

12 February 2021

Committee Secretary
Parliamentary Joint Committee on Intelligence and Security
PO Box 6021
Parliament House
Canberra ACT 2600

By email: pjicis@aph.gov.au

Dear Sir/Madam,

Review of the Security Legislation Amendment (Critical Infrastructure) Bill 2020 and Statutory Review of the Security of Critical Infrastructure Act 2018

The Australian Investment Council welcomes the opportunity to contribute to the Parliamentary Joint Committee on Intelligence and Security's review of the *Security Legislation Amendment (Critical Infrastructure) Bill 2020* and Statutory Review of the *Security of Critical Infrastructure Act 2018*.

At this critical juncture in our national response to the COVID-19 pandemic, it is vitally important for our economic recovery, and Australian jobs, that the introduction of new market regulation strikes an appropriate balance between the, sometimes, competing interests of policy and business and market efficiency. In our view, the proposed changes to the *Security of Critical Infrastructure Act 2018* (**SOCI Act**) risk impeding the market efficiency of business investment activity within our domestic economy both now and in the future.

As a net importer of capital, Australia's economy relies on a dependable and steady flow of foreign capital to drive economic growth and job creation. To fund our national recovery, Australian businesses need prompt and reliable access to capital from domestic as well as offshore investors. The proposed changes to the SOCI Act, through its links to the *Foreign Acquisition and Takeovers Act (FATA)*, have the potential to impede the ability of Australian business to access this vitally important funding.

In balancing our national interests and security, it is important that any new regulatory obligations are proportionate to the risks posed by certain business activities in the market, and the ability of firms to respond in an appropriate way to the requirements being considered. The private capital industry's main concern is that, as currently drafted, the definitions incorporated in these reforms would likely capture a wide range of investment activity, most of which are small and pose no security risk in our view. While the private capital industry understands this is not the government's intent, unnecessarily broad, or unclear, definitions will likely have flow-on affects in relation to investor perceptions and the FATA.

Our analysis shows that of the Australian private equity and venture capital deals between 2010 and August 2020, the number of deals potentially brought within scope of an expanded SOCI Act would:

- Increase from 1.8% and 55.1% for private equity; and
- Increase from 3.3% and 56.8% for venture capital.

The private capital industry's key recommendations in respect of the review are set out below. The Council encourages the Committee to carefully consider all elements of the feedback at both a high level and a more granular transactional level. It is vitally important that policy changes in this area are calibrated to deliver the right long-term outcomes for the nation.



We look forward to participating in future discussions about the proposed reforms, including the development of sector specific guidance. If you have any questions about the recommendations or any specific points outlined in this submission, please do not hesitate to contact me [REDACTED], the Australian Investment Council's Head of Policy and Research, [REDACTED].

Yours sincerely



Yasser El-Ansary
Chief Executive



Overview

The Australian Investment Council is the voice of private capital in Australia. Private capital investment has played a central role in the growth and expansion of thousands of businesses and represents a multi-billion-dollar contribution to the Australian economy. Our members are the standard-bearers of professional investment and include: private equity, venture capital and private credit funds, alongside institutional investors such as superannuation and sovereign wealth funds, as well as leading financial, legal and operational advisers.

Private capital fund managers invest billions of dollars into Australian companies every year. Funds under management of Australian-based private capital funds topped \$33 billion in 2019, testament to the growth in available capital to support investment into businesses across every industry sector of the economy. Private capital investment offers smart, patient capital to support the growth of (generally) unlisted businesses along with expert guidance and strategic support.

More and more businesses are choosing to raise capital from private investors, rather than through public markets, because of the benefits of partnering with venture capital, private equity and private credit firms. Private capital investors can help unlock the growth and expansion opportunities of businesses through active asset management in a way that public markets simply cannot. This is evidenced by the fact that private capital-backed Australian businesses generate one in nine new Australian jobs and contribute 2.6 per cent of Australia's GDP.¹

Efficient and reliable access to domestic and foreign capital is a vitally important ingredient in enabling billions of dollars of investment capital to flow into Australian businesses. The industry's ongoing capacity to continue to invest greater amounts of capital into Australian businesses, leading to the creation of new high-value Australian jobs, will not happen automatically – policy and regulation must support and encourage capital investment into the domestic market. While the private capital industry currently has more than \$13 billion in available capital to support investment into existing or new portfolio companies, the sector's ability to continue to fund new investments, now and over the coming years, will be increasingly dependent on inbound capital from offshore investors. There are four main drivers underpinning the flow of private capital investment into the medium-term:

- 1) History shows investment into innovation and research falls after a crisis, despite being a key economic driver;
- 2) Early evidence of 'capital rationing' and some risk aversion materialising;
- 3) Constraints on access to institutional investment from superannuation funds due to a heightened focus on maintaining liquid positions and uncertainty in relation to future valuations; and
- 4) COVID-19 restrictions hampering the ability of fund managers to connect with (potential) investee businesses and institutional investors. This is particularly acute for new funds that do not have established relationships.

Uncertainty regarding Australia's regulation of critical infrastructure and systems of national significance, combined with changes to the foreign investment review regime, have added additional pressure on investment flows in the already challenging current environment. The potential impact of this drag on investment and growth should not be downplayed. Nor should the impact on dampening collaboration and cross-pollination within Australia's economy. The Council is aware of a number of investments that have been delayed alongside an increase in offshore (and domestic) investor perceptions of sovereign risk in Australia as a result of the changes and ongoing uncertainty surrounding Australia's foreign investment review framework. These concerns are likely to accelerate as a result of the potential implications of the changes to the SOCI Act. In considering these proposed changes, it is imperative that the government considers the direct and indirect impacts, including on Australia's (future) foreign investment review framework. There is a need to carefully balance the current and future needs of Australia businesses against the need to safeguard the nation's collective interests.

¹ Deloitte Access Economics (2018) *Private Equity: Growth and innovation*, April



1. Wide reach of the proposed changes

The proposed increased scope and broad definitions could have material costs and impacts on the private capital industry and Australian businesses.

The material broadening of the industries subject to the SOCI Act would likely lead to a wide range of businesses being captured within the regime. Currently, only electricity, gas, water and maritime ports (and other declared assets) are captured as 'critical infrastructure'. The proposed expanded coverage would include: banking and finance; communications; data and the cloud; defence industry; education, research and innovation; energy; food and grocery; health; space; transport; and water. This change is material in itself, in addition to the significant interconnectivity between the proposed changes to the SOCI Act and the foreign investment policy reforms.

The definition of "national security business" within the FATA includes:

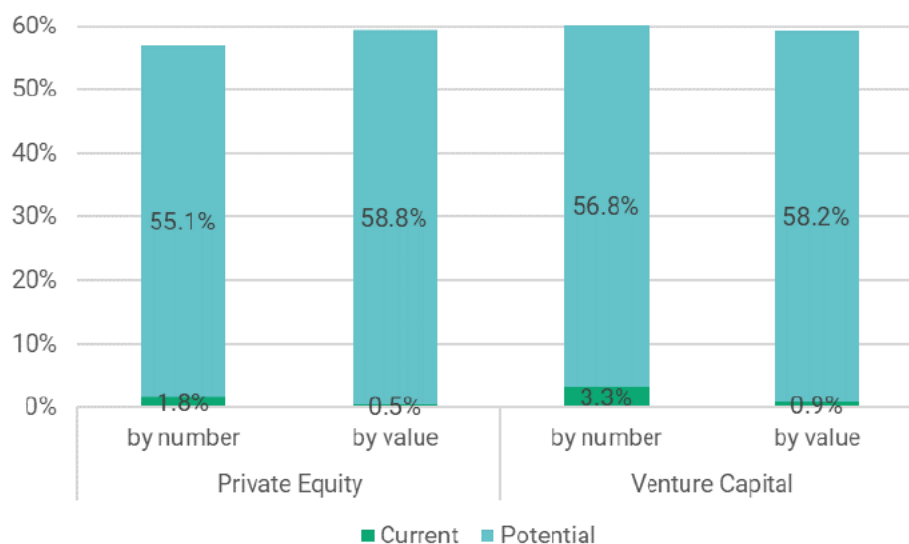
- "(a) a responsible entity (within the meaning of the Security of Critical Infrastructure Act 2018) for an asset; or
(b) an entity that is a direct interest holder in relation to a critical infrastructure asset (within the meaning of those terms in the Security of Critical Infrastructure Act 2018);"*

The practical implication of the proposed changes to the SOCI Act would be to capture a wider range activities and assets and to force a broader range of transactions to require FIRB approval. This will likely significantly increase the regulatory burden on industry, lead to reduced investment flows and, dampen economic activity and jobs growth. Given Australia's current economic position, such outcomes should be seen as highly undesirable – especially given the exceptionally low national security risks posed.

An analysis of Australian private equity and venture capital deals between 2010 and August 2020 shows that number of deals captured potentially be brought within scope of an expanded SOCI Act would:

- Increase from 1.8% and 55.1% for private equity; and
- Increase from 3.3% and 56.8% for venture capital (Figure 1).

Figure 1: Private Equity and Venture Capital deals currently and potentially captured by (expanded) SOCI Act deals from 2010 to August 2020



Sources: Preqin and Australian Investment Council, 2020

This would represent a *substantial* increase and supports the industry's view that there will likely be a material increase in private capital activity caught by the SOCI Act and investment deals requiring FIRB approval in the future, based on current design features of the proposed changes.



It is difficult for investors to make a confident appraisal of the regulatory and legal risks associated with potential investments in this context. Until these uncertainties are resolved, which appears unlikely until well into 2021, there will be a constraint on new investment and increased funding costs for Australian businesses.

The Council urges the Committee to closely review the potential for unintended consequences to arise from the proposed changes to the SOCI Act when viewed in parallel with the recent reforms to the foreign investment review framework.

2. Impact on private capital fund managers

The impact of the proposed changes on the private capital industry are far reaching, direct and indirect, and likely to impact both funds and investee business (portfolio companies).

Indirect impacts include increased funding costs, tighter funding conditions and broadening the capture of FATA and, therefore, an increase in the costs and delays associated with needing FIRB approval.

Funding costs

The capture of private capital funds and their portfolio companies under a broader regime, or even the perceived risk of capture, would likely lead to increased funding costs and stricter funding conditions. If lenders perceive an increased sovereign risk, it is likely they will look to introduce additional conditionality in financing commitments. This will impact funding certainty, which is a key 'sell side' focus point for private capital bidders.

Lending appetite for 'at risk' transactions may also fall – preferred equity/debt funding mix for private capital bidders may become unattractive for some bidders to pursue such transactions. This would reduce the flow of funds into Australian businesses and potentially impact asset valuations (due to decreased competition).

Narrowing the definition

It is the private capital industry's understanding that the government is not intending to capture private capital funds themselves as either 'critical infrastructure' or 'systems of national significance'. However, the definitions proposed are sufficiently broad that they produce regulatory risk and will likely lead to some institutional investors questioning the impacts of legislation.

In its recent workshop on banking and finance, the following definition was presented by the Department of Home Affairs:

Critical infrastructure assets in the banking and finance sector are proposed to be those assets associated with the delivery of services involved in the provision of, and facilitating the provision of, financial services ('banking and finance').

Arguably, private capital funds could be captured by this definition. The Council recommends this definition be narrowed to more clearly articulate the government's intent. A narrower and more proportionate definition would also more closely align to the current definition in the Australian Government's Critical Infrastructure Resilience Strategy which includes concepts such as "unavailable for an extended period" and "significantly impact on the social or economic wellbeing of the nation".

These concepts are similar to those in the Financial Stability Board's (FSB) guidance on identifying critical functions and critical shared services, which may be useful in this context. In its guidance, the FSB considers concepts of:

- Material impact on third parties;
- Systemic relevance of the function; and
- Substitutability.



While the private capital industry is important to Australia's economy and the generation of Australian jobs, individual firms do not provide critical infrastructure or systems of national significance. While the sudden incapability or failure of a particular private capital fund may impact some of its portfolio companies, this impact:

- is unlikely to be material;
- would be contained to the portfolio company/ies;
- could be quickly and efficiently substituted for an alternative provider; and
- would not have a significant impact on the nation or be of systemic relevance.

It is also extremely unlikely that private capital funds would be captured by any critical functions analysis conducted by APRA or ASIC.

As such, the Council recommends it be made clear that firms, such as private capital funds, are excluded from the reach of the proposed changes. Failure to do this will result in increased regulatory uncertainty, compliance costs, funding costs and ultimately, a slowing down of the Australian economy and reduction in jobs growth.

3. Impact on portfolio companies

While the private capital industry is of the view that private capital funds themselves should not be captured by the proposed expanded regime, there is a high degree of uncertainty surrounding the possible treatment of portfolio companies. As private capital funds invest in every sector of the Australian economy, some of those investments will likely fall within the proposed expanded coverage of sectors.

As described above, the implications of this go beyond the requirements set out in the Department of Home Affairs' consultation paper to include increased burden from other government legislation and regulation and, increased funding costs.

Examples of definitions that could be interpreted very broadly and are relevant to the private capital industry are:

Critical infrastructure assets in the health sector are proposed to be those assets, systems or networks involved in the provision of health care, production of medical supplies and medical research.

It is unclear, for example if the provision of health care should be interpreted to include aged care facilities, or what stage or areas of medical research are covered.

Education providers, and
Entities or institutions that are responsible for a research program (however described) that:

- has received investment, funding or a grant from the Commonwealth Government, or
- is relevant to one or more critical infrastructure sector.

Similar to the health sector definition, the description of a 'research program' is unclear and would potentially capture many programs of no national significance that receive some "investment, funding or a grant from the Commonwealth Government".

To reduce current and future uncertainty and costs, greater clarity should be provided on the proposed definitions for each of the sectors proposed to be covered. This clarity, including the concepts of materiality and breath of impact, systemic relevance and sustainability, should be included in the SOCI Act to reduce potential spill over to other legislation and regulation. The sector specific guidance should then provide further clarity how these concepts will be interpreted and applied.