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31 August 2021

Manager
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The Treasury
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By email
FIRBStakeholders@treasury.gov.au

Dear Sir / Madam

Submission on Evaluation of the 2021 foreign investment reforms: consultation paper

Baker McKenzie appreciates the opportunity to comment on the matters set out in the Evaluation of the 2021 foreign investment reforms: consultation paper published in July 2021 (**Consultation Paper**).

We regularly advise foreign investors on Australia's foreign investment framework and act on their investments in Australian businesses.

Our responses to a number of consultation questions are set out below. There are issues such as timing, which Treasury and FIRB are very aware of, and hence, we have not commented on those issues. The views expressed in this submission are ours alone, and do not necessarily reflect the views of our clients.

Consultation Paper: Item 4. - Reform analysis - national security

Consultation questions

To inform the evaluation, the Treasury is interested in hearing from stakeholders with regards to:

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;

4.2 whether the framework for defining these concepts (i.e. across the legislation, regulations and official guidance notes) is appropriate and sufficient; and

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*.

Response to consultation questions 4.1, 4.2 and 4.3

FIRB Guidance Note 8 (National Security) (**G8**) has been helpful in providing guidance regarding reviewable and notifiable national security actions.

However, the sectoral guidance in G8 in relation to critical service providers and suppliers[1] and critical technologies[2] is unclear and potentially captures businesses and entities that are not intended to be captured. In particular, the sectoral guidance on critical technologies and when mandatory notification obligations apply should be more specific. A more precise list of categories and technologies, services and goods, would be helpful as is the practice in the US.

Although G8 contains information technology, data and cloud sectoral guidance, G8 would be enhanced by providing guidance in relation to investments in businesses which produce products which may have both civilian and government applications which would not ordinarily be considered to be "dual use" products. It is currently not sufficiently specific in the legislation or in G8. More detailed guidance on when mandatory notification obligations apply, not just voluntary notification, would be helpful.

In addition, foreign investors are concerned that investments in businesses which, at the time of investment, do not service government, intelligence or defence customers (e.g., businesses which produce communications software applications) may in the future come to service those customers and so be subject to the call-in power within 10 years after the initial investment. This perceived risk can affect the attractiveness of Australian businesses to foreign investors.

Uncertainty around the application of the amended legislation, and the ability for retrospective action through the call-in power, increase regulatory uncertainty and sovereign risk, which are key factors foreign investors take into account when investing in any jurisdiction, including Australia. This is also relevant to consultation question 3.1.[3]

It would also be helpful for page 18 of G8 (which discusses dual use technologies) to be expanded because the concise and broad manner in which dual use technologies are addressed (e.g., reference to dual use technologies involving "communications and sensing") may have the practical impact of creating more uncertainty regarding the manner in which FIRB may view such technologies.

[1] Pages 16 to 17 of G8
[2] Pages 17 to 18 of G8
[3] Consultation question 3.1 asked what are investors' key considerations when choosing to invest in Australia, and where foreign investment screening fits among these considerations.

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Consultation Paper: Item 5. - Reform analysis - compliance

Consultation questions
To inform the evaluation, the Treasury is interested in hearing from stakeholders with regards to:
5.1 whether the new powers and increased enforcement penalties have resulted in a change in investors' attitudes and behaviours towards compliance.

Response to question 5.1

Two issues which create operational and compliance difficulties for applicants in the context of follow on/ bolt on acquisitions are:

1. Inconsistency of conditions of foreign investment approval imposed on investments by the same investor: we have seen examples where the conditions applicable to a smaller follow on / bolt on acquisition to the initial investment are different and more onerous. In this context, it would be helpful if FIRB could confirm that the conditions which are imposed on bolt on investments would be the same as the conditions imposed on the initial investment unless specifically required by the characteristics of the bolt on investment.

2. Inconsistent compliance timelines / periods: where foreign persons are required to submit periodic reports regarding compliance with conditions (e.g., data-related conditions), the reporting conditions should be mandated in such a way that they align with existing reporting periods/conditions that the investor is subject to. Particularly in the context of bolt on acquisitions we have seen instances where this does not necessarily happen.

Consultation Paper: Item 6. - Reform analysis - streamlining

Consultation questions
To inform the evaluation, the Treasury is interested in hearing from stakeholders with regards to:
6.1 whether the streamlining measures have reduced the regulatory burden on investment funds making investments into Australia;
6.2 the expected utility and impact of the new passive foreign government investor Exemption Certificate; and
6.3 other opportunities for streamlining the screening process to reduce regulatory burden while enabling appropriate scrutiny of risk.

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Response to questions 6.1, 6.2 and 6.3

1. Case study

To illustrate some of the regulatory burdens currently placed on foreign investors, consider the following scenario, variations of which are becoming increasingly common for US and global private equity funds:

(a) A feeder fund (**Feeder Fund**) has an interest of just over 20% in a large private equity fund (**PE Fund**).

(b) More than 20% of the interests in the Feeder Fund are held by US foreign government investors (which as an administrative matter are construed broadly, and includes US state pension funds[4] and US public university endowment funds, who are frequently large investors in US private equity funds) as passive limited partners (**LPs**).

(c) A passive sovereign wealth fund of another country other than the United States holds an interest in the Feeder Fund of just over 5%.

(d) The PE Fund is a majority owner of a US-based and domiciled technology company (**USCo**).

(e) USCo wishes to make an investment in an Australian technology company (**AusCo**) to grow the US business of AusCo.

2. Application of the definition of "foreign government investor"

Under the current legislation:

(a) The US state pension funds and US public university endowment funds are considered "foreign government investors" (**FGIs**) as well as "associates", notwithstanding there is substantively no engagement between these funds.

(b) As the interests of the US state pension funds and US public university endowment funds constitute more than 20% of the interests in the Feeder Fund, the Feeder Fund, the PE Fund and USCo are deemed to be FGIs, with the relevant "foreign government" being the United States. The streamlining measures introduced in 2021 for certain investment funds with FGIs[5] do not apply.

This is so notwithstanding that:

(a) the FGIs in question are US entities, and often state pension funds or public university endowment funds; and

(b) a look-through interest of such FGIs of as little as 4% can be sufficient to treat a US private equity fund, and its portfolio companies, as a "foreign government investors".

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[4] Typically these pension funds are for the benefit of public sector employees and public school teachers.
[5] Section 17(2) of *Foreign Acquisitions and Takeovers Regulation 2015* (Cth)

This suggests the need to review the scope of which entities constitute FGIs, in addition to the application of the tracing rules.

In addition, while the streamlining measures were a welcome development, they do not address the situation where foreign government investors from the one jurisdiction hold more than 20% of the interests in a fund, which is a very common scenario for US private equity funds where multiple US state pension funds and public university endowment funds are participating.

3. Strict disclosure requirement

In the above scenario, under the current processes, notwithstanding that the sovereign wealth fund holds approximately 1% in the PE Fund and any portfolio companies on a look-through basis, FIRB requires the PE Fund to disclose the identity of the sovereign wealth fund, notwithstanding that the disclosure is only required due to the fact that the PE Fund is an FGI and not due to the fact that the sovereign wealth fund has an involvement in the making and monitoring the investment. This is because application of the tracing rules (rather than applying the 5% test on a look-through basis) can lead to very small interests being required to be disclosed.

This strict disclosure requirement imposed by FIRB has significant adverse consequences for private equity funds and other private pooled funds such as private venture capital funds. This is because it is customary for private equity funds and other similar pooled funds to be subject to strict confidentiality obligations to not disclose to third parties an investor's investment and that express consent to disclose must be obtained in this case from the sovereign wealth fund. Investors can be uncomfortable about small, passive investments in private funds in various global jurisdictions requiring disclosure to a governmental entity in a different global jurisdiction.

4. Potential adverse outcomes may discourage investment in Australia by US and global private equity funds

The application of the definition of "foreign government investor" and the strict disclosure requirement outline above may result in adverse outcomes.

In the above scenario, given USCo is deemed to be a FGI, the review threshold for the acquisition of AusCo by USCo is $0, and a period of 3 to 4 months (and up to 6 months) must be allowed for the FIRB's screening process to be undertaken.

The strict disclosure requirement has led to unreasonable outcomes: delays affecting transactions, additional regulatory burden and significant commercial, reputational and administrative consequences for private equity funds.

Further, the burdens may be disproportionate to the size of the investments (particularly for private funds investing in start-ups, growth companies, etc. and also the nature of the investments where they do not involve notifiable nor reviewable national security actions.

These outcomes could materially discourage investment in Australia by US and global private equity funds and make Australia uncompetitive as an investment destination, affecting capital that would otherwise flow to Australian growth companies.

We submit that FIRB reassess the risks posed by transactions described in the above case study (or permutations of the case study) and explore opportunities to reduce the regulatory burdens on private equity funds.

We also ask FIRB to consider the current rules against rules of other jurisdictions that are competing for foreign investment. From the information we have received from a number of Baker McKenzie offices outside Australia, the Australian tracing rules could lead to anomalous outcomes that make Australia less attractive to foreign investors in comparison to other OECD countries.

In that respect, we note the tracing rules can lead to requirements for approval or certain disclosures being triggered even in circumstances where very small interests are being acquired. For example, generally speaking, if Company A owns 20% of Company B, and Company B owns 20% of Company C, and Company C owns 100% of Company D, then Company A will be taken to own 100% of Company D, despite that its indirect interest, calculated on a look through basis is 4%.

This contrasts with the position in other jurisdictions, such as the UK (under the *Enterprise Act 2002* (UK)) and the US, where triggers for notification are based on a concept of control. The UK will (under the *National Security and Investment Act 2021* (UK)) have limited "tracing" type provisions, but these are only triggered when entities acquire or hold a "majority stake". The US tracing provisions apply in narrow circumstances - to foreign government affiliates investors, and only where the relevant holding entity is a "parent" of the "lower" entity. Germany does have a form of tracing, but those provisions work very differently to the Australian tracing rules and, in our view, are much less likely to lead to the types of conclusions outlined above. Spain and Italy's foreign investment regimes do not incorporate any equivalent concept of tracing.

We would be very happy to provide a detailed comparative analysis of the foreign investment screening regimes in other jurisdictions.

5. Strict disclosure requirement relating to private investor LPs

In circumstances where a particular investment by a private equity fund (or a portfolio company of a private equity fund) is a notifiable action only because of the interest held by certain FGIs invested in the private equity fund (or feeder funds), then FIRB's policy of asking for details of each other investor (whether private investors or other FGIs) with an interest of more than 5% of the private equity fund (or feeder fund) should be carefully considered given the difficulties it creates for private equity funds as a result of strict confidentiality obligations that apply to disclosure of their investors in such fund. We submit that FIRB's focus should be on the identity of the FGIs that triggered the notifiable action, and not the identity of other unrelated investors that do not trigger a notifiable action.

By way of example, if a private equity fund is deemed to be a US FGI because of the identity of certain US FGIs, requiring the disclosure of the identity of an unrelated investor from outside of the US which holds a 5% interest in a private equity fund (or less after application of tracing rules), in circumstances where the interest of such investor does not trigger a notifiable action, creates a range of issues for private equity investors,

while seemingly not advancing critical features of FIRB's analysis (given that such interest alone would not otherwise trigger a notifiable action at all).

6. Follow on / bolt on investments

A core of private equity growth strategy is to grow investee companies, including Australian investee companies such as that described in the above scenario by having the Australian investee companies make follow on / bolt on investments of similar businesses. In the above scenario, as the Australian investee company itself would be considered an FGI, the requirement is that such Australian company has to obtain FIRB approval, even where the investment falls below the monetary threshold which applies to non-FGIs, constrains the ability of the Australian company to make such investments since it will be at a competitive disadvantage against other bidders who are not FGIs and, more generally, result in these smaller transactions being more costly (due to the additional filing fees and advisory costs associated with the FIRB process) and extended deal timelines.

The private equity sponsor in this context would also be unlikely to seek the new passive FGI exemption certificate either because the fund triggers the threshold in relation to the FGIs from the one country holding more than 20% of the fund (noting that there may be a change in policy in this regard) or the uncertainty in applying the passive investor tests to the relevant FGIs.

It would be helpful if:

- FIRB could provide clearer guidance regarding the application of exemption certificates in the context of follow on / bolt on investments; and
- at the time of the initial FIRB application made in connection with the private equity sponsor's investment in an Australian investee company, there would be an option for an exemption certificate to be issued at the same time as the initial FIRB approval.

7. Treatment of foreign public pension funds as FGIs more generally

Certain foreign public pension funds, which are operated independently for the benefit of members without any ability for the respective foreign government to control or influence decision making, are treated as FGIs under the current regime. These funds are not unlike Australian superannuation funds which may manage superannuation funds on behalf of government employees, but which are commonly understood in Australia to be independent of government control or influence.

Similar to the process for private equity funds to seek an exemption certificate, it would be most welcome if there was a process by which an application could be made to FIRB by such public pension funds themselves to disapply (i.e., be exempt from) the FGI rules if they can clearly demonstrate their independence from a foreign government with respect to individual investment decisions and the management of any individual investments.

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We would welcome the opportunity to discuss our submission and our views on any other element of Australia's foreign investment frameworks in greater detail.

Yours faithfully

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