Nadhim Zahawi
Minister for Industry
(Department for Business, Energy and Industrial Strategy)

Lord Grimstone
Minister for Investment
(Department for International Trade; Department for Business, Energy and Industrial Strategy)

By e-mail: minister.zahawi@beis.gov.uk, grimstone@trade.gov.uk
cc: Andy.OrmerodCloke@beis.gov.uk

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Dear Mr. Zahawi and Lord Grimstone,

Re: BVCA submissions on the National Security and Investment Bill (the "Bill")

Thank you kindly for inviting the BVCA to join the roundtable on the Bill, held on 13 November. This letter sets out our further comments, as requested. By way of reminder, the BVCA is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Between 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology, the majority of which were SMEs. Companies backed by PE/VC currently employ around 972,000 people in the UK.

As outlined in previous submissions[1], the BVCA supports, in principle, the measures being introduced in this Bill to protect the UK's national security interests. We consider that, if calibrated correctly, the new rules should be helpful in ensuring the UK remains an attractive location for investment and conducting business. However, the Bill must strike a balance between protection of genuine areas of critical national security interest on one hand, and raising unnecessary hurdles for foreign investment in UK infrastructure and businesses on the other.

Feedback from a range of our member firms is clear that, in the absence of sufficient clarity, a large number of transactions will be notified voluntarily and a huge number will be notified as mandatory notifications in the absence of clear guidance as to what is outside the scope of the mandatory regime. The potential for a flood of notifications relating to transactions constituting no threat to national security (which could mask transactions that actually pose a threat) and damaging interruptions to inward investment is high. Clarity, transparency, precision, and proportionality are key.

We are particularly concerned about the impact of the new framework on venture capital funding for innovative UK-based start-ups in high-tech sectors like quantum technologies, engineering biology, artificial intelligence and others. This kind of investment depends on speed of execution (often much less than 30 days from proposal to completion) and low transaction costs that correspond to the much smaller investment size than is typical in M&A (so the costs associated with the national security due diligence and filing process will have a much bigger impact on the viability of an investment, relative to

[1] We have responded to previous consultations relating to the Bill, including the 2017 Green Paper (Chapter 7 and Chapter 8) and the 2018 White Paper.

larger transactions). The UK has the biggest VC industry in Europe largely because global entrepreneurs see an ecosystem that helps their businesses access capital quickly and efficiently, allowing them to meet their growth ambitions.

The proposals in the Bill have the potential to delay and increase the cost of transactions in this space to the extent that they will reduce the appeal of the UK as a base for international early-stage innovators, whose start-ups are much more mobile than more firmly established businesses, at a time when other jurisdictions are introducing policies that explicitly seek to attract these people to contribute to their national economies. For this reason, the Bill in its current form cuts directly across BEIS' policy goals under other proposals, such as December's consultation on restricting non-compete clauses, which aims to "unleash innovation, create new jobs… increase competition… [and] maximise opportunities for individuals to start new businesses… to drive the economic recovery".

In short, the UK has a lot to lose, quickly, and the Government needs to tread very carefully to avoid damaging this country's reputation as Europe's premier destination for innovative and ambitious start-ups, which, once tarnished, will be difficult to restore. This is particularly the case as the world moves to remote working which means the choice of jurisdiction to establish a start-up is even more global.

These concerns underpin many of our suggestions below:

1. Trigger events

- We strongly support the call-in trigger's focus on clear tests of shareholding and parties that obtain "material influence" over the entities or assets in question from the Enterprise Act 2002, which properly focuses on control and influence (as distinct from the PSC regime, which is focused on beneficial ownership as much as on influence). This test will foster much greater certainty and reduce the need for unnecessary notification of transactions, as the Enterprise Act 2002 and its related body of law are well understood by advisers and the market.

- While we understand the rationale for stating that a personal block on a shareholder resolution should constitute a trigger event, the extension to "any class of resolution" is too wide and would potentially catch holdings that cannot put the acquirer in a position to threaten national security. For instance, in venture transactions it is typical for each investment round to have a separate class of shares (Series A shares, Series B shares, etc). As a company law point, each class of shares will have a separate majority vote on any variation of the rights attaching to that class, and it may often be the case that an investor has a controlling majority of a single class (and is therefore able to block the passing of a resolution of that class) without meeting the other trigger tests. Such a class resolution would generally only be needed to approve a detrimental variation of the rights of that class, and so should not of itself constitute a trigger event. We would suggest the following as an alternative: "*The acquisition of voting rights by an individual investor [including any of its affiliates] that grants that investor the ability to enable or prevent the passage of an ordinary or special shareholder resolution governing the affairs of the entity.*"

3. Process, scope and resources

- We also welcome the plans for a confidential, informal process to engage with officials in relation to potential transactions at an early stage to enable parties to understand the potential risks of a transaction being called in. This is important given the inevitable imbalance of information relating to national security matters between the Government and transaction parties.

- Entities engaged in or contemplating M&A activity in the UK should also be able to consult with the Government generally in relation to their own acquirer and typical target risks, rather than just in relation to a particular transaction.

- We note there is provision for secondary legislation to exempt certain transactions and consider that:

    - Acquirers that are <u>funds managed by regulated fund managers</u> should be such an exempted category. This would encourage benign inward investment in the UK, give much greater certainty to our members, and avoid unnecessary or disproportionate vetting of firms that are already supervised by the FCA and equivalent regulators globally.

    - Businesses that have been vetted by and received funding from UK Government sources aimed at promoting innovation and growth in certain sectors should be deemed as presenting no target risk and therefore exempt from voluntary or mandatory notification. This, again, would be a proportionate approach consistent with the Government's aim of supporting innovative new business.

    - Businesses, particularly early-stage ventures, whose ownership structures conform to an approved set of criteria that appropriately limit control and information rights before and after the relevant transaction could also be granted a safe harbour exempting them from mandatory notification.

    - The UK should also consider an analogous framework to the Excepted Investor concept adopted by the CIFUS regime, whereby investors from certain key states fall under certain different provisions.

- It will be critical to ensure that the Investment Security Unit has sufficient, appropriately skilled resources to allow it to process both the confidential guidance requests and the inevitably high number of notifications it will receive, particularly in the early years of the regime. In particular, we consider that to validly identify whether businesses pose a threat to national security requires a detailed operational and technical understanding of those sectors, particularly in areas such as technology and AI, where innovation is constant.

- It is also vital that the ISU has the appropriate senior links with relevant officials to provide decision-relevant insight from across Government and that the ISU itself be staffed with enough senior decision-makers to allow the notification process to run smoothly and efficiently, and for decisions to be reached as quickly as possible. As noted above, this is particularly important for venture transactions.

- Notifiable acquisitions that are completed without the approval of the Secretary of State should be voidable at the discretion of the Secretary of State, rather than automatically void. This would provide an extra layer of protection and a clear point at which a completed transaction is void.

- The extra-territorial nature of the Bill makes the UK proposals significantly more expansive than similar regimes in other jurisdictions, where the target entity typically must be registered in the relevant jurisdiction. To avoid the UK becoming an outlier in this regard, we believe that the new regime should only catch UK-registered targets or businesses with a significant UK presence. Our colleagues at the Europe-wide private equity and venture capital association, Invest Europe, are planning a separate submission to BEIS to provide the perspective of UK inbound acquirers of unlisted UK businesses, which may offer further comparisons with FDI screening regimes (those of EU jurisdictions).

4. Definitions of key sectors

- It is critical that the key sectors that are in scope of the mandatory regime are clearly and narrowly defined as those which are of material interest to national security. This aligns with the political aim of the legislation. The list provided is very broad and all encompassing. We will be responding to the consultation on these sector definitions, but would like to flag now that in order for this regime to focus solely on national security, and not on broader premises of public or national interest, these sectors must be precisely and narrowly defined. For example, "artificial intelligence" covers a huge range of increasingly ubiquitous yet innocuous applications (such as software designed to assist in due diligence processes or litigation management) that are likely to pose no national security risk.

- It becomes more problematic to identify whether there is a potential target risk the more removed the relevant entity is from the relevant sector, and it would be helpful to have a greater clarity on the extent of the supply chain that needs to be considered in examining a particular transaction. For example, suppose that Company A operates gas generator plants. Company B is the exclusive supplier of gas turbines to Company A. Company C is a critical supplier of turbine blades to Company B. Company D is the sole manufacturer of the specialist metal alloy used to make the turbine blades. Will Companies C and D be caught even though they are not directly critical suppliers to a core sector?

- Another example is "Energy" as a category – it should define precisely what energy networks are to be included. In addition, given small energy suppliers or parts of the energy supply chain are unlikely to pose any threat to national security of themselves, thresholds should be included (e.g. one million users/20 million barrels/5% of UK traffic) and a clear time period for measurement should be included, for example by reference to the last accounting period or an average over a number of years etc. This is also relevant to "Transport" as a category which could feasibly capture a major hub airport, a local logistics company.

- Critical suppliers to emergency services are Government-controlled and so we would expect that the Government's procurement processes, and any operational restrictions to be imposed by Government, should be sufficient to protect the national interest, and therefore consider that this should be narrowly drawn.

- Similarly, "dual use" as a category potentially brings into scope many businesses which manufacture or hold items which present no national security concern.

- The BVCA response to the consultation on secondary legislation to define the sectors subject to mandatory notification will provide further details on these points.

5. Proportionality and impact on venture capital funding

- One of our key concerns about the Bill is its potential impact on our members active in the emerging company and venture capital community. You will appreciate that venture capital funding of innovative new companies in technology and related industries is critical to the UK's business ecosystem. Early-stage investments of relatively small amounts in an expedited timeframe to fund key milestones during R&D phases is common amongst young businesses with strong growth potential. It is also critical to the effective commercialisation of innovative IP generated within the UK that seed and early-stage UK investors are able to secure further co-investors and syndication partners to continue funding promising businesses as they seek to scale up. The UK investor community does not have sufficient resources to achieve this alone, but the UK funding ecosystem currently compensates to some degree with its openness to foreign investment. This openness is especially important in persuading global (particularly US) specialist investors with considerable resources and expertise to venture away from their domestic markets and back the growth within the UK of exciting new businesses in sectors like health tech, life sciences and deep tech.

- Imposing a mandatory filing obligation in this context will have a significant impact on the timeframe for funding rounds, which is usually much less than 30 working days. Speed of execution is particularly critical here, as the targets are often fast growing but initially loss-making businesses that may fail if they cannot secure timely injections of further capital.

- In addition, the cost of preparing notifications may be prohibitive in the context of these investments, as national security due diligence and mandatory filings will represent a significant proportion of total transaction costs.

- The number of notifications should primarily be limited by ensuring a narrow scope to the mandatory regime. Where this is not possible and notifications have to be made in the genuine interests of national security, they must be dealt with rapidly and cheaply. Ideally using a simple, short template for initial screening purposes. Otherwise, the framework risks discouraging potential investors from investing in UK-based companies, and encouraging businesses to locate elsewhere.

- Were the development of high-tech innovations to shift out of the UK for these reasons, it strikes us that this loss of visibility would in itself be detrimental to national security.

- For these reasons, we would strongly recommend adding sector-specific 'de minimis' exclusions to the mandatory regime. These would best be designed on a sector-by-sector basis to reflect the scale of a particular business in its own sector context (in the absence of any monetary threshold).

- In addition would we would favour blanket: (i) acquirer-specific clearance of individual acceptable investors (where the investor is managed by a regulated fund manager); and (ii) target-specific clearance of acceptable businesses (e.g. those that have received funding from Government sources, as outlined above). These exceptions would be very useful in reducing the notification burden both on the investment community and the Government. Indeed, the work of the Future Fund (a Government-backed investment scheme) will be substantially undercut by making it materially harder for the companies the Future Fund has funded to raise additional venture capital. Attracting additional external investment is a key part of the construct of the Future Fund.

- Our members' experience with the somewhat analogous CFIUS regime provides the following initial observations regarding cost and timing issues from a venture capital perspective over the past two years in the US:

- Transaction costs have increased significantly. CFIUS diligence to determine if a voluntary or mandatory filing is required can consume up to 30% of the cost of legal diligence on a venture capital investment. Where filings are required, costs rise dramatically and can increase by a further $50,000 (even then, the advisers often have to write off much more, sometimes the same amount as billed) where mandatory filings are required. Some of these fees are sometimes written off by lawyers, resulting in losses, with the rest borne by investors and/or the company. The significant potential cost increase and uncertainty impacts the overall attractiveness of a transaction, with investors sometimes electing at the outset not to pursue investments where a filing may be required. The Government and ISU officials that are overseeing the process should also consider what procedural efficiencies they can implement to mitigate any potential risks of investors choosing not to pursue a transaction due to these costs (or the additional time that will be added to the investment timetable), which can disproportionally dwarf traditional transaction costs and timeframe.

- The regime has added otherwise unnecessary delays to the completion of transactions, causing uncertainty (see "Timing" below).

6. Timing

- In order to limit the impact on deal timelines and the potential for parties to use the rules strategically, we would welcome the removal of the current ability to "stop-the-clock" whilst information is gathered, as this gives rise to significant uncertainty. This is not an uncommon feature in regulatory regimes but there should be some guidance or limitation on the maximum period that might arise.

- In relation to the timing for assessment once a trigger event has been called in, we would recommend including a reasonable threshold, on the basis of clear and objective criteria, for any extension of the review beyond the initial 30 working day period, in order to reduce the risk and uncertainty to the transacting parties involved.

- We recommend that notified transactions should be deemed cleared where the acquirer has received no clearance nor extension decision from the Government within 30 days of notification. This will ease the burden on the ISU, prevent deals being held up due to lack of Government resource and provide certainty to parties that receive no decision within the timeframe.

7. Retrospective application

- We also believe that retrospective application is unfair to the vast majority of benign market participants and damaging to the UK's reputation for legal certainty and predictability, given the inherent uncertainty in the fact that the consultation on the mandatory sectors is ongoing and the Bill itself remains subject to parliamentary scrutiny and possible amendment. We recommend that the earliest date for the new rules to apply should be upon Royal Assent.

- The threat of retrospective application is also already providing evidence of the general dangers in the UK establishing too expansive and uncertain a regime. Our members are reporting that this threat is already causing a cooling effect in the marketplace. We are aware of a number of transactions that have stalled or been cancelled completely, with both international and UK based investors involved.

8. Proposed remedies

- In our view, remedy powers should only be available where "necessary to impose a remedy in order to prevent or mitigate a national security risk." We believe that it is important that the legislation should expressly state that the Secretary of State should only be able to block or unwind a transaction if no other remedy is reasonably available, and that (in relation to other remedies), the Secretary of State may only impose a remedy which, out of the possible remedies, is the least disruptive to the transaction parties while satisfying the national security concerns.

- The threat of criminal sanctions for individuals involved should be removed because it is both unnecessary (as it will not deter state-level hostile actors) and damaging (as it will fuel cautious notifications from innocent parties relating to transactions of little interest to the Government, as well as discouraging businesses from locating in the UK in the first place).

We would be very happy to discuss the contents of this letter with you further; please contact Tom Taylor (ttaylor@bvca.co.uk).

Yours sincerely,

Amy Mahon
Chair, BVCA Legal & Accounting Committee