowing the acquirer to use the asset, or use it to a greater extent than prior to the acquisition. The call-in right exists even if there is no transfer of ownership in IP or the licensor transfers the rights on a nonexclusive basis. It is also important for businesses to understand that the NSI Regime applies even to intra-group transactions. Therefore, an intra-group transfer of IP assets (or a spin-out) could nevertheless trigger an NSI review.

There is also no requirement that any of the transaction parties be domiciled in the United Kingdom for the NSI Regime to apply. Likewise, the asset itself need not be located in the United Kingdom. The only connection to the United Kingdom required is that the asset is used *"in connection with activities carried on in the UK, or the supply of goods or services to persons in the UK."* By way of example, a non-UK entity's trade secrets located abroad could fall within the scope of the NSI Regime if those assets are key to the supply chain of another good or service sold into a critical sector in the United Kingdom.

Key Takeaways

- Businesses that regularly deal in IP-rich assets should ensure they have policies in place to identify transactions that may attract interest from the UK government. To that end, businesses should consider systematically tracking sensitive IP they own or use.
- IP and other assets developed by UK higher education institutions and research organizations are a particular focus of the UK government. Parties to collaborations or licenses with those organizations should pay particular attention to the risk of an NSI review.

Internal Corporate Reorganizations

It may come as a surprise that the UK government expects businesses to notify even internal corporate reorganizations involving entities carrying on specified activities in the NSI Regulations if one or more of the relevant trigger events occur. The notification requirement exists even if the ultimate beneficial owner remains the same. The United Kingdom is not alone in applying FDI rules to internal reorganizations—a number of other European jurisdictions, including Germany and Italy, do so as well.

Although the threat of the ISU detecting a missed notification due to an internal reorganization may seem low, the consequences of failing to make a mandatory notification can be significant. In particular, the fact that the transaction will be void as a matter of UK law may bring into question the validity of the appointment of any directors appointed by the new shareholder(s) and/or decisions of the board. In addition, buyers in M&A transactions and investors are increasingly asking about NSI Regime compliance during due diligence, given the risks associated with prior internal reorganizations being void. Therefore, missed notifications can complicate future transactions.

Key Takeaways

- Businesses that carry on NSI Specified Activities should adopt internal procedures to ensure that they evaluate NSI rules before completing any intra-group transactions involving a subsidiary carrying out those specified activities (or that is a parent entity to such a subsidiary).
- Investors acquiring an interest in entities carrying on NSI Specified Activities should ensure that due diligence confirms that any notifications required as a result of past transactions (including internal reorganizations) have been appropriately notified.

Insolvency and Bankruptcy

Although an administrator's or creditor's acquisition of voting rights in an insolvency proceeding is exempt from the NSI Regime's mandatory notification, there is uncertainty about whether a liquidator's or receiver's acquisition of voting rights will be subject to mandatory notification. There are at least two cases where mandatory notifications likely would apply:

- If a liquidated entity has shares in a solvent entity that carries on NSI Specified Activities, and as a result of the appointment of a liquidator or receiver, that liquidator or receiver gains voting rights over those shares; and
- If an individual is declared bankrupt and they hold shares in a solvent entity that carries on NSI Specified Activities, and those shares are transferred to the trustee in bankruptcy during the insolvency process.

The timeline required for a mandatory NSI notification can be a particularly difficult consideration to navigate in liquidation and bankruptcy proceedings. It is also worth noting that the NSI statute provides for an exception to the duty to notify if doing so would be "impossible." However, there is no clear guidance on the meaning of "impossible." During UK Parliamentary debates on the NSI Regime bill, government representatives indicated that notification might be impossible if the acquirer lacked awareness about the entity or assets it was about to acquire, or if it was otherwise impossible to notify in the time available before the acquisition took place. Government representatives suggested that examples might arise in bankruptcy acquisitions but provided no further detail. Careful consideration should be applied before relying on this exception.

Key Takeaways

- At the outset of an insolvency matter that might involve the grant or acquisition of voting rights or shares in a solvent entity, liquidators and receivers should assess whether that entity carries on activities in the United Kingdom specified in the NSI Regulations. If a mandatory notification is required, this will need to be factored into the insolvency process.
- Where a mandatory notification would be required but for the fact that it would be impossible due to timing constraints, legal counsel should be engaged at the earliest opportunity (and potential engagement with the ISU could be appropriate).

Financing

The NSI Regime excludes most financing arrangements from mandatory notification requirements to the extent that they involve the grant of share security (i.e., title to the shares is not transferred, and any reserved rights for the lender are limited to ordinary protections). The NSI Regime will be relevant for those arrangements only if the lender seeks to gain title to the shares (e.g., as a result of default).

However, there are circumstances in which the provision of financing itself can give rise to a mandatory notification requirement if the entity in which security is taken carries on NSI Specified Activities. Those activities include:

- Lending by way of a Scottish law share pledge, given that legal title to the equity of the entity against which security is taken actually transfers to the lender (despite all voting rights remaining with the borrower); and
- Lending by way of Shariah-compliant loans, such as murabaha and musharakah contracts, which also can involve the transfer of legal title to equity.

The enforcement of security in relation to borrowers carrying on NSI Specified Activities can itself be unlawful if any necessary mandatory notifications have not been made. That can raise a number of practical difficulties, both in terms of the assessment (in some cases, only the borrower will have the information necessary to conclude whether the NSI Regulations would apply) and timing (i.e., factoring a 30-working-day review period into enforcement proceedings).

Key Takeaways

- Borrowers and lenders using financing arrangements that involve the transfer of legal title should assess whether the entity in relation to which legal title is transferring (or a subsidiary of that entity) carries on activities in the United Kingdom specified in the NSI Regulations.
- All lenders considering enforcing security should ensure that they have assessed whether entities against which they are intending to enforce security (or their subsidiaries) carry on activities in the United Kingdom specified in the NSI Regulations.

ENDNOTES

1 While the SoS is the final decision-making authority under the NSI Regime, the ISU conducts reviews with input from other government agencies and prepares recommendations that carry significant weight in the SoS's decision-making process.

2 Decisions of the SoS can be appealed but only on a judicial review basis.

3 For example, see Section 3 Statement: "The Secretary of State 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"; and "the Secretary of State will not make judgements based solely on an acquirer's country of origin."

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