THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

# Investment Canada Regulation Amendments and National Security Review of Investments Regulations

**NATIONAL COMPETITION LAW SECTION**
**CANADIAN BAR ASSOCIATION**

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## PREFACE

The Canadian Bar Association is a national association representing 37,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the National Competition Law Section of the Canadian Bar Association with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the National Competition Law Section of the Canadian Bar Association.

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# Investment Canada Regulation Amendments and National Security Review of Investments Regulations

## I. GENERAL COMMENTS

The Competition Law Section of the Canadian Bar Association (the CBA Section) appreciates the opportunity to comment on the draft amendments to the *Investment Canada Regulations* (the Draft IC Regulations) and the *National Security Review of Investments Regulations,* both published in *Canada Gazette Part 1* on 11 July 2009. However, because there was no public consultation on these regulations prior to publication in the *Canada Gazette*, the 30 day comment period has been insufficient for a thorough review of regulations that are complex and critical to an efficient and predictable foreign investment review process. Accordingly, the CBA Section is not able at this point to provide comprehensive comments with proposed solutions. Rather, this submission focuses on major concerns with light commentary on more detailed issues. We would be pleased to elaborate upon our concerns and to assist with their resolution.

## II. INVESTMENT CANADA REGULATION AMENDMENTS

The CBA Section"s overarching comments are as follows:

- The term "enterprise value" as defined in the Draft IC Regulations for asset acquisitions and private company acquisitions is not consistent with the intent of the report of the Competition Policy Review Panel.
- The "market capitalization" definition raises a host of issues, the most serious of which arises from the timing for determining the market capitalization value. We expect this will cause substantial unpredictability for foreign investors and urge that the Government address this issue.
- A possible solution to a number of the CBA Section"s concerns would be to consider incorporating definitions relating to "market capitalization" and other definitions from securities laws which are known to investors and their counsel and are "tried and true".

## A. Enterprise Value

The Consultation section of the Regulatory Impact Analysis Statement notes that the amendments to the *Investment Canada Act* (the ICA) to which these Draft IC Regulations relate stem from the Competition Policy Review Panel report, *Compete to Win* (the Wilson Report). However, the definition of "enterprise value" in the Draft Regulations does not accord with that in the Wilson Report. The Wilson Report advocated that enterprise value be defined as the purchase price plus assumed liabilities minus current cash assets to ensure that the relative importance of target companies in technological sectors was recognized[1]. While the CBA Section recognizes that there may be difficulties in using the purchase price concept, it is not clear why an alternative measure of value other than the book value of assets could not have been found in those scenarios where purchase price was not suitable. As an example, the US pre-merger notification regime in the *Hart Scott-Rodino Act* offers alternatives to purchase price when this is not available as a measure[2].

The distinction in the Draft IC Regulations between enterprise value for public versus private companies emphasizes the form of a transaction over its substance (i.e., the relative importance of the Canadian business to the Canadian economy). A transaction structured as an asset acquisition would be subject to the book value determination as opposed to a market capitalization test, so one could be reviewable while the other is not.

## B. Market Capitalization Determination

### 1. Trading Period

The CBA Section is concerned that the market capitalization definition as currently formulated will raise serious timing issues as a result of the proposed definition of the "trading period". A transaction might close very shortly after the end of a fiscal quarter such that the value of the equity securities cannot be determined until very close to closing, or

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1 See page 111 of the Wilson Report at www.competitionreview.ca.

2 For example, for non-publicly traded voting securities, the securities are valued at their "acquisition price" or, if the "acquisition price" has not been determined, at "fair market value." See http://www.ftc.gov/bc/hsr/introguides/guide2.pdf at 7.

may not even be known at closing. In situations where the market capitalization hovers around the review threshold, this would cause substantial unpredictability for the investor.

For example, for a proposed purchase of a publicly traded Canadian corporation with a calendar-based fiscal year, a foreign purchaser who signs an agreement in January but is not able to complete the transaction until July would not have definitive knowledge of the market capitalization value required to calculate the enterprise value until the end of June. In a volatile market, a deal that was not reviewable on the basis of its market capitalization in January might well be reviewable in June, if the target's stock was increasing in value on the market, with the converse being possible in a declining stock value situation[3]. Moreover, the proposed transaction itself could well have an impact on the market capitalization value as the share price may trend towards the offer price as the closing date approaches. This means that market capitalization may change significantly between announcement and closing.

The Regulatory Impact Analysis Statement notes that the Government rejected purchase price as an element of enterprise value because "the 'price paid' may not be known until or, in some cases, after the closing of a transaction and because investors need to file an application for review in advance of closing". The same issue arises with the timing of the "trading period", as currently proposed: the purchaser's obligation to obtain pre-closing Ministerial approval may not be known until shortly before closing, or even after closing in some cases. To avoid this possibility, investors could feel compelled to make a "just in case" filing that might not ultimately be required. This scenario should be avoided, as neither the investor nor Industry Canada should expend resources on an unnecessary approval process[4].

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[3] While this concern may be mitigated to a certain extent by the fact that share price will often trend towards the offer price as the closing date approaches, in a deal where the consideration for the target's shares includes not only cash but shares of the acquirer, volatility in the acquirer's share price could mean a wide divergence between the share price and the offer price.

[4] Moreover, it is not clear how this scenario would be managed. If an investor has already signed undertakings and received Ministerial approval for a transaction that turns out to be below the review threshold, these undertakings should be considered null and void on the basis that the Minister did not have jurisdiction to review the transaction. One way to address this possibility would be to make the undertakings conditional on the transaction exceeding the applicable review threshold. However, it would be preferable to revise the regulations to avoid this scenario altogether.

Conversely, a last minute increase in share price should not result in an unanticipated ICA approval requirement and the delay of an imminent closing for two to three months to permit the investor to obtain the Minister"s approval.

The CBA Section recommends defining "trading period" with reference to the most recent 20 days of trading before the end of the last fiscal period for which the necessary information is publicly available preceding signing of a definitive agreement or the first public communication of an offer which will result in an investment.

## 2. Other Issues Regarding Market Capitalization

- In certain circumstances, the shares of a publicly traded company that is normally listed may not be traded at all (for example, if there has been a cease trade order in effect or a bankruptcy). In this scenario, it would be inappropriate to measure the entity"s market capitalization by using the share price in the most recent 20 days of trading as this would likely result in an artificially high or arbitrary value.

- Regarding paragraphs 3.2(2)(i) and (ii):

    - The number of shares outstanding can change on a daily basis and therefore may be difficult to determine. The Government should consider the total number of shares outstanding at the end of each quarter as a more practical alternative to address this issue, as this figure must be determined and publicly disclosed in any event.

    - For simplicity"s sake, both paragraphs should refer to the "simple" average daily number of its securities of that class as opposed to a weighted average.

    - There may be different series of shares in each class of equity securities with different share prices. The regulations should indicate how this situation should be handled.

- In regard to the definition of "primary market", the NASDAQ may not be considered a "stock exchange" but should be included as it is considered to be equivalent to an exchange. The CBA Section also notes that it is not clear how to measure the "volume" of trading (by value of shares or by number).

- The valuation of unlisted shares of a public company that has other (listed) classes seems arbitrary. This valuation will be accurate only where the economic rights

attached to the unlisted securities are substantially similar to those attached to listed shares. For example, an unlisted security may be used to give a particular shareholder additional voting rights but may not carry any economic value. In addition, splitting or consolidating either class of shares would have an arbitrary impact on the value of the unlisted shares. The CBA Section urges the Government to consider an alternative for unlisted shares that do not have substantially the same economic rights as the listed shares. In particular, in the context of securities law, Multi-national Instrument 61-101 may offer a helpful precedent.

- For the market capitalization value, it should be clarified as to what date the conversion should be calculated and by reference to what source. For example, the *Competition Act Notifiable Transactions Regulations* refers to the Bank of Canada rate. Similarly, the conversion rate in section 3.1 of the existing *Investment Canada Regulations* does not refer to a source for the currency conversion.

- The CBA Section observes that, if the objective is to measure "enterprise value", then the test for liabilities should reflect a market value, not book value. A book value of liabilities may well be significantly higher than its market value, especially for failing or "flailing" companies whose liabilities are valued at significant discounts. Secondly, "enterprise value" typically does not include liabilities other than those in respect of borrowed money.

- The Draft IC Regulations need to address the possibility that, in certain transactions, a target company may be acquired as a result of the purchase of the target company"s debt. For example, purchasers of bonds may have a voting right such that they would be considered under the current definition of equity securities to be equity holders. As "enterprise value" includes both market capitalization and liabilities, there would be double-counting of the bondholders" stake in this scenario. Further consideration needs to be given to how the *Investment Canada Regulations* should address this type of issue.

- It would be helpful to clarify the meaning of the term "cash equivalent".

## C. Book Value of Assets

Paragraph 3.3 of the Draft Regulations contemplates the use of the book value as at the end of the last fiscal year for asset acquisitions or acquisitions of private entities. However, if the parties close after year end but before that year's financial statements become available, then they may not know the relevant asset value. This is equally an issue for section 3.1 of the existing *Investment Canada Regulations*. The CBA Section proposes permitting investors to rely on the previous year's financial statements for up to three months following the completion of the target's fiscal year both for sections 3.1 of the *Investment Canada Regulations* and section 3.3 in the Draft IC Regulations. This is similar to the use of the "reference period" in the *Competition Act Notifiable Transaction Regulations*.

# III. COMMENTS ON THE SCHEDULES

Schedules I, II and II of the Draft IC Regulations prescribe the information requirements for notification and application for review forms. The proposed information requirements would modify the current forms by adding new categories of information and by making consequential changes necessitated by the recent amendments to the ICA.

The CBA Section understands that the additional information requirements are intended to provide the Investment Review Division (IRD) with information to help assess whether or not a proposed (or implemented) investment may raise a potential national security concern.[5] The CBA Section respectfully submits that disclosure of some of this additional information in connection with notifiable investments, particularly investments to establish new Canadian businesses, may be unnecessarily burdensome for investors and unlikely to provide the IRD with information relevant to assess potential national security issues. The CBA Section believes that its comments are relevant to reviewable transactions as well, but is particularly concerned about the burden that the additional information requirements would impose on investors in connection with non-reviewable transactions.

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[5] The Section is not aware of any other rationale for the disclosure of this additional information: it is not relevant to an assessment of whether an investment would be a reviewable transaction or of net benefit to Canada.

The Wilson Panel recommended that the government "remove the obligation under the ICA to notify Industry Canada with regard to an acquisition that falls below the threshold for review or for the establishment of any new business."[6] The Wilson Panel was clearly of the view that notification forms were not sufficiently useful to justify the administrative burden of requiring investors to complete them. In this context, it would be inappropriate to move in the opposite direction of the Wilson Panel recommendation and impose additional information requirements on investors.

The CBA Section's specific concerns are as follows:

- Disclosure of personal information about the directors, officers and owners of the investor[7] will be time-consuming to gather in many cases and of questionable utility in most cases.
- The 10% ownership disclosure requirement in section 2 of Schedules I, II and III relates to ownership of the investor's "equity or voting rights", which are not defined in the ICA. These terms are unclear and capable of different interpretations. The CBA Section suggests that the phrase "voting interest" be used because it is defined in the ICA.
- The CBA Section has a number of concerns about the requirement to disclose "direct or indirect ownership" interests held by a foreign state[8]:
  - The requirement refers to "ownership" whereas the ICA uses and defines the phrase "voting interest", and the 10% ownership requirement noted above refers to the investor's "equity or voting rights". Introducing a new undefined word in this context creates uncertainty. Moreover, "ownership" suggests that non-voting ownership interests may be included, which some members of the CBA Section believe are unlikely to allow a foreign state to influence an investor and thereby raise a national security concern. The CBA Section suggests that it would be clearer and more consistent with the rest of the ICA to use the phrase "voting interest" here too.
  - The CBA Section believes that disclosure should be required only where a foreign state has an ownership (voting) interest or the ability to exercise significant influence over the investor. The proposed requirement in the Draft IC Regulations may extend to small, passive ownership interests that are unlikely to raise national security concerns. Moreover, as a practical matter, many investors

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6 *Compete to Win* (Ottawa: Government of Canada, 2008) at p. 37.

7 The Schedules propose to require the disclosure of the names, addresses and dates of birth for all directors, the five highest paid officers and any persons owning more than 10% of the equity or voting rights in the investor.

8 Section 4 of Schedules I, II and III.

are unlikely to know whether a foreign state may have a small ownership interest, voting or otherwise[9]. A number of alternative approaches could be adopted. A 10% voting interest threshold would establish a clear, bright-line test and require the disclosure of information investors are more likely to have. To the extent there is a concern about "golden share" control issues, where a foreign state may have a small voting interest but be able to outvote other shares in specific circumstances, the 10% voting interest threshold could be coupled with a *de facto* control test. Investors would be required to disclose whether a foreign state either owns 10% or more of the voting interests of the investor or has the ability to exercise control in fact of the investor, through the ownership of voting interests. This form of requirement, which adopts a bright line *de minimis* test plus *de facto* control concepts, would be clearer to investors and consistent with concepts of ownership and control found elsewhere in the ICA.

- Many investors are unlikely to be aware of an indirect ownership interest by a foreign state. For example, an investor may not know whether one of its shareholders is ultimately owned by a foreign state. As a practical matter, an investor will therefore simply have to complete the form requirements to the best of its knowledge and belief. As suggested below, the signing requirements for the forms therefore ought to expressly state that is the standard investors are required to meet.
- The CBA Section questions whether the concept of "foreign state" is sufficiently clear and whether a "foreign state" would include commercially-oriented government-owned entities such as postal services or pension funds. It may be helpful to define the term in the regulations.

- If investors are required to disclose "sources of funding" for the investment,[10] disclosure should be limited to principal, not all, sources of funding. Some members of the CBA Section also questioned whether this disclosure is relevant to a national security assessment of an investment. If a lender were to acquire control, the IRD could presumably assess any national security issues at that time.

- Sections 18 and 19 of Schedule I contain references to investments referred to in sections 14 and 14.1 of the ICA but Schedule I contains the information requirements for non-reviewable transactions and sections 14 and 14.1 relate to reviewable transactions. The CBA Section believes these references ought to refer to section 11 of the ICA.

- The signing requirement (in section 4 of the Draft IC Regulations) should make it clear that the investors are required to certify that the form is complete and correct in all material respects to the best of the investor"s knowledge and belief. This is likely

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9 An investor may know the identity of its shareholders, but may not know who owns its shareholders. For example, an investor may know that Company A has a 10% ownership interest in the investor, but the investor may not know that a foreign state has a 0.5% interest in Company A.

10 Section 6 of Schedules I, II and III.

the standard investors believe they have to meet in practice and it would be helpful if the regulations explicitly confirmed the compliance standard.

# IV. NATIONAL SECURITY REVIEW OF INVESTMENTS REGULATIONS

The draft *National Security Review of Investment Regulations* (National Security Regulations) flesh out the procedures and timeframes for national security screening under the ICA. Although the National Security Regulations contemplate that reviewable transactions will be screened before closing, no comparable pre-closing process is available for notifiable transactions, or transactions that are neither reviewable nor notifiable. This is a significant deficiency that can and should be remedied to provide greater predictability and transparency to foreign investors and the Canadian businesses in which they invest. We also recommend that notifications filed under the ICA should be treated as confidential.

## A. Pre-Clearance

Sections 2 and 4(b) of the National Security Regulations set out the time frames for the Minister to inform a non-Canadian that its investment is being screened on national security grounds. The Minister provides a notice to the non-Canadian by the end of the prescribed time frame either indicating no action will be taken, or initiating further screening activity. As the vast majority of foreign investments in Canada do not raise national security issues, these benign transactions will result in an eventual no-action response from the Minister.

In the case of a reviewable transaction under the ICA, the national security screening will be done simultaneously with the review. The screening timelines in sections 2(b) and 4(b)(ii) of the National Security Regulations dovetail with the review timelines in the ICA.

## B. Notifiable Transactions

In the case of transactions that are notifiable under the ICA, the timelines in the National Security Regulations do not dovetail with the notification process. Under sections 2(a) and 4(b)(i), the screening can be initiated up to 45 days <u>after</u> the investment has been implemented. Thus, even where the Minster has received ample notice of the proposed

transaction prior to its implementation, the investor cannot be certain that its investment will not be challenged on national security grounds post closing.

In our view, this is a serious deficiency in the National Security Regulations that can and should be remedied. Foreign investors, and Canadian businesses in which they invest, are entitled to a higher level of predictability and transparency from the federal government. By not providing for a procedure that allows pre-closing clearance, (i) an objective of the ICA, namely promoting foreign investment, is undermined, and (ii) Canada will deviate significantly from how our major trading partner handles national security screening. In the U.S., pre-closing clearance can be obtained under their *Exon-Florio Act* from the Committee on Foreign Investment in the United States – CFIUS.

Accordingly, the CBA Section recommends that sections 29(a) and 4(b)(i) be reworded as follows:

> "in respect of an investment referred to in section 11 of the ICA, the period ending 45 days after the certified date referred to in subsection 13(1) of the ICA"

This approach will give the Minister a full 45 days to decide whether to initiate a fuller screening process, which should be an ample amount of time.

## C. Other Transactions

Transactions that are neither reviewable nor notifiable under the ICA may also be susceptible to national security screening. For example, a minority non-controlling investment by a non-Canadian could be caught by section 25.1(c) of the ICA. In such cases, the proposed regulations allow for national security screening up to 45 days after implementation of the investment. See sections 2(c) and 4(b)(iii)[11].

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[11] We would also point out that sections 2(c) and 4(b)(iii) are technically flawed because the prescribed period begins "on the date the investment first comes to the Minister's attention" and ends "45 days after the day on which it is implemented". Because this drafting could result in the illogical possibility that the period begins after it has ended, we would suggest deleting the reference as to when the period begins, as only the end date is relevant (which we suggest should be 45 days after the earlier of the implementation of the investment and the date that the optional filing is certified as complete).

Consistent with our recommendation for notifiable investments under the ICA, we recommend that a mechanism be in place for foreign investors to obtain clearance before closing of non-notifiable investments, if they so choose. To achieve this result, foreign investors should have the option to submit information equivalent to what would be submitted in a notification and, if this is done, the investor should either receive clearance 45 days thereafter or, within that same timeframe, the Minister should take further national security screening steps as required in the ICA. Thus, sections 2(c) and 4(b)(iii) would be rewritten to specify an end point of the earlier of 45 days after the date that the optional filing is certified as complete and, as already contemplated by the draft regulations, 45 days after the implementation of the investment. The actual contents of the optional filing will need to be specified and set out in the proposed regulations. This optional filing can in large part be based on Schedule 1 of the *Investment Canada Regulations*, with suitable modifications.

## D. Confidentiality of Notifications

The CBA Section recommends that the proposed regulations be amended to state that any notification filing discussed above, whether mandatory or optional, will be maintained in confidence by the Ministry. That way, investors contemplating notifications will be encouraged to make early filings, knowing there is no risk that the fact of the investment will be disclosed before implementation. In the case of a mandatory notification, once implementation has occurred, the usual disclosure would occur on the Ministry website: name of foreign investor, acquiree, and type of business of acquiree.

For optional filings, the regulations should state that no information from an optional filing shall be disclosed (except where enforcement proceedings are undertaken in accordance with the ICA). An optional filing is solely for the purpose of national security screening. It is not a foreign investment notification to which the ICA otherwise applies. The government should be satisfied that non-Canadians are willing to voluntarily disclose their investments for Canadian national security screening purposes when not otherwise required, and these investors should not have to worry that this voluntary disclosure will become public knowledge.

We recognize that section 36 of the ICA sets forth certain requirements of confidentiality. However, it is not clear that these confidentiality requirements will apply in all the circumstances noted above. Hence, clear statements in the regulations will be helpful both for foreign investors and the Canadian businesses in which they invest.

## V. CONCLUSION

The CBA Section appreciates the opportunity to submit these comments and hopes they are of assistance. Given the short consultation period, the CBA Section would be pleased to discuss its comments further at Industry Canada"s convenience.