Law Council
OF AUSTRALIA

Business Law Section

Foreign Investment Reform (Protecting Australia's National Security) Bill 2020 & Foreign Investment Reform (Protecting Australia's National Security) (National Security Business) Regulations 2020

Tranche 1

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About the Business Law Section of the Law Council of Australia

The Business Law Section was established in August 1980 by the Law Council of Australia with jurisdiction in all matters pertaining to business law. It is governed by a set of by-laws adopted by the Law Council and the members of the Section. The Business Law Section conducts itself as a section of the Law Council of Australia Limited.

The Business Law Section provides a forum through which lawyers and others interested in law affecting business can discuss current issues, debate and contribute to the process of law reform in Australia, as well as enhance their professional skills.

The Law Council of Australia Limited itself is a representative body with its members being:

- Australian Capital Territory Bar Association
- Australian Capital Territory Law Society
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar
- Law Firms Australia
- The Victorian Bar Inc
- Western Australian Bar Association

Operating as a section of the Law Council, the Business Law Section is often called upon to make or assist in making submissions for the Law Council in areas of business law applicable on a national basis.

Currently the Business Law Section has approximately 900 members. It currently has 15 specialist committees and working groups:

- Competition & Consumer Law Committee
- Construction & Infrastructure Law Committee
- Corporations Law Committee
- Customs & International Transactions Committee
- Digital Commerce Committee
- Financial Services Committee
- Foreign Corrupt Practices Working Group
- Foreign Investment Committee
- Insolvency & Reconstruction Law Committee
- Intellectual Property Committee
- Media & Communications Committee
- Privacy Law Committee
- SME Business Law Committee
- Taxation Law Committee

- Technology in Mergers & Acquisitions Working Group

As different or newer areas of business law develop, the Business Law Section evolves to meet the needs or objectives of its members in emerging areas by establishing new working groups or committees, depending on how it may better achieve its objectives.

The Section has an Executive Committee of 11 members drawn from different states and territories and fields of practice. The Executive Committees meet quarterly to set objectives, policy and priorities for the Section.

Current members of the Executive are:

- Mr Greg Rodgers, Chair
- Mr Mark Friezer, Deputy Chair
- Mr Philip Argy, Treasurer
- Ms Rebecca Maslen-Stannage
- Professor Pamela Hanrahan
- Mr John Keeves
- Mr Frank O'Loughlin
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- Dr Richard Dammery
- Dr Elizabeth Boros
- Mr Adrian Varrasso

The Section's administration team serves the Section nationally and is based in the Law Council's offices in Canberra.

For Further Information

This submission has been prepared by the Foreign Investment Committee of the Business Law Section of the Law Council of Australia.

The Section would be pleased to discuss any aspect of this submission.

Any queries can be directed to the chair of the Committee Malcolm Brennan on malcolm.brennan@au.kwm.com or 0417 290 705, and the deputy chair of the Committee Wendy Rae on Wendy.Rae@allens.com.au or 0411 646 774

With compliments

Greg Rodgers
Chair, Business Law Section

Introduction

1. The national security changes announced by the Commonwealth Treasurer are the most significant reforms to the *Foreign Acquisitions and Takeovers Act 1975* (**FATA**) since its introduction. We accept the Commonwealth Government's objectives of addressing national security risks and strengthening compliance. At the same time, the foreign investment regime needs to remain workable for the vast majority of foreign investments which do not pose a national security concern.

2. As the Treasurer pointed out in his media statement, foreign investment drives economic growth, creates skilled jobs, improves access to overseas markets and enhances productivity. Without foreign investment, production, employment and income would all be lower. As Australia seeks to recover from the impacts of the coronavirus, it must continue to welcome foreign investment and be seen to do so. Australia's economy, technological advancement and wellbeing depend on it.

3. Australia's broader national interest had been the bedrock of Australia's foreign investment regime. It encompasses more than just national security. While in some cases national security may be a determinative factor, it should be balanced against the broader national interests and addressed in a measured way.

4. In this respect, the rule of law, transparency and proportionality are critical to instil confidence in the system, even if more flexibility is needed against the small minority of investments that give rise to concerns. We have recommended a number of safeguards below with these principles in mind.

5. The Australian foreign investment regime has in recent years become very time consuming and onerous, even for benign investments in non-sensitive sectors. A focus on simplification and streamlining to reduce the time and costs associated with applying for approval would be welcomed.

6. The FATA and the regulations made under it are complex and difficult pieces of legislation. They have suffered from challenging drafting that has led to confusion across investors, advisers and bureaucrats. The proposed legislation continues and expands upon the complexity. Unclear, subjective and complex laws may mean that inevitably even diligent investors could breach the laws. Clarity is needed, especially if the proposed changes seek to implement harsh penalties and give the Government the power to issue infringement notices without going through the court process and pre-emptive directions in anticipation of a breach.

7. Whilst this submission has been able to be made in the shortened time available it is not a comprehensive review or critique of the drafting or the possible unintended outcomes. Ongoing engagement with the Treasury is very much appreciated and will be necessary to deliver an understanding of the new process to all stakeholders. We recommend in any event that a review of the legislation be undertaken on a regular basis to reduce the risk of confusion and unintended outcomes.

8. For some years now the Government has been using Australia's foreign investment regime (most notably via the imposition of conditions on approvals) to plug holes in domestic legislation or policies. Australia's foreign investment regime with its case-by-case mantra is structurally unfit to deal with complex matters which should be regulated by consistent and transparent domestic legislation or policies applicable to all. The unfortunate result is often decision making on the run which exacerbates the issues noted above. We note that the Government is currently undertaking an all-encompassing critical infrastructure / cyber security reform. That parallel reform is welcomed and is hoped to facilitate better policy making and relieve the stress on Australia's foreign investment regime. We encourage the Government to accelerate its domestic regulatory programs in areas where it is perceived to be deficient and resist the temptation to use the foreign investment rules as a stop gap measure.

9. What follows are our specific comments on the exposure drafts of the legislation released on 31 July 2020.

Recommendations:

We recommend that the foreign investment regime:

- Have regard to Australia's broader national interest while seeking to protect Australia's national security.
- Uphold the rule of law, improve transparency and implement the reforms proportionately.
- Streamline the application process and reduce the time and costs of applying for approvals.

In addition, we recommend that the Government accelerate relevant domestic regulatory programs and avoid using the foreign investment rules as a stop gap measure.

National Security Reforms

Definition of national security

10. At present, national security is only defined in section 5 of the draft Foreign Investment Reform (Protecting Australia's National Security) (National Security Business) Regulations 2020 (**National Security FATR**) as part of the definition of national security business, by cross-referencing the definition in the National Security Information (Criminal and Civil Proceedings) Act 2004 (**NSI Act**). However, national security is not defined where it triggers the call-in power and the last resort power. Also undefined are the terms "national security concern" and "national security risk" as used in the context of the Treasurer's call-in and last resort powers respectively.

11. In our view, national security should be defined in the FATA to provide an anchor and certainty to investors and should not be left entirely to the issue of the day. We also submit that the terms "national security concern" and "national security risk" should be defined in the FATA, or alternatively that a Guidance Note explain what level of concern or risk is expected to trigger the call-in power or last resort power. We expect that a remote risk should not be sufficient but that should be clarified. For example, section 17 of the NSI Act provides that "Something is likely to prejudice national security if there is a real, and not merely a remote, possibility that it will prejudice national security."

12. While the national interest test is also undefined, it does not trigger the new call-in power nor the last resort power. The call-in power is similar to that triggered by the current significant actions, but the call-in threshold is lower (e.g. 10% interest regardless of value or any level of control, as opposed to 20% and the value being in excess of the usual monetary thresholds for a private foreign person) and it extends to an action to start an Australian business. The new last resort power enables the Government to repeatedly review a past approval for misleading statements, material changes in an investor's business or structure, or material changes in circumstances where it could not do so before. It should be clear when these additional powers are triggered.

13. National security is defined in various other important legislation that is critical for Australia's national security, e.g.:

    - Office of National Intelligence Act 2018 (which, like the draft National Security FATR, cross-references the definition of national security in the NSI Act);

- Australian Security Intelligence Organisation Act 1979 (**ASIO Act**) (which defines the concept of security);

- Inspector General of Intelligence and Security Act 1986 (which cross-references the definition of security in the ASIO Act);

- Telecommunications Act 1979 (**Telco Act**) (which cross-references the definition of security in the ASIO Act); and

- the Security of Critical Infrastructure Act 2018 (**SOCI Act**) (which national security definition is based on the definition in the NSI Act and cross-references the definition of security in the ASIO Act).

14. There is no suggestion that defining national security in these other contexts has hampered the protection of Australia's national security or prevented national security agencies such as the Office of National Intelligence (**ONI**) and the Australian Security Intelligence Organisation (**ASIO**) from performing their functions.

15. To say the least, the possibility that the same term could have different meanings when used in different parts of the same law is confusing. They should be used consistently.

16. In addition to the lack of certainty, leaving national security undefined is problematic for the reasons below.

17. First, the national security definition proposed for national security business in the draft National Security FATR is already very broad. By limiting its use to only national security business but not elsewhere is likely to mean that the Government's view of national security is even broader. Given the potential breadth, what then is the distinction between national interest and national security? For example, is foreign investment in a significant manufacturer or supplier of a handful of grocery items (arguably part of a critical supply chain) a national security or national interest issue? National interest could be left hollow as matters could be cast as a national security concern without regard to the thresholds under the pre-covid foreign investment regime. Query whether this is consistent with Australia's obligations under its free trade agreements.

18. Second, if the commonly used national security definition is insufficient for its additional call-in power and last resort power, it should be clear what other circumstances trigger these powers that are currently not covered by the national security definition. Leaving national security undefined unnecessarily creates a perception of secrecy. For example, if the Government's intention is to protect the security of supply chain or personal information, this should be clearly stated.

19. Third, even if the national security definition is moved from the National Security FATR to the main legislation, given the breadth of that definition, additional detailed guidance should be given to provide clarity. However, policy guidance notes are not a complete substitute for what should be a legislative matter. There needs to be democratic checks and balances to ensure that the additional powers are not misused in the name of national security. There could be an unhelpful perception that the power could be invoked to protect uncompetitive domestic industries or for political purposes with real detriment on individual foreign investors and Australian jobs that depend on them. Committing to the rule of law and transparency would instil greater public confidence in the regime.

Recommendations:

We recommend that:

- National security as currently defined in the draft National Security FATR be moved to the FATA, so that it applies to all references of national security.

- The terms “national security concern” and “national security risk” be defined in the FATA, or alternatively that the explanatory memorandum or a Guidance Note explain what level of concern or risk is expected to trigger the call-in power or last resort power. We expect that a remote risk should not be sufficient but would like that clarified.

Definition of national security business

Cross-reference to the expanded Security of Critical Infrastructure Act (sections 10A(2)(a) and (b) of the draft National Security FATR)

20. As an initial matter, the definition of “national security business” in the draft National Security FATR relies on concepts of “responsible entity”, “direct interest holder” and “critical infrastructure asset” from the SOCI Act.

21. The SOCI Act is currently under review as part of the Government’s critical infrastructure / cyber security reform. We understand that the Government is looking to expand the scope of the SOCI Act significantly to cover sectors like banking & finance, data/cloud, education, food & grocery, health, transport, in addition to the critical electricity, gas, water and ports assets currently covered by the SOCI Act (set out in the consultation paper released by the Department of Home Affairs on 12 August 2020). The new legislation is expected to be introduced before the end of this year.

22. The proposed expansion of the concept of “critical infrastructure asset” to include these other sectors would result in a definition of “national security business” that is so broad as to render the rest of the regime in FATA meaningless, as virtually every transaction would be subject to the mandatory notification requirements relating to national security business.

23. While Australia may need robust, broad-based critical infrastructure/cyber security legislation, that broad scope and different purpose may not necessarily be appropriate for the FATA. In fact, the existence of broad-based critical infrastructure/cyber security legislation may mean less need for Australia’s foreign investment rules to be used to regulate critical infrastructure/cyber security. The list of critical infrastructure covered under the FATA could well be shorter than that covered under the expanded SOCI Act. Cross-referencing the SOCI Act in the FATA which results in automatic updating may be inappropriate and result in a disincentive to investment.

24. We would appreciate an opportunity to discuss with the Government this aspect of the national security business definition when the expanded scope of the SOCI Act is clearer. In the meantime, we recommend that the cross-reference to critical infrastructure assets under the SOCI Act in section 10A of the draft National Security FATR be fixed to the current list of critical infrastructure assets without automatic updating. Any additions to the definition should be the subject of consultation.

Recommendations:

We recommend that:

- The cross-reference to critical infrastructure assets under the SOCI Act in section 10A of the draft National Security FATR be fixed to the current list of critical infrastructure assets without automatic updating or the current definition of critical infrastructure assets be replicated in the draft National Security FATR as a standalone category.

- The Government specifically consults on the impact of the expanded SOCI Act on the FATA when the scope of the expanded SOCI Act is clearer.

Important concepts within the definition of national security business (sections 10A of the draft National Security FATR)

25. Aside from this, the application of the term "national security business" will make compliance difficult, costly and time-consuming, in exchange for perceived but very marginal benefits to Australia's national security.

26. First, the definition of "national security business" is very broad and open to interpretation in several respects, such that:

    - important terms, such as "critical goods, "critical technology" and "critical services" are not defined. Presumably the withholding of goods, technology and services should cause sufficient detrimental impact on Australia's defence and intelligence capability for them to fall within the definition;

    - the distinction between the following terms is unclear:

        - "for a military end use" (which applies to critical goods) and "for a military use" (which applies to critical technology);

        - "is / are intended" (which applies to development and manufacture of critical goods and critical technology) versus "is / are, or is / are intended for" (which applies to supply of critical goods and critical technology).

27. Second, the application of the definition also involves assessments that a business person may not be able to make. For example, it is not reasonable to expect a business person to determine:

    - which goods, technology or services are critical (absent any further guidance from Treasury) – in this regard we suggest that the concept be limited to Part 1 of the Defence and Strategic Goods List, a list used for an existing regulatory process and regulates goods and technology for military end use from an export control perspective);

    - whether activities are "relating to Australia's national security" or "may affect Australia's national security" (there are presumably a number of activities that relate to or may affect Australia's national security which will not be obvious to foreign investors or to any person who does not deal with questions of Australian national security on a day to day basis).

28. Third, unlike the existing definitions of agribusiness or land entity (which include threshold tests that must be met before the business would be caught by either of those definitions), a business will be a national security business even if a small proportion (e.g. 1%) of the business can be said to involve any elements of the definition. As a result, there will be a number of applications involving businesses that would not truly be national security businesses.

29. Fourth, the implications of the incorporation of the current definitions from the SOCI Act are such that a significantly larger array of interests are captured by the reforms than perhaps were intended. For example, the definition of "critical infrastructure asset" incorporated by reference to the SOCI Act under section 10A(2)(b) of the Draft National Security FATR means that "an asset is a critical port if it is land that forms part of" any of the declared ports. For example, if a foreign person intends to enter into a lease of a warehouse at a port designated under the SOCI Act, the foreign person will presumably be starting a national security business (assuming they do not already conduct a national security business of the same kind) and will need FIRB approval for the acquisition of that interest. This is the case even though the foreign person would not have required FIRB approval for the acquisition of the interest provided the interest was below the low threshold land value of $60 million pursuant to section 52(6) of the FATR. This is irrespective of the criticality of that warehouse, its size, or its permitted use. In what appears to be an anomalous outcome, the same acquisition of the

same interest in the same land by the same foreign investor would appear not to require FIRB approval if that investor already conducts a national security business of the same kind.

30. The anomalous outcomes continue if you then apply the definition of a "direct interest holder" under section 8(1) of the SOCI Act in the FIRB context. This section provides (for example) that an entity is a direct interest holder in an asset (e.g. the warehouse at a port) where the entity holds an interest in the asset that puts the entity in a position to directly or indirectly influence or control the asset. An entity is taken to be in a position to directly or indirectly influence or control an assets where the entity is in a position to exercise voting or veto rights in relation to the body that governs the asset (see section 8A(1)(a) of the SOCI Act). A common situation in commodity businesses is that there is a centralised entity that holds a facility (such as a warehouse or loading facility) at a critical port that deals with distribution of the commodities. All of the participants in the industry hold a small shareholding (including voting rights) in that centralised body which entitles them to use a portion of the storage or loading capacity. Where this centralised entity holds an interest in land at a critical port it will govern that asset and any other entity that is in a position to exercise voting rights in relation to that centralised entity will be deemed to directly or indirectly influence or control that asset by operation of section 8A(1) of the SOCI Act. In those examples, every participant in that industry that holds a voting share in the central entity will be a national security business. This seems to be an unintended outcome.

31. Finally, compounding each of the above issues, the definition ignores the commercial reality that investors do not always have the benefit of comprehensive due diligence of a business (particularly where competition issues may arise) and that in some instances (for example, in acquisitions of minority interests or in hostile takeovers), acquisitions proceed on the basis of public information only. In this regard, relevant public information is limited because:

    - the Register of Critical Infrastructure assets is not public;
    - carriage service providers do not require a licence so it is not possible to ascertain from public searches whether a person is a carriage service provider; and
    - it is unlikely to be public knowledge (or information that would be volunteered by the target) that a business has access to information with a security classification.

32. We consider that the following measures could be taken to alleviate these concerns without compromising the protection that the measures are designed to create.

Recommendations:

We recommend that:

- The concepts of "critical goods", "critical technology" and "critical services" be limited to Part 1 of the Defence and Strategic Goods List. This would provide certainty though linking the definition to itemised goods and technology, and a process/'regulator' that the industry is used to working with from an export control perspective.
- In any case, if the link to the Defence and Strategic Goods List is not made, the issuance of a Guidance Note which provides examples of what "critical goods", "critical technology" and "critical services" would include (or what things would not be included) would be very helpful. The Guidance Note should clarify how critical is critical, to whom/what it should be critical, how specific should the military use be, and what if the goods, technology and services are multi-use. The Guidance Note could also expand on the other terminology used in the definition (as discussed above).
- Introduce proportionality into the definition of "national security business" (particularly in relation to paragraphs (b), (c), (d), (e), (f), (g) and (h)), so that some meaningful proportion of a company's business must consist of the elements set out in those paragraphs in order for the business to be considered to be a national security business. This would assist to

alleviate the burden on foreign investors when conducting due diligence on potential targets.

- A foreign person should not be subject to penalties if they have made reasonable enquiries in the circumstances as to whether a business is a national security business. The legislation could include a defence to cover such cases. Alternatively, to give some assurance to foreign persons that this will be the case, a new Guidance Note which provides the kinds of assurances that are contained in Guidance Note 23 would be helpful.

Critical services to defence and intelligence personnel (section 10A(2)(h) of the draft National Security FATR)

33. The explanatory memorandum explains that the critical services provided to defence and intelligence personnel at section 10A(2)(h) of the definition of national security business includes the wide variety of services that may be relevant to national security (such as maintenance or operation of goods that are relevant to national security, services for personnel, and other support services). Clarification is needed whether "services for personnel, and other support services" need to be relevant to national security. For example, is catering service for defence and intelligence personnel intended to be covered?

Storing or maintaining personal information of a kind collected as part of arrangement with defence or a national intelligence agency (section 10A(2)(l) of the draft National Security FATR)

34. Section 10A(2)(l) of the definition of the national security business refers to a business which stores, maintains or has access to personal information "of a kind" mentioned in section 10A(2)(k) which, if disclosed, could compromise Australia's national security. Paragraph (k) in turn refers to a business which collects, as part of an arrangement with defence or a national intelligence agency personal information of defence intelligence personnel which, if disclosed, could compromise Australia's national security.

35. It is unclear whether the information at paragraph (l) must be the information collected as part of an arrangement described at paragraph (k) or whether it merely needs to be information of the same kind. If it is information of a kind, then there is a risk that the possible range of businesses captured is very wide including medical practices that may have Defence personnel clients.

36. It may be clearer to say "personal information collected as part of an arrangement described at paragraph (k)" rather than "personal information of a kind mentioned in paragraph (k)".

Activity carried on by the Commonwealth, State or Territory or a local governing body or their wholly owned entity (section 10A(3) of the draft National Security FATR)

37. We understand that the intention of section 10A(3) of the draft National Security FATR is to overcome the issue that an activity carried on by the Commonwealth, State or Territory or a local governing body or their wholly owned entities may not be considered to be a business. However, the provisions could be read to deem all activity carried on by the Governments or their wholly owned entities to be national security businesses. The drafting should be clarified – we suggest that section 10A(3) refer to subsection (1)(a) rather than subsection (1).

Recommendations:

We recommend that:

- The drafting points above for sections 10A(2)(h), 10(2)(l) and 10A(3) of the draft National Security FATR be clarified.

Whose and what intention is relevant for the military use?

38. The explanatory memorandum explains that the definition of national security business at sections 10A(2)(d), (e), (f) and (g) of the draft National Security FATR is intended to include the critical industries and supply chains for all defence and national intelligence goods, technology, and services. These goods, technology, and services are defined with reference to an intention for military use.

39. It is unclear whose intention is relevant. Presumably it is the intention of the entity that is the subject of the action that is relevant (as opposed to the acquirer or the entity's reseller or customer). In theory, in a long supply chain, an upstream supplier may have technology that is critical for military end-use but the upstream supplier may have no intention for its technology to be used for a military purpose. This may be the case if the original technology is only part of the end materials for military use or that it may have been adapted for military use by a downstream supplier. The upstream supplier may not even be aware that its technology may be critical for military use. In this case, the upstream supplier should not be a national security business.

40. Also, there is ambiguity whether future intentions should be caught and whether intentions should be assessed with respect to likelihood of certain goods/technology being used for military purposes. For example, nascent technology could be aspirationally intended for military use but is not proven (and the likelihood of being proven is unclear). Another example is a company bidding to supply goods, technology or services to defence but have not been awarded the contract. We submit that these should not be caught. It should be clarified that the intentions are meant to be current intentions for current use, not intentions about the future that may never happen.

Recommendations:

We recommend that:

- Clarification be given in the draft National Security FATR that the intention for military use at sections 10A(2)(d), (e), (f) and (g) means the intention of the entity the subject of the action and further guidance should be given on how intention should be determined as noted above.

Notifiable national security actions

Start to carry on a national security business

41. Guidance is needed as to what constitutes starting to carry on a national security business. The application of this is broader than the current requirement for a foreign government investor starting an Australian business to seek a no objection notification. This is because before a foreign government investor is taken to start an Australian business, the foreign government investor is usually only newly established or has not carried out any activity of substance. It is relatively clear when the foreign government investor should seek a no objection notification.

42. In contrast, the limb of this definition covering "start[ing] a national security business" is ambiguous and has some unintended consequences for any investor that invests into young and dynamic companies, the business model of which changes quickly. In this context, the issue of when a company starts conducting a national security business (which is notifiable to FIRB) is highly relevant because there is no carve-out for undertaking an activity that is incidental to an existing business and is within the same division under the ANZSIC code

(unlike the position in the current FATR with respect to foreign government investors starting an Australian business).

43. For example, a technology company may have technology that is initially for general use and is arguably considered to be operating a non-national security business. However, the company subsequently adapts this technology for military use. Is the company starting a national security business (even though it already carries on an Australian business)? If so, at what point does the company start to carry on a national security business?

44. As mentioned above, a different example could be if the nascent technology is aspirationally intended for military use but is not proven (and the likelihood of being proven is unclear). The application of starting a national security business to start-ups, research and development focussed entities and emerging technology should be clarified in the explanatory memorandum or Guidance Note. The significant burden of having to go through the FIRB process may mean that these businesses and technologies may never get off the ground.

45. Separately, it is not clear whether a company is taken to start a national security business merely because it submits (or proposes to submit) a bid to provide critical goods, technology or services to defence, or to acquire a direct interest in such a business.

46. We assume that foreign persons who, as at 1 January 2021, already carry on a business that constitutes a 'national security business' will not be taken to start to carry on a national security business if they undertake activities which are the same as or incidental to those of an existing business line. Likewise, where a foreign person receives FIRB approval to start to carry on a national security business and undertakes activities which are the same as or incidental to that approved business.

Recommendations:

To alleviate these concerns, we recommend the following measures:

- Guidance be given as to what activities would be regarded as starting to carry on a national security business.
- The concept of starting a national security business should include the kinds of carve-outs that apply to foreign government investors starting a new business, in addition to the carve-outs currently contained in proposed new section 8A.
- As discussed above, introduce proportionality into the definition of national security business (particularly in relation to paragraphs (b), (c), (d), (e), (f), (g) and (h)), so that some meaningful proportion of a company's business must consist of the elements set out in those paragraphs in order for the business to be considered to be a national security business. This would assist companies to determine whether they have started a national security business.
- Empower the Treasurer to specify exemptions to the starting to carry on a national business trigger.
- Amend section 8A to make clear that a new entity whose parents carry on a national security business is not starting a new national security business. The same amendments are recommended for regulation 10(2) of the *Foreign Acquisitions and Takeovers Regulation* (**FATR**). (see paragraphs 89 to 91)

Offshore transactions

47. It is not clear whether the concept of "notifiable national security action" (which relates to taking an interest in a "national security business") will capture offshore transactions with an

Australian connection. This is partly due to the fact that it is unclear whether a national security business is an entity or a business. The current FATA differentiates between an action relating to entities and businesses. See for example how provisions relating to agribusiness is expressed. Guidance Note 28 should be amended to clarify this.

Recommendations:

We recommend that:

- Guidance Note 28 should be amended to clarify whether the concept of "notifiable national security action" will capture offshore transactions with an Australian connection. A de minimis threshold should be considered.
- Section 19(3) of FATA and regulation 48 of FATR should be amended if the intention is for offshore transactions not to be captured.

Acquisition of interest in national security land

48. It is unclear what enquiries a foreign investor must undertake to ascertain whether a proposed acquisition of an interest in Australian land constitutes a notifiable national security action. Specifically it is unclear when an investor could "reasonably be expected" to be aware of an interest in Australian land that is held (or prospectively held) by a national intelligence agency.

49. We acknowledge that investors should be aware of information that is readily available and in the public domain. However, investors will often be limited in their ability to assess potential land interests, such as in hostile takeovers or in the acquisition of minority interests in listed entities. There will also be instances where a target entity is prevented by confidentiality or other legal obligations from disclosing land interest information to a potential investor.

Recommendations:

We recommend that:

- The legislation specify that what is reasonably expected is to be determined by having regard to the circumstances of the proposed transaction.
- The legislation include a defence that is available where a foreign person has undertaken all reasonable enquiries in the circumstances and has been unable to obtain sufficient information to reasonably ascertain the interest or prospective interest of a national intelligence agency. Alternatively, a new Guidance Note which provides the kinds of assurances that are contained in Guidance Note 23 would be helpful.
- A Guidance Note be issued to supplement the above with worked examples to guide investors as to the Government's expectations.

Call-in powers

Clarity on scope of call-in powers

50. The introduction of the call-in power presents material unmitigable risks on transaction certainty, investment flows and cost of capital.

51. The call-in powers will permit the review of transactions that are not otherwise caught by FATA (reviewable national security actions) or that are significant (but not notifiable) actions which

were not notified, where the Treasurer considers that these actions may pose a national security concern.

52. There is circularity in the definition of "an action that may pose a national security concern" and the operation of section 37C, in that section 37C allows the Treasurer to call in an action if the Treasurer considers that it is "an action that may pose a national security concern", but the definition of "an action that may pose a national security concern" is one that has in fact been called in under section 37C.

53. This circularity means there is no other consideration (other than the type of action) that enlivens the Treasurer's call-in powers. Foreign investors will have little choice but to lodge applications in order to achieve some degree of transaction certainty. This would leave things in essentially the same state they are in now (too many applications required), increasing deal lead times and only marginally improving transaction certainty (given the introduction of the last resort review powers).

54. We would suggest that the following measures are taken to give more certainty to investors as to when the call-in powers will be used.

Recommendations:

We recommend that:

- The definition of "an action that may pose a national security concern" is amended to remove the circularity and to provide some substantive criteria that may enliven the Treasurer's powers.
- A Guidance Note should also be introduced which provides examples of the sorts of actions that may pose a national security concern.

Starting an Australian business should not be subject to the call-in power

55. Clarity is needed as to how starting an Australian business that is not a national security business would pose a national security concern warranting the use of the call-in power. By definition, the business does not exist beforehand. They are essentially start-ups and greenfield businesses of private foreign persons.

56. It is hard to see how subjecting the mere starting of an Australian business to the call-in power could be proportionate, given the significant impact an exercise of the power may have on start-ups.

57. The call-in power means that any private foreign investor starting a new business in Australia on or after 1 January 2021 may be subject to the risk of a disposal order if their business is considered to pose a national security concern. Perhaps this may happen if the business has successfully grown organically to become a critical link in the supply chain (assuming the call-in power is enlivened by issues concerning the security of supply chain) however the proposal would be well past mere start up by that time. This includes a start up growth funded entirely by the foreign investor.

58. If it was not for foreign capital, these new businesses may never grow in Australia. For technology start-ups or research and development focussed entities, the new technologies may never be developed in Australia. The significant burden of having to go through the FIRB process may mean that these businesses and technologies may never get off the ground. From a policy point of view, the benefits of such greenfield investments and positive national interest benefit should outweigh any hypothetical national security concerns which, if any, may be due to circumstances which occur after the mere starting of the business.

59. The longer that private foreign persons have to operate their start-ups or greenfield businesses under the shadow of a call-in power, the more likely the call-in power will deter greenfield investments. We recommend that starting an Australian business not be subject to the call-in power.

60. Australia is protected against national security risks posed by private foreign persons gaining control over Australia's critical technology because private foreign persons acquiring a direct interest in an Australian start-up with critical technology is still subject to the call-in power.

Recommendations:

We recommend that:

- Starting an Australian business should not be subject to the call-in power.

Call-in period

61. The uncertainty from the call-in power may cause foreign investors to delay follow-up investments in Australia after they make their initial investment. Therefore, we welcome the Government's proposal to time limit the call-in power. In principle, the time limit should be as short as possible so that foreign investors can achieve certainty (subject to the last review powers) as to their investments. We would appreciate the opportunity to make further submissions on this point in September.

Recommendations:

We recommend that:

- In principle, a call-in period that is as short as possible be considered.

Last resort powers

Changes in circumstances or market outside the investor's control

62. Of most concern to investors is the new section 73A(1)(b)(iii) which provides that the Treasurer may review a previously approved (or deemed approved) action if the circumstances or market in which the action was taken have materially changed since the time of the approval or deemed approval.

63. Investor concerns with this section are many, including:

    - an investor has no control over whether there is a change in the circumstances or market in which an action happened;
    - the concept of a material change in circumstances or market is so broad as to be meaningless – there is no effective brake on the Treasurer's ability to commence the last resort review process;
    - some of the safeguards that were embedded in the Telco Act and the SOCI Act were not replicated for the draft FATA (see paragraphs 65 to 69 below);
    - the ability to redact notices under section 73B creates information asymmetry, making it difficult for an investor to engage in productive discussions about mitigating any risk the Treasurer suspects exists (see paragraphs 70 to 72);

- the ability to seek Administrative Appeals Tribunal (**AAT**) review is limited to reviewing the Treasurer's decision on whether a national security risk exists rather than the appropriateness of the Treasurer's decision (see paragraphs 73 to 77);

- it does not appear that there is any time limit on the trigger of the last resort review powers, which means that an acquisition will never be fully free of foreign investment review risk; and

- it appears that the power can be exercised repeatedly.

64. The fact that an investor, having been told there are no objections to their transaction and having paid valuable consideration, may be subject to a future divestment order for circumstances beyond their control, for reasons that cannot be made clear and with limited rights to appeal (which divestment would likely be at a discount, given there would presumably be a narrow range of potential acquirers and there will be a time limit imposed) is likely to at best depress values for, and at worst be a deterrent to investment in, any areas that an investor considers may touch on national security. Even if divestment is not sought, the imposition of more restrictions by varying the conditions could alter the business case for the investment significantly. From a policy point of view, a lack of investment and technology advancement in this area may in fact weaken Australia's ability to protect its national security.

Recommendations:

We recommend that:

- The last resort power under the new section 73A(1)(b)(iii) of the draft FATA should in the first instance be deleted as it gives the Government overbroad powers that are highly likely to stifle investment.

- If it is not deleted, further clarification is required regarding its potential application – either by further clarification in the legislation, explanatory memorandum or by a Guidance Note which explains in further detail the circumstances that are likely to amount to a change of the kind described in section 73A(1)(b)(iii).

- If the Government effectively has the power to force an investor to divest through no fault of the investor, the Government should be required to compensate the investor for its losses.

Additional factors to take into account and consultation

65. The last resort power under the draft FATA amendments is modelled on the last resort powers under the Telco Act and the SOCI Act. However, some of the safeguards that were embedded in these legislation were not replicated for the draft FATA.

66. For example, before issuing a direction under section 315B of the Telco Act to a carrier or carriage service provider (**C/CSP**):

    - the Attorney General must have regard to the cost and impact on the C/CSP of implementing the direction, as well as the impact on customers, the market, competition and innovation; and

    - the Attorney-General must consult both the Minister for Communications and the affected C/CSP, to ensure that security considerations do not unnecessarily impede market innovation and business autonomy and the direct impact on the C/CSP is taken into account and the C/CSP is given a voice to explain their position on why they cannot agree to implement ASIO's security advice.

67. Consideration of similar factors is also a pre-condition for the exercise of the Minister's last resort power under section 32 of the SOCI Act. In addition, the Minister for the SOCI Act must consult with the relevant state or territory minister, and Premier or Chief Minister before issuing a direction and have regard to representations made by the entity or a consulted Minister.

68. In this context, the harm to security could be given the greatest weight in this balancing exercise to ensure that Australia's security interests are properly safeguarded despite potential impacts on the foreign person and the Australian community. However, the requirement to have regard to other factors and representations, in addition to the risk to security, will ensure that the exercise of the last resort power is proportionate and reasonable in all of the circumstances and guards against an exercise that would possibly address security risks but have an unnecessary detrimental effect on the foreign person's business or undue adverse impact on the Australian community who rely on the investment.

69. Given the potentially drastic consequences of the exercise of the last resort powers and that the foreign person will have in good faith acted and invested in Australia in reliance on a prior approval, we recommend that these additional factors and consultation requirement be replicated for the last resort power under the FATA to ensure that the power is not used arbitrarily. The additional matters to have regard to can be tailored for foreign investment.

Recommendations:

We recommend that:

- Consideration of additional factors such as the cost and impact on the foreign person, as well as the impact on customers, the market and the broader Australian community, be added as conditions for the exercise of the last resort power under the FATA to ensure that the power is not used arbitrarily.

- Before the Treasurer exercises the last resort power, the Treasurer consults with the Prime Minister, the Minister for Foreign Affairs, the Minister for Trade, the Minister for Home Affairs and other relevant ministers from the Commonwealth, States or Territories, as well as the foreign person impacted, to ensure that all voices are being heard.

Redactions should be reviewable by the Administrative Appeals Tribunal

70. Section 73B of the draft FATA requires the Treasurer to give reasons for deciding that a national security risk exists as a result of the national security review. However, the Treasurer may redact any reasons that would disclose the national security risk or result in prejudice to Australia's national security interests, or any information relied on.

71. Redaction of any reasons or any information relied on should only be permitted if the disclosure would "result in prejudice" to Australia's national security, not merely that the disclosure discloses the national security risk or that there is a ground of national security.

72. In addition, we recommend that the redaction be subject to review by the AAT to ensure that the Treasurer does have proper grounds to withhold information.

Recommendations:

We recommend that:

- Redaction of any reasons or any information relied on should only be permitted if the disclosure would result in prejudice to Australia's national security, not merely that the disclosure discloses the national security risk or that there is a ground of national security.

- The redaction be subject to review by the AAT to ensure that the Treasurer does have proper grounds to withhold information the disclosure of which would result in prejudice to Australia's national security.

Expand the scope of the AAT review

73. The only independent review currently proposed in the draft FATA is the AAT's review of the Treasurer's decision under the last resort power that a national security risk exists in relation to an action. We note that the Common Law prerogative writs remain an option for review despite their cost and time taken to pursue.

74. The review by the AAT's Security Division should extend to the appropriateness and reasonableness of the orders that the Treasurer makes to address the national security risk (whether under the last resort power or the call-in power), and rejection of a proposal on national security grounds. The advice given by the national intelligence community to the decision maker which underpins the decision should also be formalised, e.g. in the form of an adverse security assessment by ASIO, and be subject to review by the AAT.

75. The Telco Act provides an example of such review process. Under the Telco Act, an adverse security assessment by ASIO is a precondition to the exercise of the last resort powers under sections 315A and 315B of the Telco Act. The Minister's direction pursuant to the last resort powers, as well as the ASIO adverse security assessment which underpins the direction, are both subject to review by the AAT.

76. An ASIO adverse security assessment reviewable by the AAT is also a precondition to the exercise of the last resort powers under section 32 of the SOCI Act.

77. It may be said that the Treasurer's decisions under the FATA are not presently reviewable by the AAT under the Administrative Decisions (Judicial Review) Act 1977 (**ADJR Act**), so why should the new powers be subject to review. However, decisions are presently made with reference to the national interest test. The new powers deal with national security. There are expertise and pre-existing structures in the national security area that could improve accountability for national security decisions. Also, in relation to the last resort powers in particular, investors will have in good faith acted and invested in Australia in reliance on a prior approval, warranting a higher level of scrutiny. Submitting national security decisions under the new FATA to review would instil confidence in the public that the new powers will be used appropriately and not for matters unrelated to national security.

Recommendations:

We recommend that:

- In addition to whether a national security risk exists in relation to an action which triggered the last resort power, the review of AAT's Security Division should extend to the decision maker's exercise of the last resort power and call-in power, and rejection of a proposal on national security grounds.

- The advice given by the national intelligence community to the decision maker which underpins the decision should also be formalised, e.g. in the form of an adverse security assessment by ASIO, and be subject to review by the AAT.

Additional INSLM reviews to provide safeguards and instil public confidence

78. We recommend that additional safeguards be placed around the new national security powers to ensure that they are not misused for ends unrelated to national security and to instil public confidence.

79. The Independent National Security Legislation Monitor (**INSLM**) appointed by the Governor-General on recommendation of the Prime Minister following consultation with the Leader of the Opposition in the House of Representatives performs a useful role. The INSLM's role is to:

    - review the operation, effectiveness and implications of Australia's counter terrorism and national security legislation;
    - consider whether the laws contain appropriate protections for individual rights, remain proportionate to terrorism or national security threats, and remain necessary; and
    - assess whether the laws are being used for matters unrelated to terrorism and national security.

80. INSLM reports are tabled in Parliament. The INSLM could be tasked to undertake a similar review of the new national security laws in the FATA on a regular basis (say, within the first 18 months and every 3 years thereafter) to ensure that they are not being used for matters unrelated to national security. Alternatively, a similar body could be set up to undertake a similar review of the operation of the new national security powers.

Recommendations:

We recommend that:

- The new national security powers under the draft FATA should be subject to review by the Independent National Security Legislation Monitor (or similar body) to ensure that it is not being used for matters unrelated to national security.

Reporting on the use of national security powers to increase transparency and accountability

81. Given the breadth of the new national security powers and the potential for them to be used for purposes that are not strictly for national security reasons, it is important that there is transparency and accountability to the extent possible without prejudicing Australia's national security.

82. To this end, we recommend that FIRB's annual reports be required to include meaningful, appropriately aggregated and de-classified information relating to the exercise of powers in the name of national security. For example:

    - The number of notifiable national security actions and reviewable national security actions notified;
    - The number of times a no objection notification is given for these notified actions, including information about the conditions and protective measures put in place;
    - The number of times a no objection notification is not given for these notified actions (including any preliminary views letter by the Treasurer) and the circumstances giving rise to the national security concerns;
    - The number of times the call-in powers are exercised and the circumstances in which the powers are exercised;

- The number of times the actions called in (actions that may pose a national security concern) have been found to be contrary to national security and the circumstances giving rise to the national security concerns;

- The number of times national security reviews are undertaken prior to the exercise of the last resort powers and the circumstances in which the reviews are triggered;

- The length of time for each national security review; and

- The outcome of each national security review, e.g. whether alternative arrangements were negotiated or whether the last resort powers were exercised and the circumstances of the national security concerns that could not be resolved.

83. The Telco Act also requires the reporting of the number of times the Minister's last resort powers were exercised.

Recommendations:

We recommend that:

- FIRB's annual reports be required to include meaningful, appropriately aggregated and de-classified information relating to the exercise of powers in the name of national security.

Banking and finance implications

84. Feedback from a range of market participants indicates that the introduction of the call-in and last resort powers will impact financing transactions by significantly increasing the perceived "FIRB risk", costs and compliance burden around those investments.

85. Specific risks identified include:

    - Lenders are unlikely to accept "call-in power risk" on a transaction and are likely to require that bidders "cleanse" this risk by voluntary reporting. Transaction costs will increase and transaction timelines will be extended to take the FIRB assessment into account. The cost of capital from lenders is also likely to increase as lenders will have to carry contingent capital for a longer period.

    - Lenders are likely to introduce additional conditionality in financing commitments. This will impact funding certainty, which is a key sell side focus point for private capital bidders.

    - Lending appetite for 'at risk' transactions may also fall – the preferred equity/debt funding mix may not be achievable and may mean that investors are unable to pursue transactions they otherwise would have. This would reduce the flow of funds into Australian businesses and potentially depress asset valuations (due to decreased competition).

86. In addition, we make the following observations:

    - It is unclear if any safe harbours for the call-in or last resort powers will be afforded if a (foreign) lender exercises default or enforcement rights in respect of a loan for a transaction otherwise cleared. This should be considered in connection with the proposed changes to the moneylending exemption.

    - Further guidance is required on what an asset disposal order would require in terms of process and timing. The following issues should be considered:

- as divestiture post-closing will be very complicated, lenders will seek debt reduction from any proceeds;

- it is unclear if lenders will be committed to continue to fund the target post divestiture or will instead seek to exit entirely (due to reputational risks or because the business case that they funded against can no longer be performed).

Recommendations:

We recommend that further guidance be given on:

- whether there are any safe harbours for the call-in or last resort powers in the event a (foreign) lender exercises default or enforcement rights in respect of a loan for a transaction otherwise cleared; and

- the process and timing of asset disposal orders.

Other technical drafting points

87. Below are a number of drafting points for your consideration.

Declaring national security land

88. The power of the Treasurer to declare land for the purposes of paragraph (b)(iii) in the definition of a notifiable national security action (third limb of the national security land as per the terminology in the explanatory memorandum but not in the draft FATA) should be tied to grounds of national security. In other words, the Treasurer should not be able to declare land to be national security land for reasons unrelated to national security.

Establishing a new entity to carry on the same business

89. Under section 8A(2) of the draft FATA, a person does not start a national business merely because the foreign person, alone or together with one or more persons, establishes a new entity that carries on the same national security business or for the purposes of acquiring interests in assets of the same national security business. This wording mirrors section 10(2) of the current FATR in relation to whether a foreign government investor starts an Australian business.

90. The existing section 10(2) of the current FATR has a longstanding issue as it does not clearly cover the new entity that is being established. It also does not cover another entity within the same corporate group establishing the new entity to carry out the same business, meaning that only a subsidiary can be established and not a sibling company. This is contrary to normal commercial practice.

91. The drafting of both section 8A(2) of the draft FATA and section 10(2) of the current FATR should be clarified so that establishing a new entity within the same corporate group to carry out the same business does not constitute starting a business by that existing corporate group or the new entity. It should also be made clear that if two entities jointly establish a new entity (where the two entities each carry on an existing Australian business with the same activities), the new joint venture entity does not start to carry on a business (this position is acknowledged in existing Guidance Note 23 but is not expressly stated in the FATA or FATR).

Variations of orders

92. A variation of orders under sections 71(1A) and section 73G of the draft FATA cannot merely be not contrary to national security. Should the investor's consent or a qualifier that the variation must not disadvantage the person be included, by replicating the same wording at

section 71(1)(b) of the current FATA? The same consent and no disadvantage qualifier also appears in section 73M(6) of the draft FATA.

93. Compare the different formulation for a variation at section 73N of the draft FATA – a variation can only be made if the Treasurer is satisfied that the variation is "reasonably necessary for purposes relating to eliminating or reducing the national security risk".

Recommendations:

We recommend clarifying the drafting points above.

Integrity and technical amendments

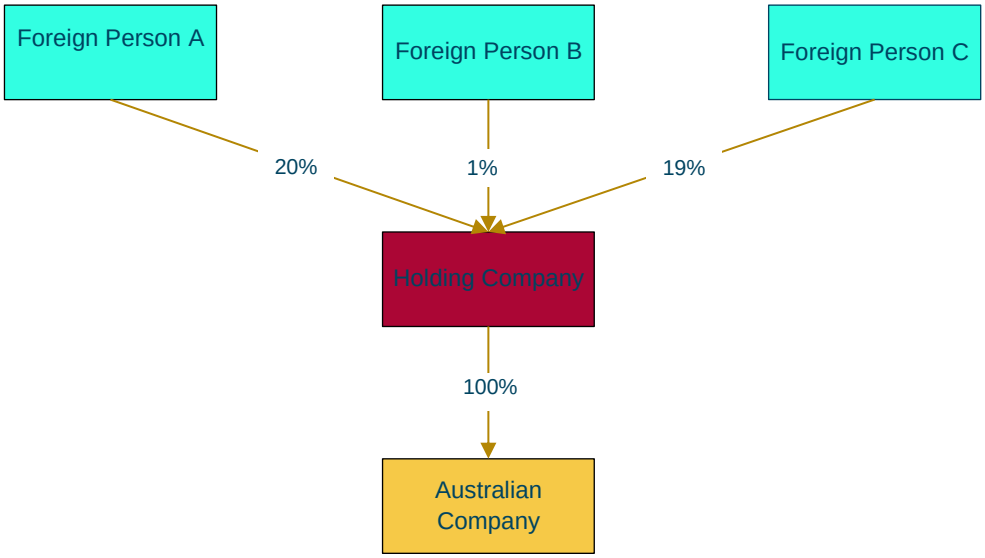
Change in control test

94. Subject to our comments below, we support the addition of sections 40(7) and 41(6) to the FATA as we believe that it will effectively address the following issues.

- In cases where there is no cessation of control by another person, the Treasurer has no power currently to prohibit a foreign person (other than a foreign government investor), who controls an Australian entity or business (other than an agribusiness), from increasing its interest in the Australian entity or business even if the increase is against the national interest.

- The meaning of "control" in FATA s 54(4) exacerbates this regulatory gap because, in relation to the acquisition of interests in securities in an entity or an issue of securities in an entity, a person will "control" an entity with an interest of 20%. Further, the effect of FATA s 54(4)(b)(ii) appears to be that a person will control an entity even with one share simply by virtue of being one of a number of shareholders, with whom it is not associated, who collectively hold an interest of at least 40% in the entity.

- Through the operation of the tracing rules in FATA s 19, each of the foreign persons in the diagram below is considered to hold a 100% interest in the Australian Company: Foreign Person A because it holds a substantial interest in the Holding Company and Foreign Persons B and C because, together with Foreign Person A, they hold an aggregate substantial interest in the Holding Company.



When coupled with FATA's meaning of control, the result is that any of Foreign Persons A, B and C can acquire additional interests in the Holding Company:

- without triggering a notifiable action, even if they are foreign government investors or the Australian Company is an agricultural land corporation or an Australian land corporation (all situations where the tracing rules were intended to trigger a notifiable action); and
- provided that no-one ceases to control the Holding Company as a result of the increase, without triggering a significant action and, therefore, the Treasurer's powers to prohibit the action or unwind it.

95. A change will also eliminate an existing lacuna in FATA whereby an action involving the acquisition by a foreign person of a substantial interest in an Australian entity may be a notifiable action but not a significant action where the acquisition does not cause a change in control because the foreign person already held a substantial interest in, and no person ceases to control, the Australian entity. Actions that are notifiable actions only must be notified to the Treasurer but the notification is pointless because the Treasurer has no powers to prohibit the actions or to give no objection notifications in response to them.

96. There are three additional changes that we recommend be made in connection with a change in control:

- Amend FATA sections 40 to 43 (as appropriate) to provide that any action that is a notifiable action is also a significant action. There are two benefits to doing this:
  - It could simplify the drafting of Division 2 of Part 2, for example, by allowing for sections 40(2)(a), 41(2)(a) and 43 to be omitted on the basis that the relevant actions are addressed in section 47.
  - It would assist readers to understand that there are no actions that can be notifiable actions only.
- Omit section 54(4)(b)(ii).

  It is not appropriate for a person to be considered to control an entity simply because it is one of two or more persons, who are not associates and happen to hold an aggregate interest in the entity of 40% or more. For example, according to this section, any person who holds 100 shares in Commonwealth Bank of Australia controls that bank (until such time as the Treasurer determines

otherwise) simply because the person is one of two or more shareholders, not being associates of the person, with an aggregate shareholding of 40% or more.

The purpose of the Act is not advanced by this section – the remaining parts of section 54 and the definition of "associate" in section 6 are sufficient to capture circumstances where there is potential for real control to be exerted over a target entity.

- Currently, there is debate about whether the rights issue exemption in the FATR section 41(2)(a) applies to wholly-owned entities, particularly if the relevant entity is offering a new class of securities[1]. We recommend that the rights issue exemption be modified to expressly provide for its application in the case of wholly-owned entities. While not relevant to the change in control test, we also recommend that the exemption be modified to expressly provide for an offer of a new class of securities.

Recommendations:

We recommend the following:

- Amend FATA sections 40 to 43 (as appropriate) to provide that any action that is a notifiable action is also a significant action.
- Omit FATA section 54(4)(b)(ii).
- The rights issue exemption be modified to expressly provide for its application in the case of wholly-owned entities. While not relevant to the change in control test, we also recommend that the exemption be modified to expressly provide for an offer of a new class of securities.

Buy-backs and capital reductions

97. The effect of the new share buy-back provisions is that a person could be deemed to have undertaken a significant action or notifiable action without having taken any action at all.

98. We note as an initial matter that FATA could already be construed to cover buy-backs in the following ways:

    - FIRB has taken the view previously that a share buy-back could be a significant action, in circumstances where the company buys back shares and there is a change in control[2];
    - if a buy-back is implemented with the intention of a foreign person acquiring an interest of 20% or more of an Australian entity without there being a notifiable action, we consider that the anti-avoidance provisions of FATA would already cover this kind of behaviour.

[1] The meaning of rights issue in s 9A of the Corporations Act 2001 (Cth) contemplates the offer of securities in a particular class to every person who holds securities in that class (s 9A(1)(b)(i)). Therefore, an offer of a new class of securities cannot be a rights issue.

[2] There is a contrary intention to the effect that there can be no acquisition of an interest in a security in the case of a buy-back because the relevant focus in FATA s 9(1) is on a person having a legal or equitable interest in a security (i.e. what the person acquires, not on what the transferor gives up) and an entity cannot hold a legal or equitable interest in its own securities.

99. Even if the legislation is expanded so that such transactions became notifiable actions, there are good reasons why the compliance burden should be placed on the company, rather than the investor:

- shareholders may not necessarily have knowledge that a buy-back occurs;
- while foreign investors tend to seek advice as to their obligations under a variety of Australian laws including FATA when they take steps to acquire interests in an Australian company (or an offshore company that has an Australian subsidiary), it is not reasonable to expect a person to seek the same advice when they are taking no action at all (even more so where the capital reduction or buy-back is occurring in an offshore entity);
- as a policy matter, it is difficult to impose on foreign investors a requirement to lodge an application and pay a fee when they are choosing to do nothing at all.

100. The ability for a foreign person to notify these events after the fact is not sufficient if the end result is that a foreign person could be forced to divest a portion of their holdings (noting that the circumstances of a forced sale may dictate that it happens at a price less than the buy-back price, all for the decision not to participate in the buy-back).

101. The proposed regime would be particularly burdensome for exchange traded funds, listed companies and widely held unit trusts, where changes that would be captured by the proposed new legislation would be frequent.

102. We note that the proposed regime is also inconsistent with regulations which allow increases for rights issues (as long as the investor does not acquire any shortfall securities) and dividend reinvestment plans – the proposed regime would put more compliance burden on those that are passively increasing their stake than on those that are taking active steps which could have the result that their stake is increased.

103. We suggest some measures below which should assist in achieving Treasury's intended policy aims while not needlessly increasing the burden **on foreign investors who are not actually taking any action. Please also refer to the Schedule to this document for further information.**

Recommendations:

We recommend the following:

- Put the burden of compliance on the company undertaking the buyb-ack.
- Introduce a de minimis "creep" exception, similar to "creep" provisions included in the Corporations Act, where investors could passively increase their interest by a certain amount in a given period of time before a notification had to be made.

Exemption where percentage interest has not increased

104. Under the current FATA, a person who already has an interest in an entity and acquires additional securities in an entity will be taken to have acquired an "interest" in the entity even if the person's percentage interest in the entity does not increase. This is because of section 20(1)(c) which provides that a person who already holds an interest of a specified percentage is taken to acquire an interest of that specified percentage if the person "starts to hold additional interests in the issued securities in the entity".

105. We submit that transactions which do not result in a foreign person increasing their percentage interest in an entity should not constitute a notifiable action, significant action or

notifiable national security action, nor be subject to the call-in power. As a policy matter such transactions should not raise any national interest concerns. To an extent this is already recognised in the legislation, given there is an exception for rights issues. But there can be situations where the rights issue exception is not available, whether because a particular rights issue does not satisfy the technical requirements of the exception or because the transaction does not involve, or does not solely involve, a rights issue.

Recommendations:

We recommend introducing an exception to the notifiable action, significant action, notifiable national security action and call-in power regimes that applies to transactions which do not result in a foreign person increasing their percentage interest in an entity.

Section 15 – Interests acquired by entering agreements

106. Under the FATA, a person holds or acquires an interest in a security or an asset if the person has any legal or equitable interest in that security or asset (sections 9 and 10). In many transactions involving the acquisition of a security or an asset, the purchaser will acquire an equitable interest in the security or asset ahead of the legal interest, which will be acquired at or shortly after completion.

107. Section 15(1) provides, for the purposes of the FATA, that an interest is acquired at the point of entry into an agreement to acquire the interest, having or acquiring an option to acquire the interest, or having a right to have the interest transferred. In understanding the impact of section 15(1), it is important to appreciate that, under section 25, a person can be considered to have entered into an agreement to acquire an interest well before the point in time at which there might be any real prospect of it actually acquiring any relevant equitable or legal interest. This is because of the wide meaning section 4 gives to 'scheme'. Based on that definition (and but for the exception we discuss below), section 15(1) is likely triggered by the following events:

- a person entering into a non-binding memorandum of understanding, such as will often occur at a very preliminary stage in the commercial negotiation of a transaction;
- a person making a proposal, whether or not the proposal is accepted; and
- a person adopting a plan to do something, whether unilateral or otherwise.

108. There are a number of important consequences of section 15, some sensible and some potentially unreasonable.

- A foreign person that proposes to take an action only needs to test its action against monetary thresholds on one occasion. As such, the potential for a person to be caught by an increase in valuation after agreeing to purchase a legal interest but before actually acquiring the legal interest is avoided.
- A corporation or trust that has no foreign securityholders could be considered to be a foreign person simply on the basis that a foreign person has proposed to acquire its securities even in circumstances where its securityholders have rejected the proposal.
- A person could be considered to have acquired interests that it never ends up actually acquiring.
- A person could be considered to have acquired interests that do not exist (e.g. an apartment in a building that has not been built and may never be built).

109. To some extent the potential for unreasonable outcomes to arise is tempered by the exception in sections 15(4) and (5), which currently provides that, for certain purposes, the time of acquisition is deferred until conditions precedents to relevant provisions to the agreement becoming binding are satisfied. Currently, there is no restriction on what the conditions precedent may be.

110. The proposed amendment to section 15 (a new paragraph (4), which replaces the current paragraphs (4) and (5)) will only operate in respect of "a condition relating to the operation of this Act", not conditions generally. We are concerned that this will exacerbate many of the unreasonable consequences of section 15(1).

111. For example, two parties may reach an in-principle understanding on a notifiable action. They specify that their in-principle understanding is non-binding and subject to legal documentation. They do not mention anything about FIRB (or even the need for regulatory approval generally) because they are yet to consult with their respective legal counsel. Based on section 15(1) alone, the notifiable action has been taken and an offence committed. However, as a result of the current exception in paragraphs (4) and (5), the notifiable action is deferred and the parties will have the opportunity to obtain legal advice and make provision for FIRB notification and clearance in a definitive agreement. In contrast, the new paragraph (4) will be of no assistance.

112. Consider another example: two parties enter into a definitive agreement on a notifiable action, which requires a number of conditions to be satisfied, including FIRB notification and clearance. The acquirer notifies FIRB and obtains a no objection notification. Under the new paragraph (4), the acquirer will have taken the notifiable action at that point even if there are other conditions that have not been satisfied and are never satisfied. This could have a number of unreasonable consequences depending on the nature of the notifiable action:

- a target entity may be treated as a foreign person as a result of an acquisition of securities that never occurs; and
- a foreign person may be treated as having acquired agricultural land for the purposes of the cumulative $15 million threshold that the foreign person never actually acquires.

113. We would like to see the new paragraph (4) operate based on the fulfilment of conditions generally, not just conditions relating to the Act (FATA). Any concerns that paragraph (4) could be exploited through the use of contrived conditions to artificially defer the point at which an action should be considered to have been taken are, in our view, ameliorated by the fact that:

- at the time the Treasurer is ready to give a no objection notification, FIRB will be able to ask what conditions remain outstanding; and
- the Treasurer can use the anti-avoidance powers to annul the deferral achieved by a contrived condition.

114. If FIRB remains concerned about the potential for contrived conditions, a similar approach could be taken in paragraph (4) to that taken in the Australian takeovers law which, to paraphrase, prohibits conditions in takeover bids that depend on a bidder's opinion or the happening of an event that is within the sole control of the bidder (Corporations Act, section 629).

115. One aspect of the new paragraph (4) that we support is the move away from the requirement that a condition be a condition to the relevant provisions of an agreement becoming binding. Currently, concerns often arise because a condition is not clearly expressed to be a condition to the binding effect of the agreement. For example, the general

approach of Australian courts is to interpret "subject to" conditions as not being conditions to a contract binding the parties but rather to the performance of contractual obligations.[3]

116. In a similar vein, it would be helpful if a drafting note could be included (or guidance otherwise given) that a condition can relate to the operation of the FATA without having to refer to the FATA expressly. This would address problems that we often experience with offshore transactions that include generic regulatory approval conditions.

Exclusion of section 95 from the new section 15(4)

117. The proposed amendment to section 15 purports to exclude section 95 from the operation of section 15(4). The policy intent behind this is difficult to understand, and it creates significant issues for foreign property developers (see example below).

118. Section 95(4) provides that a foreign person who is not a temporary resident must not acquire an interest in an established dwelling. Section 95(5) provides that 95(4) does not apply where there the interest to be acquired is specified in an exemption certificate or no objection notification.

119. Initially, we query what the purpose of section 95(4) and (5) is? The acquisition of an established dwelling is a notifiable and significant action. The combined effect of sections 81, 82, 84 and 85 of the FATA is that a foreign person cannot acquire an interest in an established dwelling unless they first obtain a no objection notification (or an exemption certificate – by operation of sections 45(1)(b), 45(2)(b) and 49(1)(b)). In that context, it would appear that sections 95(4) and (5) have no real effect and should be deleted.

120. The same analysis applies to sections 95(1), (2) and (3) which relate to temporary residents. Temporary residents are also prohibited from acquiring established dwellings (see sections 81, 82, 84 and 85 of the FATA) unless they first obtain a no objection notification (or an exemption certificate – by operation of sections 45(1)(b), 45(2)(b) and 49(1)(b)). Again, these sections appear to serve no purpose and should be deleted.

121. Two examples of the anomalous outcomes that will arise if the cross-reference to section 95 in the proposed new section 15(4) is not removed are set out below:

- a temporary resident who has sought and obtained FIRB approval for the acquisition of an established dwelling to be occupied as their principal place of residence cannot enter into an option or contract (which is subject to FIRB approval) to acquire another established residence for the purposes of redeveloping the property to increase the housing stock. The temporary resident would be required to obtain a no objection notification or an exemption certificate before being able to enter into the contract or option. This would appear to be an unintended consequence and an unfair outcome for the temporary resident;

- a foreign property developer proposes to acquire all 20 apartments in an old apartment block, demolish it and redevelop into a new apartment complex with 40 apartments. The developer could not enter into options or contracts to buy the apartments, even if they were subject to FIRB approval. The developer would be required to obtain a no objection notification or an exemption certificate before being able to enter into the contracts or options. Given the significant application fees, it would generally be commercially sensible to try to tie up the apartments through options before seeking FIRB approval because if only one of the existing apartment owners refuses to sell, the project cannot proceed and any FIRB application fee paid will not be refundable. This also seems to be an unintended consequence.

[3] For example, *Gange v Sullivan* (1966) 116 CLR 418 and *Sandra Investments Pty Ltd v Booth* [1983] 2 Qd R 233, both of which involved contracts for the sale of land that were subject to development approval conditions.

122. On a separate point, the operation of section 15 has caused the issue that necessitated the introduction of the concept of "near new dwellings" and a "near new dwelling exemption certificate". The proposed changes to section 15 do not address this issue. If a complete reconsideration of the operation of section 15 is not possible in these current amendments, we suggest an alternative solution to the "near new dwelling" issue. We would suggest that the definition of "new dwelling" be amended by replacing the words "has not been previously sold as a dwelling" with "has not been the subject of a transfer of legal title". This would separate the definition of "new dwelling" from the operation of section 15 and would mean that a dwelling would only cease to be new if it were in fact sold, or if it were occupied for the relevant period.

Recommendations:

We recommend:

- The proposed section 15(4) operate in respect of conditions generally.
- If the reference to "the fulfilment of a condition relating to the operation of the Act" is retained, a drafting note be included to clarify that this does not require the condition to explicitly reference the Act.
- Section 15 be amended to include a mechanism for the acceleration caused by an agreement, right or option to be unwound where the agreement, right or operation is terminated.
- The cross-reference to section 95 in section 15(4) is removed.

Other technical drafting points

Subsection 81(2)

123. Items 5 and 6 of Part 1 of The *Foreign Investment Reform (Protecting Australia's National Security) Bill 2020: Technical amendments* purports to delete note 2 to subsection 81(2). There is only one note in subsection 81(2) and we presume this is intended to refer to note 2 to subsection 82(2).

Recommendations:

We recommend clarifying the drafting points above.

Compliance and Enforcement

Reporting

124. Repeat investors may have many sets of conditions they need to comply with. Proposed new sections 98B, 98C, 98D and 98P impose further reporting obligations, as does the new register of foreign ownership.

125. The proposed penalties for failure to comply with sections 98B, 98C and 98D are unreasonably high, and should not be greater than the 250 penalty units proposed for non-compliance with notification obligations under the Register of Foreign Ownership of Australian Assets (**Ownership Register**) provisions.

Recommendations:

We recommend that:

- All reporting obligations should be streamlined to allow foreign investors to combine all of their reporting into a single report lodged at a single time.
- Reporting deadlines should be every 3 or 6 months (in line with existing land exemption certificates) rather than within 30 days of each acquisition and disposal.
- Proposed penalties for failure to comply with obligations to notify the Treasurer of the taking of actions specified in a FIRB approval should not be greater than the 250 penalty units proposed for non-compliance with notification obligations under the Ownership Register provisions.

Communication

126. Given the extent of changes to the foreign investment regime and the anticipated significant consequences of non-compliance, Treasury should:

- assure investors that Treasury is committed to administering the new regime fairly and efficiently; and
- provide guidance on what measures need to be taken to comply with Australia's foreign investment regime.

Recommendations:

We recommend that:

- Treasury maintains open channels of communication with all foreign investors in order to provide them with the necessary assurance and guidance as mentioned above.

Consequences of misleading statements or omissions

127. Given the uncertain application of the national interest and national security tests, the matters that could be material to the Treasurer's consideration will often be unknown to the applicant. In addition, the applicant may not have the technical expertise to assess what matters would be relevant to national security. There could be cases where material facts are left out, because the applicant is not aware of what is relevant.

128. Penalties for misleading statements or omissions should only be triggered where there is a mental element. For example, it should be limited to circumstances where the applicant knew or could reasonably have known that those statements or omissions are misleading in the circumstances of the acquisition. It should also be made clear that the misleading information or omission should relate to the statement given to the Treasurer, rather than what would be relevant to the national interest or national security factors considered by the Treasurer.

Recommendations:

We recommend that:

- Penalties for misleading statements or omissions should only be triggered where there is a mental element.

- The misleading information or omission should relate to the statement given to the Treasurer, rather than what would be relevant to the national interest or national security factors considered by the Treasurer.

Other technical drafting points

Definition of "reviewable national security action"

129. The meaning of "reviewable national security action" is set out in section 37B of the draft FATA but has not been referenced in the dictionary of definitions in section 4.

Foreign Investment Reform (Protecting Australia's National Security) Bill 2020: Improving compliance and additional enforcement tools

130. The *Foreign Investment Reform (Protecting Australia's National Security) Bill 2020: Improving compliance and additional enforcement tools* (**Improving Compliance Bill**) seeks to introduce two new amendments which are both proposed to be inserted as Subdivision D in Division 3 of Part 5 and numbered Section 98A. The first amendment, "Subdivision D – Other civil penalties" is set out in Item 3 of Part 1 and the second amendment, "Subdivision D – Civil penalties relating to directions", is set out in Item 7 of Part 1.

131. Item 35 of Part 6 of the Improving Compliance Bill proposes to insert a new provision after subparagraph 115(2)(b)(i) of the FATA. As no such subparagraph exists, we suggest this is meant to be a reference to subsection 115K(2)(b)(i).

Recommendations:

We recommend clarifying the drafting points above.

Register for Foreign Ownership

Scope of reporting obligations is unclear

132. We support the Government's desire to promote transparency in foreign investment in Australia through the new Register of Foreign Ownership of Australian Assets (**Ownership Register**). However, we recommend certain modifications so that the compliance burden for foreign persons is not unreasonably burdensome and is consistent with the existing notification regime under the *Register of Foreign Ownership of Water or Agricultural Act 2015* (the **Existing Register Act**).

133. The scope of the reporting obligations is unclear and inconsistent with the other parts of the FATA and with the Existing Register Act. For instance:

- Section 130J to 130N of the Ownership Register provisions refer to a concept of "interest (other than an equitable interest) in registrable land" which does not refer to the meaning of "interest in Australian land" in section 12 of the current FATA. The term "interest" for this purpose is not defined (though, oddly, proposed section 130P(a) refers to "interest in Australian land" in the context of reporting notifiable actions). Is it meant to cover legal interests in land only under property law, or all types of interests so long as they are not equitable interests? If the latter, property leases and licences with terms of 5 years or less would need to be reported, as well as easements.

Contrast this to the Existing Register Act which only requires reporting of freehold interests and >5 year leases and licences in agricultural land. While we recognise the Government's intention to broaden the classes of interests captured under the Ownership Register, it is important to balance the increased burden of compliance on investors relative to the significance of obtaining any additional information. It seems unlikely that including <5 year leases and licences on the Ownership Register would materially assist the Government's oversight of foreign interests in Australian land. But it would definitely impose significant administrative burdens on foreign persons, particularly on public utility and mining businesses given the volume and frequency of their day-to-day dealings in Australian land.

- How are changes in interests in Australian land entities dealt with? Assuming that the definition of "interest in Australian land" in section 12 of the current FATA does not apply to the Ownership Register provisions, then it appears that Australian land entities are not caught by the notification provisions in sections 130J to 130N of the Ownership Register provisions. It is unclear if they would be caught by sections 130P to 130T because section 130P carves out acquisitions of interests in Australian land whereas the other sections do not.

Recommendations:

We recommend that:

- The phrase "interest (other than an equitable interest) in registrable land" be defined to mean legal interests in land only, excluding: (i) leases and licences that would not come within section 12(1)(c) of the FATA; (ii) easements; and (iii) any legal interests acquired pursuant to an exception to the FIRB approval rules.
- It be made clear that any reporting of interests in Australian land entities are covered only by sections 130P to 130T and not also sections 130J to 130N.

Duplication of reporting obligations and penalties

134. The Ownership Register notification requirements overlap with notifications already required under existing land exemption certificates. Of greater concern is that there are significantly different penalties proposed for failure to comply with the reporting obligations under the Ownership Register provisions (250 penalty units) versus under an exemption certificate (5,000 penalty units or, for a corporation, 50,000 penalty units), and in any case the proposed penalty in the latter case is unreasonably high. All reporting matters should be addressed in one place only, which logically is in the Ownership Register provisions.

Recommendations:

We recommend that:

- The abovementioned issues be addressed by removing all reporting conditions under existing land exemption certificates.

Reporting deadlines

135. The Ownership Register provisions require notifications of all acquisitions and disposals of interests (other than equitable interests) in Australian land within 30 days of the event. We consider this to be overly burdensome, particularly for foreign investors who have a wide portfolio of land interests.

Recommendations:

We recommend that:

- Reporting deadlines should be every 3 or 6 months (in line with existing land exemption certificates) rather than within 30 days of each acquisition and disposal.
- Alternatively, the Treasurer be given the power to approve less frequent reporting deadlines for specific foreign persons.

Exemptions to reporting

136. It appears that foreign persons who acquire interests in Australian land pursuant to an exception from the FIRB approval requirements (such as easements and interests acquired pursuant to the moneylending exemption) will nonetheless need to register those interests. We think this would unnecessarily increase the compliance burden on foreign persons, particularly on public utility and mining businesses given the volume and frequency of their day-to-day dealings in Australian land, and on debt financiers. Contrast this to the Existing Register Act where foreign persons who acquire registrable interests in agricultural land as a result of enforcing a security held under a moneylending agreement do not need to register their interest.

137. In addition there does not appear to be any scope for the Tranche 2 Regulations to provide exemptions to the Ownership Register notification requirements. To address any unintended consequences, an express provision should be built into the FATA that allows the FATR to prescribe circumstances or specify classes of persons that are exempt from the notification requirements.

Recommendations:

We recommend that:

- The Ownership Register provisions not apply to the acquisition of any interests in Australian land which falls within an exception to the FIRB approval rules.
- An express provision should be built into the FATA that allows the FATR to prescribe circumstances or specify classes of persons that are exempt from the notification requirements. This power should address any unwarranted duplication of reporting obligations by giving the Treasurer power to:

  (a) exempt a foreign person from notification requirements if they have already reported the relevant actions pursuant to conditions attaching to an approval;

  (b) vary existing conditions to remove the reporting condition with the applicant's consent;

  (c) approve less frequent reporting deadlines for specific foreign persons who are already subject to reporting requirements (pursuant to an exemption certificate or existing FIRB approvals); and

  (d) allow investors to combine all reporting into a single report lodged at the same time.

Report of Registrations

138. We make the following recommendations relating to the Register.

Recommendations:

Whilst we agree the Register should not be public, we recommend that:

- FIRB should continue providing reports of registrations (as required under the Existing Register Act) to ensure debate over foreign ownership of Australian assets remains informed.

Schedule – Buy-backs of securities and capital reductions

1. Commentary

Buy-backs and other forms of capital reduction are used regularly by entities as an efficient means to manage their equity capital. We have identified 183 ASX-listed entities that engaged in buy-back activities alone during the period 1 January 2020 and 24 August 2020. Add to this number the many buy-backs undertaken by unlisted entities and other forms of capital reductions undertaken by both listed and unlisted entities.

In the case of companies with limited liability, company law has regulated buy-backs and other forms of capital reduction as part of the doctrine of capital maintenance. For example, an Australian company may only buy-back its shares if the buy-back does not materially prejudice its ability to pay its creditors and certain procedures are followed: Corporations Act section 257A. Subject to limited exceptions, buy-backs require shareholder approval. One relevant exception is for on-market buy-backs within the "10/12 limit" i.e. the number of votes attaching to voting shares in a company that are bought back within a 12 month period does not exceed 10% of the smallest number, at any time during that period, of votes attaching to the voting shares in the company: Corporations Act, sections 257B(4) and (5).

Although buy-backs and other forms of capital reduction can be used to effect a change in control of an entity, a more common use is as an efficient and flexible means for a company to return excess capital to its shareholders.

Another common use is where collective investment funds, such as unit trusts and limited partnerships, use a redemption process to facilitate the exit of investors from the fund. In an unlisted fund, a redemption process may be used because a secondary market through which existing interests in the fund could be bought or sold has not developed. Further, the fund sponsor may wish to restrict secondary market activity in order to control new entrants into the fund. In an exchange-traded fund (i.e. a listed fund that invests in listed shares or other liquid assets), a redemption process may be used by a market maker to help manage a divergence between the value of the fund's assets and the value of the fund as implied by the trading price of its interests.

A buy-back, or capital reduction involving the cancellation, of securities in an entity will increase the interests held by non-participating securityholders in the entity. However, there is some doubt at present as to whether a buy-back or such a capital reduction can trigger a significant action.

For there to be a significant action there must be an acquisition of interests in securities in an entity (FATA section 40(2)(b)).[4] In our view, a buy-back of securities cannot involve an acquisition of interests in the securities[5] and there is certainly no acquisition of interests in securities in a capital reduction involving their cancellation. FATA section 20(1) does not assist because it is directed to interpreting the acquisition of a direct interest or substantial interest in an entity, not specifically the acquisition of an interest in the securities of an entity.

[4] This does not include cases involving Australian entities that are agribusinesses or foreign government investors. In those cases, the test for a significant action is the same as the test for a notifiable action: FATA sections 40(2)(a) and 47(2) and FATR section 56(1)(a).

[5] Refer to Clark, M. and Wong, A., *Foreign Investment in Australia*, Thomson Reuters, [4.40] for relevant case law and analysis. In essence, by virtue of FATA section 9(1), an entity cannot acquire an interest in its own securities because the entity cannot hold an interest in its own securities.

We have mentioned in paragraph 95 of this paper the lacuna that exists when a notifiable action is not also a significant action. We support reforms that will ensure the Treasurer has the power to regulate an increase in interests from a buy-back or capital reduction that may be contrary to the national interest. We do not think it is sufficient to simply rely on the Treasurer's anti-avoidance powers in FATA section 78 because those powers are only available if the Treasurer is satisfied that the sole or dominant purpose of the buy-back or capital reduction was to avoid a FATA provision – a bona fide buy-back can still result in an increase in interests that is contrary to the national interest.

Notwithstanding our support for reform, we have the following concerns about the effect of proposed FATA section 15A.

(a) **Overreach** – In our view, the proposed section is disproportionate in terms of the administrative burdens it will impose compared to the national interest risks that it seeks to manage. There is a real possibility of this proposed section causing dislocation in Australia's capital markets. For example, widely-held entities may take the view that it is no longer practical for them to engage in buy-backs because of the administrative burdens that the transactions impose on their foreign investors. Some institutional investors may limit or cease their investments in Australian capital markets because they are concerned about their ability to manage this compliance risk.

The following aspects of the proposed section are, in our view, particular causes for concern.

(i) The compulsory nature of notification and the potential for it to be triggered against a foreign person for not participating in a transaction.

(ii) Some entities may trigger compulsory notification for their investors on a regular basis. For example, widely-held collective investment funds that provide redemption facilities on a regular – in some cases, daily – basis. Also, listed entities that conduct on-market buy-backs as these generally involve a number of separate purchases of relatively small parcels of securities over an extended period and, where buy orders are made, are offers made to everyone.

(iii) Tiny increases in interests will trigger compulsory notification.

(iv) A single event may trigger multiple notifications by different foreign persons all relating to the same entity.

Many foreign investors may consider it very unfair that a buy-back or redemption over which they have no control can trigger a compulsory notification for them or, in the case of a buy-back, force them to sell. It also exacerbates an existing problem for foreign government investors in the sense that they are unlikely to have oversight of the investment activities of other foreign government investors in relation to the same country (each of whom is its associate). Whereas, currently, the problem only manifests when securities are acquired, the problem will now arise when an investor is simply looking to hold an existing position.

(b) **Exempt capital reductions** – The proposed section does not recognise the following specific capital reductions that the Corporations Act permits as exceptions to the controls that usually apply:

(i) **Cancellation of forfeited securities** – A common ground for forfeiture of securities is when a security holder fails to pay a call on partly paid securities. Following a forfeiture, typically, the entity can elect to either

re-issue the securities to another person or cancel them. In the case of shares, pending a decision on re-issue or cancellation, forfeited shares have been held to exist "in abeyance" with no dividend or voting rights.[6] Failing to pay a call on partly paid securities is a very different circumstance to a security holder electing not to participate in a buy-back or capital reduction offered to it. Often, the security holder will continue to have personal liability for the unpaid call.

(ii) **Cancellation of returned securities** – The Corporations Act recognises the following situations where a company may cancel shares that are returned to it.

(A) The company issues shares as consideration under a takeover bid, later offers a new form of consideration and the relevant shareholder elects to take the new form of consideration (section 651C).

(B) The company issues shares under a prospectus or other disclosure document that contains a misleading or deceptive statement or is subject to a condition that is not satisfied (sections 724(2) and 737).

(C) The company issues shares offered in breach of the securities hawking prohibition (sections 736 and 738).

(iii) **Court order** – Section 1325A of the Corporations Act empowers a Court to make orders that it considers appropriate in response to breaches of takeovers laws (Chapters 6, 6A, 6B or 6C of the Corporations Act). If an order is made to cancel shares, the resulting capital reduction is permitted under section 258E(3) of the Corporations Act.

(c) **Terminology** – The proposed section uses the term "entity", which is defined in FATA section 4 to mean "a corporation or a unit trust". However, the terms "buy-back" and "capital reduction" are terms more commonly associated with corporations through the doctrine of capital maintenance.[7] The term "redemption" (not used in the proposed section) is an analogous arrangement commonly associated with trusts. Further uncertainty as to the application of the proposed section to trusts arises from the fact that paragraph (1)(a) refers to an entity buying back a security or otherwise reducing its capital – as a trust does not have a separate legal existence, it would be the trustee of a trust that effects a buy-back or other capital reduction in respect of the trust.

(d) **Buy-back as capital reduction** – Paragraph (1)(a) refers to a buy-back as a form of capital reduction. This is generally correct for an Australian company because of the requirement that shares be cancelled immediately after the registration of a buy back (Corporations Act, s 257H(3)); however, it is not the case in other jurisdictions (e.g. the United States of America) where a corporation that has bought-back its shares may elect to either hold them as treasury shares or cancel them. Treasury shares can be reissued and, until reissued, typically carry no dividend or voting rights.

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[6] *Pennington's Company Law* (6th ed, pp 173–4) cited in *Bundaberg Sugar Ltd v Isis Central Sugar Mill Co Ltd* (2006) 62 ACSR 502 at 513.

[7] Albeit, there is some recognition of buy-backs in the context of listed managed investment schemes – eg, *ASIC Corporations (ASX-listed Schemes On-market Buy-backs) Instrument 2016/1159* (Cth).

(e) **"Entity"** – Another consequence of the use of the term "entity" is that the proposed section does not address an increase in interests in a relevant entity that may occur as a result of a redemption of interests in a trust (that is not a unit trust) or in an unincorporated limited partnership. This could lead to an anomalous outcome given that FATA section 19 provides for the tracing of interests through trusts generally and there is a proposal to amend that section to provide for the tracing of interests through unincorporated limited partnerships.

(f) **back acceptance exception** – For a buy-back to trigger a significant action, paragraph (1)(c) of the proposed section requires that the entity make a buy-back offer to the relevant person. We have the following concerns with this provision.

(i) To the extent an on-market buy-back occurs as a result of the entity placing buy orders, the entity is making an offer to all of its securityholders.

(ii) We cannot think of a justification for treating offers under a buy-back differently to offers under other forms of capital reductions.

(iii) The exception appears to be open to easy avoidance through the simple expediency of excluding a foreign person from the offers made under the buy-back.

(iv) The inclusion of the words "where the result mentioned in paragraph (b) occurs other than by the person accepting an offer to buy back securities in the entity" is confusing. We cannot think how the acceptance of a buy-back offer by a person could ever result in an increase in the proportion of the total voting power total potential voting power or interests in issued securities that the person controls or holds. There may be a scenario where a buy-back results in such an increase because variable offers were made and other securityholders accepted a higher portion of their variable offers but the increase would still not result from the person's acceptance of the offer that was made to it.

(g) "**as a result of the buy-back or capital reduction"** – FATA section 17 provides the meaning for when a person holds an interest of a specified percentage in an entity. It would be simpler to simply apply that concept to paragraph (b) of the proposed section rather than introduce new drafting concepts. Also, the focus of paragraph (1)(b)(ii) is placed on an increase in the proportion of interests in issued securities that a person holds rather than on an increase in the proportion of issued securities that a person holds interests in.

(h) **"Security"** – The proposed section uses the term "security", which is defined in FATA section 4 to mean "a share in a corporation or a unit in a unit trust". This does not catch various rights that are convertible into, or exchangeable for, unissued shares in a corporation or units in a unit trust. For example, convertible debentures, and share warrants and options. A buy-back or cancellation of these rights by an entity may have the effect of increasing a person's potential voting power in the entity.

(i) **Inaccurate drafting note** – Paragraph (2) refers to a person, whose proportion of voting power, potential voting power or securities is increased, as a result of a buy-back or capital reduction, as being taken to have acquired an interest in securities in the entity. This picks up one of the conditions to a significant action (FATA section 40(2)(b)). There is a proposed note which says "As a result of this

subsection, the buy-back or capital reduction might amount to the taking of a significant action or a notifiable action".

We do not agree with the conclusion in this drafting note in paragraph (2), insofar as it relates to a notifiable action. A notifiable action may be triggered by the acquisition of a direct interest or a substantial interest in an entity. The focus is on the acquisition of an interest of a specified percentage in the entity rather than the acquisition of interests in a security. FATA section 20(1) already provides that a person can acquire an interest of a specified percentage in an entity other than through an acquisition (e.g. if the person becomes in a position to control more of the voting power or potential voting power). Proposed paragraph (2), as drafted, has no impact on whether an action is a notifiable action.

(j) **Non-voting securities** – Following on from our analysis in section 1(i) of this Schedule, based on the current drafting of FATA section 20(1) and proposed paragraph (2), a buy-back, or capital reduction involving the cancellation, of non-voting securities may not trigger a notifiable action because none of the criteria in FATA section 20(1)(c) would be satisfied – in particular, a person could not be said to start to hold "additional interests in the issued securities in the entity" as a result of a buy-back or other capital reduction.

(k) **Anomalous treatment** – FATR section 41 exempts a number of other important capital markets transactions from compulsory notification including rights issues, dividend/distribution reinvestment plans, bonus share plans and switching facilities. In common with buy-backs and redemptions, the exempted transactions have the potential to increase an investors interest in an entity but are not commonly undertaken for a control purpose. It will be anomalous to have a routine buy-back or redemption trigger compulsory notification while these other types of transactions do not.

(l) **No acquisition of interests in securities by entity** – For the reasons we explained in the opening to this paragraph 1, we do not think that a buy-back of securities involves the acquisition of interests in the securities. Were it to be otherwise, there would be no need for the proposed section because the necessary elements for a significant action would be present, noting that the necessary elements for a significant action do not require that the acquisition is made by a foreign person.

- While the inclusion of paragraph (3) contradicts the need for the proposed section, we do not object to its inclusion if that promotes more certainty. However, we are concerned that the inclusion of paragraph (3) will cause uncertainty for transactions that are analogous to a buy-back because including paragraph (3) implies that a buy-back (and any analogous transaction) does involve an acquisition of interests in shares. The analogous transactions that we are concerned about include security forfeitures and returns.

2. Recommendations

(a) **Voluntary notification regime** – As a starting point, we recommend that, where a buy-back or other form of capital reduction causes a foreign person to increase its interests in an entity, this be a significant action only.

The benefit of this approach is that it will give the Treasurer the power to address increases of interests caused by these transactions that gives rise to national interest concerns without imposing compulsory notification burdens in the 99.9% of transactions that do not give rise to national interest concerns.

(b) **Additional safeguards** – If our recommendation for a voluntary notification regime was accepted, there are two additional safeguards that could be adopted.

(i) Implement the voluntary notification regime via a FATR exemption. This would make it easier to adjust or eliminate the voluntary notification regime if concerns arose that it was being misused.

(ii) Consider requiring compulsory notification for a foreign person who aids, abets, counsels or procures an entity to undertake a buy-back or other capital reduction for the sole or dominant purpose of effecting a change in control of the entity. Whereas, the anti-avoidance powers in FATA section 78 place the onus on the Treasurer to initiate action, this feature would place the onus on the foreign person to notify the Treasurer (or otherwise commit an offence).

(c) **Empower target entities to clear transactions** – We recommend that entities, who propose to undertake a buy-back or other capital reduction, be given the option to notify the transaction to FIRB and obtain clearance for it. The clearance could be in the form of a special exemption certificate similar to the new (and near-new) dwelling exemption certificates that developers can apply for. The benefits of this approach include the following.

(i) Buy-backs and other forms of capital reduction are controlled by the target entity (or its trustee if the entity is a trust). As such, the target entity will be in a position to make a notification earlier than affected investors and will have an interest in doing so in order to better ensure the success of its buy-back or other capital reduction proposal.

(ii) In most cases, the target entity is also likely to have access to more complete information about its overall ownership and activities than individual investors.

(iii) A single clearance by a target entity may replace the need for notifications by multiple foreign investors of multiple individual transactions.

(d) **De minimis exemption** – We recommend that an exemption be provided which would permit an increase in interests of a certain percentage before a notification was required. By way of analogy, Australian takeover rules include a 'creep' exemption that permits the acquisition of not more than a 3% interest in any six month period outside of a takeover bid.[8]

In the context of FIRB, we do not think it would be appropriate to adopt an evergreen exemption similar to the creep exemption under Australian takeover laws. This is because the exemption could be used to effect a change in control of an entity over time.

Instead, we recommend the adoption of an exemption that would permit the acquisition pursuant to a buy-back or other capital reduction of a 5% interest above the following thresholds:

(i) if the foreign person has not had its acquisition of an interest in the entity cleared by FIRB, the applicable threshold for compulsory notification (i.e. a 5%, 10% or 20%); or

[8] Corporations Act, s 611 item 9.

(ii) if the foreign person has had its acquisition of an interest in the entity cleared by FIRB, the maximum interest cleared for acquisition (if a no objection notice is still active) or the interest acquired (if a no objection notice is no longer active).

The exemption would not apply to a foreign person who aids, abets, counsels or procures an entity to undertake a buy-back or other capital reduction for the sole or dominant purpose of effecting a change in control of the entity.

The de minimis exemption would not apply to acquisitions outside of buy-backs and other capital reductions; however, increases of interests pursuant to certain other exemptions (i.e. rights issues, dividend/distribution reinvestment plans and bonus share plans) could be counted against the 5% tolerance.

The benefits of a de minimis exemption is that it will enable a foreign person to avoid multiple notification triggers as a result of small and frequent increases in its interests that are unlikely to give rise to national interest concerns.

(e) **Exempt capital reductions** – We recommend that exemption from the application of the proposed section apply in the cases we have listed in section 1(b) of this Schedule as well as analogous cases. In these cases, we think an exception is justified because of the relatively unusual circumstances and so as not to place constraints on an entity's ability to effectively enforce calls on partly paid securities and comply with requirements relating to the return of securities and Court orders.

(f) **Technical recommendations** – We recommend that the proposed section be amended to address the technical issues we have identified in sections 1(c) to (h) including by:

(i) clarifying whether redemptions are intended to be covered by the proposed section (refer to section 1(c) for analysis);

(ii) remove the reference to 'otherwise' in paragraph (1)(a) (refer to section 1(d) for analysis);

(iii) removing paragraph (1)(c) (refer to section 1(f) for analysis);

(iv) replacing paragraph (1)(b) with the following (refer to section 1(g) for analysis):

> "(b) as a result of the buy-back or capital reduction, the percentage interest in the entity that the person holds increases"

(v) consider supplementing the reference to "security" with a reference to rights that are convertible into, or exchangeable for, securities (refer to section 1(h) for analysis);

(vi) vary paragraph (2) to read as follows (refer to sections 1(i) and (j)):

> "(2) For the purposes of this Act, the person mentioned in paragraph (1)(b) is taken to acquire an interest in securities in the entity and to start to hold additional interests in the issued securities in the entity."

(viii) vary paragraph (3) to read as follows (refer to section 1(l) for analysis):

> *~~"Buy-backs of securities – n~~No acquisition of interests ~~in securities~~ by entity in its securities*

(3) Neither ~~T~~the buying-back or forfeiture of a security in an entity by the entity ~~does not~~nor the acceptance by an entity of the return of a security in the entity pursuant to a legal requirement or Court order constitutes an acquisition by the entity of an interest in a security in the entity."