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THE FOREIGN DIRECT INVESTMENT REVIEW PROCESS IN CANADA AND OTHER COUNTRIES

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THE FOREIGN DIRECT INVESTMENT REVIEW PROCESS IN CANADA AND OTHER COUNTRIES

INTRODUCTION

Foreign direct investment is an important tool for building wealth and economic prosperity. It creates jobs in the host country, facilitates economic expansion, helps to create a more competitive business environment, and contributes to productivity-enhancing investment in machinery and equipment. For these and other reasons, most countries are eager to attract direct investment from around the world.

At the same time, however, many feel uncomfortable with the idea of foreign ownership of a significant share of domestic economic activity. They argue that foreign-controlled enterprises may not always act in the national, or local, interest; that profits can be redirected out of the country; and that foreign ownership could have national security implications in cases where products or industries are of strategic importance. These concerns tend to be most pronounced in the energy and natural resource sectors.

For these reasons, countries tend not to offer foreign investors unlimited access to domestic assets; many limit or restrict investment in sectors deemed to be of strategic (or cultural) importance. In addition, numerous countries have in place a screening process that reviews all major proposed foreign direct investments in order to determine whether they serve the national interest.

Canada is among the countries that uses such a screening process. Under the 1985 *Investment Canada Act*, any proposed foreign direct investment above a certain value automatically triggers a review by the industry minister. To be approved, proposed investments must demonstrate that they provide a "net benefit" to Canada.

However, recent events have caused the foreign direct investment review process to come under some scrutiny in Canada. A spate of foreign takeovers of high-profile Canadian companies, as well as attempts by Chinese state-funded or state-backed companies to buy Canadian natural resource assets, have raised questions about how Canada screens proposed foreign direct investments to ensure that they are in the country's best interests.

This paper examines the foreign direct investment approval process in Canada and the criteria that are considered in determining whether to accept or reject foreign investments. By way of comparison, it also examines the investment review process in two other major industrialized economies: Australia and the United States.

THE FOREIGN DIRECT INVESTMENT REVIEW PROCESS IN CANADA

The *Investment Canada Act* is the primary tool for the regulation of foreign direct investment in Canada.(1) Its purpose is to "encourage investment in Canada by Canadians and non-Canadians that contributes to economic growth and employment opportunities and to provide for the review of significant investments in Canada by non-Canadians in order to ensure such benefit to Canada."(2) With the exception of investments in cultural industries, which fall under the purview of the Department of Canadian Heritage, Industry Canada is the department responsible for the administration of the Act.

Any foreign direct investment in Canada above a certain value threshold automatically triggers a review under the Act. The review threshold varies, depending on whether or not the investing country is a member of the World Trade Organization (WTO) and on the specific sector in which the investment is being made:

- For investors that are not WTO members, the threshold is $5 million for a direct acquisition and $50 million for an indirect acquisition.(3) However, the threshold for an indirect acquisition falls to $5 million if the asset value of the Canadian business being acquired is greater than half of the value of the global transaction.

- The threshold for reviewable direct acquisitions by investors from WTO-member countries is calculated annually according to a pre-determined formula based on growth in Canada's gross domestic product (GDP). The threshold was $281 million in 2007. Indirect acquisitions by WTO investors are not reviewable, but are subject to a requirement to provide notification.

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(1) For more information on the *Investment Canada Act*, see the Industry Canada website, http://strategis.ic.gc.ca/epic/internet/inica-lic.nsf/en/home?OpenDocument.

(2) *Investment Canada Act*, http://strategis.ic.gc.ca/epic/internet/inica-lic.nsf/en/h_lk00071e.html.

(3) According to Industry Canada, an indirect acquisition is one in which the investor buys shares of a company that is incorporated outside Canada but owns subsidiaries in Canada.

- The higher thresholds for WTO members do not apply to foreign investment in uranium production, financial services, cultural industries, or transportation services. In these sectors, the threshold is $5 million, as for non-WTO members.

The *Investment Canada Act* is intended to ensure that all foreign direct investment in Canada provides a net benefit to the country. However, the Act does not specify what constitutes a "net benefit." It is up to the industry minister to make that decision, giving consideration to the following factors:(4)

(a) the effect of the investment on the level of economic activity in Canada, employment, resource processing, utilization of parts and services produced in Canada, and exports from Canada;

(b) the degree and significance of participation by Canadians in the Canadian business or new Canadian business and in any industry or industries in Canada;

(c) the effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada;

(d) the effect of the investment on competition within any industry in Canada;

(e) the compatibility of the investment with national industrial, economic and cultural policies; and

(f) the contribution of the investment to Canada's ability to compete in world markets.

If, in the minister's view, a proposed investment is unsatisfactory in any of these areas, it can be rejected. As of 30 June 2007, there have been 12,342 applications to acquire Canadian businesses, and 3,652 applications to start new businesses in Canada, since the Act came into effect. Of the foreign acquisitions of Canadian companies, 1,545 were of sufficient size to trigger a review under the Act. To date no investments have been rejected under the *Investment Canada Act*.

The fact that the industry minister has never rejected a proposed foreign direct investment has led some to believe that the *Investment Canada Act* is not an effective mechanism for screening foreign investments. Some have suggested that the industry minister does little more than rubber-stamp investment proposals.

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(4) Industry Canada ICA FAQs, http://strategis.ic.gc.ca/epic/internet/inica-lic.nsf/en/h_lk00007e.html.

It is true that governments are reluctant to publicly reject foreign direct investments; doing so runs the risk of signalling that the country does not welcome foreign capital. Given the important role that foreign direct investment can play in spurring economic growth and prosperity, this is not a message governments are typically anxious to send.

However, it would be erroneous to conclude that governments are powerless to reject undesirable foreign investments and takeovers. In Canada, for example, firms are given opportunities to amend their investment plans so as to provide a "net benefit" to Canada if, in the opinion of the industry minister, none was evident in the original plan. Such amendments might include promises to employ a certain number of Canadians, keep factories open, or keep the corporate head office in Canada.

Moreover, the evaluation process is not akin to a "pass or fail" exam in which the investor answers a series of questions and then waits for the results to be posted. Prospective investors work with the federal government on a continual basis to respond to any concerns the industry minister may have about the nature of the investment. If, in the opinion of the investor, the minister's concerns cannot be addressed without compromising the economic basis for the investment, that fact would be apparent long before any final decision to reject the proposal was reached. The investor would thus be far more likely to withdraw or abandon his or her investment proposal than to proceed futilely through the review process.

THE FOREIGN DIRECT INVESTMENT REVIEW PROCESS IN OTHER COUNTRIES

A. Australia

Australia's investment policy is set by the national treasurer and is administered by the Foreign Investment Review Board (FIRB). Like Canada, Australia encourages foreign direct investment as a way to build its domestic economy. It also operates an investment review process similar to the process employed in Canada.

In Australia, most relatively small purchases of land or business interests by foreigners are exempt from any requirement to provide notification to the Australian government. However, if a foreign interest wishes to make a purchase of land or capital over a certain value threshold, then it must report its intention to do so to the Australian government, thus triggering a review.

The thresholds that trigger such a review in most industries are as follows:[(5)]

- an investment greater than A$50 million for the acquisition of a substantial interest in any existing business;
- an investment greater than A$10 million for the establishment of a new business; and
- an investment greater than A$50 million for an offshore takeover.

As a result of the Australia–US Free Trade Agreement, which came into effect 1 January 2005, a considerably more generous set of thresholds is in place for US investors.

The review process, which also allows for comments and feedback from relevant and affected parties, is intended to ensure that any larger foreign investment in Australia is in the national interest. According to paragraph 3 of the Australian government's *Summary of Australia's Foreign Investment Policy* document:[(6)]

> The Government has the power under the *Foreign Acquisitions and Takeovers Act 1975* (the FATA) to block those proposals subject to the FATA which would result in a foreign person acquiring control of an Australian corporation or business or an interest in real estate where this is determined to be contrary to the national interest.

Paragraph 5 of the same document elaborates on the notion of investments "contrary to the national interest:"

> The Government determines what is 'contrary to the national interest' by having regard to the widely held community concerns of Australians. Reflecting community concerns, specific restrictions on foreign investment are in force in more sensitive sectors such as the media and developed residential real estate. The screening process provides a clear and simple mechanism for reviewing the operations of foreign investors in Australia whenever they seek to establish or acquire new business interests or purchase real estate. In this way the Government is able to encourage foreign investors to operate in Australia as good corporate citizens if they wish to extend their activities in Australia.

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(5) More stringent foreign ownership rule apply in urban real estate, media and telecommunications, aviation, airports, shipping and banking.

(6) See http://www.firb.gov.au/content/_downloads/General_Policy_Summary_Apr2007.pdf.

According to this description, these provisions constitute a "negative test." That is, the onus is on the Australian government to find reasons to reject an investment proposal. This stands in marked contrast to the Canadian system, under which prospective investors must demonstrate a "net benefit" to Canada in order that their investments be approved.

However, like the Canadian approach, the Australian test clearly has a discretionary element. Critics of Australia's investment screening process argue that there is no definition of the criteria that are used to determine whether an investment is in the national interest.

With the exception of some real estate investment proposals, the rejection of foreign investment is rare in Australia. Unlike Canada, however, Australia has used its "national interest" test in the past to block large-scale foreign investment. The most recent, and high-profile, example occurred in 2001, when the Australian government rejected an attempt by the energy company Shell to mount a hostile takeover of Australian energy company Woodside Petroleum Ltd. The A$10 billion bid was rejected on the grounds that Shell would operate Woodside as part of its global portfolio and not in the best interests of the company itself.(7)

B. The United States

The US is generally considered to be very welcoming of foreign direct investment. Unlike Canada and Australia, it does not have a mechanism that automatically triggers a review of large foreign investment proposals. Only a few explicit limitations exist in certain industries, notably airlines, marine shipping, media, communications and fishing. Otherwise, the US generally grants all investors national treatment status – foreign investors are treated no differently from domestic investors.

However, the US does employ a mechanism that screens all foreign acquisitions on the basis of national security concerns. The Committee on Foreign Investment in the United States (CFIUS) is mandated to conduct these investigations under the provisions of the *Exon-Florio Amendment to the Defense Production Act* of 1950 (*Exon-Florio).* Under *Exon-Florio*, the president of the United States has the power to block any foreign investment or acquisition believed to threaten national security, if the provisions of existing laws, save the *International Emergency Economic Powers Act*, are deemed insufficient for the task.

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(7) David Richardson, *Foreign Investment and the Australia United States Free Trade Agreement*, Current Issues Brief no. 7 2003-04, Parliamentary Library, Parliament of Australia, 8 March 2004, http://www.aph.gov.au/library/pubs/CIB/2003-04/04cib07.htm.

Unlike Canada and Australia, there is no threshold or set of conditions that triggers a national security review. For the most part, these reviews under CFIUS are voluntary. The exceptions, only recently introduced, are discussed further below. CFIUS can, however, also initiate a review of its own accord. As such, if there is any doubt that an investment might prompt national security concerns, it is often in the investor's best interest to apply for a review before proceeding with the acquisition rather than to have a review initiated after the fact.

It is important to note that *Exon-Florio* does not define national security. It merely provides a list of factors to be considered in determining whether a foreign acquisition may constitute a national security threat. These factors are:(8)

- domestic production needed for projected national defence requirements;
- the capability and capacity of domestic industries to meet national defence requirements, including the availability of human resources, products, technology, materials, and other supplies and services;
- the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the US to meet the requirements of national security;
- the potential effects of the transaction on the sales of military goods, equipment, or technology to a country that supports terrorism or proliferates missile technology or chemical and biological weapons; and
- the potential effects of the transaction on US technological leadership in areas affecting US national security.

Until recently, this list was considered to be merely a guideline to help the president and CFIUS review foreign investments. *Exon-Florio* did not *require* those factors to be considered; neither was the list considered to be exhaustive.

In July 2007, however, amendments were made to *Exon-Florio* in an effort to improve its transparency and effectiveness. These amendments were precipitated by two proposed acquisitions of US assets by foreign companies: the attempted purchase of Unocal by the China National Offshore Oil Corporation (CNOOC) in 2005; and that of P&O Steam Navigation Company's port operations by Dubai Ports World (DPW) in early 2006.

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(8) Taken from the Exon-Florio website, http://www.treas.gov/offices/international-affairs/exon-florio/index.html.

Among the amendments were two important developments. First, two conditions were specified under which an investigation would automatically be triggered: if the transaction involved an entity controlled by a foreign government, or if the transaction involved "critical infrastructure"[9] and had the potential to threaten US national security if it were not otherwise mitigated.[10]

Second, in addition to making it easier to trigger an investigation, the July 2007 amendments now require CFIUS and the president to consider the above list of factors in assessing the national security implications of foreign investments. In addition, although they have long been considered *de facto* criteria even if they were not explicitly laid out, the bill adds three new factors that must be considered in evaluating investments on national security grounds. These are:[11]

- the potential for national security-related effects from the acquisition of US critical technologies and/or infrastructure, including energy;
- whether the transaction involves an entity controlled by a foreign government, and, if so, the foreign country's adherence to nuclear non-proliferation policies, its co-operation with regard to counter-terrorism activities, and its export control record; and
- the potential effects of the transaction on sales of military goods, equipment, or technology to a country that poses a regional military threat to the interests of the US.

Since *Exon-Florio* was introduced in 1988, over 1,500 notices have been filed with CFIUS. Of these, 25 investigations were triggered. Eleven were allowed to proceed, and thirteen would-be investors withdrew their transaction. Only one deal (in 1990) was prohibited – a Chinese company was required to sell its interest in a Seattle aerospace company.[12] However, as is the case in Canada, if it becomes apparent that a proposed acquisition is unlikely to receive approval, it is far more likely that the foreign investor in question will abandon or withdraw a proposal rather than go through the review process.

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(9) "Critical infrastructure" is intended to be defined in a similar manner as by the Department of Homeland Security and the US *Patriot Act*.

(10) Freshfields Bruckhaus Deringer, *Summary of legislation* (*Foreign Investment and National Security Act*, 2007, H.R. 556), July 2007, http://www.freshfields.com/publications/pdfs/2007/aug22/19382.pdf.

(11) Ibid.

(12) The Organization for International Investment, http://www.ofii.org/factsheet.htm.

CONCLUSION

Although Canada, the United States and Australia all have mechanisms in place that allow their federal governments to screen foreign direct investment proposals, there are significant differences among the three. In both Canada and Australia, a formal process exists whereby if a proposed foreign direct investment exceeds a certain value threshold, a review is automatically triggered. In Canada, the prospective investor must demonstrate to the industry minister that the investment offers a net benefit to Canada; although not specifically stated, this "net benefit" is usually assumed to be economic. In Australia, however, the onus is on the government to determine whether or not an investment is "in the national interest."

In the US, by contrast, there is no such automatic review process for most types of foreign direct investment. Only in cases where national security is a concern does a screening process exist. Even then, foreign investors normally apply for national security reviews on a voluntary basis, although the US government can also initiate such reviews of its own accord. Only if an investment is made by a state controlled enterprise, or involves critical US infrastructure, is the review process automatically triggered.

Although the investment review process is different in all three countries, they all share an important feature. The basis on which foreign direct investments can be rejected – failure to demonstrate a "net benefit;" a determination that an investment is not "in the national interest;" or a determination that the investment could violate national security – are not well defined. This is not an oversight. The US specifically does not define what constitutes a national security concern in order to ensure that it does not limit its own ability to respond to unforeseen circumstances. In Canada and Australia as well, many argue that the definitions of "net benefit" and "in the national interest" are vague for similar reasons.

Although Canada employs a "net benefit" test that allows for some flexibility in interpretation, recent cases of high-profile takeovers of Canadian companies, as well as of Chinese state-controlled enterprises expressing interest in Canadian natural resource assets, have led some to call for a review of the foreign direct investment screening process in Canada. The *Investment Canada Act* is more than 20 years old and was designed in the context of a very different economic environment than the one that exists today. For this reason, in July 2007, the federal government appointed an independent five-member panel to examine all aspects of Canadian investment policy (as well as competition policy), including the *Investment Canada Act*. The panel will make its recommendations to the government by the end of June 2008.