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Foreign investment reforms
Submission on FATA changes

This submission has been prepared by Herbert Smith Freehills in response to the Treasury's request for feedback on the operation of the foreign investment reforms, which commenced on 1 January 2021 (the **Foreign Investment Reforms**) which gave effect to the major reforms to the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (the **FATA**) and associated legislation announced on 5 June 2020.

Our submission on the Foreign Investment Reforms is based on our extensive experience advising leading international and domestic businesses on Australia's foreign investment regime and applications to the Foreign Investment Review Board (**FIRB**). Herbert Smith Freehills is a top tier international law firm with a market-leading corporate and capital markets practice in Australia.

1 Overview

(a) The rationale for the Foreign Investment Reforms is to ensure the protection of Australia's national interest against rising national security risks, resulting from changes in technology and the international security environment.

(b) The Foreign Investment Reforms were extensive, and not limited to the headline national security measures. We are concerned that due to the limited consultation period and expedited passage of the draft legislation to enact the Foreign Investment Reforms, there have been some unintended consequences with the Foreign Investment Reforms which are not identified and addressed during the consultation period due to the time limitations.

(c) This submission addresses some of the key issues arising from our experience of reviewing, interpreting and advising clients on the FATA (as amended) to give effect to the Foreign Investment Reforms.

2 Implementation

2.1 Updated FIRB Website and Guidance Notes

(a) In our experience, the updated FIRB Website and Guidance Notes are generally very good and have been a useful tool to assist practitioners and foreign investors understand the new foreign investment framework and investors' obligations under the framework.

(b) In particular, the new Guidance Notes are well drafted and a helpful reference point to provide an understanding of how FIRB is viewing and interpreting the FATA as amended.

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(c) It will be important to ensure that the existing Guidance Notes are updated on a regular basis to address technical issues in the FATA as these are identified and clarified, as is often the case with new legislation.

2.2 Stakeholder engagement

(a) It is always important for Treasury to be active in initiating stakeholder engagement with prospective investors and their advisers to understand issues that are being grappled with at the coal face. There has been significant Treasury engagement with stakeholders and this is welcomed and appreciated. On certain issues, there has been additional clarity provided by Treasury which has helped to clarify investor obligations.

(b) However, the key concerns of investors are generally identified during an active FIRB application process and there has been some unevenness in terms of how FIRB applications have been processed since 1 January 2021. This has been challenging in view of the expectations from investors when high FIRB application fees are imposed which creates a presumption of prompt attention and efficient assessment of FIRB applications.

3 Macroeconomic analysis

3.1 What are investors' key considerations when choosing to invest in Australia, and where foreign investment screening fits among these considerations?

(a) Key considerations for investors when choosing investment destinations vary based on a multitude of factors. However, in our experience, key factors include:

(1) general stability of the legal system and rule of law;

(2) openness to foreign direct investment and the general ease of doing business in that jurisdiction;

(3) ability to transact quickly;

(4) ease of deployment and extraction of capital from the jurisdiction (noting that many foreign investors are financial investors who will invest and then seek to extract capital in due course); and

(5) strength of the economy and its financial institutions.

(b) If a jurisdiction has a complicated, expensive or time-consuming screening process, this does not create a positive impression that such a jurisdiction welcomes foreign investment. It will also greatly impact a foreign investors competitiveness when bidding for investment opportunities. As a result, it is important that FIRB adopts a rigorous but focused assessment on FIRB applications and is diligent in adhering to statutory deadlines wherever practicable.

3.2 The impact that COVID-19 and the international investment environment has had, or is having, on foreign investment inflows into Australia?

(a) Initially COVID-19 appeared to stall most forms of M&A (and international investment) as corporates and investors worked through what the likely impact of COVID-19 would be on existing and proposed investment opportunities. This was coupled with increased foreign direct investment rules in many jurisdictions around the world including the temporary measures which applied in Australia.

(b) However, following a short hiatus, M&A returned and there has been strong deal flow over the past 12 months with speed of execution being a key consideration and determining factor.

3.3 Whether, or how, the reforms have affected Australia's attractiveness as a destination for foreign investment?

(a) In our view, it is likely to be premature to make an informed assessment of this issue noting the inherent uncertainty created by COVID-19 and other volatility in global markets. However, based on M&A activity levels over the past 8-9 months, it would appear that Australian M&A activity is still strong and whilst foreign investment from some countries (such as China) has reduced, the foreign direct investment flows still appear to be reasonably strong.

(b) However, whilst certain of the reforms appear to have been received positively (such as the exemption certificates and foreign government investor (**FGI**) changes) other changes have not been well received (such as the substantial increases in FIRB application fees and the breadth and uncertainty of the call-in powers).

(c) It is also worth noting that delays in FIRB applications being processed, with statutory deadlines being frequently sought, and broad conditions on FIRB approvals being sought without adequate regard to the specific circumstances of the FIRB application, are causing some angst amongst investors. This may be, at least in part, a result of the reforms which have created some uncertainty as to how certain provisions will be interpreted and applied in practice by FIRB. It may also be dictated in part by the familiarity of the relevant FIRB case officer with the industry to which the FIRB application relates with certain industries facing significant challenges with the imposition of impractical FIRB conditions (such as the renewables industry). It is therefore important for FIRB to practically assess what conditions may be imposed on any FIRB approval so as to ensure that these are commercially feasible and do not place undue burden on investors going forward.

4 Reform analysis – national security

4.1 Whether the national security screening requirements, and the concepts of NNSA, RNSA, and national security business and national security land, are well understood?

(a) In our view, the concepts of notifiable national security action, national security business and national security land are complex, can be difficult to apply in practice and accordingly have created some uncertainty for investors seeking to determine whether an action meets the test. We highlight below some of examples of this.

(b) *Critical services or technology:* There is significant uncertainty as to what constitutes 'critical technology' or 'critical services' – under the current guidance, investors are required to make difficult judgments about what is '*vital to advancing or enhancing Australia's national security and could be detrimental to Australia's national security if not available or misused*'. We appreciate these are difficult issues and it is important to balance national security concerns. While there are some examples in the current guidance, it would be helpful for this to be built out further, in particular, what is not considered critical. For example, if a good or service is easily substitutable (and not just where it is widely available or off the shelf), this may point to it not being critical. Other factors which may point to a good or service not being critical could be that it is provided on a short term basis only or can be easily terminated.

(c) *Starting a national security business:* The guidance for what constitutes starting to carry on an Australian business (which we understand applies in determining when a foreign person starts a national security business) includes matters which we think more appropriately fall within preparatory steps and should not be considered starting a business, for example, applying for an ABN. We also

consider that form a policy perspective, engaging consultants to assist in preparatory steps or entering into contracts where commencement is subject to FIRB approval should not give rise to concerns and it would be helpful for the Guidance Note to clarify this.

(d) *Reasonable enquiries:* A business is only a national security business if the applicant knows that it is, or could know this on the basis of making reasonable enquiries of publicly available information. Similarly, land is national security land if an agency in the national intelligence community has an interest, if the existence of the interest is publicly known or could be known upon the making of reasonable inquiries. We think it would be helpful to provide additional guidance on what 'reasonable inquiries' means – for example which sources need to be reviewed and who an investor needs to make reasonable inquiries of. For example, in a hostile bid process or competitive processes, the investor may not have the opportunity to ask the vendor or target.

(e) There is current no de minimis concept in determining what constitutes a national security business. For example, an arrangement which contributes only a de minimis amount to the revenue or assets of the target business, or even where may result in the business being a national security business – this has particularly significant implications in the context of offshore transactions.

(f) The concepts of notifiable national security action and national security business will become even more difficult to apply in practice once the *Security of Critical Infrastructure Act 2018* (**SOCI Act**) is amended to significantly expand the categories of critical infrastructure.

4.2 Whether the framework for defining these concepts (i.e. across the legislation, regulations and official Guidance Notes) is appropriate and sufficient?

(a) We consider that the overall framework for defining these concepts across the legislation and regulations and providing more detailed guidance through the official Guidance Notes is appropriate. While we think the Guidance Notes are very helpful, as noted above we do think there is scope for more clarity to be provided in the Guidance Notes.

(b) Given the complexity of these concepts, it would also be helpful if the FATA, the regulations made under it and the Guidance Notes are, to put it colloquially, the '*source of truth*' and do not require extensive cross-referencing to other legislation and materials. While we appreciate this cannot be avoided in some circumstances, it would be helpful if the Guidance Notes spell out key definitions or concepts as much as possible. This will be of even greater importance once the amendments are made to the SOCI Act.

4.3 What factors investors consider when deciding whether to voluntarily notify, including the effectiveness of the guidance on voluntary notification of RNSA in the *National Security Guidance Note*?

(a) Some factors investors consider in deciding to voluntarily notify are:

(1) mitigating against the risk that the action is called-in for assessment post-closing and not having certainty of orders that may be made (whether divestment or imposition of conditions);

(2) assessing the likelihood of the transaction being called-in – noting that the investors are also influenced by the guidance on voluntary notification of RNSA in the *National Security Guidance Note* in making this assessment; and

(3) where an investor has determined that an action is not mandatorily notifiable (e.g. where they consider it is not 'critical technology or

services') but want some certainty, they may make a voluntary notification.

(b) The above is also weighted up against factors including:

(1) in a competitive bid process, investors may not voluntarily notify as they want to maintain an attractive bid with minimal conditions;

(2) the risk of conditions being imposed on the transaction (when possibly no conditions would be imposed if the transaction is not notified and not later called-in);

(3) where there is a strategic advantage or a need to undertake the transaction quickly and there is uncertainty as to how long the FIRB process will take (which may jeopardise the ability to undertake the transaction); and

(4) if there are significant fees involved, investors may be less inclined to notify.

5 Reform analysis – compliance

5.1 Whether the new powers and increased enforcement penalties have resulted in a change in investors' attitudes and behaviours towards compliance?

(a) In our experience, investors do their best to seek to comply with the regime and most non-compliance is inadvertent. The new powers and increased enforcement penalties do not change that position.

(b) We understand that FIRB takes into account a wide range of factors in determining what penalties to apply but it could be helpful to provide some guidance on those.

5.2 Whether the new compliance obligations of investors are clear and adequately explained in the available guidance material?

Yes, we believe the compliance obligations are clear.

6 Reform analysis – streamlining

6.1 Whether the streamlining measures have reduced the regulatory burden on investment funds making investments into Australia?

(a) The changes have been very well received in the industry. Investment fund managers have appreciated the efforts by FIRB to reduce the regulatory burden and we have been approached by investment fund managers to understand how these processes can be utilised. The additional information in the "Key Concepts" Guidance Note regarding when a member of a scheme will be considered able to influence individual investment decisions is also very helpful as there had been some uncertainty as to whether veto rights or participation in advisory committees could be deemed to be a form of "influence".

(b) However, in practice, we are finding that a significant number of large and well-known investment funds are unable to qualify for the streamlining measures, because such funds often have FGIs from a single country who hold, in the aggregate, a substantial interest in the fund (e.g. United States pension and educational endowment funds). As a result of this, these investment funds are deemed to be FGIs under section 17(1)(d)(i) of the *Foreign Acquisitions and Takeovers Regulation 2015* (Cth) (**FATR**) and do not qualify for exemptions under section 17(2) of the FATR.

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6.2 The expected utility and impact of the new passive foreign government investor Exemption Certificate?

(a) Conceptually, this is an excellent proposal and we expect that many investment funds will explore whether this could be of benefit to them. Subject to our comments below, we expect that the Exemption Certificate regime will be of particular benefit to portfolio companies that, following a previous acquisition are deemed to be FGIs, and are pursuing a clearly defined strategy for bolt-on acquisitions. This will enable such companies to participate in competitive sale processes on an equal footing relative to other foreign persons.

(b) It would be useful to have further guidance on the extent to which an FGI who obtains an exemption certificate will be deemed to be a foreign person only under the FATA. For example, based on the guidance it is not clear whether an entity is granted an exemption certificate, will be treated as a foreign person (only) for all purposes of the FATA, including the tracing provisions. In particular, it would be useful for further guidance to be published clarifying whether, in the situation where an exemption certificate holding FGI holds an interest in another entity, the higher entity will be deemed to be a foreign government investor or just a foreign person when determining whether the downstream entity is a foreign government investor or not.

(c) Investment funds regularly use investment structures that involve the aggregation of a number of feeder funds into intermediate vehicles which in turn invest into Australian entities. If the scope of the Exemption Certificate is limited to the offshore investment fund alone, this would mean that the Exemption Certificate would only apply to investments undertaken directly (which would be of limited practical utility).

(d) In respect of investment funds more broadly, we expect that the level of use of these certificates will be driven by the following key factors: (1) the level of detail required to be disclosed in order to satisfy the passivity requirements as investment funds will likely be unable to disclose establishment documents or partnership agreements (for confidentiality reasons); (2) whether investment funds that comprise multiple parallel investment vehicles that operate as a single fund can be treated as a single economic entity (which is contemplated by Guidance Note 9); and (3) the level of specificity required in relation to potential target investments (noting that, for certain large investment funds, the deal size and nature of the targets could vary significantly whilst still falling within the remit of their investment mandate).

6.3 Other opportunities for streamlining the screening process to reduce regulatory burden while enabling appropriate scrutiny of risk?

(a) While all investment funds understand the need for foreign investment controls, most struggle with the level of scrutiny given to offshore transactions with a limited connection to Australia. Although favourable modifications have been made for investment funds, many are still deemed to be FGIs, which means that offshore acquisitions with a limited connection to Australia are frequently caught by the legislation. We would suggest that consideration could be given to revisiting section 56 of the FATR.

(b) We have detailed this proposal in paragraph 8.1 as it applies to FGIs generally and not just investment funds that are deemed to be FGIs.

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7 Reform analysis – fees

7.1 Whether the new fees framework affects investor decisions on investing into Australia?

(a) The short answer is yes. We consider that some of the fees are very high and arguably disproportionate. This is particularly the case in relation to residential land.

(b) This is proving to be particularly challenging for property development companies aiming to redevelop what is currently residential property into subdivided properties. Many of Australia's leading property developers are foreign persons under FATA. FIRB may wish to consider revisiting fees for residential property redevelopment, which directly assists one of FIRB's stated objectives of increasing Australia's housing supply.

7.2 Whether the new fees framework affects when and how investors apply for foreign investment approval?

Yes – see our comments below regarding competitive sale processes. These comments apply equally to competitive sale processes for businesses and for land (i.e. auctions).

7.3 Whether there is a need for further guidance on the fees framework and, if so, what that guidance should address and in what format?

(a) The latest Guidance Notes are, in our opinion, the most comprehensive and clearest Guidance Notes that FIRB has ever issued.

(b) The guidance is relatively clear in our opinion – the issues that we see do not relate to the guidance but rather the quantum of fees and lack of visibility on refunds.

8 Other matters

8.1 FGI offshore dealings

(a) Unlike foreign persons, investors which are considered to be FGIs may require FIRB approval under section 56(1)(a) of the FATR in respect of an incidental interest acquired in an Australian entity or business, which is a subsidiary of an offshore target, notwithstanding that such interest may only be a minor component of the overall transaction (section 56(1)(a) of the FATR).

(b) In these circumstances, an exemption may be available under section 56(4) of the FATR if the incidental Australian assets are:

(1) less than 5% of the total value of the offshore entity;

(2) are less than $60m in value; and

(3) are not assets of a sensitive business.

(c) We consider that the threshold for this exemption is too low and catches quite a lot of transactions. This makes Australia an "anchor drag", making multinationals less willing to invest here.

(d) In our view, the appropriate way to deal with this would be to repeal section 56(4)(c) of the FATR, such that the exemption would apply if an investment comprised less than 5% of the value of the total assets of the target (even if that was more than $60 million). Practically, if the value of the Australian entities within a target group comprise such a small percentage, they were unlikely a material motivation for the acquisition. This would still provide appropriate protection in relation to an indirect investment in a sensitive business.

(e) We would further suggest that the FGI exemptions (including this exemption for offshore dealings) under s56(3)-(7) of the FATR should be amended to clarify that they also apply to the standard significant and notifiable actions under the FATA. As currently drafted, the exemptions are of limited utility as they are expressed only to apply to the significant and notifiable action under section 56(1)(a) of the FATR (in contrast to the exemptions in Part 3 Division 3 of the FATR, which apply broadly to the 'excluded provisions').

(f) In addition, there is some uncertainty regarding the application of the de minimis exception in circumstances where the relevant Australian subsidiaries hold both assets in Australian and assets offshore. The note immediately following section 56(4) of the FATR, which deals with this issue, mentions that the total asset value only takes into account the value of assets in Australia and references section 20 of the FATR in support of this. However, this note appears to be inconsistent with section 20(5)(a) of the FATR which includes, for the Australian subsidiary, the total assets of that entity wherever held. It would be helpful if the intended application of this exception could be confirmed as we are aware of applicants not availing themselves of the exception where the "total asset value" of an Australian subsidiary (including offshore assets held directly by that entity) exceeds the threshold.

8.2 Moneylending exception

(a) Secured lenders who are classified as foreign persons are currently required to seek FIRB approval where the borrower is a national security business, even if wholly Australian owned, in order to be able to exercise their security.

(b) As lenders need to know up front, before lending, that they will be able to exercise their security, lenders must apply up front for FIRB approval in these circumstances. Multiple FIRB applications are often required by different lending groups in these circumstances, and delays in these FIRB applications being considered are inevitable. In our view, this is a structural deficiency which restricts access to finance and increases financing costs for business in Australia. There is no risk where the moneylending exception is suitably limited.

8.3 Application of the rights issue exemption

(a) There is some doubt as to whether the exemption from mandatory notification for a rights issue (section 41(2) of the FATR) applies to the capitalisation of wholly-owned subsidiaries by foreign persons. In our view, FIRB approval should not be required for additional capitalisation of a wholly-owned subsidiary unless this is associated with another action (e.g. an acquisition of a new company or business which itself requires FIRB approval). This could usefully be clarified in a FIRB Guidance Note or an amendment to the FATA or FATR.

(b) There is also some doubt as to whether the rights issue exemption applies to unlisted public companies or private companies in relation to a capital raise where there is a pro-rata offer to existing shareholders to subscribe for their pro-rata share of equity. In our view, FIRB approval should not be required for a shareholder participating in such a rights issue. This could also be usefully clarified in a FIRB Guidance Note or an amendment to the FATA or FATR.

8.4 Technical Foreign Entities

(a) This concerns foreign entities who hold only as a trustee. We had understood that it was the intention of FIRB that these entities would be exempt but actions taken by them still constitute "significant actions" and entities in which they hold a substantial interest are still "foreign persons". We do not consider that there is a policy rationale for this.

(b) Interests in trusts: the definition of foreign persons in the FATA opens with the words "the trustee of a trust" but it seems they were intended to include the general partner of a limited partnership and many parties proceed on that basis. As has been done with section 17(1)(d) of the FATR, which mirrors section 17(1)(c) of the FATR but applies to general partners of limited partnerships instead of trustees of trusts, we would suggest that this could be clarified.

8.5 De minimis foreign government investor holdings in ASX listed companies

(a) Paragraphs (c) and (e) of the definition of 'foreign person' should be amended to include a reference to a 'separate government entity'. This will clarify that section 47 of the FATR (which permits less than 5% holdings by foreign persons in listed Australian companies to be disregarded for the purposes of determining whether that company is a foreign person) also permits less than 5% FGI holdings to be disregarded.

(b) On the current drafting, the exemption permits holdings held directly by a 'foreign government' to be disregarded, but not by another type of FGI, such as a 'separate government entity', and there seems to be no policy basis for that distinction.

8.6 Acquisitions of interests from government

(a) Section 28(2) of the FATR (on a technical reading) results in all acquisitions of interests in land from government being excluded from the exemption in section 31 of the FATR (as all acquisitions of land are reviewable national security actions under section 55F of the FATA, and therefore excluded from Division 3 of the FATR under section 28(2)) of the FATR.

(b) It would be desirable that section 28(2) of the FATR is amended to clarify that acquisitions falling with section 31 of the FATR are not significant or notifiable actions (but remain subject to the call-in power).

8.7 Refunds for FIRB application fees

(a) Due to the increasingly complicated foreign investment regime in Australia, vendors of Australian assets are becoming more concerned about deal certainty when dealing with a prospective purchaser that is a foreign investor which requires FIRB approval. In order to deal with this, vendors are regularly requiring that prospective purchasers in a competitive sale process obtain FIRB approval (and thereby incur a FIRB application fee) prior to entering into binding legal documentation. This can often mean that multiple prospective purchasers are seeking FIRB approval when ultimately only one purchaser will be the successful party to acquire the relevant target assets.

(b) The current foreign investment regime appears to have limited opportunities for a prospective purchaser in a competitive sale process to receive a refund of its FIRB application fee in the circumstances referenced above.

(c) Noting the proposed introduction of the call-in power and an enhanced penalty regime, there is a risk that more prospective purchasers will seek FIRB approval even in instances where it may not be strictly required.

(d) It is considered that in all of these circumstances, greater consideration needs to be given to refunds of FIRB application fees being provided to prospective purchasers that ultimately do not enter into binding legal documentation with an Australian vendor on a transaction in relation to which a FIRB application has been submitted.

(e) An alternative in a competitive sale process may be that only one fee is paid by all bidders (and for example split between all foreign bidders requiring FIRB or paid by just the successful bidder).

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8.8 Fees for internal reorganisations and actions taken by wholly-owned groups

(a) The *Foreign Acquisitions and Takeovers Fee Imposition Regulations 2020* (Cth) imposes a fee of $12,700 for actions that satisfy the definition of 'internal reorganisations'. The relevant definition is satisfied if the internal reorganisation involves the acquisition of interests in securities and both the acquiring entity and the target entity are subsidiaries of the same holding company or when the target entity is a subsidiary of the acquiring entity.

(b) As noted in previous submissions on the proposed changes for Australia's foreign investment regime, we consider that the internal reorganisations of foreign persons, where the ultimate beneficial ownership remains unchanged, should be exempt from the foreign investment regime. Where the ultimate beneficial ownership does not change, the risks imposed from an internal reorganisation are likely to be minimal. The requirement of preparing a FIRB application and seeking approval seems to be onerous and unnecessary for this type of internal reorganisation.

(c) Noting that tax leakage may be an issue to consider in relation to a restructure, it is considered that any tax concerns arising from internal restructures for foreign entities should be regulated through the usual tax system on a non-discriminatory basis with domestic entities, rather than through the foreign investment system.

Yours sincerely

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