KEY POINTS
- The National Security and Investment Act 2020 may affect acquisition financings, security arrangements (whether or relating to an acquisition) and related legal opinions.
- The application of the Act and related guidance to secured creditors has prompted some debate among practitioners.
- A key question is whether equitable mortgages and charges over in-scope shares are capable of triggering the mandatory notification upon creation, or, as the government intends, only when the security is enforced.

Feature

Author Kathrine Meloni

The National Security and Investment Act 2021 revisited: when are secured creditors obliged to make mandatory notifications?

The National Security and Investment Act 2021 (NSIA or the Act) is a complex and wide-ranging piece of legislation with the potential to impact many acquisitions and other corporate transactions. It empowers the Secretary of State for Business, Energy and Industrial Strategy (the Secretary of State) to review and where appropriate, intervene in investments in qualifying entities and assets that have given, or may give rise to a risk to national security. Since the NSIA came into force at the beginning of 2022, its practical implications have inevitably come to the fore. This includes how the Act's mandatory pre-notification requirements apply to creditors taking security over shares in entities operating in qualifying sectors of the economy. While the government's intent seems clear in terms of when the NSIA will impact secured creditors, the text of the Act itself and related guidance have resulted in some questions among practitioners.

The Secretary of State's review of a relevant investment under the Act can be initiated in three ways:

- **Call-in notification**: the Secretary of State issues a "call-in" notice to the parties.
- **Voluntary notification**: one or more of the parties (the investor(s), the seller or the target) voluntarily decides to give notice of the investment to the Secretary of State.
- **Mandatory notification**: in certain circumstances, investor(s) are required by the Act to seek approval from the Secretary of State before completing an investment.

The Secretary of State's call-in power is widely cast. It applies to transactions involving UK and foreign investors, and can apply to foreign entities as well as UK entities, if the former have sufficient nexus to the UK. It is not limited to a particular sector of the economy, rather turning on the existence of a "trigger event" (broadly, a change of control within the meaning of the Act) in relation to a "qualifying entity" or "qualifying assets".

The voluntary notification regime applies in the same circumstances as the call-in power. Its purpose is to assist parties who wish to be certain that the investment/transaction will not be the subject of a call-in notice. If the Secretary of State confirms in response to a voluntary notification that no further action will be taken under the Act in relation to the relevant investment, this is known under the Act as "validation".

The mandatory notification requirement applies to a narrower range of investments than are subject to the call-in power. Mandatory notification is required only where an acquirer "gains control" of a "qualifying entity". Further, the qualifying entity must operate in a sector of the economy specified in the NSIA (Notifiable Acquisition) (Specification of Qualifying Entities) Regulations 2021 (the "Notifiable Acquisition Regulations"). The consequences of failure to comply with the mandatory notification requirement are serious. The investment is void and criminal and monetary penalties apply.

An investment, for the purposes of the NSIA, extends some way beyond a simple acquisition of shares or assets. While the issue of most loans and bonds should not give rise to notification requirements or the exercise of call-in powers under the Act, the Act may nonetheless have an effect on: (i) the structure and terms of acquisition financing; (ii) security arrangements and documentation (whether or not entered into in the context of an acquisition); and (iii) any related legal opinions.

The nature and scope of each of the government's powers under the NSIA and the various implications of those powers for financing and restructuring transactions have been discussed in previous articles in this journal. This article considers a specific aspect of the NSIA which is currently attracting attention in relevant financings: the application of the mandatory notification obligation to creditors taking security over shares in an in-scope entity.

"NOTIFIABLE ACQUISITIONS"

The mandatory notification regime becomes relevant when an acquirer gains "control" of a "qualifying entity" and the entity undertakes activities in an area of the economy identified in the Notifiable Acquisition Regulations.

A "qualifying entity" is any entity that is not an individual, so includes a company, LLP, any other body corporate, a partnership, unincorporated association and a trust (s 7(1)). If the entity is not formed under the laws of the UK, it must carry on activities in the UK or supply goods or services to persons in the UK to be in-scope (s 7(2)). The mandatory notification regime does not apply to acquisitions of "qualifying assets", although the government has reserved a secondary legislative power to expand the scope to include assets at a later date.

The Notifiable Acquisition Regulations specify seventeen areas (the "17 specified areas") which the government considers of particular risk to national security: Advanced Materials, Advanced Robotics, Artificial Intelligence, Civil Nuclear, Communications, Computing Hardware, Critical Suppliers to Government, Cryptographic Authentication, Data Infrastructure, Defence, Energy, Military and Dual-Use, Quantum Technologies, Satellite and Space Technologies, Suppliers to the Emergency Services, Synthetic Biology and Transport. The Schedule to the Regulations describes each in more detail.

Acquisitions that fulfil these conditions ("notifiable acquisitions") require the acquirer to seek the approval of the Secretary of State *before* the acquirer gains "control". The only exception to this requirement applies where complying with the requirement to give mandatory notice would be "impossible" for the acquirer (s 6(3)).

The Secretary of State must as soon as practicable notify the submitter whether the notification is accepted or rejected. Acceptance triggers a 30-working day review period, which will result in approval (no further action) or a call-in notice.

A notice may be rejected because it is not needed, ie it does not meet the criteria for a notifiable acquisition under the Act (s 14). It may also be rejected as containing insufficient information, in which case, a further submission will be needed.

A notifiable acquisition that is completed without the approval of the Secretary of State is void (s 13(1)) and carries criminal and significant monetary penalties. The maximum fixed penalty for a business is the higher of 5% of turnover and £10m and daily penalties may also be imposed.

If a mandatory notification is not made when required, the Act includes a process for retrospective validation, which, if cleared by the Secretary of State, will mean that the investment is treated as if it were valid at inception.

MEANING OF "CONTROL"

Section 8(1) of the Act is the starting point for determining whether a person has gained "control" of an entity. It provides as follows:

> "… a person gains control of a qualifying entity if the person acquires a right or interest in, or in relation to, the entity and as a result one or more of the cases described in this section arises."

The "cases described in this section" which are relevant for the purposes of determining whether the transaction is a notifiable acquisition are:

- An increase in the percentage of shares in the entity held by that person to more than 25%, more than 50% or more than 75% (s 8(2)). (Equivalent tests are provided for entities without a share capital and LLPs.)
- An increase in the percentage of voting rights in the entity held by that person to more than 25%, more than 50% or more than 75% (s 8(5)).
- The acquisition of voting rights in the entity that enable the holder to control the passage of any resolution governing the affairs of the entity (s 8(6)).

The control tests for entities in s 8 must be applied in conjunction with s 10 and Sch 1. These provisions address particular cases where a person is (or is not) to be treated as "holding a right or interest" under s 8(1). Cases addressed in Sch 1 include the treatment of jointly held interests, holdings through chains of companies ("indirectly held" interests), nominee arrangements and certain security arrangements.

GOVERNMENT'S POLICY INTENT

The ability confidently to identify when the notification obligation is triggered is critical from the perspective of the secured creditor, given failure to notify the Secretary of State where required, among other undesirable consequences, renders the security arrangement void. A key question is whether the security arrangement becomes a notifiable acquisition when granted, or only on enforcement (or at the point the lenders take control of the security asset, ie at the point it is capable of being enforced). The text of the Act on this point, is not straightforward. Some practitioners have expressed concern that it does not spell out the government's policy intent as clearly as it could.

The government's policy intent, in terms of when the Act should determine that "control" of relevant shares has passed to a security-taker, appears to have been nuanced. In summary, it depends on whether or not the nature of the security arrangement involves the security-taker being registered as a shareholder. If the security-taker is a shareholder, the acquisition *will* be notifiable notwithstanding that the security-taker does not (according to the terms of the security arrangement) control the voting rights attached to the shares. If the security-taker is not a shareholder, whether a notifiable acquisition occurs depends on when the security-taker acquires voting control, which will normally be the case only when the security becomes enforceable.

This may seem slightly surprising (and makes the Act more cumbersome to navigate for security takers), but does appear to be a deliberate policy choice. The government's intention that an acquisition of control takes place only when lenders exercise their enforcement rights over share collateral is apparent in the government's July 2018 White Paper that preceded the NSIA Bill, its Draft Statement of Policy Intent of March 2021, the s 3 statement and is also apparent in the Guidance relating to the Act. The fact that that intent would not hold in relation to all types of security (ie where the security-taker becomes a shareholder) was spotted and discussed at some length during the passage of the Bill.

English law legal mortgages and Scots law pledges are examples of security interests that involve the security-taker becoming a shareholder. English law legal mortgages, however, are relatively unusual. Most English law share security is created by way of equitable mortgage or charge. These methods (which are not available in Scotland) confer an interest on the security-taker in the charged asset, but do not involve the security-taker being registered as the legal owner of the shares (in other words, the shareholder) when the security is granted.

The Lords' debate on these provisions of the Bill was therefore heavily focussed on the implications for Scots law share pledges, amid concerns that the Act would have an inequitable impact on Scottish law security compared to English law security. This prompted the proposal of amendments that purported to remove security arrangements from the scope of the mandatory notification regime altogether. These were, however, withdrawn. Subsequently, amendments were proposed that aimed to treat registered title security such as Scots law pledges in the same way as English law equitable mortgages and charges. These also failed.

The government, while sympathetic to the Scots cause, argued that security arrangements involving the holding of shares must be in-scope (ie they must be notifiable acquisitions) as an anti-avoidance provision:

"[It is] needed because it will prevent hostile actors artificially structuring acquisitions in the form of loans which, following a swift and convenient default—let us put it that way—might otherwise allow them to evade scrutiny."[1]

"The Government have reflected carefully on the issue, but we continue to believe that an exclusion would not be appropriate in this case. In such circumstances, the legal title to shares will, as a matter of fact, have been acquired by the lender, and it is important that we do not inadvertently create a loophole that those who wish us harm might otherwise seek to exploit."[2]

Lord Callanan did note however, that the government would keep these provisions under review:

"… both my noble friend Lord Grimstone and I have committed to monitoring the operation of the regime in practice with regard to this issue. Clause 6 provides the Secretary of State with the power to make 'notifiable acquisition regulations' to amend the scope of the mandatory regime. That could be used in future, if considered appropriate, to exclude circumstances related to acquisitions by way of security from the mandatory notification regime."[3]

The upshot of this intent is that security-takers may be subject to different obligations and implications under the Act depending on the type and terms of the security taken.

Whether the Act adequately reflects the policy intent and the reasons behind some of the concerns are outlined below. For simplicity, the discussion references the application of the Act to creditors taking security over shares in a "qualifying entity" only, which will be the relevant collateral in the vast majority of affected financings. How the Act applies to security over other types of qualifying entity, eg LLPs, will also need to be considered in relevant cases.

SECURITY-TAKERS AND VOTING CONTROL

The control tests in ss 8(5) and 8(6) of the Act refer to control of the voting rights attached to shares. If a security-taker controls the voting rights attached to the charged shares in excess of the thresholds in s 8(5) and 8(6), a security arrangement could be a notifiable acquisition. These limbs of s 8 are more straightforward to analyse than the s 8(2) shareholding test in the context of security arrangements. This is largely because of the assistance of the supplemental interpretation provisions in para 7 of Sch 1, which reflect how many security arrangements (certainly those governed by English law) are already set up.

Security-takers normally seek to avoid voting control when security is granted, not least because the acquisition of voting control can result in the security asset becoming a subsidiary of the security-taker. As a matter of English law, this can be avoided by granting the security on terms that are consistent with the provisions of the Companies Act 2006 (CA06).

Section 1159(1) of the CA06 provides that a "company" is a "subsidiary" of another company if that other company "(a) holds a majority of the voting rights in it; (b) is a member of it and has the right to appoint or remove a majority of its board of directors; or (c) is a member of it and controls alone, pursuant to an agreement with other shareholders or members, a majority of voting rights in it …". Paragraph 7 of Sch 6 to the CA06 expands on s 1159 to make clear that rights attached to shares held by way of security shall be treated as held by the person providing the security if such rights are exercisable by the security-taker only in accordance with the security-provider's instructions apart from the right to exercise them for the purpose of preserving the value of the security, or of realising it.

The NSIA does not expressly apply the CA subsidiarisation test in a manner that might put the question beyond doubt, but para 7 of Sch 1 of the Act closely tracks the equivalent clarificatory wording in Sch 6 to the CA06:

"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."

On the basis that a court would interpret that to apply the CA06 subsidiarisation test, s 8(5) and s 8(6) should only be engaged on the grant of security in quite unusual circumstances, certainly where the security arrangement is created under English law.

SECURITY-TAKERS AS SHAREHOLDERS: S8(2)

The control test in s 8(2) of the Act raises more questions in the context of security arrangements. It captures shareholders, referring to an increase in the percentage of shares in the qualifying entity "held" by an acquirer.

A statutory reference to a "holder" of shares is perhaps most obviously construed as reference to a member of the company, in other words, the registered owner of the relevant shares. This is the construction that has been consistently applied to such references in the Companies Acts, where the question has most commonly come before the courts.[4] The terms of s 8(2) do not make any distinction between holders of shares in the ordinary sense, and holders by way of security. Accordingly (provided the percentage thresholds in s 8(2) are satisfied, which will typically be the case), the creation of an English law legal mortgage would seem to qualify as a notifiable acquisition, as would a Scots law share pledge.

Share security tends to be created under the law of the entity whose shares are the subject of the security. As qualifying entities for the purposes of the NSIA do not need to be UK entities, forms of security governed by the laws of other jurisdictions that involve a transfer of legal title to the shares to the security-taker may also be caught.

Section 8(2) does not specify how the term "held" should be construed in the context of the relevant shares, ie whether it is intended to capture only registered shareholders. The government may not have considered further definition necessary.
As already noted, Sch 1 to the Act purports to clarify a range of circumstances where there might otherwise be uncertainty as to whether

Feature

Biog box

Kathrine Meloni is a Special Adviser at Slaughter and May, in London.
Email: kathrine.meloni@slaughterandmay.com

the control tests are satisfied. In certain instances where a party or parties are to be treated as having gained control in the absence of registered title (for example, nominee arrangements), this is addressed specifically. Given the reference in that Schedule to voting rights in the hands of security-takers, security arrangements were very much in the draftsman's mind, so if the word "held" in this context were to be interpreted expansively to extend to the holder of (for example), an English law charge, that would be surprising.

Any broader construction of the word "held" in s 8(2) as extending beyond registered holders of shares is certainly at odds with the policy intent that was clearly evident from the Hansard discussion that preceded the Act and referenced above. However, in the absence of any specification of the meaning of "held" for this purpose, some practitioners have raised concerns that a court could deviate from the apparent policy intent.

IS THE ACT SUFFICIENTLY CLEAR IN ITS APPLICATION TO SECURITY ARRANGEMENTS?

The concerns with regard to the construction of s 8(2) are grounded in a difference between the wording of s 8(1) and para 7 of Sch 1. The starting point for the control test in s 8(1) bites on the acquisition of a "right or interest". However, the exclusion for security arrangements in para 7 of Sch 1 refers only to "rights", as do certain other clarificatory provisions in para 6 of Sch 1 of the Act (which themselves have been suggested by some to muddy the waters in interpreting para 7). On the grant of *any* form of English law security, regardless of whether it acquires rights, the security-taker acquires an interest in the security assets.

The government's view is that the acquisition of a security interest falling short of the transfer of legal title to the shares (eg by way of charge) does not, of itself bring security arrangements as described within para 7, within the scope of the mandatory notification requirements. This requires s 8(1) to be read as two conditions, both of which must be satisfied for the mandatory notification regime to be engaged: there must be an acquisition of a right or interest in the shares *and* that acquisition must give rise to a shareholding or voting control (ie one of the cases in ss 8(2), (5) or (6)).

All English law security interests (and no doubt most other security interests) will confer on the security-taker a *right* in, or in relation to, an entity as well as an *interest*, thus satisfying the first hurdle under s 8(1). However, not all such interests will satisfy the second hurdle, ie that "one or more of the cases described in [section 8]" must result from the acquisition of that right or interest, which will depend whether the security-taker holds shares or controls voting rights in the entity in question.

The various sources referenced in this article indicate that the government believes the Act is sufficiently clear in its application to security arrangements. The "two hurdle" construction above would seem to accord with the legislative intent. However, given the severe consequences of failure to comply with the mandatory notification regime, any perceived lack of clarity is regrettable.

IN PRACTICE

In the context of an acquisition financing, the treatment of the acquisition under the Act will determine (and focus attention) on whether the Act is engaged (although not whether it is separately applicable) for the purposes of the financing arrangements. The legal risk is perhaps heightened (or at greater risk of being overlooked) in the context of "business as usual" secured financings extended to entities in one of the 17 specified sectors.

The discussion in this article focusses primarily on the application of the NSIA mandatory notification regime to UK law security. The analysis of foreign law security arrangements to determine whether the s 8 control tests are engaged may be more challenging. How the mandatory notification regime affects security-takers during the life of the security arrangement also prompts questions. For example, whether voting control is adequately deferred such that ss 8(5) and 8(6) are not engaged prematurely. In some instances, security documentation may provide that voting control passes to the security-taker automatically upon an applicable default, which if the security is within the scope of the Act, means lenders will need to monitor closely whether a notification has been triggered. Should such provisions be altered? Another question is whether a notifiable acquisition can occur as participations in secured loans or bonds are traded, particularly where the underlying security interest is of a form (such as a legal mortgage) which requires notification under the Act. This point is not addressed specifically in the Act.

The application of the NSIA mandatory notification regime to security over shares – even if limited as the government intends – adds an additional layer of legal risk assessment to secured financings, where in each case, the application of the Act will need to be analysed to determine whether and when a notification obligation arises. Holders of security over shares in qualifying entities in sectors within the scope of the mandatory notification regime are currently looking very carefully at the implications of the NSIA, both in terms of holding the security and in the context of enforcement. It is to be hoped that the government fulfils its promise to keep these aspects of the Act under similarly close review to ensure that the practical implications and/or uncertainties do not inhibit transactions or access to finance, in accordance with its stated intentions. ■

1 Lords Hansard 9 March 2021, Lord Grimstone of Boscobel at Column 647GC.

2 Lords Hansard 15 April 2021, Lord Callanan at Column 1480.

3 Lords Hansard 15 April 2021, Lord Callanan at Column 1481.

4 See, eg *Eckerle v Wickeder Westfahlensahl GmbHD* 2013 EWHC 68 (Ch).

Further Reading:

- Calling it in: the implications of the new National Security and Investment Act 2021 on financing transactions (2021) 9 JIBFL 616.
- The UK's proposed foreign investment regime: a new consideration in transaction planning (2018) 10 JIBFL 636.
- LexisPSL: Banking & Finance: Practice Note: The National Security and Investment Act – implications for finance transactions.