IS THE INVESTMENT CANADA ACT OF NET BENEFIT TO CANADA?

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This brief submission is responsive to the Panel's questions on "Investment Policies" on page 19 of *Sharpening Canada's Competitive Edge*. It argues for the repeal of the Investment Canada Act (the "ICA").

As noted in *Sharpening Canada's Competitive Edge*, and as Canadian foreign investment lawyers are well aware, a non-Canadian investor must obtain approval under the ICA in the form of a net benefit ruling from the Minister of Industry or Canadian Heritage when acquiring control of a Canadian company whose assets exceed certain specified financial thresholds.

Following the submission of an "application for review" by the investor, which includes a document outlining the investor's plans for the Canadian business, the investor will almost always be required to make binding undertakings to the Minister relating to capital expenditures, R&D expenditures, employment, Canadian participation in management and governance and in other areas to satisfy the Investment Review Division of Industry Canada or the Department of Canadian Heritage that it has a sound basis for recommending approval of the investment to the Minister because it is likely to be of net benefit to Canada.

To be clear, the reason for undertakings is to establish net benefit. In short, the undertakings create positives which are balanced against negatives to arrive at a conclusion as to the net impact. If the positives outweigh the negatives (even by a small amount), then net benefit is achieved. Without the undertakings, net benefit cannot be achieved because there are no positives to outweigh the negatives. Pure "status quo" undertakings are generally insufficient to create net benefit because they do not compensate for the loss of control of the Canadian business, which is a negative. Implicitly therefore, a primary underpinning of the ICA is that the loss of control of a Canadian business is a negative thing which must be at least slightly more than offset by suitable undertakings. Foreign investment, in the absence of undertakings, is negative for Canada.[1]

As a primary underpinning of the ICA is that foreign investment is a negative thing which must be offset by positive things, then the position the Panel takes on the ICA is crucially important in terms of articulating Canada's stance on foreign investment to Canadians and the world. If the Panel chooses to maintain the ICA in its current form, or to amend the ICA without fundamentally restructuring it, then

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[1] It is also significant to note that the IRD and the relevant Ministers do not consider the major injection of capital into the Canadian economy represented by the purchase price for the Canadian business (which typically includes a significant premium to the historical value of the company) in assessing net benefit.

the Panel will arguably have taken the position that foreign investment is *prima facie* a bad thing requiring government intervention. That is fundamentally how the ICA works. Vague statements relating to the enormous benefits of foreign investment (particularly to a small economy with a large government sector relative to total GDP) that may be included in the Panel's final report may be viewed with real scepticism, if the ICA is substantially maintained in its current form.

Another troubling point regarding the ICA is that it applies even when the Canadian company in question is already controlled by foreigners. For example, if a UK owner sells a Canadian company to a US buyer, and the relevant financial thresholds are exceeded, then the US entity will need to obtain a net benefit ruling. In other words, the application of the ICA does not turn on whether the Canadian business in question is currently controlled by Canadians.[2] The ICA is therefore internally inconsistent. That is, the major reason for seeking undertakings is to compensate for the loss of control in the Canadian business but if Canadians do not have control in the first place, then this rationale does not exist. Where the seller of a Canadian business is foreign, then Canadians are not losing control of anything and it is not clear why the ICA should apply at all. In such a situation, the foreign seller would not necessarily be operating the Canadian business in accordance with any undertakings but the foreign buyer would need to give undertakings to effect the acquisition of control. If the foreign buyer must labour under the potential burden of undertakings, then it is not clear why the foreign seller should not also face this requirement. Indeed, the logic of the ICA arguably dictates that foreigners should be subject to perpetual undertakings in their operation of Canadian businesses. This would amount to extraordinary interference in the free market economy, and yet if one follows the logic of the ICA, it would be a fantastic thing, creating net benefits throughout the Canadian economy.

This leads to another fundamental underpinning of the ICA, which is that the state is better placed to use a Canadian business to create benefits for the Canadian economy than is the foreign investor seeking to acquire the Canadian business. If the foreign investor were better placed, then undertakings would be unnecessary. This is profoundly uneconomic. That is, it assumes that the state, which does not own the Canadian business and does not face the powerful incentives an owner faces, is better placed to make capital expenditure decisions, R&D decisions, employment decisions, etc., that will be of benefit to Canada, than is the foreign owner. In other words, the ICA assumes that the profit-maximizing motives of a firm's owner diverge from the best interests of Canada. That is a remarkable implication, which contradicts the central argument advancing free-market economics since Adam Smith wrote the *Wealth of Nations* in 1776. Smith famously wrote:

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[2] In fact, the sale of a Canadian business from one US entity to another US entity is also caught by the ICA (*i.e.*, the ICA applies even where the buyer and seller are from the same country).

> It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own self interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.[3]

In other words, the profit-maximizing foreign investor is driven to create benefit despite not caring one iota for Canadians. An investor, whether foreign or Canadian, does not increase capital expenditures or hire Canadians because he wishes to confer benefits on Canadians, but because it perceives that in the long-run this will improve profits and therefore the value of the firm. Moreover, if the investor decreases capital expenditures or employment, it is not because it wishes to deprive Canadians of benefits, but because it views this to be a more profitable strategy in the circumstances, and therefore ultimately is actually of greater benefit not simply for the investor but likely also for the economy as a whole. In other words, while the Canadian government causing expenditures to be incurred or employees to be hired or projects to be undertaken that would not otherwise be undertaken by the owner of the firm may have a certain superficial appeal, it could potentially damage the Canadian business in question. Competitors and other companies not subject to undertakings would be expected to grow at a faster rate. In the limit, economic theory would predict that companies not subject to decision-making restrictions would simply out-compete and replace companies that are subject to decision-making restrictions. Indeed, the fact that the details of ICA undertakings are kept strictly confidential, suggests that it is understood that the undertakings may have a negative impact on the businesses in question.

The point here is that where undertakings cause firms to do things that they otherwise would not do, inefficiencies can result – the Canadian business in question may not be as productive as it otherwise might be. Where undertakings do not cause firms to do things that they otherwise would not do (for example, because the investor would already want to take certain actions in its own self-interest), then the undertakings serve no meaningful function.

Finally, if one genuinely believes that undertakings create net benefit for Canada, then why limit their application to the context of foreign investment? Why not insist that Canadian-owned firms conduct their businesses in accordance with undertakings? We could require that each Canadian-owned firm employ a specified number of Canadians or make certain R&D expenditures or require that they not hire too many foreign managers. Following the logic of the ICA, this would create massive benefits for Canada. If one has difficulty supporting this argument, then one should have at least some difficulty supporting the ICA in its existing format.

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[3] Adam Smith, *The Wealth of Nations*, Book 1, Chapter 2.

Indeed, the Canadian government implicitly acknowledges that the ICA imposes costs on companies by not encumbering Canadian-owned firms with undertakings. If we truly believed that the undertakings were a good thing, we should want them imposed on Canadian companies to help them create benefit for Canada.

The counter-argument is that Canadian owners do not need to make undertakings. The ICA implicitly assumes that it is not necessary to impose undertakings on Canadian-owned firms, presumably because the owners are Canadian and will consider broader Canadian interests in the operation of the firm, or because Canadians control the firm and that is *per se* of benefit to Canada. These assumptions seem generous – Canadian-owners could be nudged towards producing benefits for Canada in the same manner required of foreign owners.

The above arguments lead me to the conclusion that the ICA in its existing format should be repealed. The fact that other countries do not allow some of their companies to be bought by foreigners (through the use of golden shares, for example) is no reason to hurt ourselves similarly. A neat analogy can be drawn to international trade laws – when a trading partner imposes a new trade barrier, domestic producers often successfully lobby their government to have a retaliatory trade barrier imposed, which is to their narrow benefit, but to the overall detriment of their country. If the ICA is to be replaced by anything new, it should be with a statute that encourages foreign investment, which would promote competition, which would strengthen Canadian companies.

It is not a coincidence that those sectors where investment restrictions are greatest (banking, airlines, telecoms, bookselling, etc.) are precisely those where Canada experiences relatively low levels of competition, and high prices. Swaths of the Canadian economy are either off-limits to foreign investment or notably unfriendly toward it. If the concern is that head offices are disappearing from Canada (which is far from empirically clear) and that this is tangibly a negative thing, then a vastly scaled-down ICA focussed simply on the maintenance or partial maintenance of the head office in Canada may represent a compromise solution.

With respect to national security, it is difficult to assess in economic terms the arguments put forth in favour of national security restrictions on foreign investment. That is, the arguments are not economic in nature, but rather relate to the safety of Canadians. While there may be considerable merit in such arguments, we should be very cautious before erecting further barriers and disincentives to invest in Canada. One could easily envision protectionist sentiment carrying the day, wrapped in the flag.

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