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Online Submission

Dear Sir/Madam

Submission on Options Paper entitled 'Australia's Foreign Investment Framework: Modernisation Options'

Herbert Smith Freehills is pleased to provide this submission on the Government's Options Paper entitled 'Australia's Foreign Investment Framework: Modernisation Options' (**Options Paper**).

This submission is based on our submission in relation to the consultation paper entitled 'Strengthening Australia's Foreign Investment Framework' submitted on 20 March 2015, and provides further comments in response to the Options Paper.

We have also reviewed the previous submissions made by the Business Law Section of the Law Council of Australia dated 19 June 2014 and 20 March 2015,[1] and have commented on those submissions where relevant.

1 Item 1: A Legislated Framework Supported by Guidance

Item 1.1 Incorporate the foreign government investor rules into the legislative framework

Recommendation: We agree with the comments made under Item 1 and Item 1.1 of the Options Paper and with the proposal in Item 1.1 that the foreign government investor rule under Australia's Foreign Investment Policy (the **Policy**) should be incorporated into the legislative framework however, we would urge the Government to bring the regulation of foreign government investment closer in line with the framework for other foreign investors and consider the following matters:

- pro-rata issues and dividend reinvestment plans and other Takeovers Rules (see Item 3.6 in section 3 below);
- underwriters (see item 3.7 in section 3 below);
- thresholds (see item 4.5 in section 4(a) below);
- tracing (see item 4.5 in section 4(b) below);
- interest granted by governments (see item 4.6 in section 4 below); and
- internal restructures (see below item 4.6 in section 4 below).

In addition, we support the Law Council's view that more guidance is required on what types of equity investments constitute "direct investments" requiring approval under the Policy.[2] The Law Council states that it is unclear how the following sentence is to be applied in situations other than those involving only acquisitions of issued shares or units in a single class: "Any investment of an interest of 10 per cent or more is considered to be

[1] Available on the Treasury website and referred to below as **Law Council 2014 Submission** and **Law Council 2015 Submission** respectively.

[2] Law Council 2014 Submission, page 15.

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a direct investment". The Law Council proposes defining "interest" with reference to the definition of "substantial interest" from s 9 of the *Foreign Acquisitions and Takeovers Act 1975* (Cth) so that a person is taken to have an "interest" of 10% or more if they have voting or potential voting power of at least 10%, hold interests in at least 10% of the issued shares or units or would hold interests in at least 10% of the issued shares or units if converted. Subject to our comments below regarding the threshold for various types of foreign government investors,[3] we support this proposal.

Recommendation: We also support the proposal under Item 1 that the Government will provide administrative guidance (we would suggest through an amended policy or guidance note) to supplement the understanding of some fundamental concepts.

2 Item 2: Update the Legislation to Reflect Core Administrative Practices

Item 2.1 Update the legislation to reflect core administrative practices such as the no objections validity period, information sharing, screening timeframes and conditions

We agree with the basic premise of the recommendation made under Item 2.1 that the legislation should be updated to reflect core administrative practices; however there are a number of practices which we believe should be improved when incorporated into the legislation:

(a) 30 day rule

We refer to the '30 day rule' under section 25 of the *Foreign Acquisitions and Takeovers Act 1975* (Cth) (the **Act**) and the practice of FIRB requesting that applicants withdraw and resubmit applications if FIRB requires more than 30 days to come a decision. This practice has the following effects:

- creating a procedure which foreign investors find puzzling – causing them to ask why they should be required to take action when the Government has not been able to meet the targeted timeline;
- applicants are effectively forced to withdraw and re-apply because they do not want to get FIRB offside and they do not want their proposed acquisition made public pursuant to a 90 day order;
- creating additional legal and internal expenses for investors; and
- reducing the intended impetus under the Act to ensure that FIRB functions efficiently, effectively and predictably.

We do not support the proposal in Item 2.1 to introduce a mechanism by which applicants voluntarily agree to extend the screening period on a confidential basis. In our view, it would be preferable if no further action was required by applicants. The Treasurer should be able to grant an extension if he or she is satisfied that there are good reasons why a decision has not been made within 30 days.

Recommendation: We agree with part of the Law Council's recommendation in relation to this topic, that the Treasurer should have the ability to issue an extension of up to **30** days if more time is required,[4] (a power he can delegate to another person, but not FIRB). Such an extension should not be published. If the extension is not signed, the approval would be deemed to have been given. That would help to ensure that applications are efficiently processed and provide applicants with greater certainty. FIRB should then be required to

[3] See Item 4.5 in section 4(a).

[4] Law Council 2014 Submission, page 4.

report in its annual report on the number of matters where extensions were granted and the reasons why (grouped into categories).

In addition, FIRB should provide clear guidance (either in the Act or guidance note/ policy) on how informal clearance from the ACCC could affect timing for approval.

(b) 12 month validity

We refer to the default 12 month validity period for approvals currently included in the Policy and referred to in Item 2.1 and Item 6.2.

Recommendation: Given there are numerous situations in which FIRB approval is required for more than 12 months (e.g. exercise of share options and development of greenfields projects, which require property to be acquired over several years), there should not be a blanket validity period written into the Act. Rather, we would support the Government providing a guidance note/ policy which states that the standard validity period is 12 months but provides examples of circumstances in which FIRB would be prepared to give approvals which last for more than 12 months.[5]

(c) Two-step notification

Under the Policy, foreign government lenders who are not APRA regulated ADIs (as those terms are defined in the Policy) must notify FIRB if they will retain an interest of 10% or more of an Australian business or assets following the enforcement of a security interest. In our experience, for practical reasons (ie timing of enforcement is likely to be unpredictable) such lenders notify FIRB before acquiring a security interest in prescribed assets, however there is some uncertainty as to whether a subsequent notification needs to be made before that security interest is enforced.

There are deeming provisions contained in the Act which, broadly speaking, have the effect of requiring a single notification to be made to FIRB when private foreign persons acquire a right or option to acquire prescribed shares or assets. We are aware of examples where FIRB has taken the view (albeit informally) that foreign government lenders who are not APRA regulated are entitled to rely on those deeming provisions, despite the fact that any notification made by them may only be required under the Policy and not the Act. In those circumstances, foreign government lenders have only been required to adopt a one stage notification process, with any foreign investment approval extending to both taking and enforcing the relevant security. However, this position is by no means settled.

Recommendation: the Act should be amended to clarify that foreign government lenders who are not APRA regulated ADIs and who intend to acquire a security interest requiring notification to FIRB, need only notify FIRB once of the proposed acquisition and are not required to notify FIRB again if, following enforcement, an interest of 10% or more is retained (if this is the intention of the Government).

(d) Notification

With the introduction of an online application system, there has been inconsistent messaging from FIRB (in its 'How to Apply Guide' and verbally) as to whether an application still needs to be accompanied by a statutory notice.

[5] See similar recommendation in Law Council 2014 Submission, page 12.

Recommendation: the Notice Regulations should be amended to make it clear that statutory notices are no longer required when making an application to FIRB (if this is the intention of the Government).

3 Item 3: Closer Alignment with Other Commonwealth Legislation

Item 3.2 Allowing certain interests to be disregarded when applying the foreign person definition

We agree with comments made under Item 3.2 of the Options Paper that the Government should consider options to reduce the regulatory burden for substantially Australian entities where they are Australian domiciled and controlled but are deemed to be "foreign persons" because of the interests of numerous unrelated passive foreign shareholders exceeding the 40% aggregate ownership threshold (**Widely-held company**).

There are two circumstances under which the Act applies for a Widely-held company:

1 when the Widely-held company is making an acquisition of an Australian asset or company it must obtain FIRB approval because it is a foreign person; and

2 when a foreign person or company wishes to acquire an interest in a Widely-held company – no matter how small – they must obtain FIRB approval as the aggregate foreign shareholding will exceed 40% after the acquisition.

The latter issue is not mentioned in the Options Paper but should be considered at the same time as the former.

(a) Widely-held Australian companies exemption

Recommendation: the Act should be amended to exempt investments by ASX Listed or Widely-held companies which are at least 40% foreign owned from the scope of the Act. There would need to be parameters to the exemption – for example, it should not be available if the relevant entity satisfies any of the other tenets of the 'foreign person' definition (for example, if an individual foreign investor owns 15% or more in the corporation) or if the relevant corporation is a 'foreign government investor'. It could also be a pre-condition to availability of the exemption that the entity is Australia-based and managed, with at least 50% of the board members being Australian residents.

(b) Foreign investors exemption for listed entities

Imposing a requirement on foreign investors to seek FIRB approval prior to acquiring an interest in a Widely-held company listed on the ASX or a foreign exchange raises the following issues:

- accurate information regarding aggregate foreign ownership levels in the company will not always be readily available, particularly where large numbers of small parcels are foreign owned; and
- the voluntary notification requirement will be triggered each time a different investor acquires securities (no matter how small a percentage interest they hold).

For these reasons, the foreign investment framework is practically unworkable in this context, both from a compliance and enforcement perspective.

Recommendation: the Act should be amended to exempt trading in listed securities from the scope of the Act. There would need to be parameters to the exemption – for example the proposed acquisition of a controlling interest by a foreign person (ie, of 15% or more) should continue to require prior notification.

Item 3.3 Simplifying the 'associates' definition without compromising integrity of the framework

Recommendation: We agree with the comments made under Item 3.3 of the Options Paper that the associates definition should be simplified to better align with modern practice. We support the Law Council of Australia's recommendation that the definition be replaced with the definition of "associate" taken from the *Broadcasting Services Act 1992*.[6]

Item 3.6 Import selected exceptions from Australia's takeovers rules (subject to necessary modifications)

Recommendation: We agree with the comments made under Item 3.6 of the Options Paper and support the proposal to include exemptions from the Act for pro-rata rights issues and dividend reinvestments. These exemptions should be extended to all securities including units in a unit trust (as proposed in Item 4.3 of the Options Paper) and to foreign government investors (as proposed in Item 4.6 of the Options Paper).

We also support the Law Council's submission that for the purposes of such an exemption an offer will still be considered to be pro-rata if there is a separation between the institutional and retail offer and the offer is not made in certain jurisdictions due to illegality or cost.[7]

Item 3.7 Provide an exemption for underwriters

Recommendation: We agree with the comments made under Item 3.7 of the Options Paper and support the proposal to include an exemption for acquisitions in the ordinary course of underwriting (this should apply to government-controlled underwriters too). We also support the Law Council's recommendation that the exemption only apply so long as the securities are sold down to third party investors within 30 days and no voting rights are exercised by the underwriters.[8]

Item 3.9 Refine the foreign person definition

As noted under Item 3.9, the Act's definition of "foreign person" includes Australian citizens who are not ordinarily resident in Australia. The Policy expressly exempts Australian citizens (whether resident or not) from requiring FIRB approval before buying or taking an interest in commercial real estate or residential real estate, but there is no express exemption in the Policy relating to investments in businesses and agricultural/rural land. There does not appear to be any policy reason behind this inconsistency between the Act and the Policy, and within the Policy itself.

Recommendation: We recommend expressly excluding from the definition of "foreign person" a person who is "an Australian citizen within the meaning of the *Australian Citizenship Act 2007* (Cth)".[9]

[6] Law Council 2014 Submission, page 9.

[7] Law Council 2014 Submission, page 8.

[8] Law Council 2014 Submission, page 8.

[9] This reflects the definition of 'foreign natural person' in the *Foreign Ownership of Land Register Act 1988* (Qld) and *State Taxation Acts Amendment Bill 2015* (Vic).

4 Item 4: Exempting Proposals That Are Unlikely to Impact the National Interest and Increasing the Consistency of the Exemptions Available Across the Different Acquisition Types

Item 4.3 Broaden the scope of exemptions for Australian urban land corporations and trusts

Recommendation: We agree with the proposal in Item 4.3 to extend the current exemptions to interests acquired indirectly through urban land corporations and trusts.

Item 4.5 Adjust definition of 'foreign government investor' to reflect the proposed new single foreign person control threshold of 20 per cent

In addition to the proposal under Item 4.5 to increase the control threshold from 15% to 20% for foreign government investors (to reflect the new single foreign person control threshold), we have two further recommendations set out in (a) and (b) below.

(a) Distinguish between governments, SWFs and SOES

Recommendation: We support the Law Council's recommendation that the Act distinguish between foreign direct investment by governments and their instrumentalities and foreign direct investment by sovereign wealth funds (**SWFs**) and state owned enterprises (**SOEs**).[10] We support the Law Council's proposed mechanism for dealing with these three types of investors, including the following points:

- continue to apply existing Policy to foreign direct investment by government and their instrumentalities (although we would add that this should be done through the Act not the Policy);
- provide a mechanism for an SWF to be certified as a recognised SWF investor and apply the general review threshold to recognised SWF investors; and
- provide a mechanism for an SOE to be certified as a recognised SOE investor and apply an increased approval threshold to recognised SOE investors to facilitate immaterial or ordinary course investment (say $50 million).

(b) Tracing and "foreign government investors"

When determining whether upstream or indirect ownership arrangements mean that an entity should be categorised as a 'foreign government investor' under the Policy, it is not clear whether the tracing provisions contained in section 12C of the Act should be applied (although we understand that this is the approach which is taken by FIRB).

Recommendation: the regime should be amended to clarify that the tracing mechanisms in section 12C of the Act are applicable to the definition of 'foreign government investor' (if that is the intended approach of FIRB and the Treasury).

Item 4.6 Extend some existing exemptions to foreign government investors

We agree with the proposal under Item 4.6 that some existing exemptions for non-government investors could be extended to foreign government investors, for example

[10] Refer to pages 1-3 of Law Council 2014 Submission.

pro rata capital raisings (see comments under Item 3.6 above) and underwriters (see comments under item 3.7 above).

Another example of an exemption that should be extended to foreign government investors is the exemption for acquisitions of interests in Australian urban land granted by a government body (section 12A(7) of the Act). A private foreign investor who transitions from an exploration licence to a mining/production licence (which is granted by the Commonwealth Government) would generally get the benefit of this exemption and not require approval under the Act. Because foreign government investors are not eligible for this exemption it presents an additional risk for investment in exploration projects by foreign government investors, one which does not seem reasonably justifiable based on the character of the investor alone.

Recommendation: In addition to the examples provided in Item 4.6, the exemption for Government grants of interests in Australian urban land (s 12A(7) of the Act) should be extended to foreign government investors.

Internal restructures

Another acquisition type that we consider should be exempted because it is unlikely to impact the national interest is internal restructures.

Recommendation: We support the Law Council's recommendation that an exemption should be included for intragroup transfers/internal restructures "where the ultimate controller or the net foreign investment does not change (i.e. there is no "new" foreign person other than an interposed subsidiary of the foreign controller) or where the transaction is tax neutral as it involves a tax consolidated group". [11] As such restructures do not pose a threat to Australia's national interests.

In support of this, we believe exempting internal restructures is consistent with the spirit and intention of Australia's free trade agreements the US, New Zealand, Chile, Japan and Korea, in particular the Australia/US free trade agreement (as reflected in the exchange of letters between Ambassador Zoellick and Mark Vaile (then Minister of Trade) dated 18 May 2004).

That exchange of letters acknowledged that "internal corporate reorganisations and foreign-to-foreign takeovers have historically been classes of transactions that in almost all cases give rise to no concerns under foreign investment policy". It further goes on to say "Accordingly, Australia further notes that it would be desirable to minimise any screening of foreign-to-foreign takeovers and internal corporate reorganisations".

We add that the exemption should be extended to foreign government investors (consistent with Item 4.6).

5 Item 6: Other Issues

Item 6.2 Tidy-up the legislation and Policy

Recommendation: We support the proposed general tidy-ups in Item 6.2 (with the exception of legislating for the approval validity term, which we have commented on above at paragraph 2(b)).

In relation to the proposal to ensure consistent use of terms such as interests in shares and units, we would like to add that section 18 of the Act currently only applies to shares, not units, but it should apply to both. Exemptions for share acquisitions under the Act should apply equally for acquisitions of units e.g. moneylending exemption in s 11(5)(a) and rights issue exemption s 26(4).

[11] Law Council 2014 Submission, page 8.

6 Further Recommendations

We would like to propose further recommendations that do not relate specifically to any of the items in the Options Paper but which are relevant to modernising the foreign investment framework. These are contained in Schedule 1.

We thank the Government for the opportunity to put forward our recommendations in this letter and look forward to discussing any of the matters contained herein if required.

Yours sincerely

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Schedule 1

Further recommendations

(a) Fees

Recommendation: We support the Law Council's recommendations in relation to FIRB application fees that:

- "a fee should not be required for internal restructures of foreign owned groups";
- "a fee should not be required for offshore foreign to foreign transactions (that is, acquisitions by foreign persons of interests in offshore companies who have Australian subsidiaries or assets)";
- "where multiple bidders are making applications as part of a competitive sale proves, the fee should be deferred and payable only by an applicant that has been identified as the preferred bidder... Fees should also be refundable on request if the acquisition the subject of the approval does not proceed. Otherwise bidders at auctions and in other competitive bidding situations may lose substantial sums (more than just a cost of doing business) without securing any transaction"; and
- most importantly, "there should be mechanisms to provide flexibility such as the conferral of a discretion on FIRB or the Treasurer to waive all or part of a fee in certain circumstances or classes of circumstances".[12]

(b) Tax conditions

We refer to the trend in recent years of FIRB imposing conditions regarding income tax, which add administrative burden and, in some cases, do not rest easily alongside Australia's international treaties. Our concern is that FIRB is being used to impose an unlegislated form of tax administration law.

The Treasurer has indicated that tax conditions will increasingly become a feature of FIRB approvals, however no guidance has been given of the circumstances in which conditions would be imposed or what they would be designed to address.

Recommendation: if the Government believes there are deficiencies in the way the tax law works it should be addressed through the implementation of new or amended laws, not through the imposition of tax conditions on FIRB approvals.

(c) Third party penalties

[12] Law Council 2015 Submission, p 4-5.

Recommendation: We support the submission of the Law Institute of Victoria that "any accessorial liabilities or penalties should only extend to lawyers or conveyancers where they have actual and particular knowledge of their clients' residency status".[13]

(d) Definition of "prescribed foreign investor"

'Prescribed foreign investors' (as defined in the Act) theoretically get the benefit of a higher $1,094 million threshold which removes the need to notify FIRB in respect of an investment in a target which is valued at or below that threshold (Prescribed Investor Threshold). Unfortunately, the Prescribed Investor Exemption is very prescriptive and has only limited application. In particular, it is not available if a foreign investment is undertaken through an intermediate holding company or special purpose vehicle which is incorporated in any jurisdiction other than the relevant prescribed foreign investor's jurisdiction. To reflect these often-used commercial structures, and enable prescribed foreign investors to benefit from the higher investment thresholds which have been agreed to, we suggest that the Prescribed Investor Threshold be broadened, with a proviso included to ensure that if a non-prescribed foreign investor (under the current meaning) holds 15% or more in that entity, the higher threshold will not apply.

Recommendation: the Regulations should be amended so that the 'prescribed foreign investors' specified in regulation 9 include entities (e.g. intermediate holding companies or special purpose vehicles) in which no less than 85.1% is held by entities constituted under the laws of the jurisdiction of the relevant prescribed foreign investor (i.e. the US, New Zealand, Korea, Japan or Chile), whether or not the first mentioned entity is incorporated or established in Australia or in an overseas jurisdiction, provided that the entity is not incorporated in a country that Australia does not maintain diplomatic relations with.

(e) Regulation 3(o)

In 2013 the Foreign Investment Review Board (**FIRB**) released a memorandum stating that the exemption for passive investments by foreign persons in Australian public (real estate) trusts that are Australian urban land trusts (in regulation 3(o)) was no longer operational due to the fact that references to 'a prospectus approved by the Corporate Affairs Commission of a State or Territory' had become obsolete. The memorandum declared an interim policy to replace regulation 3(o) whilst the Government considered how to clarify its position.

We think that the interim policy is unclear and inconsistent with the original legislative intent of regulation 3(o) for the following reasons:

- it imposes a lower threshold (10% and 5% respectively, each lower than the substantial interests test specified in regulation 3(o));
- "Listed trusts" must now have a predominantly non-residential property portfolio. The interim policy does not specify what percentage of residential property holding would cause a listed trust to fall within this test. Contrast this with a clear 10% threshold for developed residential real estate in regulations 3(o)(i)(D) and 3(o)(ii)(C);

LIV Submission on 'Strengthening Australia's Foreign Investment Framework', 20 March 2015, available on the Treasury website, page 7.

- other "public trusts" must also hold less than 10% of the trust's real estate assets in developed residential real estate assets that have been acquired from non-associates. The interim policy does not specify at what time the associate relationship is determined and whose associates it is referring to and does not take into account the burden of calculating which assets were acquired from associates in the past;
- the interim policy also requires interests to be "passive interests" and refers to the concept of a "strategic stake", neither of which are defined in the interim policy or the Act.

The cause for the change to regulation 3(o) was the abolition of the Corporate Affairs Commission in 1990. Nowadays, unit trusts which accept funds from the public do so by issuing a product disclosure statement in accordance with Part 7.9 of the Corporations Act (as opposed to a 'prospectus'). In addition, there was a transitional stage between the state based Corporate Affairs Commission and the introduction of the PDS regime where unit trusts lodged prospectuses with ASIC (or its predecessor the Australian Securities Commission) in connection with offers to the public. Therefore there is a straight-forward solution to updating regulation 3(o), as follows.

Recommendation: We support the recommendations of the Law Council[14] and in addition suggest the following amendments: the interim policy relating to regulation 3(o) should be removed and regulations 3(o)(i)(A) and 3(o)(ii)(A) should be amended to include the following underline language: '...a prospectus approved by the Corporate Affairs Commission of a State or Territory or a prospectus approved by the Australian Securities and Investments Commission or any predecessor, or product disclosure statement issued pursuant to Part 7.9 of the Corporations Act 2001'.

[14] Law Council 2014 Submission, page 11.