FINANCIAL SERVICES COUNCIL

2 September 2020

James McLean Dreyfus
Manager, Policy Framework Unit
Foreign Investment Division
The Treasury
Langton Crescent
PARKES ACT 2600

via: FIRBStakeholders@treasury.gov.au

Dear Mr McLean Dreyfus

The Financial Services Council (**FSC**) welcomes the opportunity to comment on the first tranche exposure draft of the *Foreign Investment Reform (Protecting Australia's National Security) Bill 2020* (collectively referred to as the **reforms**). The FSC welcomes the release of further detailed information, further to the 5 June 2020 Treasury foreign investment reform paper. The FSC previously wrote to Treasury providing initial comments on the reform paper on 14 July 2020 (see copy attached).

The FSC is a leading peak body that sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services. Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

Overall Comments

Foreign investment has been, and will continue to be, an important part of Australia's economy, and any restriction on that investment comes at a cost. In a recent report, the Productivity Commission found[1] that a more restrictive foreign investment policy regime would cost between $0.8 and $7.1 billion in foregone national income, depending on the policy settings. The report noted that a decrease in foreign investment flows by a quarter would decrease the wages of Australians by about 2 per cent. The FSC therefore argues that any reforms must strike a balance between national security and ensuring that Australia remains an open and welcoming destination for foreign investors.

The FSC's interest in this issue is on behalf of fund managers, which play an important role in providing capital to the Australian economy. Whilst some fund managers are foreign owned, they are local companies that are locally regulated, with offices in this country that employ Australians and manage billions in Australian assets. The scope of these reforms is very broad and the FSC believes this will have unintended consequences in adversely impacting on the normal activities of fund managers who invest on behalf of underlying investors. We believe that it should not be the intention of these reforms to capture these types of investments.

The FSC is concerned that these reforms will have a significant impact on fund managers, who are not the intended target of these reforms. These reforms will introduce uncertainty and the additional burden of time, expense and legal risks. This will in turn raise the risk premium of investing in Australia. The FSC notes that Australian owned fund managers would not have to bear this regulatory burden.

[1] Productivity Commission (2020) *Foreign Investment in Australia*, Commission Research Paper.

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Fund managers purchase and sell securities on a daily basis to comply with a fund's investment objective, as a result, these reforms would have an impact on fund managers' daily operations. It would not be uncommon for a fund manager to hold positions in a single security in excess of 10 per cent (a "direct interest" under the *Foreign Acquisitions and Takeovers Act*). The potential monetary and time costs of complying with these reforms are significant and the uncertainty that these reforms create may have a negative impact on the free flow of capital in the Australian economy.

The FSC understands that Treasury proposes to release a second tranche of legislation for comment which may include potential reforms to streamline investments for low risk investors. We look forward to the release of these details.

Before the release of tranche 2 of the reforms, it is difficult to fully comment on the proposed reforms in tranche 1 without understanding these yet to be released measures. Given this context, in this submission we outline several concerns in relation to the proposed reforms in tranche 1 and practical recommendations to address these issues. The most critical issue in the FSC's view will be what exemptions are ultimately made to facilitate the legitimate activities of fund managers who invest billions of dollars into Australia.

The Role of Fund Managers

The FSC submits that fund managers have a number of unique characteristics that are not specifically noted in the proposed reforms. Fund managers mange assets on behalf of clients, from the smallest retail client to the largest institutional investors. Fund managers are fiduciaries that have statutory and common law duties to act in the best interests of their underlying clients. Foreign fund managers themselves are strongly regulated, both in Australia by the Australian Securities and Investments Commission and by regulators in their home jurisdictions, such as the US Securities and Exchange Commission. As fiduciary investors, the primary objective is to secure better financial futures for their clients and the people they serve.

Many fund managers are portfolio investors or passive investors in that they and do not seek to influence, control or secure board positions of the companies in which they invest. Some fund managers may not even actively choose which companies to purchase because they manage index funds, which generally purchase and maintain positions in securities only in the approximate proportion that such securities are represented in the benchmark index the fund seeks to track. Some of these index funds frequently purchase Australian equities because they track an independently sourced index. Therefore, if the manager of a fund had to submit a foreign investment application each time it wanted to purchase a security in the fund's index where there is a potential for a direct interest of over 10 per cent, doing so would impose a substantial cost and time burden on the fund or fund manager.

Additionally, funds managed by foreign fund managers (or by an Australian subsidiary that is owned by a foreign fund manager) often will invest money on behalf of Australians such as Australian retail investors or superannuation funds or provide the necessary capital to adequately finance Australian assets that are not available from purely domestic sources. As such, imposing regulatory burdens on the fund or fund managers, even if foreign, often has the greatest impact on underlying Australian investors or the development of assets in Australia.

Accordingly, the FSC recommends that a fund manager that poses a low risk based on the nature of their investing activity should be able to access a broad investor specific exemption certificate that applies to all their investing activity in Australia. This low risk not only reflects they are fiduciaries acting on behalf of others but they are often regulated both in Australia and in comparable jurisdictions to Australia, such as the United States. This will ensure that those fund managers can invest their portfolios in Australia without uncertainty and an unreasonable compliance burden – and therefore facilitate investment in Australia

while meeting legitimate national security concerns and still helping Australian and global investors meet their financial objectives.

International Comparisons

Other comparable jurisdictions to Australia have recognised the need for exemptions to balance the need to be notified of investments by foreign investors into local companies which may pose risks to national security while still ensuring that foreign investors are not unduly restricted with respect to their investments.

For example, the FSC highlights the *Foreign Exchange and Foreign Trade Act* of Japan that only came into effect in May 2020. While that regime introduces a prior notification regime for foreign investors, it also relevantly permits a range of exemptions for foreign fund managers, including the "Foreign Financial Institution Exemption" for foreign financial institutions that are regulated in their home jurisdiction – these institutions will be exempt from having to submit a prior notification with respect to its acquisition of shares in listed companies. A key element of the Japanese foreign investor regime is express recognition and awareness of passive shareholdings by foreign investors and that this should not be caught by the regime, noting that the exemptions are not limited to passive or portfolio investing but include investments made on behalf of investors. The Japanese Ministry of Finance noted without a blanket exemption, there would have been significant operational burden that would make it operationally unsustainable for foreign financial institutions.

Recommendation:

1. The FSC recommends a broad, investor specific exemption certification to ensure investor certainty for low risk investors such as those who undertake passive or portfolio investment.

Implications of the Reforms

The reforms would have a broad range of impacts on Australia as a destination for foreign investment and create sovereign risks for investors. The reforms:

- introduce investor uncertainty;
- significantly increase in the cost of investing;
- disproportionately impact on foreign fund managers compared to domestic fund managers that do not have the additional compliance burden of time, expense and legal risk; and
- add additional costs of compliance through the new register of foreign interests and the need to submit more applications for approval.

The FSC is also concerned that the reforms will not only result in increased costs but also create further uncertainty in the delays that are created by the new process. The reforms increase the potential time to consider an application to 6 months. The median processing time for a foreign investment application is 45 days for the period 2018-19.[2] This processing time is still 50 per cent higher than the 30 day statutory timeframe; these delays create a substantial level of investor uncertainty. It also creates problems for fund managers that are attempting to match the return stock indexes – the delays while foreign investment applications are processed could mean funds are prevented from adequately tracking the movements in underlying stock values, leading to tracking error and a loss of value for underlying investors.

The broad nature of the reforms also leads to extraterritoriality concerns. The application of the tracing rules to a "notifiable national security action" means that off-shore acquisitions by an Australian managed fund may be captured – the mandatory notification could be triggered by an acquisition of 20 per cent or

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[2] Foreign Investment Review Board (2020) *2018-19 Regulator Performance Framework Report*, Annual Report

more in an offshore entity which has an Australian "sensitive national security business" within its controlled group structure. Even with prudent due diligence, the broad scope of the definition means there is uncertainty as it is not clear what is caught by the reforms and what is not caught.

Combined, these frictions slow down the flow of capital and increase the cost of doing business in Australia. These effects ultimately lead to lower returns for Australian investors, the ultimate owners of the funds that the fund managers advise.

National Security Business

Under the proposed reforms, the FSC understands that entities will be required to provide a notification of any proposed investment in a sensitive national security business or proposed investment in certain sensitive land. A new definition of national security business will be introduced in the *Foreign Acquisitions and Takeovers Regulations 2015* (**Regulations**).

The FSC submits that the definition of national security business under the draft Regulations is too broad and unclear. As drafted, entities are not able to determine if a company falls under the definition of a national security business without undertaking significant due diligence and even then, may not have access to the information required to make a proper determination. For example, publicly available information may not disclose that a business supplies goods to the Australian Defence Force, which is one of the triggers for a national security business.

A requirement for detailed due diligence for portfolio investors will significantly increase the compliance burden and risk on fund managers to ensure that they are not inadvertently taking a direct interest in a sensitive national security business or a sensitive national security land entity. For example, fund managers who seek to track an index would be required to undertake continued due diligence on a fund's underlying entities and in turn submit applications in the event that the index required the fund manager to take a 10 per cent or greater interest. Without an appropriately broad exemption such as the one recommended by the FSC, this would be a costly and impractical process.

Equally, in a context of an M&A transaction pursued by a fund manager on behalf of its clients, in particular in the infrastructure and real estate sector, it will be challenging for a fund manager (or any other investor) to determine definitively whether a proposed target or assets fall within the definition of the "national security business" given the absence of public registers for critical infrastructure, carriage services providers or land used for defence purposes. This, together with the "call in" powers proposed to be granted to the Treasurer may lead to foreign investors erring on the side of caution and applying for a FIRB approval where they would otherwise not be required to do so, therefore resulting in investment execution uncertainty and a potentially diminished investment appetite to pursue investments in Australia.

Furthermore, there are practical limitations to the proposed reforms. Under the draft Regulations and as explained in the explanatory memorandum (**EM**) at paragraph 1.52, a business which provides goods, technology or services for both civilian and military purposes may be captured under the criteria of "military end-use". The draft Regulations and EM notes that there is a criticality threshold and that it includes "goods, technology and services that may be detrimental to Australia's national security if not available or if misused". The scope of these reforms is even broader than existing regimes such as the Defence Export Controls. The FSC submits that Government, not the investor, is more suitably positioned to make an assessment on the detriment to national security in relation to the acquisition of a good, service or technology to ensure a consistent application.

Finally, the draft reforms tie the definition of a national security business to a responsible entity or direct interest holder in a critical infrastructure asset as defined under the *Security of Critical Infrastructure Act 2018* (**SOCI Act**). The FSC notes that the Department of Home Affairs is currently undertaking consultation on protecting critical infrastructure and systems of national significance. We understand that

this will result in change to the SOCI Act and recommend that the Government ensure that any changes to the SOCI Act do not unnecessarily broaden the definition of national security business even further.

In relation to the comparable Japanese reforms referred to earlier, the Japanese Ministry of Finance agreed to make public list of companies which are subject to the Japanese regime. Industry in Japan has recognised that this is a significant commitment by the Japanese Government but this list does provide certainty under which investments can be made. For fund managers who may invest regularly in the Australian markets, these reforms raise significant compliance and due diligence burdens. Additionally, they create significant risks of investor uncertainty in processing times and sovereign risk given the proposed call-in powers. The introduction of compliance and penalty provisions highlight the issues with the breadth and uncertainty of the definition as even taking all available and reasonable diligence measures, a fund manager may still not comply with this regime as it may fail to properly characterise a company that meets the definition of a "national security business".

The FSC requests that Treasury provide certainty around the definition of a "sensitive national security business" so that fund managers can apply the regime with confidence.

Recommendations:

2. For publicly listed companies, the FIRB Secretariat, in consultation with the Department of Defence and relevant government agencies, develops, publishes and maintains a register of national security businesses.
3. That the explanatory memorandum provides examples of what is and is not considered a national security business, land or land entity under each of the limbs of the draft Regulations.
4. Government should ensure that the changes to the SOCI Act do not inadvertently increase the scope of the proposed reforms.

Compliance and Register of Foreign Interests

The FSC recognises the importance of a robust foreign investment framework which supports investor confidence and meets community expectations. Likewise, the FSC understands that the government must have confidence in the foreign ownership of certain assets critical to Australia's national security. However, the FSC has concerns around the provisions relating to the Register of Foreign Ownership of Australian Assets.

The draft legislation requires a foreign person to register certain events, including an event relating to a no objection notification or exemption certificate. It also requires notification when a foreign person changes their interest of 5 per cent or more or ceases to hold an interest. While such a requirement may be appropriate for single, one-off transactions or a set program of acquisitions, the FSC is concerned that this may create an onerous burden on fund managers.

As stated earlier, some fund managers frequently trade Australian equities which may trigger a requirement to register their interest or register a change of interest. The draft reforms require that these changes be registered within 30 days. Given the activity of some fund managers, this would create a significant compliance burden. It may also deter future investment as prospective investors may have concerns that the register could be used outside of its stated mandate or even made public in the future.

In addition, these requirements duplicate existing requirements including reporting of substantial shareholdings under the Corporations Act. Under the Corporations Act, shareholders owning 5 per cent or more of the voting rights of an issuer must report their shareholdings to the issuer and the relevant market operator. After reaching this 5 per cent notification limit, shareholders must also report each 1 per cent change in their ownership on an ongoing basis. The proposed foreign person notifications are therefore duplicative of reporting requirements already in place and unnecessarily burdensome since the

Corporations Act filings are publicly available. Furthermore, all investors are subject to the takeover provisions to acquire an interest above 20 per cent.

Recommendations:

5. For foreign persons who are already subject to existing reporting and disclosure requirements of substantial shareholding of companies to be exempt from the proposed regime to maintain a register of foreign interests.
6. The draft legislation be amended to allow the decision maker to specify a period longer than 30 days to give notice to the Registrar so that entities can report on a net basis (for example at the end of a financial reporting period).

Fees

The FSC supports in principle the proposal to reform fees to make them fairer and simpler, while ensuring that the cost of administering the foreign investment regime is borne by foreign investors. We note a recent paper by the Productivity Commission[3] that demonstrates that the current fees are much higher than the cost of administration.

Given the broad nature of the proposed reforms, it is likely that the FIRB will see an increase in applications, including from investors who had previously made smaller transactions that fell outside of the framework. It is expected that foreign investors will now need to make more applications than before. This process will cause fund managers to incur significant costs – both in monetary fees paid but also in time spent applying for exemption certificates. Many of these affected fund managers are investing money on behalf of Australian retail investors or superannuation funds. A significant increase in fees and compliance costs would negatively impact the return that these funds could provide to everyday Australians. For repeat investors, the time and resources needed to assess an application should be reduced as FIRB becomes familiar with specific investors. Alternatively, broad-based exemption certificates should be provided to fund managers based on a review of the manager, rather than on a security-by-security basis so that a fund manager only has to apply once and not multiple times for different securities.

Recommendations:

7. That the Government implement the Productivity Commission's recommendation that fees for foreign investment applications be charged on a cost-recovery basis to administration costs.
8. Fees for regular applicants should be further streamlined to better reflect the cost of assessing each application.

The FSC would welcome the opportunity to discuss this submission and looks forward to the release of the second tranche of draft legislation. Should you wish to discuss any of these matters further, I can be contacted a

Kind regards,

Jamie Kennedy
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[3] Productivity Commission (2020) *Foreign Investment in Australia*, Commission Research Paper.