

## CORONAVIRUS RESOURCE CENTER

# COVID-19-Related Changes to Foreign Direct Investment Rules Pose Unique Challenges to Secondaries Market

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For international investors, one noteworthy response to the COVID-19 pandemic by national governments, including Australia, Canada, India, and various EU Member States, has been the introduction or tightening of legislation related to foreign direct investment (“FDI”). These legislative changes, which follow a broader global trend of enhancing FDI regulation that has emerged in recent years, are being proposed to curb what many national lawmakers perceive as opportunistic takeovers by foreign investors of companies that are struggling in the current crisis, in particular companies involved in infrastructure, technology, healthcare and other critical industries.

Naturally, FDI rules have a direct impact on traditional cross-border M&A, and as a result, legal advisers who regularly advise on cross-border M&A closely track the applicable legislative processes around the world, advise on deal structures that address their application and assist in making required filings. For private equity secondaries market participants, however, the breadth of recently adopted FDI laws in certain jurisdictions, which might also impact many types of secondaries transactions, may come as a rather unwelcome surprise and have significant knock-on effects on transactions.

The nature of the restrictions varies from jurisdiction to jurisdiction, with certain governments focusing on proposed foreign investment in particularly sensitive sectors while others focus on particular types of foreign investors (such as investors from particular jurisdictions or state-backed investors generally). Regardless of their thrust, the most recently enacted FDI rules have been implemented quickly in response to a rapidly evolving COVID-19 pandemic and presumably without regard for private equity structures and, specifically, the potentially far-reaching consequences that such measures may have on the private equity secondaries market (which does not appear to have been the intended target of such restrictions from a policy perspective).

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This note provides an overview of the unexpected obstacles these recent legal developments may pose to private equity secondaries transactions and suggestions as to how to navigate them.

- Identify applicable regimes. Whether a secondaries transaction being contemplated is an LP interest transfer or tender offer, a preferred equity investment or a GP-led restructuring, parties should consult with legal counsel early in the process to identify whether a particular jurisdiction's FDI regime will be implicated by the transaction. The analysis can be complex and unclear and may require input from several layers of counsel (investor fund counsel, transaction counsel and local counsel) to bottom out.

For example, FDI legislation recently enacted in India restricts investments from China and other bordering countries without prior governmental approval. The new legislation covers any direct and indirect investments from, or where the beneficial owner of the investment is based in, such neighbouring countries. It remains unclear what "beneficial ownership" means in the context of these FDI rules, but extrapolating from the various definitions of beneficial ownership under existing Indian laws, it appears a transfer to a Chinese LP of a fund interest in a fund (wherever domiciled) that owns a portfolio company with any Indian operations (regardless of its sector) could require prior governmental approval under the new FDI regime. Until the much-anticipated clarifications from the Indian government are published, parties are advised to act cautiously.

Similarly, recent temporary changes to Australia's FDI rules could have far-reaching implications on private equity secondaries transactions, in particular GP-led transactions. Under Australia's Foreign Acquisitions and Takeovers Act 1975 (Cth) ("FATA"), the acquisition by a foreign government investor ("FGI") of an interest of 20% or more (or by multiple FGIs of an aggregate interest of 40% or more) in a non-Australian entity will trigger a notification obligation if that non-Australian entity has an indirect interest of 20% or more in any Australian assets. Ordinarily, the monetary value of such an acquisition must exceed a certain threshold to trigger a notification obligation under FATA; however, in response to COVID-19, all such thresholds temporarily have been reduced to A\$0. Due to the makeup of their investor bases, and the application of the relevant FATA rules, a private equity fund structure (or its acquisition vehicles) is typically considered an FGI.<sup>1</sup> And because the FATA regulations do not provide an exemption for internal reorganisations, GP-led transactions such as fund-level preferred equity issuances or restructurings may trip

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<sup>1</sup> On 5 June 2020, Australia's Federal Treasurer announced further proposed changes to Australia's FDI regime, that, if implemented, would relax the rules applicable to certain types of passive investments that would otherwise be subject to the FATA regulations. The changes are proposed to come into effect on 1 January 2021.

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the notification requirement, even where there is no change of control (or even beneficial ownership) of an Australian entity subject to the FATA regulations. Australia's Foreign Investment Review Board, which oversees the FATA notification process, has advised that approvals may take up to six months in the current environment, meaning transactions that are subject to the FATA notification requirement could face lengthy, unexpected delays in their implementation.

- Understand timing implications. To the extent a proposed transaction falls within the purview of a particular jurisdiction's FDI regime, parties should understand the timing implications of any filing obligations. The review periods differ markedly across jurisdictions, ranging, for example, from 30 business days in France to seven months or more in Germany, and such review periods can be stopped if an authority is not satisfied that the documentation provided is complete, potentially delaying a transaction even longer. Moreover, these review periods have become increasingly uncertain as regulators adapt their processes to the impacts of COVID-19. Secondaries participants should work closely with their advisers from the outset of a transaction to ensure any FDI related filings are navigated as efficiently as possible.
- Consider risk allocation. If a secondaries transaction will attract scrutiny under a jurisdiction's FDI rules, the parties should consider risk allocation around responsibility for obtaining approvals (including in respect of costs), pre-closing covenants, the consequences of failing to obtain approvals and further changes in law—much in the same way that merger control and other regulatory approvals are routinely addressed in transaction agreements. Similarly, parties should consult legal counsel to understand the possible sanctions for noncompliance under a particular jurisdiction's FDI regime, which may entail financial penalties (as in Italy and Spain) and/or criminal sanctions now or in the future (as in Australia and France, Germany and Poland).

While certain governments have adopted an increasingly interventionist approach to FDI rules throughout the last few years, COVID-19 has led to a flurry of new rules expanding existing regimes and introducing new ones. These new rules may impact even routine private equity secondaries transactions in unexpected ways. Secondaries market participants should be aware of these developments as they evaluate transactions and consult with their legal advisers so as to ensure the potential pitfalls of these FDI regimes are mitigated.

We would be happy to discuss this topic or any questions you may have or issues you may be facing in connection with current or prospective transactions affected by recently expanded or recently implemented FDI regimes.

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For more information regarding the legal impacts of the coronavirus, please visit our [Coronavirus Resource Center](#).

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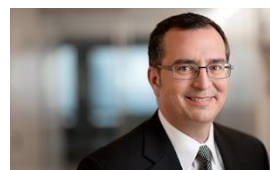


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