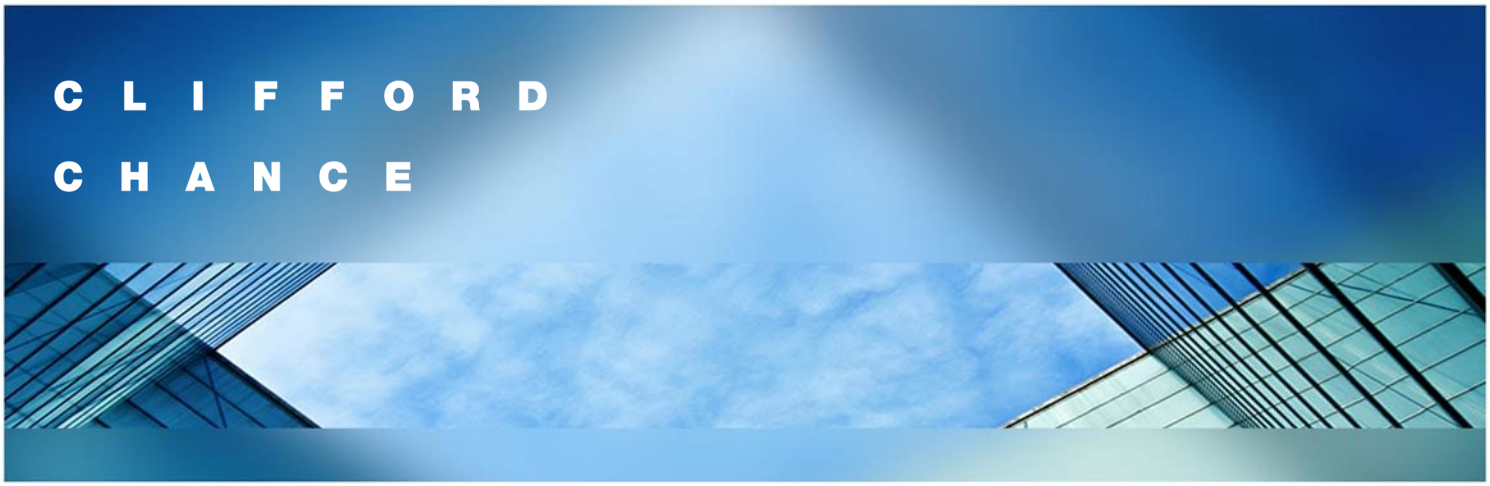

CHANGES TO AUSTRALIA'S FOREIGN INVESTMENT LAWS: TRADING INVESTOR SECURITY FOR NATIONAL SECURITY?

The Australian Government has announced what it has labelled as "the most comprehensive reforms to Australia's foreign investment review framework in more than 20 years". This briefing highlights key changes in the reform package and identifies the potential implications for PE, financial sponsors and other foreign investor clients.

BACKGROUND

On 5 June 2020, the Treasury released a paper which outlines a major overhaul of Australia's foreign investment regime. The reform primarily targets increased screening of nationally sensitive acquisitions by the Foreign Investment Review Board (**FIRB**). This will be achieved by introducing a new zero-dollar threshold (above which Government approval must be sought) for foreign investment in "sensitive national security businesses" and by enhancing review and enforcement powers on national security grounds.

The proposed changes have arisen in response to rising national security concerns relating to foreign investment in sensitive businesses and critical infrastructure assets. The changes have been announced amidst the current COVID-19 environment, under which temporary measures have already been passed to reduce monetary thresholds to zero for all foreign acquisitions.

The reforms are proposed to come into effect on 1 January 2021, but remain subject to a consultation period and release of draft legislation.

THE KEY CHANGES AND OUR OBSERVATIONS

This briefing summarises the key changes in the reform package and provides our initial observations. The changes present as a mixed bag for foreign investors. There are positive developments for PE funds and limited partners, who will benefit from a narrower 'foreign government investor' definition and more widespread use of exemption certificates. This is contrasted by heightened scrutiny of all nationally sensitive assets (including critical infrastructure and, potentially, essential services) and the uncertain application of broad-ranging review and divestment powers.

Zero-dollar threshold for nationally sensitive acquisitions

Under the reform initiatives, any foreign person acquiring a direct interest (generally a 10% ownership interest or in a position of control) in a "sensitive

Key points

- New 'national security test' with a zero-dollar screening threshold for foreign investment in a "sensitive national security business" – not yet defined but likely to include critical infrastructure, essential services and national security/defence sectors.
- Streamlining approvals for "foreign government investors" through tightening definitions and issuing exemption certificates to bypass zero-dollar thresholds (for non-sensitive acquisitions).
- "Call in" and "last resort" powers, including ongoing review/investigatory powers (not limited to acquisitions) and mandatory divestment powers.
- Narrowing of the moneylending exemption so that foreign lenders must obtain FIRB approval to take security over nationally sensitive assets.
- Incremental increases in equity interests through creep acquisitions, share buybacks and selective capital reductions above legislative thresholds will trigger further FIRB approvals.
- Existing agricultural land, water and residential registers are to be expanded to include information on all foreign acquisitions (but not publicly assessible).
- Civil and criminal penalties will be heavily increased, coupled with an expansion of the infringement notices regime.

national security business" will need to notify FIRB and obtain approval prior to making the acquisition. The requirements extend to a foreign-owned entity that starts carrying on a business of this nature, regardless of whether an acquisition has taken place. This applies irrespective of the value of investment, investor nationality or whether the investor is a private investor or a foreign government investor. Under this national security test, the Government will be able to impose conditions or block an investment on national interest grounds.

A definition for "sensitive national security business" has not yet been provided - this will be left to draft legislation. The reform paper does signal a move away from the breadth of the current test for "sensitive business" but, paradoxically, existing broad definitions under telecommunications and critical infrastructure legislation are referred to for guidance.

The *Security of Critical Infrastructure Act 2018* is mentioned in the reform paper. This Act casts the net fairly wide to not only include network services (electricity, water, gas and ports) but also has the potential to capture essential services such as transport, banking, healthcare, aviation and manufacturing. Businesses involved in national defence or security-related goods or services (or located close to defence systems) are likely to be covered under the new definition. Telecommunications and data centres (who store national security information) will also almost certainly be included.

The "sensitive national security business" definition will, arguably, form the most critical feature of the reform package. It will be essential for legislators to produce a clear definition which achieves a balance between protecting national interest and maintaining commerciality. There should be little doubt as to the types of businesses or assets which will be screened under national security. If the definition misses the mark, there is a risk of creating substantial investor uncertainty when considered alongside the ongoing review and mandatory divestment powers outlined below.

Streamlining approvals for passive 'foreign government investors'

"Foreign government investors" (**FGI**) are currently subject to zero-dollar thresholds for all acquisitions of a direct interest in businesses and land assets in Australia. The FGI test is broad and extends to all agencies of foreign governments, which includes state-owned entities (SOE), sovereign wealth funds and public sector pensions. Deeming provisions provide that any fund that has 20% or more interests held by FGI from the same country (or 40% from different countries) is also a FGI for foreign investment purposes.

The reform paper proposes changes that seek to reduce the red tape for funds with passive FGI investors that do not have management rights, influence or control over investment or operational decisions of the fund or its assets. The proposed changes tighten the FGI definition to increase the threshold to only include funds with more than 40% FGI ownership in aggregate (without influence or control) but less than 20% from any single FGI.

The impact of expanding the thresholds in the FGI definition will make a big difference to the determination of FGI status (in our experience, current thresholds are typically triggered through the aggregation of de minimis minority interests only). In many cases, the funds are discretionary in nature with full investment discretion residing in the general partner or fund manager.

In addition to the amended FGI definition, broad exemption certificates will be available for funds with a single FGI over 20% (provided there is no element of influence or control). The exemption would be granted for a specified time period such as 5 or 10 years, or up to the life of the relevant fund, and allow investments to be made subject to conditions in the certificate. We are aware of PE funds who have recently sought (and obtained) exemptions along similar policy grounds under the current general exemption regime.

These changes will be welcomed by PE and the many fund managers and pension funds investing in Australia through limited partnership or similar structures that include passive FGI interests. These funds operate at a competitive disadvantage to funds raised from local capital, given the current requirement to obtain FIRB approval for each transaction.

Significantly enhanced review, investigation and enforcement powers

'Call in' power

It is proposed that the Treasurer will have a new "call in" power to require a FIRB application to be submitted under the new national security test to determine if the investment raises security concerns. This change is expressed as intended to target investments which raise national security concerns, regardless of whether they qualified for original screening.

Although the "call in" power will likely be time-limited and confined to nationally sensitive investments only, this power will increase the complexity of investor decision-making processes. In particular, investors will need to decide whether a voluntary notification ought to be given for an acquisition which does not fall squarely within the nationally sensitive category. Voluntary notification might also encourage additional applications to be added to the screening queue, translating to potentially longer FIRB review time and less deal certainty.

'Last resort' power

A "last resort' review power will also be introduced to allow the Government to reassess approved foreign investments where subsequent national security risks emerge, allowing the Treasurer to impose or vary conditions, or, as a last resort, require a foreign investor to divest certain investments.

This represents a potentially seismic conceptual shift in the regulation of foreign investment in Australia - from acquisition-based review to a more active approach to monitoring and investigating ongoing compliance. This approach is not dissimilar to the ACCC's role in anti-trust/merger review in Australia. Key points to address through the legislation will be the process for compelling an investor to dispose of interests and whether this will involve the Government stepping in to purchase the relevant interests.

We expect the "last resort" review power will cause the most worry for PE and financial sponsors, who will be concerned with ensuring that the 'goal posts' do not move on them during the investment lifecycle. They will not want to be exposed to any potential for mandatory divestment. The concern will also be to ensure that the "last resort" power is expressed to have no retrospective application to investments that have occurred prior to the new legislation.

The reform paper appears sympathetic to this plight and outlines a number of mechanisms to support investor certainty. This includes time limits on the exercise of these powers and specific exemption certificates to permit types of

eligible acquisitions without screening. This is intended to avoid multiple assessments of national security considerations for the same investor.

In addition, it is expected that the "last resort" divestment power will be fettered with a number of conditions, including that the power is truly a last resort where there are no other regulatory mechanisms available and reasonable steps have been made to negotiate an outcome with the investor. It is also intended that the power will be limited to circumstances where there has been a material misstatement/omission in an original review process or where there has been a change to the investors' activities or operating environment such that new national security risks have emerged.

The enhanced powers will be supported by increasing monitoring and investigative powers, including access to premises with consent or by warrant to gather information.

Tracing of acquired assets

If an investment was originally made in breach of approval requirements, current exemptions permit the acquisition by a new buyer to proceed without FIRB intervention if interests are acquired by operation of law (for example, devolution or wills). New changes are proposed so that a new foreign buyer must notify FIRB if approval was not originally sought for the acquisition.

It is possible that FIRB notifications could lead to conditions or mandatory disposal to safeguard national interests. The devil will be in the detail, but conceptually this new change will highlight the need for foreign buyers to undertake due diligence to investigate ownership and FIRB compliance history (particularly in nationally sensitive businesses).

OTHER NOTABLE REFORMS

Foreign debt funding into Australia

The scope of the moneylending exemption is proposed to be narrowed to require foreign lenders to obtain FIRB approval before taking or enforcing security over assets relating to a "sensitive national security business". Under the current exemption, security interests arising from moneylending agreements entered into by lenders (in the ordinary course of carrying on a business of lending money) are exempt from FIRB approval requirements.

This change has the wider potential to impact the ability of nationally sensitive businesses and critical infrastructure to obtain competitive debt terms by weakening foreign lender competition. This may be perceived to be problematic for leveraged buy-out transactions tapping into alternative debt markets in Europe and offshore banks to provide funding instead of traditional local bank sources (a common theme in the debt financing space in Australia).

Proportional increases in shareholdings through no acquisition

The new changes will clarify that foreign persons are required to seek further FIRB approval for any increase in actual or proportional holdings above what has been previously approved. This may occur as a result of increases in interests in local entities above 20% (the 'substantial interest' threshold) from creep acquisitions or proportional increases through share buybacks and selective capital reductions. Foreign buyers with material ownership interests

will, therefore, have to stay mindful that increases in shareholdings incrementally over time may potentially trigger further FIRB requirements.

Register of Foreign Ownership

A new Register of Foreign Ownership is proposed to merge and expand the existing agricultural land, water and residential registers. This Register would record the details of all business acquisitions that require FIRB approval.

Whilst concerns from investment funds and local businesses relating to commercial sensitivities and privacy considerations will understandably arise following the expansion of the Register, the current proposal is for the Register to remain non-public and will only be shareable across the Government in line with information sharing provisions.

Increased penalties

The reform package proposes heavy increases in civil and criminal penalties available to enhance enforcement measures, including up to 10 years in prison and up to $525 million in civil penalties (a 500x increase for individuals and 50x increase for corporations). This will be supplemented by an expanded infringement notices regime to cover all types of foreign investments and a third-tier penalty to allow for a more graduated approach to enforcement.

Extended review timeframes

When considering complex and sensitive cases, the Treasurer will have a new power to extend the statutory timeframe by up to 90 days to consider the application. This would replace the current process of FIRB requesting voluntary extensions or requiring stop orders to extend out to 6 months.

WHAT'S NEXT?

Exposure draft legislation is anticipated to be released in July 2020 ahead of a six-week consultation period.

We will continue to monitor the development of the reforms and legislative drafting, including the "sensitive national security business" definition and foreign government investor exemptions, and report back on issues which could give rise to specific client concerns.

Please reach out to us if you would like any further information on the changes or to discuss how they may affect you (including the potential need for issues to be raised on your behalf during the consultation stage).

CONTACTS

ANDREW CROOK
PARTNER

T +61 2 8922 8001
M +61 423027882
E andrew.crook
@cliffordchance.com

MARK CURRELL
PARTNER

T +61 2 8922 8035
M +61 427828142
E mark.currell
@cliffordchance.com

REUBEN VAN WERKUM
COUNSEL

T +61 2 8922 8054
M +61 488300201
E reuben.vanwerkum
@cliffordchance.com

NADIA KALIC
PARTNER

T +61 2 8922 8095
M +61 401450025
E nadia.kalic
@cliffordchance.com

DAVE PODDAR
PARTNER

T +61 2 8922 8033
M +61 422800415
E dave.poddar
@cliffordchance.com

JACOB KAHWAJI
COUNSEL

T +61 2 8922 8060
M +61 409681351
E jacob.kahwaji
@cliffordchance.com