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31 August 2020
By electronic lodgement

Foreign investment reforms
Submission on exposure draft legislation

This submission has been prepared by Herbert Smith Freehills in response to the Australian Government's exposure draft legislation released by Treasury on 31 July 2020, proposed to give effect to the major reforms to the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (the **Act**) and associated legislation announced on 5 June 2020.

Our submission 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 announced rationale for the proposed 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) As part of the reform process, the Government has also reaffirmed its strong commitment to welcoming foreign investment, which is recognised as important to Australia's long-term economic success, stability and prosperity.

(c) The proposed reforms are extensive, and are not limited to the headline national security measures. However, it is acknowledged that reform of the Act is necessary in order to deal with a changing landscape and that other countries around the world have introduced, or are considering the introduction of, similar measures in relation to foreign direct investment regulation.

(d) This submission addresses some of the key issues arising from our review of the exposure drafts of:

(1) the Foreign Investment Reform (Protecting Australia's National Security) Bill 2020 (the **draft Bill**); and

(2) the Foreign Investment Reform (Protecting Australia's National Security) (National Security Business) Regulations 2020 (the **draft Regulations**).

2 Key issues on the draft Bill and draft Regulations

2.1 Expanded screening and approach to defining 'national security business'

(a) The proposed expansion of the category of mandatory notification actions (to include new 'notifiable national security actions') represents a significant shift in the basic approach to the classification of transactions that rests at the core of the screening mechanism.

(b) The existing categories are generally based on *quantitative* aspects of a transaction (percentage and monetary thresholds) and certain characteristics *of the person taking the action* (such as whether the person is a 'foreign person' or 'foreign government investor'). The need to assess qualitative characteristics of the target is generally limited to relatively clear sectoral definitions (such as agribusinesses, 'sensitive businesses' including telecommunications, and media businesses).

(c) The category of 'notifiable national security actions' upends the existing general approach, with the focus becoming almost entirely upon a *qualitative* assessment *of the target* of the action. In principle, this may represent a rational extension of the screening regime. However, at least three (3) practical concerns arise which we submit should be addressed in the implementation:

(1) Qualitative criteria are necessarily more difficult for investors to assess with a high degree of confidence (and high confidence is needed, noting the severity of the penalties discussed below). This requires clear drafting and appropriate use of definitions or examples.

(2) Characteristics of the target land, business or entity are necessarily more difficult for an investor to assess. This is because prior to an action the investor does not usually possess complete information about the target of its acquisition or investment. This is a more difficult problem to solve (especially for transactions with no or limited due diligence, such as hostile takeovers or time-sensitive insolvent sales by administrators or liquidators). In addition to clear drafting, this requires qualitative assessment criteria based on reasonably ascertainable information about a business.

(3) The zero threshold for notifiable national security actions means that investors will need to consider this definition for *all* acquisitions, no matter how small. Previously, relatively high thresholds were deliberately set to encourage investment and establish a low regulatory hurdle for many acquisitions. This means that, since *every acquisition* will now need to be considered against the new definitions, there is an even stronger need for clear and easily understood criteria.

(d) The proposed definition of 'national security business' in section 10A of the draft Regulation does not appear to us to adequately satisfy these requirements. We submit that the current drafting requires some revision and re-consideration, addressing in particular:

Breadth of definition of 'critical':

(1) Paragraph (a) may need to be limited, given the ongoing review and potential expansion of the remit of the *Security of Critical Infrastructure Act 2018* (Cth) to cover many major parts of the economy (including banking, data, education, energy, food, health and transport). The potential breadth of what is included could be unintentionally all-encompassing which appears to cut across the policy rationale for these changes.

(2) Paragraphs (d) to (h) are insufficiently clear. The natural meaning of 'critical' does not appear to align with the intention identified in the draft Explanatory Memorandum (**EM**), in particular the EM's suggestion of reference to strategic priorities identified in publicly available Defence materials.

Use of 'intended' and 'intends'

(3) The use of 'intended' / 'intends' appears to be somewhat confusing and inconsistent:

(A) since goods and technology cannot possess their own intentions, 'intended to be for' presumably means to refer to the intention of a developer, manufacturer, supplier or customer, but does not identify which – if this is instead targeted at the objective characteristics of the good / technology itself, 'designed for' may be more appropriate;

(B) the intended relevance of the distinction between goods and technology that 'are … for' or 'are intended to be for' is not immediately apparent: if a good is 'intended to be for' a purpose, it may also be 'for' that purpose; and

(C) future intention to provide 'critical' services is captured, but not future intention to supply, develop or manufacture goods or technology – the rationale for this distinction is unclear, and as starting a national security business in the future is separately notifiable in any event, the words 'or intends to provide' in paragraph (h) should be deleted.

(4) Paragraphs (i)-(l) also appear to create difficulty because targets of investment may not be permitted to disclose the fact of their holding the relevant information to potential investors, given that the information is necessarily highly sensitive.

Overarching reasonable awareness requirement

(5) In addition to clarifying the drafting of the definition of 'national security business', we consider that the definition may also include a reasonable awareness limitation so that a business is only a 'national security business' to the extent that an investor could have reasonably been aware of that in the circumstances of the acquisition, e.g., for a hostile acquisition where the acquirer had no or limited due diligence, that would mean based on information that was publicly available.

Meaning of 'starts a national security business'

(e) There is also some uncertainty in the meaning of 'starts a national security business' in section 8A. For example, we consider it should be made clear that starting new activities which are incidental to a national security business that is already carried on by the foreign person would not be taken to be 'starting a national security business'.

(f) The screening regime is sometimes viewed as a balance between protecting the national interest and securing investment in a competitive global economy. However, uncertainty harms both: it increases costs and deters investment, while also increasing the possibility of honest mistakes leading to FIRB not being notified of genuinely sensitive actions.

Narrowing of moneylending exemption

(g) Although the draft Regulations in relation to the narrowing of the moneylending exemption are yet to be released, we consider it relevant to note the dramatic potential consequences of this change. It appears to be proposed that all lenders would need to seek approval, with a zero monetary threshold, before taking security over any national security business, even if that business is 100% Australian-owned. If that is the effect of the proposed change, the necessary consideration of FIRB issues for *every* secured finance transaction,

regardless how small, could have serious impacts on the costs of and access to finance for Australian businesses.

2.2 Treasurer's power to extend the statutory review period

(a) Historically one of the great benefits of the FIRB application process was the prompt and efficient review process undertaken by FIRB which generally resulted in a decision being made within the statutory period of 30 days. The process for extending the statutory period required engagement from FIRB with the applicant, rather than this being a unilateral extension process at the behest of the Treasurer.

(b) The draft Bill is proposing to grant the Treasurer a unilateral right to extend the statutory period by a period of up to 90 days. We understand that it is also proposed that the Treasurer is not required to consult with the applicant prior to extending the decision period by up to 90 days.

(c) Noting the quantum of the fees now being charged by FIRB in relation to FIRB applications, we are concerned about how the inclusion of a unilateral right to extend a decision period by 90 days without consultation will be received by foreign investors.

(d) Whilst it is acknowledged that the current regime provides the applicant with limited ability in practice to reject a FIRB request for an extension to the decision period, there is at least structured engagement between FIRB and the applicant prior to an extension of the decision period occurring. If this proposed power is regularly used by the Treasurer, we would be concerned about an impression that Australia's FIRB approval process is slow and expensive which may deter jurisdiction agnostic capital from being allocated to Australia.

(e) If this unilateral power of the Treasurer is to be retained, at a minimum we consider that it would be appropriate to require the Treasurer to at least consult with the applicant (even if this did not require reaching agreement with the applicant) prior to an extension of the decision period being made.

2.3 Penalties

(a) Significant increases to penalties are proposed in the context of limited evidence of widespread, deliberate breaches of the foreign investment rules. In particular, directors of corporations that fail to notify transactions or contravene conditions imposed on FIRB approvals may be liable for:

   (1) maximum criminal penalties of up to 10 years' imprisonment and 15,000 penalty units (over $3.3 million); or

   (2) maximum civil penalties ranging (subject to the value of the transaction) from about $1 million to $555 million.

(b) We submit that the proposed maximum penalties for individuals are excessive, disproportionate, and inconsistent with general community standards relating to the punishment of wrongdoing. In view of this, we consider that the quantum of the proposed penalties should be revisited and reduced accordingly.

(c) When added to the uncertainty generated by the proposed expansion of the screening regime, the imposition of substantial penalties also has significant potential to generate fear amongst the makers of ultimate investment decisions.

(d) We are concerned that if there is heightened anxiety, this may lead to a significant number of 'precautionary' applications being made to FIRB, causing significant costs and delays for investors. Such 'precautionary' applications are also unlikely to be of significant assistance to FIRB, as the applicant will have limited ability to comprehensively flag the unknown features about which it is concerned (especially given the substantial penalties for providing information

that is misleading in a material particular – or doing so by omission – even where this is not intentional).

(e) We also consider that there should be a provision introduced which exculpates any party where the relevant breach is attributable to a failure to identify a national security business (arising in some obscure way) or a misleading statement made in an application in circumstances where the matter could not reasonably have been identified by making enquiries which were reasonable in the circumstances. There are some businesses which, by their nature, are very widespread. In these circumstances, it may not be practicable for prospective foreign investors to identify physical defence or intelligence facilities across a wide geographic scope. Similarly, the engagement of a business with defence or intelligence might be extremely minor when examined as part of a larger transaction. These nuances and a materiality test should be applied when these provisions are being examined.

2.4 Last resort power

(a) The proposed last resort power, which allows the re-examination of a previously FIRB approved transaction, is a dramatic change to Australia's foreign direct investment regime. Put simply, the last resort power significantly erodes the benefits of receiving FIRB approval if such an approval can be subsequently re-visited following completion of the relevant transaction. Whilst the last resort power may only be exercised in exceptional circumstances, its mere existence creates a sovereign risk issue – that is, the rules can be changed after material investment decisions have been made in reliance on government approval – which may deter foreign investment into Australia. This is particularly problematic for long-term capital intensive projects which often require a 30-40 year investment horizon underpinned by certainty as to the likely return on capital.

(b) If the last resort power is to be retained, its potential exercise must be subject to restrictions and protections for provide a greater level of comfort for prospective foreign investors. This could include a standard of reasonableness as to what level of ongoing monitoring is required by a foreign investor so as to identify a future national security risk arising. It may also be worth considering a consultation right for foreign investors in circumstances where the business, structure or organisation have materially changed.

(c) It is also considered that foreign investors will need to be provided with greater clarity as to the remedies available them in the event that the last resort power is exercised. This could include the right for foreign investors to seek an AAT review to cover the appropriateness of orders made by the Treasurer and any new conditions imposed by the Treasurer in relation to an exercise of the last resort power.

2.5 Integrity measures – share buy-backs and capital reductions

(a) We have some concerns about the proposed new section 15A of the Act, which seeks to deal with certain buy-backs of securities and capital reductions. As we understand it, the proposed section 15A is intended to apply to:

(1) equal access share buy-backs undertaken by an Australian company (i.e. it will not apply to <u>selective</u> share buy-backs);

(2) equal access capital reductions undertaken by an Australian company (i.e. it will not apply <u>selective</u> capital reductions); and

(3) a capital reduction (or capital redemption) undertaken by an Australian unit trust in which a capital reduction (or capital redemption) is offered to all unitholders (as opposed to a unilateral capital redemption

initiated by an individual unitholder seeking a partial or full liquidity event).

(b) It is not clear from the drafting of the proposed new section 15A that this section will only operate in the circumstances outlined above, despite some guidance provided to this effect in the Explanatory Memorandum (see paragraph 2.30).

(c) We envisage that the relevant obligations crystallised by section 15A being triggered are only intended to apply if the relevant share buy-back or capital reduction is effectively initiated by the relevant company or unit trust and offered to all shareholders or unitholders. If our understanding of the intention is correct, further clarity on this in the final legislation would be useful to ensure that the proposed new section does not have unintended consequences. For example, if a unitholder is entitled to redeem some or all of its units in order to obtain liquidity (e.g. by notifying the trustee in accordance with the underlying unit trust deed), it is considered that such a redemption (which would effectively be a selective capital redemption) should not be within the scope of the proposed section 15A.

(d) In addition to the matters outlined above, it is also unclear how the proposed section 15A would work in practice, in terms of shareholders and unitholders having sufficient information to be able to know with certainty whether or not section 15A will be enlivened if the relevant shareholder or unitholder does not participate in a particular share buy-back or capital reduction. Whilst it is accepted that the obligation crystallises 30 days after the completion of the relevant share buy-back or capital reduction, it is not clear whether the necessary information would be available to the shareholder or unitholder in order for it to comply with its obligations.

(e) We would envisage that a shareholder or unitholder may need to have access to the entire shareholder base or unitholder base pre- and post- the relevant share buy-back or capital reduction in order to determine whether it had an obligation to notify FIRB upon deciding not to participate in such a share buy-back or capital reduction.

2.6 Integrity measures: exempt routine transactions

Whilst it is appropriate to tighten various parts of the Act to deal with various integrity concerns, the substantial re-drafting of the Act that is proposed should also address problematic aspects of the current legislation which trigger FIRB applications in circumstances where it is difficult to understand the policy rationale or logic behind a FIRB approval being required. We have outlined below four (4) examples of this which we submit should be considered as part of the revamping of the Act.

(a) Initial establishment and further capitalisation

Capitalisation of wholly-owned Australian subsidiaries of foreign persons can potentially be captured under the Act, as notifiable actions (but, oddly, not significant actions, as there is no change in control), where the capitalisation is by way of issuing new securities to the foreign parent.

Although section 41(2)(a) of the *Foreign Acquisitions and Takeovers Regulation 2015* (**Existing Regulations**) provides for a 'rights issue' exemption which, in principle, could apply to this scenario, 'rights issue' is not defined in the Existing Regulations (with no reference made to the definition in section 9A of the Corporations Act 2001 (Cth)), and conventionally refers to scenarios involving multiple shareholders, often in listed companies. This creates uncertainty for what should be routine, non-controversial transactions where there is no new business started or new acquisition. We consider that the existing legislation should be amended to make clear that routine initial or further capitalisations of a wholly-owned subsidiary for existing working capital purposes by its current foreign shareholder are exempt.

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(b) Internal corporate re-organisations or restructures

Internal corporate restructures involving a foreign person also seem to be regularly caught under the Act, requiring a FIRB application and approval. In particular, an internal corporate restructure may satisfy the requirements of a notifiable action under the Act for reasons similar to the reasons why a capitalisation may be deemed to be a notifiable action. However, ambiguity exists as to whether the first condition in section 47(2)(b) of the Act is met as an 'acquirer' under an internal reorganisation may not be acquiring a substantial interest in the target entity, as the acquirer, in the case of an internal reorganisation, may already hold an indirect interest in the target entity. (The application of the tracing rules in section 19 of the Act to these scenarios presents another source of ambiguity, where the existing indirect holding of the 'acquirer' may be taken to be directly held in certain circumstances.)

It is proposed that the foreign investment rules around internal corporate restructures of foreign persons, where the ultimate beneficial ownership remains unchanged, should be amended, such that these actions 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.

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.

(c) Offshore global transactions by foreign government investors

Section 56(4) of the Existing Regulations is intended to provide an exemption for an acquisition of Australian interests by a foreign government investor where the Australian interests are non-material and merely incidental to an offshore global acquisition (i.e. where the criteria set out in sections 56(4)(a)-(d) are met).

We consider that, for clarity, if the criteria are met, this exemption should apply to exempt the action from being a significant and notifiable action under the Act (or at least from being a notifiable action) and should not be limited to being an exception specific to the acquisition of a direct interest under section 56(1) of the Existing Regulations.

(d) Foreign persons in which foreign custodian corporations have interests

We welcomed the insertion of section 41A into the Existing Regulations in 2017 to clarify that entities who are only technically a 'foreign person' due to foreign custodian holdings (**Technical Foreign Entity**) do not have to notify of actions which may otherwise fall within the scope of the Act and regulations.

However, there remains uncertainty in relation to the application of the Act and regulations to such Technical Foreign Entities, in particular:

(1) actions taken by these Technical Foreign Entities remain significant actions under the Act (as Division 2 of Part 2 of the Act (meaning of significant action) is not currently included in section 41A(1)); and

(2) entities in which a Technical Foreign Entity holds a substantial interest will be a 'foreign person' and will not have the benefit of section 41A.

We do not see any policy rationale for the above and consider that to avoid the uncertainty outlined above, section 41A should be broadened to clarify that entities who are only foreign due to custodian holdings of the kind mentioned in paragraph 30(a) of the Existing Regulations will be deemed not to be foreign persons for the purposes of the Act and regulations.

If you have any queries in relation to the above submissions, we would be happy to discuss any aspect of these with Treasury.

Yours sincerely

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