NATIONAL SECURITY AND INVESTMENT BILL

AMENDMENT TO BE MOVED AT REPORT STAGE

Clause 8, page 6, line 38,	Insert at end “For the purposes of this Act, a person does not gain control of a qualifying entity if the person acquires a right or interest in or in relation to the entity (a) solely by way of obtaining security and (b) in a situation where they obtain no effective control”

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<u>Effect</u>

To ensure that transactions only constitute a trigger event where the person gains actual control of a qualifying entity and to exempt Scottish share pledges or other situations where no effective control is obtained.

<u>Reason</u>

The proposed amendment is intended to exclude a situation whereby the sole fact of pledging shares in security under Scots law would be classed as a trigger event. A Scottish shares pledge does not allow a security holder to exercise effective control over the relevant shares in a Scottish company and our primary concern regarding the current proposal is that it suggests a trigger event would take place in a situation where no control has passed.

A previous amendment, intended to produce the same effect, was debated at committee stage but was not moved.[1] However, Lord Bruce endorsed the suggestion made by Baroness McIntosh that a meeting be held to discuss the concerns raised, which would include the Law Society of Scotland.[2] A meeting then took place on 15 March at which Lord Grimstone of Boscobel Kt, Lord Callanan, Lord Bruce of Bennachie and Baroness McIntosh of Pickering discussed concerns relating to the Bill with representatives from the Law Society of Scotland's Banking, Company and Insolvency Law Sub-Committee. Lord Grimstone sent a letter to Lord Bruce and Baroness McIntosh, dated 24 March, which set out the Government's understanding of the points raised in the 15 March meeting and the Government's response. This letter was placed in the Library. The Law Society of Scotland provided additional clarification on its key concerns in a further letter to Lord Grimstone, dated 8 April 2021.

As set out in that letter, the Bill as currently drafted fails to align with clear statutory precedents for treating shares which are subject of Scottish shares pledges as still being

[1] https://hansard.parliament.uk/Lords/2021-03-09/debates/064FF49B-3A17-4501-862E-1830F344A068/NationalSecurityAndInvestmentBill#contribution-4890C258-2668-4BB4-B92C-1B56B7EF3E55
https://hansard.parliament.uk/Lords/2021-03-09/debates/064FF49B-3A17-4501-862E-1830F344A068/NationalSecurityAndInvestmentBill#contribution-C9FF39F3-8056-4F4A-86A5-0A0794D71335

[2] https://hansard.parliament.uk/Lords/2021-03-09/debates/064FF49B-3A17-4501-862E-1830F344A068/NationalSecurityAndInvestmentBill#contribution-802B9357-DFB3-4161-A665-F93BB96837D0

controlled by the pledgor, eg the definition of “subsidiary” in Section 1159 of the Companies Act 2006 (as supplemented by paragraph 7 of Schedule 6 to the Act). This would create a disparity between the situations in Scotland and England and could make it harder for Scottish companies to obtain loan finance as well as disincentivizing potential investors from establishing vehicles under Scots law. The draft amendment above would ensure that a trigger event was recognised at the point where the transfer of control actually occurs. In doing to, it would enhance the ability of the Secretary of State to carry out a national security assessment and impose any safeguards at the most appropriate point.

This is perhaps best illustrated by a hypothetical example, reflecting a common real-life scenario. For the purposes of this scenario, it is control over Company C which gives, or may give, rise to national security concerns.

Scenario

Company A is seeking to raise finance by way of a loan and approaches Bank B. Bank B agrees to lend the money against security over the shares held by Company A in its wholly owned subsidiary, Company C. Under current Scots law, the only way to obtain fixed security over shares is by way of a share pledge, with the shares being transferred to Bank B (or its nominee). As such, it can be said that Bank B “holds” the shares as per clause 8(2) (ie the Bank “holds” 100% of the shares in Company C). However, holding the shares in this scenario is not ownership in the true sense and does not give the security holder effective control. Bank B will (a) be unable to sell the shares, (b) has no right to be paid dividends, (c) has an obligation to immediately re-transfer the shares on the monies secured being repaid and (d) most importantly will be unable to exercise voting rights other than in conformity with Company A’s wishes. **In practical terms, Company A therefore remains in full control of Company C and Bank B is not, in fact, in a position of control.**

Current clarification

Clause 8 must be read alongside Schedule 1, which provides further detail relating to the holding of interests and rights. 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."*

This recognises the scenario above where a person grants security over shares but continues to exercise de facto control. However, the clarification refers to “rights attached to shares” rather than the holding of the shares themselves and therefore does not fully account for the different situation where a lender becomes the registered holder of shares in security, as has been the case with a share pledge in Scotland, and standard Scottish legal and business practice, since the 19th Century.

Comparison with English law

By way of comparison, under an English charge over shares, this situation does not arise because no formal transfer of the charged shares is required to perfect the charge. **In the parallel English scenario, the same relationships of control (or lack of control) exist, but no trigger event is recognised.**

The disparity between the situations in Scotland and England is one of the concerns we highlighted. It is not only prejudicial to existing Scottish businesses in increasing obstacles to obtaining finance but also risks making Scotland less attractive as a jurisdiction in which to establish a business vehicle. For instance, in project financings, investors will prefer an English vehicle if this makes it easier to obtain funding. The practical effect is that long-established Scottish legal and business practice is being treated adversely compared with its English counterparts.

We note that acquisitions will only be notifiable in relation to the 17 listed sectors. However, it is not the notification requirement per se that we consider poses the risk in terms of the ability of Scottish businesses to access finance. As identified in the context of the PSC, lenders are reluctant to enter into arrangements which suggest that they have control over an entity when this is not actually the case. Furthermore, the breadth of the call-in power and the potentially broad scope of national security concerns means that many transactions may be called in for up to five years after the event has taken place. This creates uncertainty and of course uncertainty poses a commercial risk. Indeed, the potential for transactions to be called in after the event in other sectors may ultimately have a greater impact in terms of disincentivising lenders.

Acquisition in the event of default

In real life it is very rare that Bank B would seek to appropriate the shares in Company C. The most common scenario following an event of default would be for Bank B to (1) notify Company A that it was going to enforce the security and (2) sell the shares in Company C to repay the debt. The sale of the shares in Company C to Purchaser P would constitute a trigger event under clause 5.

However, there is also the potential that Bank B would decide instead to retain the shares. Having given notice to Company A, Bank B would therefore enter into control of Company C, acquiring all voting rights, the right to receive dividends and the ability to sell the shares. In our view it is this occurrence which should be recognised as the relevant trigger event under clause 5. Entering into control of the shares following a loan default could, indeed, be specifically recognised as a trigger event but we are of the view that the scenario is already suitably covered by clause 8(2).

Impact on timing of notification and call-ins

In a situation where Company C falls within one of the 17 listed sectors, Bank B’s acquisition of control would only be recognised if the appropriate notification had been given. In a situation where the transfer was not compulsorily notifiable, the 5-year call-in period would begin to run at the point that Bank B actually assumed control.

Indeed, this construction would, if anything, give the Secretary of State a longer timeframe on which to assess any risks posed by ownership of the shares vesting in Bank B. Notice of Bank B's interest would appear as a matter of public record (subject to the default occurring after the annual return showing the share pledge had been taken) before, and possibly even long before, Bank B was in a position of actual control. For these reasons we do not consider that the proposed carve-out risks hostile actors targeting lending arrangements as a means to gain control of national security sensitive entities and the Secretary of State would retain discretion over available remedies, which could be applied at the appropriate time.