Australian Private Equity &
Venture Capital Association Limited

AVCAL

29 March 2017

Manager
Foreign Investment Policy Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Email:ForeignInvestmentConsultation@treasury.gov.au

Dear Sir/Madam

Foreign Investment Framework: 2017 Legislative Package

Thank you for the opportunity to put forward a submission in relation to proposed changes to the foreign investment framework outlined in the Australian Government's Consultation Paper, March 2017 (**Consultation Paper**). This submission follows on from our letters of 12 February 2016, 16 May 2016, and subsequent discussions with Treasury in which we outlined our concerns regarding the operation of the revised foreign investment framework which came into effect on 1 December 2015.

AVCAL represents the private equity (PE) and venture capital (VC) industry in Australia, which has a combined total of around $27 billion in funds under management on behalf of domestic and overseas investors including Australian and offshore superannuation and pension funds, sovereign wealth funds, and family offices. VC and PE firms invest billions of dollars in early stage and established businesses spanning almost every sector of our national economy. These investments help support around half a million jobs, and contribute over four percent every year to Australia's national economic output. [1] In the financial year ending 30 June 2016 alone, PE and VC invested around A$3bn into Australian businesses.

Owing to the fact that a significant proportion of the investment capital managed by PE and VC firms is sourced from institutional investors based offshore, Australia's foreign investment policy framework is highly relevant and important to the efficient functioning of our industry. As Australia transitions away from resources to innovation as a key driver of growth, it is essential to ensure there is adequate and timely access to capital.

In particular, our submission focuses on the Government's proposals to: 1) improve the processing of low sensitivity business investment; and 2) simplify the Foreign Investment Review Board (FIRB) application fee framework. AVCAL stands ready to work with the Government in whatever way possible to address these issues. We encourage the Government to ensure the final reform package is introduced by no later than 1 July 2017, so as to ensure that much needed investment is not further delayed.

If implemented appropriately, we are confident that the reforms supported below would reduce uncertainty, delays and business costs for many participants in our sector, thereby encouraging greater, timelier investment into Australian businesses. The costing assumptions contained in Attachment B of the Consultation Paper also appear reasonable to us.

---

[1] Deloitte Access Economics, *The Economic Contribution of Private Equity in Australia*, 2013.

1. Executive summary – recommendations to Government

In summary, to address the issues arising from the December 2015 changes to the foreign investment framework, we propose the following:

1) For PE/VC funds deemed to be foreign government investors, issuance of an exemption certificate at the outset of a PE/VC fund's formation or alternatively on an annual basis, under certain prescribed circumstances (see part 3);
2) That any exemption certificate cover not only the PE/VC fund but also downstream investee companies, with a maximum investment consideration of $252m (indexed annually) for dealings in low-sensitivity businesses (see part 3);
3) Widening the current de minimis exemption to better reflect market realities (see part 4); and
4) A revenue-neutral flat fee regime which would reduce administrative complexity (see part 5).

AVCAL appreciates that ensuring an appropriate balance between encouraging foreign investment and protecting the national interest is of critical importance to the Government. We stand ready to offer any assistance we can so as to ensure this policy objective is met.

2. Background - PE and VC funds deemed "foreign government investors" despite being pooled, passive investments

Our particular concern with the revised foreign investment framework – introduced in December 2015 - revolves around the very broad definition of what constitutes a 'foreign government investor' (FGI) and its application to the typical structure of a PE fund in Australia (where usually several Managed Investment Trusts as well as a Venture Capital Limited Partnership, with separate investors in each, form what is known as the "fund" managed by the fund manager). Under the current regulations, PE and VC funds which have FGIs (e.g. sovereign wealth funds, public pension funds, public university endowment funds) amongst their investor base, will *themselves* be considered an FGI if their investors include FGIs from a single country which hold a 20 per cent or greater interest, or FGIs from multiple countries which hold an aggregate 40 per cent or greater interest, *in an individual fund vehicle* due to the application of the association rules. We note that were the relevant FIRB calculation made on a "whole of fund" basis (instead of individual fund vehicle basis), some PE funds would not be considered an FGI given that PE funds often comprise multiple vehicles.

The consequences of a PE or VC fund being deemed to be an FGI are significant:

1) regardless of the dollar value of the proposed investment, the entity must lodge an application with FIRB, and receive Government approval, before acquiring a direct interest (generally ten per cent or more) in an Australian entity or business, as well as pay an application fee (generally $25,000, although we acknowledge the fee concession that has been granted for investments below $10m in value) [2];
2) Any entity where the PE or VC fund has a 20% or more interest will also be deemed a FGI, and will also be subject to the above rules, thereby capturing portfolio companies including a multitude of low value "bolt-on" acquisitions; and
3) Overseas transactions with negligible Australian connections become notifiable actions.

This scenario will frequently arise for PE and VC funds given that: a) foreign sovereign wealth funds and public pension funds are often an important component of their investor base, accounting for 33 per cent of all PE commitments across FY14-FY16; and b) Australian PE and VC funds typically consist of multiple entities, increasing the likelihood that any one of those entities will be deemed an FGI.

Therefore, the end-result of the revised policy framework has been that FIRB has had to devote valuable time and finite resources to processing many low-risk applications by PE and VC funds – and their portfolio companies - for small transactions, below the general monetary thresholds applicable to non-FGI foreign investors, rather than

[2] Note: the approval requirements can be triggered by mere equity funding of an existing subsidiary of an investee entity, as well as by acquisitions.

being able to focus its efforts on larger or more sensitive transactions which involve complex national interest considerations.

With this in mind, we have supported a policy solution – the use of exemption certificates - which we believe strikes an appropriate balance between the policy objectives of the revised framework and the removal of significant market distortions which have arisen for PE and VC in respect of the recent changes. This proposal is discussed further in part 3 below.

If implemented appropriately, we believe the proposal would have significant benefits for the economy including expediting investment into Australian businesses, reducing business costs associated with FIRB applications (particularly for low value transactions), and highlighting to the global investor community that only a small number of acquisitions will pose national interest concerns for Australia.

We would like to emphasise that we have supported an exemption certificate solution in the interests of expediting reform to the foreign investment framework, rather than an acceptance that a PE/VC fund should be deemed an FGI. Our industry remains of the view that the definition of an FGI[3] has been drafted exceedingly broadly, meaning that PE funds and their investees can be captured despite the passive, pooled nature of the PE fund's investor base. Indeed, the investors (known as "limited partners" after the limited partnership vehicle typically used by US and European investment managers) in a typical PE/VC fund model are passive investors that have no capacity to influence the management or control of the fund. Management and control is exercised through the fund manager (referred to as the general partner). Indeed, in a typical PE fund, the limited partners will not know the identity of an investee entity until binding transaction documents have been signed, conditions precedent satisfied, and the fund has then issued a draw-down notice to its investors.

Therefore, in our view, a legitimate distinction can and should be drawn in the regulatory regime between 1) a direct investment by a foreign government or state-owned enterprise; and 2) investments by a pooled managed fund that has a FGI amongst its passive investor base.

3. Low sensitivity business investment – exemption certificate model

AVCAL welcomes the Consultation Paper's recognition that the revised foreign investment framework "results in a higher than desirable regulatory impost on business proposals that are of low sensitivity". Accordingly, we support proposed policy option 2 which would see the introduction of new exemption certificates for such proposals. Of particular relevance to our sector is the proposed exemption certificate for FGIs.

For completeness, we note that option 3 outlined in the Consultation Paper (exempting low sensitivity business proposals from notification requirements but still deeming them to be significant actions) would be very problematic for PE/VC funds, as in practice, under such a scenario, funds that are deemed FGIs would likely choose to notify such transactions given their contractual and fiduciary duties to their investors to ensure that the Treasurer could not exercise their powers after a transaction has been completed, potentially then requiring a 'un-winding' of aspects of the deal. Certainty is critical for any investment to take place.

3.1 General framework for an exemption certificate model

In summary, we suggest that the exemption certificate application process should involve the PE or VC fund manager applying to FIRB either once the fund has been raised (see below) and no further investor commitments accepted (i.e. when all the investors are known) *or alternatively* on an annual basis, outlining key fund information (including details and percentage interests of any foreign government investors), confirming that the fund has been structured as a managed fund with passive investors (i.e. on commercial terms), specifying a maximum level of individual investment, and agreeing to notify FIRB on a quarterly basis of any investments which the fund has made, pursuant to the certificate. Please note that a PE or VC fund may have multiple "closes" (i.e. rounds of fundraising) which can change the investor mix of the fund. We would recommend that an exemption certificate be applied for after the initial round (known in the industry as "first close"), with any further rounds which materially affected the investor mix requiring notification to FIRB (see further at part 3.2 below).

---

[3] Section 17, Foreign Acquisitions and Takeovers Regulation 2015.

In our view, such a policy solution would be consistent with the Government's commitment to encourage foreign investment into promising Australian businesses, maintain regulatory oversight of investments, and be supported by an existing precedent in the property sector (i.e. annual programs of land acquisitions).

While we accept that in order to accommodate the differing national interest risk profiles of applicants, applications for exemption certificates will need to be assessed on a case-by-case basis, some clear parameters would be helpful. AVCAL's recommended design features are set out below:

- The application should be made by the PE fund manager, on behalf of the various PE fund entities (at least one of which has been deemed an FGI), and capture both the fund *and* down-stream investee companies;
- The fund should provide FIRB with relevant fund information such as information about the fund manager, basic information about the fund's governance rights (including structural passivity of investors), the name, jurisdiction and percentage ownership of each person that holds 5% or more of the fund and each person that is an investor in the fund that is an FGI (regardless of the percentage interest held by the FGI);
- The fund specifies a maximum individual investment (not greater than the relevant sectoral monetary thresholds) and maximum aggregate annual investment for the purposes of the certificate;
- The fund undertakes that its investments will not be in "sensitive businesses"; and
- The fund notifies FIRB on a quarterly or six-monthly basis of the investments that have been made, without the need to seek individual approval (or pay individual application fees) for those investments.

To elaborate on the rationale behind some of AVCAL's suggested criteria:

- There is a need for the exemption certificate to capture both the fund *and* down-stream investee companies so as to avoid a situation whereby a fund acquires a target business (Company A), making use of the exemption certificate, but the target company (Company A) would then need to seek standard FIRB approval if a number of 'bolt-on' acquisitions were made of complementary businesses (Company B and Company C). To require the fund and its various target companies to each seek exemption certificates would create considerable administrative burden, legal fees, FIRB application costs, and significantly reduce the utility of the Government introducing an exemption certificate model for low sensitivity acquisitions. By way of example, one investee company made six FIRB applications between July 2014 and December 2015 for bolt-on acquisitions ranging in value from $1m to $20m, which if the fees had been payable in full would have meant fees in aggregate of $150,000. Similarly, in another case, an investee made three FIRB applications between September 2016 and November 2016 for bolt-on acquisitions ranging in value from $1m to $20m, under which application fees of $27,300 were paid, net of reimbursements from FIRB. The application fees payable would have been in aggregate of $75,900, if payable in full. With each case, fees were reduced following negotiations between the company's lawyers and FIRB, which is both inefficient and costly;
- While we have suggested that PE/VC funds should provide information about their investors, it must be recognised that the fund manager will not know, and therefore cannot advise the Government, of the identity of the ultimate investors within a collective investment vehicle which has invested with the fund manager (e.g. a fund-of funds). In other words, the fund manager will only know the identity of the "first layer" of investors;
- Regarding the maximum annual level of investment, we understand that the Government has previously granted exemption certificates (in the real estate sector) capping that investment at $1bn per annum. We believe that this would be an appropriate upper limit for PE/VC applicants;
- We submit that the $100m per transaction limit suggested in the Consultation Paper is too low and would mean that FIRB would continue to process many low-risk, routine commercial transactions, generating unnecessary fees and delays for business. Based on AVCAL analysis of new PE deals from FY14 to FY16, such a $100m threshold would only capture around 68% of those PE deals. We submit that a more appropriate threshold would be $252m (indexed annually) as this would capture 87% of new PE deals during the aforementioned time period while still allowing FIRB to closely assess (through the standard process) any transactions in sensitive sectors. Such a threshold would also be in line with the general monetary threshold for business acquisitions, reducing complexity in the system. If the Government were to insist on a lower threshold for FGIs, a $200m limit would capture 83% of those PE deals, while a $150m cap would only capture 77% of those PE deals. In our view, FIRB's focus should be on whether the

acquisition is sensitive and/or raises national interest concerns, rather than imposing a somewhat arbitrary lower monetary threshold for FGIs than that which otherwise applies to other foreign persons.

- To avoid a situation whereby a PE/VC fund made an acquisition which it believed to be allowed by an exemption certificate, but which the Government subsequently deemed sensitive (and therefore requiring standard FIRB approval), we strongly recommend that clarity be provided *from the outset* to the applicant regarding what businesses will be deemed "sensitive". Accordingly, we recommend that only businesses within the sectors outlined in "Australia's Foreign Investment Policy" (1 July 2016), as sensitive (media, telecommunications, transport, defence and military related industries, the extraction of uranium or plutonium, or the operation of nuclear facilities) should be deemed potentially "sensitive".
- If the Government considers that other areas are also sensitive, then this should be communicated to market participants so as to allow businesses to plan and make informed commercial decisions. We also appreciate that there may be sensitivity concerns regarding a sub-set of businesses within some sectors. We would urge the Government to provide clarity (for example in a guidance note) on any additional sensitive areas and to consult with business in relation to those areas. As PE/VC funds can have broad investment mandates, this upfront consultation would level the playing field for investors and give investors the opportunity to plan and make informed commercial decisions on the types of investments that can be covered by an exemption certificate. At a minimum, any concerns regarding potential investments in certain sectors should be made clear at the time of application for an exemption certificate.
- When considering what investments are deemed "sensitive", FIRB should have regard to the fact that FGIs within a PE/VC fund are passive investors, with no capacity to dictate the investment decisions of the arms-length fund manager (see PE/VC template agreement provided to Treasury and the Department of Foreign Affairs & Trade in October 2016). This factor should also be a relevant consideration when considering the threshold question of whether a certificate should be granted to the PE/VC fund.

3.2 Further design features

AVCAL submits that at the time an exemption certificate has been granted, the applicant should receive, in the interest of certainty, written assurance from the Government that no action will be taken against it with respect to eligible investments made pursuant to the certificate (i.e. that the certificate is irrevocable, removing any sovereign risk that a post-facto divestiture order will be made or conditions imposed by the Government).

For the avoidance of doubt, where a fund operating with a current exemption certificate seeks to invest in a "sensitive business", or the acquisition is above the general sectoral monetary thresholds (e.g. $252m) we would support that particular acquisition going through the standard FIRB process. In other words, a fund manager may make some acquisitions within the certificate framework, and others outside of it. Such an approach would maximise the compliance savings, and ensure that unnecessary investment delays are not experienced.

We also recommend that in the event that the composition of the investors of a fund materially changes during the currency of the exemption certificate (e.g. an FGI joins or exits the fund, or that another investor with a 5% stake or greater joins or exits the fund), the holder of the certificate should notify FIRB of the proposed change within 10 business days of the proposed change. Assuming the new investor does not pose national interest concerns, the exemption certificate, and investments made pursuant to it, should remain unaffected.

Similarly, there should be provision for an annual certificate to roll-over from year to year (assuming no material change in the investor base of the fund), to avoid a situation whereby a fund could be considering a transaction towards the end of one financial year (e.g. May), but may need to wait a few months into the new financial year (i.e. for the renewed certificate to be granted), in order to finalise the transaction. To ensure this process operates smoothly, it would be sensible to allow an exemption certificate to cover multiple years given that the investment period for a PE/VC fund is generally no more than five years (i.e. this is the period when the full capital amount of the fund is deployed, after which the fund sells its businesses and delivers return to investors). We note that there is a precedent in the property sector, where exemption certificates have been granted for up to three years.

We also submit that any transactions covered by the exemption certificate should not be separately notifiable even if they can otherwise be characterised as another significant or notifiable action (for example, Australian land entities or Australian agricultural land entities) where such acquisitions are incidental to the conduct of the business subject of the certificate.

Equally, in the interests of simplicity and reducing the regulatory burden, we recommend that the relevant exemption certificate should also cover all other relevant transactions where the deemed FGI classification of the PE or VC fund (or its investee) creates a need for FIRB approval which would not otherwise apply, including internal reorganisation transactions, and equity funding of investee subsidiaries.

4. Expanding the de minimus exemption– section 56(4) of FATR

Section 56(4) of the Foreign Acquisitions and Takeovers Regulation 2015 provides for an exemption for FGIs where:

1) the FGI acquires the direct interest in the Australian entity by acquiring an interest in securities in a foreign entity; and
2) the total asset value for the foreign entity is less than 1% of the value of the total assets of that entity; and
3) the total asset value is less than \$10m; and
4) none of the assets considered in working out the total asset value are assets of a sensitive business.

We submit that this exemption is exceedingly narrow, and would therefore be very rarely used. We would be interested to hear how often this exemption has been utilised since it has been introduced. As an alternative, we recommend that: (i) limb 1 of the de minimus exemption be amended so that it is also available where the FGI acquires the relevant direct interest in an Australian entity; and (ii) that the thresholds be increased, for example to 10% of the total asset value and \$100m. Such a change would better reflect market realities, and not deter foreign investment, without compromising the underlying policy rationale behind the legislative provision.

Indeed, we note that many PE funds deemed to be FGIs will make off-shore investments where the target entity has an Australian business. That business may be relatively immaterial, however the asset value would easily exceed the prescribed thresholds, thereby triggering the FIRB regime. Accordingly, a moderate broadening of the de minimis exemption would be a sensible solution.

5. Simplifying the fees framework

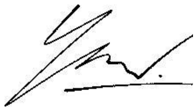
AVCAL would support Option 3A put forward in the Consultation Paper aimed at simplifying the FIRB fees framework. In particular, we believe that a flat fee structure would reduce complexity, allowing for a smoother, quicker FIRB process. It is also sensible to align the significant and notifiable actions fee with that for exemption certificates (i.e. an exemption certificate should not attract a higher fee).

In our view, this approach is preferable to a tiered system, particularly given that the Consultation Paper suggests a 0.1% value of the consideration would be levied. Such a fee level would be excessive, and possibly revenue accretive to Government, especially when one considers that a relatively small transaction by international standards (\$100m) would attract a \$100,000 fee. It is also worth bearing in mind that these fees are in addition to other costs associated with a FIRB application such as legal and tax adviser fees.

6. Next steps

We would like to thank you for considering this submission, and look forward to continuing our engagement on the foreign investment regime. We will be in touch with you in the coming days to discuss these issues further. In the interim, please feel free to contact either me or Christian Gergis, AVCAL Head of Policy & Research, on 02 8243 7000.

Yours sincerely,



Yasser El-Ansary
Chief Executive, AVCAL