THE INVESTMENT ASSOCIATION

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Dear Sir/Madam

RE: National Security & Investment Bill: Mandatory Notification Sectors

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

We appreciate the opportunity to respond to the Government's consultation on the sectors to be included within the scope of the 'mandatory notification regime' of the National Security & Investment Bill. We do not plan to respond to every question within the consultation, and will instead focus on those questions pertaining to the need to ensure an outcome that both safeguards national security while also minimising the burden on businesses and investors.

We support efforts to address national security issues and, in that context, for the Government to have an ability to scrutinise national security implications of certain business transactions. We look forward to working with the Government to ensure these reforms are implemented in a way that allows for UK markets to continue to function well, which will in turn help ensure the continued growth and prosperity of the UK economy.

While we support the intent of the Bill, there remain a number of areas which investors view with concern:

- The lack of a definition or firm guidance on what constitutes 'national security', which could allow for the power in this Bill to be used in a way not intended by its authors to target normal business, activity.

- The potential for normal portfolio management to be captured by the scope of the Bill, with a detrimental impact on investors.
- A lack of clarity around exactly what activities and sectors will ultimately be captured by the Bill, which could lead to activities not directly linked to national security being captured.
- A lack of clarity on how the Bill applies to non-UK companies that carry on activities in the UK or supply goods or services to persons in the UK.
- As a result of this lack of clarity, the possibility of businesses inadvertently failing to notify government of transactions later deemed to be within scope, leading to retrospective action causing severe business and reputational impact.
- The threshold of 25% at which, under the Bill, a person is deemed to have taken control of an entity is out of step with market norms, particularly the 30% threshold contained in the Takeover Code.
- The potential for a large number of notifications leading to delays in the government's intended timeline.

We will explore these points in more detail below.

As ever, we look forward to working with government constructively to find a solution that both safeguards national security and investor interests.

Consultation response

Sectors in Scope of the Mandatory Regime (Questions 1, 5)

Are the sector definitions sufficiently clear to enable investors and businesses to self-assess whether they must notify and receive approval for relevant transactions?

Do these definitions strike the right balance between safeguarding national security and minimising the burdens placed on businesses and investors? Is it possible to narrow the scope of the definitions without compromising national security?

The IA welcomes that the scope of the Bill is limited to questions of national security, rather than a wider public interest test. However, as long-term investors IA members have expressed strong concerns regarding a **lack of clarity** as to what activities and sectors will be within scope, particularly given the **lack of a definition of 'national security'** within the Bill. This lack of clarity could potentially lead to investors inadvertently failing to notify the Government of transactions later deemed to be within scope, leading to **costly retrospective action**. Ultimately, this has the potential to reduce political certainty and impact business and investor confidence in the UK.

The priority for our members is that there is clarity of scope and process should the proposals be implemented. This clarity will be to the benefit of the people making investment decisions, the companies involved in merger and acquisition activity, and Government Ministers and officials having to make judgments on national security grounds. Currently, however, there are concerns that these proposals are too loosely defined, or often not defined at all.

While the IA understands the reasons why the Government has selected the specific sectors referred to in the consultations, some of the definitions of these sectors remain broad. For example, and as noted within the consultation itself, 'engineering biology' covers a wide

range of activities and is not a sector where organisations specifically involved in defence and national security can be identified. As a result, it is possible that this whole range of activities could theoretically fall within scope. Furthermore, investors may not be able to determine whether a business is engaged in an activity in the specific sectors referred to in the consultations on the basis of public information alone. Without clear guidance from the Government or access to publicly available information to validate the Bill's application to organisations, this structure makes it difficult for members to determine whether an organisation falls within scope.

Additionally, the Bill is said to apply to entities outside the UK if they carry on activities in the UK or supply goods or services to persons in the UK, but does not clarify what level of contact with the UK is needed for such non-UK entities to be in scope.

Likewise, overseas companies may not want to invest in the UK if they may not be able to exit and be able to sell to overseas entities. They may choose other markets where they can exit much easier. This in turn may affect the Government's goal of attracting a larger number of listings in the UK.

These issues of clarity are exacerbated by the lack of a definition of 'national security' within the Bill. While the IA understands the Government's desire to retain flexibility on this issue, and welcomes the Government's statement that it intends to use these powers only to safeguard national defence and security, without a strict definition included in the legislation it is possible that future governments may seek to use its powers to intervene in transactions for short-term or domestic political reasons that run counter to their original intended use. Combined with the concerns raised about the broad sector definitions which could potentially bring into scope a wide range of activities, this lack of a definition greatly expands the number of organisations and activities which could be captured, further reducing the certainty of businesses and investors, and potentially impacting the UK business environment.

This lack of clarity as to the activities captured by the legislation is problematic not only because it potentially greatly expands the number of businesses subject to mandatory notification, but also because it could potentially lead to businesses inadvertently failing to notify government of transactions later deemed to be within scope, resulting in retrospective action being taken. This could ultimately lead both to significant financial costs and reputational damage for the organisation in question, along with penalties for any individuals involved, despite the organisation's best efforts to comply with the law.

Taken together, these factors will serve to make transactions more complex, time-consuming and costly, and reduce investor certainty in the outcome.

It is our fundamental role to help investors – both individuals and institutions – achieve their investment goals. That also means providing steady growth of investments over the long term and giving consideration to the material long-term risks facing each investee.

Low political risk is an important factor in the efficient functioning of capital markets. Perceived political risk can lead to portfolio managers pricing in that risk when making investment decisions, increasing the cost of raising capital. This pricing could have a particularly strong impact on smaller companies looking to raise scale up capital. There is ultimately a risk that this will deter investment at a time when the UK is seeking to expand its manufacturing and technology industries.

To address these issues, the IA recommends the regulation be fine-tuned so that:

- There is a strict definition of "national security", or at least firm guidance as to the factors considered. For example, we note that Australia's 2015 Foreign Investment Policy provides a non-exhaustive list of the factors that are typically considered when determining whether a transaction is considered a potential threat to national security.
- An internal cross-government group of officials is established, whose role is defined in the legislation, to provide advice to Government on what national security issues there might be and how these could be remedied. This advice should be published, with appropriate redactions. This cross-government group should include expert industry practitioners, to ensure industry is appropriately consulted and market participants are kept informed of the Government's bilateral and geopolitical priorities in an ongoing manner. The IA offers to support this process, whether individually or in coordination with other trade associations.
- Ministers can not require remedies which are not directly related to national security concerns, nor should they be able to require any remedies if the official group has not identified any national security issue.
- Greater clarity is provided as to the specific activities to be captured under the scope of the regulation. If possible, we ask that an exhaustive list of in-scope entities be provided.
- Investors will be able to determine whether an organisation is engaged in the specific activities to be captured under the scope of the regulation on the basis of public information alone.
- Greater clarity is provided as to the extraterritorial scope of the regulation.
- There is clarity as to what process would be required to alter the list of in-scope sectors and activities in future. Any such process should be accompanied by further consultation.
- Organisations are able to seek legally binding guidance from Government as to whether notification is required – we note that similar provisions exist under Australian legislation.
- The Bill should have an automatic review clause, where Ministers agree to review its impact on the market after a given time.

We welcome the commitment by BEIS to publish an annual review of the decisions it has taken, so that investors can better understand what deals are being called into question, and how risks are being assessed. This welcome transparency will both help reassure investors that there is a level playing field and help establish market norms.

Additional comments

Portfolio Investment

It is vital that this Bill provides **safeguards for normal portfolio investment activity**. It is important that a balance is struck between ensuring that the UK remains 'open-for-business' by ensuring that UK investment firms are protected as global investors while avoiding undue restrictions on client investment returns; while simultaneously ensuring that the government has the powers and flexibility it requires to protect national security.

Many of our members are global investment managers with client-bases worldwide and in the UK, and considerable UK operations and heritage. These reforms may have significant unintended consequences on the normal activities of global investment managers who

invest on behalf of underlying investors, if those investment managers fall into a mandatory notification scheme due to their global businesses.

Fund investment managers manage assets on behalf of clients, from small retail clients to large institutional investors. Fund managers are fiduciaries that have statutory and common law duties to act in the best interests of their underlying clients. Fund managers are also strongly regulated, both in the UK and by the regulators in their home jurisdictions. In fulfilling their duties, fund managers purchase and sell securities on a daily basis to comply with a fund's investment objective.

Additionally, many fund managers are portfolio investors or non-activist investors in that they do not seek to influence, control, or secure board positions of the companies in which they invest. Some fund managers may not even actively choose which companies to purchase because they manage index funds or replicated funds, which generally purchase and maintain positions in securities in approximate proportion to the security's representation in the fund's benchmark index or benchmark fund, respectively.

As a result, these reforms would impose a substantial cost and time burden on fund managers' daily operations. We note in particular that the notification and approval process would severely limit a fund manager's ability to buy and sell in accordance with the benchmark index or benchmark fund the fund tracks in a timely manner, particularly where a fund's holdings hovers around one of the thresholds – movement over one of these thresholds may happen regularly.

Accordingly, we would encourage the Government to consider those jurisdictions where governments have provided certain safeguards for portfolio investment – for example through offering blanket exemptions for registered investment management services providers, as in Japan – in order to focus on the entities that are more likely to be in need of examination.

If a portfolio investment exemption is not applied, we ask that the Government provide guidance to portfolio managers on whether indirect holdings (for example, if an asset manager owns a parent company that has subsidiaries that operate in a national security business sector) apply to the overall control test.

We support the suggestion made by the Minister for Business and Industry at committee stage of the National Security and Investment Bill that evidence "that acquisitions by institutional investors and pension funds are routinely being notified but very rarely remedied or even called in" could "build the case for using the powers in [clause 6] to make exemptions to the definition of a notifiable acquisition." We would welcome a commitment from the Government that a review of available evidence could take place in future, including a timetable for such a review.

Thresholds for notification

The Bill deems that a person gains control of a qualifying entity if they acquire an interest greater than 25% of votes or shares. **This conflicts with other market norms.** The IA considers that the Takeover Code definition of a change of control occurring at an interest of greater than 30% of votes or shares continues to be the one most widely used and understood by the market with regards to acquisitions.

Moreover, the change in threshold to 25%, operating in conjunction with the regulatory requirements of the Takeover Code, will result in companies having to file additional regulatory disclosures at multiple thresholds, as well as having to have additional monitoring conditions in place to identify when those thresholds are reached. This will require significantly increased resources, something which will particularly impact smaller firms.

As such, the IA recommends that the proposed threshold be raised to 30%, to bring it in line with the Takeover Code.

As noted in our comments in the previous section, index and replicated funds may move regularly across one of the thresholds, sometimes daily, as they buy and sell in line with their normal benchmark index and benchmark fund tracking activities. As a result, the notification and approval process would severely limit a fund manager's ability to buy and sell in accordance with the benchmark index or benchmark fund the fund tracks in a timely manner. We therefore reiterate our call for an exemption for normal portfolio investment activities.

Notification process

While the IA welcomes the well-defined timeline laid out for the notification process in the Bill, it remains concerned about the possibility for **delays in the review and decision process**.

While the Government has stated that it expects to impose conditions on very few transactions, it is likely that over a thousand notifications will be received, and between 75-90 trigger events called in. This number may be inflated as a result of a lack of clarity as to the mandatory notification regime (as described above in our answers to questions 1 and 5), with many businesses opting to self-notify to avoid any possible risk of retrospective action. We also note that the time limit will only begin from the point at which BEIS accept the notification, and in circumstances where BEIS receives a higher than expected number of notifications there may be delays beyond the defined timetable.

The IA asks that BEIS be provided with the significant numbers of highly skilled resources they will require to be able to accommodate these notifications in a thorough yet timely manner. It is important that there is sufficient number of skills to handle the volume of accommodations, and that they be appropriately skilled to avoid unnecessary minister referrals and requests for additional information, in order to avoid delays.

As noted above, to avoid a situation where businesses opt as a matter of course to self-notify to avoid a situation where they inadvertently fail to report under the mandatory notification regime, we ask that organisations be able to seek legally binding guidance from Government as to whether notification is required – we note that similar provisions exist under Australian legislation.

In addition, the IA asks that further guidance is provided on the self-notification process.

We welcome the opportunity to work with the Government to make sure that these measures are defined in such a way that they both protect national security and support effective markets, and would be delighted to discuss further any of the issues raised in our response.

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