

FDI Considerations For UK Venture Capital Transactions

By James Halstead, Katy Knight and Grace Kim (October 13, 2023, 3:18 PM BST)

Foreign direct investment, or FDI, considerations have come into focus in venture capital transactions in the U.K., following the introduction of the National Security and Investment Act 2021, or NSIA.

In July, the U.K. Cabinet office published the second NSIA annual report for the period running from April 2022 to March 2023 — the first to cover a full year since the NSIA came into force in January 2022.[1]

The report shows that during this period, investors from more than 50 jurisdictions have notified their planned investments — 866 notifications in total — in a range of sectors of the U.K. economy.

Parties looking to invest in companies active in the U.K. must now carefully consider whether their investment may trigger a mandatory notification requirement. This brings the U.K. in line with the growth in recent years of equivalent FDI regimes throughout Europe.

Here we discuss the impact of the NSIA on transactions, which can be significant and can shape not only the deal timeline but also the nature, structure, terms and conditions of the investment in question.

VC transactions in the life sciences and technology sectors might prove particularly likely to trigger a mandatory filing given that synthetic biology and artificial intelligence both fall within the specified sensitive sectors in the NSIA regime.

Overview of NSIA

Under the NSIA, an investor must make a mandatory filing to the U.K. government via the Investment Security Unit prior to completion of its investment if the investment meets certain conditions. There are two limbs which, if both are met, trigger a mandatory filing for a VC transaction:

- The level of the investor's control over the target company meets the relevant quantitative or qualitative control thresholds set out in the NSIA; and



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- The target company is active in any one of 17 specified sensitive sectors of the U.K. economy.

The NSIA has broad application. Unlike, for example, the U.S. Committee on Foreign Investment regime, the NSIA applies to foreign and domestic investors alike, provided the target company is active in the U.K.

An entity will be considered active in the U.K. if it has operations in the U.K., which could include selling products to, or generating revenue in, the U.K.

Condition 1: Control Threshold

Generally, the first condition will be met by an investor's ownership or voting rights crossing certain quantitative thresholds, being greater than 25%, greater than 50% or equal to or greater than 75% of either the voting rights or number of shares in the target company.

The control condition can also be met if the investor's investment does not exceed the 25% threshold, or does not cross one of the higher thresholds, but that investor acquires a veto or passing right over corporate decisions in respect of all, or substantially all, of the affairs of the target company.

In the context of a VC financing, this could mean that, where certain reserved matters that substantially affect the affairs of the target company cannot be undertaken without the consent of the investor, e.g., the ability of the target company to make strategic commercial decisions, including entering into contracts, the investor would be considered to have passed the control threshold, irrespective of its percentage of the voting rights.

Likewise, if an investor has the right to appoint a director who would control key strategic commercial decisions made at the board level, such investor may be deemed to have achieved control over the affairs of the target company, thereby meeting the control threshold.

Condition 2: 17 Specified Sensitive Sectors

The 17 sensitive sectors are defined broadly and include not only activities that appear directly related to national security, such as defense or military or dual use, but also synthetic biology, artificial intelligence, advanced robotics and transport.

VC firms looking to invest in key U.K. sectors such as technology and life sciences and health should carefully consider the activities of the target company and whether they could be caught by one or more of the sensitive sectors.

Sensitive Sectors in VC Transactions

Since the NSIA came into force, investors have had to navigate NSIA requirements and notification obligations in a range of sectors — and most notably in the key sectors of technology and life sciences and health.

In the case of investments in the life sciences and health sector, synthetic biology, and to a certain extent, artificial intelligence, activities appear to have been a particular focus when considering whether the investment could trigger a filing.

Technology spinouts from U.K. universities and early-stage life sciences companies often operate in the biotech space and undertake activities particularly susceptible to being caught under synthetic biology.

While investments in spinouts that undertake activities based on licenses from the university will not come into scope of the mandatory filing regime, they could still be subject to the NSIA call-in power.

Conversely, investments in spinouts that undertake sensitive activities without reliance on licenses could trigger mandatory filing obligations. Similarly, research into, development of, and production of goods, software or technology that use artificial intelligence also come into scope of the mandatory notification regime but only where the artificial intelligence is used for:

- Identification or tracking;
- Advanced robotics; or
- Cybersecurity.

That being said, these three applications are defined broadly, including, e.g., audio and speech recognition, autonomous vehicles, and digital twinning.

Exemptions

The NSIA regime sets out a number of exemptions to the mandatory filing requirement. This is intended to reflect the U.K. government's desire to ensure that the U.K. remains open for investment, particularly in cutting-edge life science technologies.

For example, a target's use of synthetic biology will not trigger a mandatory notification where such activities are limited to the ownership or development of human or veterinary medicines, and no harmful materials such as toxic chemicals are involved.

Also, gene therapy activities will not trigger a filing requirement where gene therapy is only used to replace missing or defective genes to restore phenotypes for therapeutic effect.

Sanctions for Failure to File

If a transaction triggers a mandatory notification requirement, failure to file prior to completion carries significant consequences. The investor and its management team could face criminal and civil sanctions, including a fine of up to 5% of the investor's worldwide turnover. In addition, the transaction in question would be rendered void ab initio.

Call-Ins and Voluntary Notification

Investments that do not trigger a mandatory notification can still be subject to the broad powers of the Investment Security Unit to initiate reviews of transactions where they may give rise to a risk to national security — the call-in power.

This call-in power can be exercised for up to five years after the transaction closes, which can be shortened to six months by making the unit aware of the transaction. Therefore, and depending on the risk profile of the deal, investors may prefer to submit a voluntary notification to obtain certainty around deal outcomes and timelines.

Other FDI Regimes

Where a target company has legal entities, operations, a presence, or any other type of nexus in another jurisdiction, which can, for some regimes, be established merely by sales activities, investors must also consider local FDI legislation in the affected countries.

Submitting notifications under different FDI screening regimes involves dealing with a range of review timelines and screening authorities and, in the case of the European Union, a cooperation mechanism involving communications among member states.

VC Considerations

Here we outline some of the key considerations that an investor and target company should take into account when undertaking a funding round.

Convertible Securities

It is not uncommon for early-stage companies to issue convertible securities, such as convertible loan notes, or enter into advanced subscription agreements or simple agreements for future equity — in particular where a valuation cannot be agreed or to bridge the target company until its next financing round.

It should be noted that, under the NSIA, the conversion of debt into equity and the allotment of shares under an advanced subscription agreement or a simple agreement for future equity — and, in limited circumstances, potentially also on grant of such rights — could trigger a notification requirement.

Syndication

Where a financing is syndicated, i.e., one or more investors is involved in the same funding round, and one investor triggers the notification requirement, all investors must wait until clearance has been obtained before they complete their investment.

Subsequent Tranches and Future Financing

It is generally accepted that an analysis of the target company's activities in the context of the NSIA is only required in VC transactions where an investor is considered to be acquiring either:

- 25% or more of the post-completion shareholding in the target company; or
- Control over key governance decisions.

However, under the NSIA, each new investment, including a subsequent tranche of an investment round, can amount to a separate trigger event. Consequently, investors must consider at each subsequent financing round, or tranche, whether a fresh notification requirement could be triggered. It is prudent to undertake the analysis at the time the initial financing is invested to avoid unexpected issues down the line.

Completing the Analysis

While the obligation to file falls on the investor, investors will expect the target company to undertake

the analysis into whether or not their activities could be caught by the NSIA or any other applicable FDI legislation, and if so, whether a filing, or filings, would be required.

The rationale is that the target company has a deep understanding of its activities and geographical reach and is, therefore, best placed to carry out the assessment. Therefore, investors now routinely raise questions in the due diligence phase to better understand the target company's activities and possible application of the NSIA regime or other FDI legislation applicable to the transaction.

Confirmation from the target company's legal counsel that the transaction will not be caught by the NSIA or any other applicable FDI legislation will provide investors with sufficient comfort in most transactions. In more complex cases, especially where ex-U.K. FDI legislation applies, the investor may require a memo from the target company's legal counsel as a closing deliverable that sets out their analysis and findings.

Contractual Protections

The latest British Private Equity & Venture Capital Association model documentation, published in February, anticipates that an NSIA warranty — the language for which can be found in the association's subscription agreement — will be included where an investor is considered to be acquiring 25% or more of the shareholding in the target company post-completion.[2]

Takeaways

- Overseas and domestic investors should be alive to the NSIA when investing in companies that carry on activities in, or supply goods or services to persons in, the U.K. Even if the control threshold is not triggered on day one of the investment, investors should carefully consider whether the threshold could be triggered in the future, e.g., on a subsequent tranche.
- Understanding whether an investment will trigger notification, or, alternatively, is likely to get called in for review, is a fact-based exercise and can take time to establish.
- It is important for any investor to have a detailed understanding of the target company's activities and operations. Investors will expect the target company to support, or in many cases, take the lead, in carrying out this assessment. This could involve diligence inquiries, questionnaires, management calls and, in more complex cases, memos to ensure the investor is sufficiently comfortable that a filing is not required.

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[1] <https://www.gov.uk/government/publications/national-security-and-investment-act-2021-annual-report-2023>.

[2] <https://www.bvca.co.uk/Policy/Industry-guidance-standardised-documents/Model-documents-for-early-stage-investments>.