



Law Society
of Scotland

Written Evidence

National Security and Investment Bill

December 2020



Introduction

The Law Society of Scotland is the professional body for over 12,000 Scottish solicitors. With our overarching objective of leading legal excellence, we strive to excel and to be a world-class professional body, understanding and serving the needs of our members and the public. We set and uphold standards to ensure the provision of excellent legal services and ensure the public can have confidence in Scotland's solicitor profession.

We have a statutory duty to work in the public interest, a duty which we are strongly committed to achieving through our work to promote a strong, varied and effective solicitor profession working in the interests of the public and protecting and promoting the rule of law. We seek to influence the creation of a fairer and more just society through our active engagement with the Scottish and United Kingdom Governments, Parliaments, wider stakeholders and our membership.

The National Security and Investment Bill¹ was introduced by the Secretary of State for Business, Energy and Industrial Strategy on 11 November 2020. The UK Government previously consulted on this topic in 2017 and 2018 to which we provided initial comments.² We welcome the opportunity to consider the National Security and Investment Bill and have the following comments to make on the text of the Bill.

If you would like to discuss this paper, or if you would like more information on the points that we have raised, please do not hesitate to contact us. Contact details can be found at the end of the paper.

General Remarks

We welcome the overarching objective of the bill, which recognises the critical importance of safeguarding the UK's infrastructure in the context of national security and a modern understanding of how that security might come under threat. The government's existing powers to intervene in mergers and acquisitions on the grounds of national security are set out in the Enterprise Act 2002 but the new regime marks a significant step-change in this area. This is in line with a global trend towards introducing and ramping up investment screening, which has been particularly apparent in recent months.

However, we have a number of concerns regarding the practical application of the proposed regime. In particular, we note that the potential parameters of the Bill are very wide indeed. While we understand that the intention is to narrow the issues through secondary legislation, we consider that further detail should be provided in the Bill in the interests of ensuring sufficient and appropriate scrutiny in parliament. As set out in our response to the government's consultation in late 2018, changes to the current regime should be

¹ <https://services.parliament.uk/Bills/2019-21/nationalsecurityandinvestment.html>

² See responses from December 2017, January 2018 and October 2018 here - <https://www.lawscot.org.uk/research-and-policy/influencing-the-law-and-policy/our-responses-to-consultations/competition-law/>

made by way of primary legislation. The concept of having a framework bill and leaving all pertinent detail to secondary legislation is not appropriate in the fundamentally important and potentially contentious area of national security. Without this further level of detail, it is also difficult to comment on the likely impact of the proposed legislation.

It is a complex task to create a system which will balance the need to maintain an open business environment and promote fair competition with the need to protect national security. We observe that the proposed process mirrors aspects of the UK's competition law regime as it applies to mergers and acquisitions. Experience from the field of competition law may therefore be of significant assistance in understanding how the proposed national security screening regime might operate in practical terms, in identifying potential "pain points" and obstacles, and accordingly in suggesting improvements to the proposals set out in the Bill.

We also note the potential impact in terms of constraining investment flows or being perceived as indicating that the UK is taking a protectionist or isolationist stance – a theme that has arisen numerous times in the context of EU withdrawal. While such considerations should not take precedence over combatting threats to national security, it is vital that the new framework is clear and transparent so that investors and their advisors can easily ascertain whether a particular transaction will be caught and what their compliance obligations will be. Ensuring this clarity and simplicity will reduce the risk of pursuing an investment in the UK and ensure it remains clear that the UK is very much "open for business".

This clarity is also essential to ensuring the practical operation of the regime. Without clear rules, we are likely to see a significant volume of unnecessary notifications from investors taking a cautious approach to ensure that they do not fall foul of the requirements. These could lead to an unmanageable high case load, which would exacerbate the challenges likely to be faced by any new government unit. In any case, we consider that the estimate of anticipated notifications is probably too low, given the breadth of potential trigger events indicated by the framework bill.

Lastly, we note that the regime is not the only means of safeguarding national security as relevant mechanisms already exist to combat terrorism and criminal activity. The National Security screening regime must therefore be targeted to guard against potential exploitation of or damage to critical national infrastructure through commercial or physical control of relevant assets that would be significantly easier to achieve or more difficult for UK law enforcement agencies to detect if the assets or entities were controlled by natural or legal overseas persons. This might be by mounting a cyberattack or otherwise creating an emergency situation, or by diverting resources out of the country or dampening response capability at a time of national emergency created by a third-party threat. We also note that the regime unusually applies to domestic threats.

Comments on the Bill

National security

We note that national security itself is not defined within the Bill. We note that the Enterprise Act 2002 definition refers to EU legislation: it might be helpful to introduce a stand-alone concept appropriate to the current context. An exhaustive definition is likely to be neither possible nor desirable but a general delineation of the concept together with detailed additional guidance as to how this is likely to be applied would be helpful.

Time limits and retrospective effect

Under clause 2(2)(a) a call-in notice can be given up to 6 months from the day on which the Secretary of State becomes aware of a trigger event, with, under clause 2(2)(b) an absolute cut-off at 5 years for issuing such notices. We note that the Bill will have retrospective effect in relation to a “trigger event taking place during the period beginning with 12 November 2020 and ending with the day before commencement day”. While this applies to events since the introduction of the Bill and stakeholders may therefore have some degree of “warning”, as a general principle, we do not believe that legislation should have retrospective effect.

The policy justification prescribed for call-in notifications seems unclear. The five-year limit is onerous and subjects potentially-relevant events to a long risk of recall, which may ultimately render the UK an unattractive jurisdiction for deployment of FDI.

We consider that the test for ascertaining knowledge on the part of the Secretary of State under 2(4) must be an objective one. In the context of competition, a test is applied which is based on publicity in the press or trade press. We also note that cases, for example relating to changes in board members of a particular nationality, are likely to remain relatively low-profile and would not normally be publicised other than by way of updates to the Companies House registers. Similar considerations will apply in this context.

Sectors of the economy to be included

We welcome the requirement for the Secretary of State to review the statement about exercise of call-in power under clause 3. In particular, understanding of sectors in the economy that are more likely to give rise to national security risks may evolve over time. The COVID 19 pandemic itself is a good example of this as the role of healthcare companies – from testing laboratories to PPE suppliers – in protecting national security has been highlighted. However, five years seems a significant long-stop for review of a published Section 3 statement, particularly in the current economic climate, where the UK's FDI appetite may need to be more dynamic. We welcome the requirement under clause 4 that the Secretary of State must consult with stakeholders at as part of the statement review.

We note that the “sectors” to which the mandatory reporting regime will apply are currently being consulted upon³ with a proposed list of 17 sectors as follows: Advanced Materials; Advanced Robotics; Artificial Intelligence; Civil Nuclear; Communications; Computing Hardware; Critical Suppliers to Government; Critical Suppliers to the Emergency Services; Cryptographic Authentication; Data Infrastructure; Defence; Energy; Engineering Biology; Military and Dual Use; Quantum Technologies; Satellite and Space Technologies; Transport. The final list will need a lot of delineation if acquirers are to have certainty as to whether the business does or does not fall within the sector in less clear-cut cases - see importance of clarity above. We are currently considering the sector consultation document.

Notifiable acquisitions

Clause 6(3) includes the words “would be impossible for the person within subsection (2)”. We do not think it is clear in which circumstances such notification would be regarded as being “impossible” within clause 6(3). It is presumably distinct from illegality, breach of contract or ignorance but further detail on the scenarios envisaged would be helpful.

We note that the regime as currently drafted may not adequately take account of investment management. Earlier in the year Japan introduced a 1% threshold for foreign investment screening and the investment industry successfully argued for a blanket exemption for portfolio investment, reflecting the way the industry operates. It may be that some variety of carve-out should be considered in a UK context to recognise market practice: this might be formulated to mirror the threshold for triggering a mandatory offer under the takeover code.

Qualifying entities and assets

The definition of “qualifying asset” is potentially extremely broad. This poses a risk that everything will be caught and therefore nothing will be effectively caught because the Office for Investment will not have the capacity timeously to approve the requisite number of transaction requests and will be unable to operate an effective enforcement regime, unless it is given sufficient funding.

Furthermore, because there is no link between “qualifying entities” and “qualifying assets”, every asset falls to be a qualifying asset. The current wording means that a trigger event occurs on any purchase, however small, which has given (or may give) rise to a risk to national security, unless acquired in an individual’s

³ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935774/nsi-consultation.pdf

personal capacity. We recognise that in terms of national security a de minimis rule relating to value of assets transferred would often fail to achieve the relevant policy objective.

We are concerned that the use of “may” could open the space to state overreach – if the state concludes that a person *may* be planning an activity which triggers a risk to national security (even without robust supporting evidence), then almost anything purchased could conceivably be employed in a plan to attack national security – eg purchasing a number of office computers, cameras, drones or HDMI cables. As such, it could provide a civil method for the state to, unchecked, freeze out transactions of certain people in addition to the intention to regulate transactions that are of a certain national importance. Again, there are dangers of the legislation therefore proving so wide as to be effectively unenforceable.

Intellectual property

Under clause 7(4), we note that the definition of assets has been expanded since the previous consultation and now includes moveable property, including intangible moveable property in the form of intellectual property (IP). However, the expression “intellectual property” is not used; we consider it ought to be expressly mentioned. At the same time, we note that UK IP law does not protect ideas – it protects the expression of the idea. Many of the examples from (5) would result in copyright protection – but for copyright to apply, there is a specific requirement for the work to be fixated (rather than in the more abstract form of an ‘idea’). If the intention is to provide protection for subject matter that extends beyond the traditional definitions of intellectual property, as appears to be the case from the current wording of the clause, adopting a definition of “ideas” akin to that of “know how” from Commission Regulation 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices may be more effective.⁴

“(g) ‘know-how’ means a package of non-patented practical information, resulting from experience and testing by the supplier, which is secret, substantial and identified: in this context, ‘secret’ means that the know-how is not generally known or easily accessible; ‘substantial’ means that the know-how is significant and useful to the buyer for the use, sale or resale of the contract goods or services; ‘identified’ means that the know-how is described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality;”

Furthermore, intellectual quasi-property in the form of a “trade secret” could be lost simply by being disclosed (eg as part of a due diligence process) without being formally or legally transferred. Indeed, the real damage could be done by engineering a failed acquisition involving a detailed due diligence procedure. This commercial reality should be addressed in the legislation

⁴ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:102:0001:0007:EN:PDF>

Extraterritorial effect

A broader definition of nexus with the UK seems appropriate in the context of national security. However, we are concerned that the extraterritorial application of 7(3) is likely to have a practically unworkable and potentially inappropriate level of extraterritorial application. The feasibility issues around monitoring of foreign entities and enforceability suggest that this provision may merit further consideration. The same comments apply in relation to clause 52. We also note that requiring extraterritorial acquisitions and transactions to be notified will also mean a higher number of transactions are reported.

Assessing control

A notifiable acquisition takes place when (1) a person gains control of a qualifying entity of a specified description (i.e. specified by the Secretary of State) by virtue of one or more of the cases described in Section 8 of the Bill or (2) a person acquires a right or interest in a qualifying entity of a specified description and as a result the percentage of the shares or voting rights that the person holds in the entity increases from less than 15% to 15% or more. The 15% share threshold ties in with assessment of material influence under the competition regime.

In clause 8(1) 'control' seems to be framed in very wide terms (including the 'fourth case' under s.8(8)). This might not necessarily be problematic however much will depend upon the Section 3 statements and notification publications issued under the legislation. For example, in exigent circumstances (eg financial crisis, pandemic or other black swan event), call-in or notification may prevent or deter urgent investment and restructuring efforts. Without detailed policy guidance or regulation, the draft legislation might prevent even a conditional sale and purchase agreement (SPA) (subject to regulatory approval) of an in-scope enterprise from being concluded to avert failure.

We note that the 25%, 50% and 75% shareholding/voting thresholds correspond to those which are applied in the context of the People with Significant Control (PSC) regime and reflect increasing levels of control in the same way as the competition regime. This appears to be broadly sensible as the level of risk may rise in tandem with the level of control exercised over a company and it accordingly makes sense to review acquisitions when each of these levels is reached.

Issues with Scots law of securities

Section 8 sets out four cases in which a person can gain control of a qualifying entity. These are tied to specific trigger thresholds at the 25%, 50% and 75% marks in terms of acquisitions of shareholdings and voting rights. The third case is where the acquisition is of voting rights in the entity that (whether alone or together with other voting rights held by the person) enable the person to secure or prevent the passage of any class of resolution governing the affairs of the entity. The fourth case is where the acquisition, whether

alone or together with other interests or rights held by the person, enables the person materially to influence the policy of the entity.

Section 8 includes provisions adapting the above scenarios to cater for entities that do not have a share capital (eg partnerships). Section 8 has to be read alongside Schedule 1, which provides for particular cases in which a person is to be treated for the purposes of the Bill as holding an interest or right. In particular, paragraph 7 of Schedule 1 states that:

"Rights attached to shares held by way of security provided by a person are to be treated as held by that person:

- (a) where apart from the right to exercise them for the purpose of preserving the value of the security, or of realising it, the rights are exercisable only in accordance with that person's instructions, and*
- (b) where the shares are held in connection with the granting of loans as part of normal business activities and apart from the right to exercise them for the purpose of preserving the value of the security, or of realising it, the rights are exercisable only in that person's interests."*

The issue here is that this carve out does not extend to the situation where a lender holds shares in security, as is the case with a legal mortgage over shares (England and Wales) or a shares pledge (Scotland). Where the shares in an entity are transferred in security to a lender, that lender may find that it has (1) gained control of the entity under scenario 1 notwithstanding that, under the terms of the security, actual control remains with the security provider, eg through the voting rights being exercisable only in accordance with the security provider's instructions (as envisaged by paragraph 7 in Schedule 1) and (2) triggered the second limb of the notifiable acquisition test.

Given that a notifiable acquisition that is completed without the approval of the Secretary of State is void, paragraph 7 of Schedule 1 should be extended to cater for the situation where shares are held in security by a lender. Paragraph 7 should similarly be extended to carve out security over qualifying assets since a security could be read as giving the security holder rights equivalent to those set out in Section 9. We therefore consider it would be helpful to include an express carve-out that nothing here is triggered by the act of holding any asset in security, where the party taking security does not factually exercise control.

Mandatory reporting

Clause 13 states that where a notifiable acquisition takes place without the approval of the Secretary of State, this transaction will be "void", although under clause 15(2) and (3), the defect can be cured retrospectively. We are concerned that this could leave a lacuna, eg for transactions where there was no title to transfer at the point of a further sale to a third party. Although it appears the third party would have an action under clause 16, this is perhaps unnecessarily complicated and we consider that a drafting solution could be found to ensure that such third party issues are also avoided.

Decisions and transparency of decision-making

There are a range of options for safeguards which might be applied and it is expected that these will be the default position rather than preventing acquisitions taking place. This is to be welcomed in the interests of facilitating and encouraging foreign investment.

The Bill does not indicate that there will be any kind of formal publication process. While the sensitive nature of national security may require a degree of confidentiality, greater levels of transparency are important in allowing investors to assess likely levels of their own commercial risk in choosing to pursue investment opportunities. Precedent is as important for those transactions that are called in and/or ultimately approved as for those to which safeguards are applied or are ultimately prohibited or retrospectively reversed. We also note that this lack of transparency may raise issues in terms of access to justice and transparency within review processes.

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