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Extended Note: National Security with a Canadian Twist: The Investment Canada Act and the New National Security Review Test

by
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I. INTRODUCTION

On March 12, 2009, the Canadian federal government passed significant amendments to the *Investment Canada Act* (ICA), Canada's foreign investment law of general application.[1] Though the amendments generally liberalize important aspects of the Canadian foreign investment review regime, they also include a broadly worded national security test that now allows the responsible Minister[2] (the "Minister") to review proposed investments in Canada on national security grounds. The arrival in Canada of national security reviews raises issues akin to those raised in other jurisdictions with similar tests, including uncertainty about the meaning of "national security", concern that the new test may be used to target sovereign investment (particularly in the natural resources and energy sectors), and the possibility of politicized national security reviews.[3]

The first twenty years of the ICA's existence were marked by relatively little controversy. The only outright prohibition of a foreign acquisition under the ICA took place in 2008, when the Minister refused to provide a determination of net benefit to Alliant Techsystems Inc., a U.S. investor that proposed to acquire the space and satellite operations of MacDonald Dettwiler &

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[1] Foreign investment in Canada is also subject to sector specific legislation depending on the industry in question. See, e.g. D. McFetridge, "The role of sectoral ownership restrictions" (15 March 2008) (on file with the Competition Policy Review Panel).

[2] The ICA provides that the federal Minister of Industry is responsible for administering the legislation in all contexts save those relating to investment in a Canadian "cultural business" (as the term is defined at section 14.1(5) of the ICA). The administration of the ICA as it relates to such businesses is the responsibility of the Minister of Canadian Heritage. Investments that are both cultural and non-cultural may be subject to the jurisdiction of both Ministers: http://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/lk00053.html (accessed March 30, 2009).

[3] See, e.g. Edward M. Graham and David M. Marchick, *U.S. National Security and Foreign Direct Investment* (Washington, D.C.: Institute for International Economics, 2006).

Associates (the "Alliant/MDA Transaction").[4] Prior to the Alliant/MDA Transaction, the Canadian government reviewed approximately 1,550 foreign acquisitions under the ICA, all of which were cleared.[5] This is not to say that the ICA was uniformly viewed as a mere formality – the applicable waiting periods (up to 75 days), the provision of significant commitments/undertakings from foreign investors in order to obtain approval,[6] and the application of sector-specific policies restricting certain foreign investments contributed to the OECD's ranking of Canada as 34th among OECD members in its index measuring receptiveness to foreign investment.[7] However, as Canada became an increasingly attractive destination for foreign investment in the early part of this decade, concerns began to be expressed over the existing regime's ability to address issues related to sovereign investment, national security and other matters. These concerns set the stage for the most significant round of changes to foreign investment review in Canada since the passage of the ICA in 1986, triggered, to some degree, by a series of investments (proposed and completed) by state owned enterprises (SOEs)[8], as well as a number of transactions involving foreign acquisitions of iconic Canadian companies such as Inco Limited, Falconbridge Limited, Hudson's Bay Corporation and Alcan Inc.

A recurrent issue in the public debate prior to the introduction of the changes was the ability of the existing "net benefit" test contained in the ICA to address national security concerns. Though it was (and is) broadly worded, the test did not expressly include national security as a factor that could be considered by the Minister in determining whether an investment was likely to be of net benefit to Canada.[9] The fact that the Minister did not block the Alliant/MDA Transaction under the "net benefit" test on grounds that were at least implicitly related to national security failed to diminish the perceived need for a national security test, and the federal government moved to rectify the perceived deficiency after extensive consultation.[10]

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[4] The potential application of restrictive policies issued pursuant to the ICA in sensitive sectors (notably cultural activities and uranium mining) has likely resulted in foreign investors abandoning planned investments, but the Alliant/MDA Transaction is the only investment that has received a determination of "no net benefit" after a review.

[5] Michael Holden, "The foreign direct investment review process in Canada and other countries" (Library of Parliament, 19 September 2007) at 3.

[6] Indeed, the Minister has recently commenced the first ever application under the ICA seeking to compel a foreign investor to adhere to commitments given to him in the context of the acquisition of a Canadian business: Greg Kennan *et al.*, "Ottawa takes U.S. steel to court over jobs" *The Globe and Mail* (18 July 2009) B1.

[7] Competition Policy Review Panel, *Compete to Win: Final Report* (Government of Canada, June 2008) at 1 [*Compete to Win*]: http://www.ic.gc.ca/eic/site/cprp-gepmc.nsf/eng/h_00040.html (accessed March 30, 2009).

[8] SOE investments included the proposed (but abandoned) bid by China Minmetals Corporation for Noranda Inc. (2004), Statoil ASA's acquisition of North America Oil Sands Corp. (2007), and the acquisitions by Abu Dhabi National Energy Company PJSC (TAQA) of Northrock Resources Inc., Pioneer Natural Resources, and PrimeWest Energy Trust (2007/2008). The federal government ultimately issued guidelines under the ICA which are applicable to SOE investments; "Guidelines – Investment by state-owned enterprises – net benefit assessment: http://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/lk00064.html (accessed April 30, 2009).

[9] Section 20 of the ICA provides that, in considering whether an investment is likely to be of net benefit, the Minister is required to consider the following six economic factors in conducting his or her assessment: (i) the effect of the investment on the level and nature of economic activity in Canada; (ii) degree and participation by Canadians in the Canadian business; (iii) productivity, efficiency, technological development, product innovation and variety; (iv) the effect of the investment upon competition in Canada; (v) compatibility with national industrial, economic and cultural policies; and (vi) Canada's ability to compete in world markets. It is important to note that the addition of a national security test does not displace the existing net benefit test, which is still applicable to reviewable investments.

[10] Notably, the creation of the Competition Policy Review Panel (the "CPR Panel"), a federal panel mandated to review Canada's competitiveness, including foreign investment policies. The CPR Panel issued its final report,

II. THE NEW NATIONAL SECURITY TEST

On March 12, 2009, the federal government passed Bill C-10, the Budget Implementation Bill, which, in addition to implementing the federal budget (and elements of an economic stimulus package), proposed significant changes to the ICA. Though the amendments generally liberalized the Canadian foreign investment review regime by increasing the financial thresholds beneath which investments are not reviewed under the net benefit test and removing certain sectoral restrictions, the new changes also included insertion of a national security test (which now stands alongside the net benefit test).[11]

The new national security test applies to a much broader range of proposed transactions than the net benefit test. First, a proposed investment may be subject to national security review even if it does not exceed the financial threshold for net benefit review. Second, the investment may be either proposed or already implemented. Third, the target does not need to be a "Canadian business" (as is the case with the net benefit test), in order to be eligible for national security review.[12] There are some limited exemptions to national security review, similar to the current exemptions from net benefit review. The provisions apply retroactively to February 6, 2009, the day that Bill C-10 was introduced in the House of Commons.

By way of overview, the new national security review process has three stages: initial notice from the Minister that a review may be ordered; review by the Minister and subsequent referral of the matter to the Federal Cabinet; and Cabinet decision. On July 11, 2009, the government published draft regulations, the *National Security Review of Investments Regulations* (the "Regulations"), that provide the details of the process. The Regulations are open to public comment for 30 days, although significant revisions are unlikely. The stages of the national security review outlined in the Regulations are described below.

If a proposed investment is eligible for national security review, the Minister, after consulting with the Minister of Public Safety and Emergency Preparedness, may refer the investment to the Governor in Council (GIC) (i.e. the federal Cabinet) to determine whether a national security review should be ordered. If the GIC orders a review, the Minister must send a notice to the foreign investor that the investment will be reviewed. Alternatively, where more time is required

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entitled "Compete to Win", in June 2008 (*supra*, note 7). The CPR Panel did not ultimately consider national security reviews in its report, though a number of its other recommendations respecting other types of foreign investment were largely followed by the federal government in proposing the eventual changes to the ICA.

[11] The idea of amending the ICA to include a national security test is not a new one. In 2004, the then Liberal Government introduced Bill C-59, which was intended to amend the ICA to include a national security test, primarily in response to the possible takeover of Noranda Inc. by China Minmetals Corporation. Pursuant to the draft legislation, direct or indirect investment in Canada by a foreign investor could be subject to review if the investment "could be injurious to national security." Nothing in the bill defined "national security", or how national security might be "injured" by a foreign investor. Accordingly, it provided the Government with a significant amount of discretion to interfere with a broad range of investments. Bill C-59 did not, however, become law.

[12] The ICA defines a "Canadian business" as a business carried on in Canada that has (a) a place of business in Canada; (b) an individual or individuals in Canada who are employed or self-employed in connection with the business; and (c) assets in Canada used in carrying on the business. Under the national security provisions, as long as the target meets any one of the above requirements, rather than all three collectively, it may be reviewed. Moreover, the first requirement does not require the target to have a place of business in Canada.

to assess whether to refer the investment to the GIC, or where expedited action is required to deal with an imminent threat to national security, the Minister may notify the foreign investor that the investment may be reviewed. Subsequent to such notification, the GIC must decide whether to order a national security review of the investment. In both cases, the issuance of a notification enjoins the foreign investor from implementing the investment unless it receives a form of "no action" letter or authorization for implementation.

Regardless of which route the Minister follows, he or she must give the foreign investor the first notification of review, or possible review, within 45 days of becoming "aware" (as the term is defined) [13] of the investment. During the 45-day period, the Minister may require the foreign investor or any person or entity from which the target is being acquired to provide *any* information that the Minister considers "necessary" to his deliberations within the time and in the manner specified by the Minister. If the first notification is sent before the GIC makes an order regarding review, the GIC has a further 25 days to make such an order.

Once the GIC orders a review of the investment, the Minister has 45 days within which to complete the review. During this period, the Minister will consult with the Minister of Public Safety and Emergency Preparedness, and other concerned departments and agencies as appropriate. As well, if the foreign investor or any other person or entity from which the target is being acquired advises the Minister that they wish to make representations, the Minister must afford them a reasonable opportunity to do so, either in person or by way of a representative.

After reviewing the investment, the Minister must make a choice: either to refer the investment to the GIC, together with a report of the Minister's findings and recommendations on the review, or to send the foreign investor a notice that no further action will be taken in respect of the investment, depending on whether the Minister is satisfied that the investment will not be injurious to national security. If the Minister chooses the later course of action, he/she must notify the foreign investor of the decision within 5 days from the expiry of the review period (i.e. 50 days from the date the GIC issued an order for the review).

If the Minister refers the investment under review to the GIC, the GIC has 15 days within which to take *any measures* that are considered advisable to protect national security, including, but not limited to:

- Directing the foreign investor not to implement the investment;

- Authorizing the investment on condition that the foreign investor give any written undertakings considered necessary or implement the investment on prescribed terms and conditions; or

- Requiring the foreign investor to divest itself of control of the target.

[13] For investments that exceed the financial threshold for net benefit review and must be reviewed by Industry Canada, the 45-day period begins on the date that the application for review is certified; for investments which are notifiable but not reviewable under the ICA it begins on the date of certification of the notification or on the date of implementation of the investment, whichever is later. For all other investments the 45-day period begins on the date of implementation of the investment.

The Minister is then required to notify, without delay, the investor of the GIC order.

Decisions of the GIC and Minister are final and binding and, except for judicial review, are not subject to appeal or to review by any court.

It is important to note that the national security review process does not require filings to be made in advance – and that in the absence of a notice of review, such filings would appear to be voluntary.

III. OBSERVATIONS

At a time when many jurisdictions, including the U.S. and certain E.U. member states, have or are contemplating national security reviews, it is unsurprising that the Canadian government has put a similar process in place. Indeed, the Canadian national security review is very similar to the U.S. CFIUS process in some respects.

There are at least three possible dimensions of national security: 1) economic welfare; 2) national security; and 3) super-national security.[14] The application of any of these dimensions to a merger review raises the possibility that a potential transaction that will increase economic efficiencies is rejected for political reasons. First, an interest in economic welfare may raise concerns that domestic industries should be protected from being bought out by foreign investors. In the past, producers of "clothespin[s], peanut[s], pottery, shoe[s], pen[s], paper and pencil[s]" in jurisdictions around the world have invoked the economic welfare dimension of national security to protect their industry.[15] Second, an interest in national security may refer to a concern that sectors of a country's economy that are strategically sensitive for defence reasons should not be owned by foreign companies. Finally, an interest in super-national security may refer to the overarching imperative to "protect the homeland" from investment by countries that are viewed as a security risk.

However, as is the case in new processes which lack precise statutory or regulatory definition, it is unclear how the new Canadian national security test will be applied, and there are reasons to believe that it could be applied in a wide range of situations. Recently, it could be argued that the federal government and Canadian public view *all* three of these dimensions as relevant to national security reviews in Canada. Successive federal governments have expressed concern over investments by SOEs in Canadian businesses, exemplified by public debate over inbound investments by UAE SOEs and the issuance of review guidelines under the ICA specific to SOEs.[16] The current government's decision (seemingly supported by all parties) to block the

[14] Deborah M. Mostaghel, "Dubai Ports World under Exon-Florio: a threat to national security or a tempest in a seaport?" (2007) 70 *Alb. L. Rev.* 583 at 607-14.
[15] *Ibid.* at 608.
[16] Industry Canada, Guidelines, "Investment by state-owned enterprises: net benefit assessment" (7 December 2007) (*supra*, note 8).The guidelines are a statement of policy and, as such, do not have any legal effect or introduce any legislative amendments to the ICA. Instead, they specify particular factors that the Minister should consider when applying the six economic factors under the ICA's net benefit test to a proposed investment by an SOE, being:

Alliant/MDA Transaction on the basis of concerns relating to U.S. access to surveillance technology further suggests that there is political will to consider similar restrictions on defence related acquisitions, even emanating from countries like the U.S.

Finally, public concern over the alleged "hollowing out" of corporate Canada, whether through elimination of Canadian head offices, stock exchange listings or reduced R&D has been apparent in the context of high profile acquisitions of Canadian businesses. Indeed, the consultation undertaken by an independent panel appointed by the federal government, which preceded passage of the amendments to the ICA, explicitly considered the issue in its deliberations, and did not rule out the possibility, for example, that the loss of Canadian head offices due to foreign acquisitions of Canadian businesses could have negative consequences for the Canadian economy, though it did not recommend further direct restrictions on foreign investment.[17]

When these tendencies are considered in light of the breadth of the national security test, the federal government should be cautious in adopting an over-expansive approach to the application of the new test. The above tendencies demonstrate the country's periodic preoccupations with national champions, Canadian control over natural resources and domestic head offices. Allowing these preoccupations to be reflected in national security reviews would counter the intended purpose of the test, and instead of functioning as a transparent tool to be used by the federal government in the limited circumstances in which foreign investment may threaten Canada's national security, the national security test would become a meaningless catchphrase to be employed against unpopular, but legitimate foreign investments. Having said this, and as of the writing of this Extended Note, the seemingly smooth progress (to date) of the recently announced acquisition by China Investment Corporation (CIC) of a minority voting interest in Teck Resources Ltd. (a major Canadian mining concern) under the new national security test is a welcome sign.[18] This transaction, involving a leading Chinese SWF acquiring a stake in a Canadian natural resource company, was precisely the type of acquisition that was to be scrutinized under the new test.

Foreign investors considering investments that could be subject to the new process will also have to adjust to a review process that is no longer primarily administrative, but essentially political. The national security review process is highly consultative in nature, and invites input from the cabinet of the federal government, departments of the federal government, as well as provinces

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- The SOE's adherence to Canadian laws, practices, and standards of corporate governance, including commitments to transparency and disclosure, independent members of the board of directors, independent audit committees and equitable treatment of shareholders;
- The nature of and extent to which the SOE is controlled by a foreign government; and
- Whether the acquired Canadian business will continue to operate on a commercial basis.

The guidelines also suggest that SOEs should submit specific undertakings to the Minister in support of a proposed transaction. Examples of possible undertakings include:

- Appointing Canadians as independent directors on the board of directors;
- Employing Canadians in senior management positions; Incorporating the new business in Canada; or
- Listing the shares of the acquiring company or the Canadian business on a Canadian stock exchange.

[17] Competition Policy Review Panel, *Compete to Win: Final Report* (Government of Canada, June 2008).

[18] "Teck Resources announces C$1.74 billion private placement," News Release (3 July 2009): <www.teck.com>.

affected by the transaction. All of these constituencies are heavily influenced by public concern about high profile transactions, especially those that are the subject of extensive media comment. Prudent foreign investors are well advised to recognize this at an early stage of their planning and to consider government relations and public relations strategies that are consistent with the approach taken to review under the ICA. Investors who appreciate the multifaceted nature of the Canadian foreign investment review process will have the most success in securing Ministerial approval in a timely and acceptable manner.

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