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# Canadian Foreign Investment Review Annual Report Confirms Shift in Emphasis Toward National Security Concerns

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The official Annual Report under the *Investment Canada Act* (ICA) for the fiscal year 2018-19 was released at the end of 2019. This document sets out various statistics and other noteworthy developments during that time frame (i.e., April 1, 2018 to March 31, 2019) relating to the two review processes under the ICA:

- the "net benefit" review process for investments in non-cultural Canadian businesses,[1] a process by which the Canadian government may deny approval to certain investments by non-Canadians on the grounds that they are not of net benefit to Canada on the basis of statutory criteria, including the effect of the investment on the level and nature of economic activity in Canada (e.g., employment) and the degree and significance of continued participation by Canadians in the business; and
- the "national security" review process, by which the Canadian government may deny or unwind certain investments by non-Canadians because they would be "injurious" to Canada's national security interests, a concept that is not defined in the ICA.

Given that the Canadian government rarely provides details of specific ICA reviews, including in some cases declining to disclose that a review even took place, the Annual Reports are an indispensable tool for gaining (at least some) insight into the workings of the ICA review processes.

Here are the key highlights of interest from the 2018-19 ICA Annual Report:

## Ongoing Decline in the Number of Net Benefit Reviews

One principal storyline from 2018-19 is that the number of net benefit reviews remains at a historical low. In 2018-19, only nine applications for net benefit review were filed under the ICA, all of which were approved. This is out of a total of 962 filings, the remaining 953 being notifications that must be submitted when there is no obligation to file a pre-closing net benefit review application.

The total of 9 applications filed is well below the average of 17 applications a year filed between 2014 and 2017, and less than half of the 22 applications for review filed in 2016-17 alone. That said, the number of notifications (for transactions below the review thresholds) was up significantly in the past fiscal year, reaching 953 notifications (up from the 742 notifications received in 2017-18).

The sustained reduction in the number of net benefit reviews is due to the Canadian government's recent decision to significantly raise the most commonly applied target enterprise value thresholds for net benefit review – that is, the thresholds for direct acquisitions of Canadian non-cultural businesses by WTO investors and "trade agreement" investors. These thresholds will be raised again for investments occurring in 2020 and are expected to stand at $1.075 billion for WTO investors and $1.613 billion for trade agreement investors. (Lower thresholds apply for state-owned enterprise investors.) All else being equal, this portends a further decline (or at best stagnation) in the number of future applications for net benefit review.

The clear message for non-Canadian investors is that the ICA's net benefit review process is less and less likely to constitute a concern and will affect only a very small fraction of transactions in the future.

## National Security Reviews Are a Growing Concern... But All Hope Is Not Lost if Transaction Is Subject to Review

The second principal storyline from 2018-19 is that, in contrast to the net benefit review process, the ICA's national security review process is gaining in significance.

This is true even though there were "only" seven formal national security reviews initiated in 2018-19. Although that number may seem (and in fact is) objectively small, it represents the most reviews commenced in a single year since the national security review process was introduced in 2009.

Moreover, unlike the net benefit review process, being subjected to national security review carries the material risk that the investment will be blocked, unwound or allowed to proceed only subject to certain conditions ("mitigation measures").

Prior to the 2018-19 Annual Report, one might have said that the triggering of a formal national security review would inevitably result in some form of remedy. However, the Annual Report discloses that of the seven reviews conducted in 2018-19, three resulted in no remedies being required. This is the first time that investors have managed to escape the national security review process unscathed. That said, two reviews ultimately led to orders to divest, and in two other cases the investors withdrew from their transactions before the review was completed. It is also notable that, in two further cases (not part of the seven formal reviews), notices of a potential national security review were issued but no further action (i.e., formal review) was ultimately taken.

So non-Canadian investors may no longer have to regard the ICA national security review process as the modern-day equivalent of Dante's Inferno – "Abandon hope all ye who enter here." But it's no Paradise either. It remains the case that in the 22 national security reviews reported to have been conducted to date, the overwhelming majority (19) have resulted in blocks, divestitures or conditions being imposed or in transactions being abandoned by the parties.

## Evaluating National Security Risk: Not Just the Usual Suspects

Another principal storyline that emerges from the 2018-19 Annual Report relates to the expanding scope of who and what may trigger the application of a national security review and suggests that caution be exercised to avoid proceeding on erroneous assumptions about the process.

### It's Not Only China

Objectively speaking, it may come as no surprise that four of the seven national security reviews in 2018-19 involved Chinese investors. Indeed, of the 22 national security reviews since 2009, almost two-thirds of them (14 in total) concerned investments from China.[2]

However, two of the reviews in 2018-19 (including one in which divestiture was ordered) involved investors from Switzerland, and another involved an investor from Singapore (that one was withdrawn). Generally speaking, one might be forgiven for assuming that investors hailing from these jurisdictions would be less likely to raise national security concerns. Although no facts have been disclosed, these may be examples of cases in which an investor, although nominally from an unassuming jurisdiction, was viewed as having links or other ties (e.g., through significant shareholders, directors, officers, creditors or business partners) that were sufficiently suspect to justify reviews or remedies.

This is a helpful reminder that businesses cannot simply assume that there won't be a national security review if the investor is controlled by nationals of an apparently "benign" foreign jurisdiction. A more thorough investigation may be necessary involving consideration of, among other factors, the nature and sources of funding for the investment and the identity of key controlling individuals.

### National Security Concerns May Arise in a Variety of Industries

In the past, national security reviews involved investments by non-Canadians in areas such as infrastructure, technology and telecom. Although these areas will no doubt continue to be the "bread and butter" of national security reviews, the statistics included in the latest Annual Report refer to investments in a variety of industries as having raised possible national security concerns (including hardware manufacturing as well as "credit intermediation" and online shopping). As a result, consistent with developments in other jurisdictions, advisers to non-Canadian investors should consider, in addition to the nature of the industry itself, whether the investor may acquire access to personal or other data that may be sensitive from a national security perspective.

**National Security Review Reaches Beyond Mergers and Acquisitions**

It also appears that certain of the national security reviews in 2018-19 may have been triggered by the establishment of new Canadian businesses rather than acquisitions of existing businesses. Although this is not a new development (e.g., in 2015 media outlets reported that the Canadian government prohibited plans by a Chinese investor to build a new factory because of its proximity to the headquarters of the Canadian Space Agency), it nonetheless serves as another helpful reminder that the scope of the national security review process extends beyond mergers and acquisitions. Indeed, investors are also cautioned that, unlike the net benefit review process, national security reviews are not limited to acquisitions of control; minority investments can be reviewed as well.

## Keeping Perspective – New Chinese and Other Investment in Canada Continues

Despite the relatively unsurprising proportion of national security reviews directed to investments from China, the 2018-19 Annual Report clearly shows that numerous investments from China (and elsewhere) continue to proceed without formal national security reviews. Indeed, China was the third-largest source of investments recorded in the time frame (behind the United States and European Union), based on the number of notified investments, and the fourth-largest source of foreign investment based on the asset value of target businesses. In particular, the 2018-19 Annual Report states that in the last fiscal year there were 36 reported (non-cultural) investments by Chinese investors in Canadian businesses, of which only 4 (or 11%) were subject to a formal national security review and only 2 (or 5.5%) were ultimately substantially affected – that is, by divestiture or withdrawal. The Chinese investments that were not subject to a national security review in the period included investments in the manufacturing, resources, wholesale and retail sectors. When one considers that there were likely many additional non-notified (i.e., minority) investments by Chinese investors, the proportion of overall investments from China that have been subject to a full national security review is likely even smaller. Another interesting observation is that there were 19 investments from Iran (albeit apparently very small ones) in 2018-19, none of which were apparently subject to formal national security reviews.

[1] The statistics in the 2018-19 Annual Report exclude foreign investments in Canadian businesses engaged strictly in "cultural activities," in respect of which responsibility under the ICA lies with a separate government department (Canadian Heritage).

[2] That being said, of the four Chinese investments that were subject to national security review in 2018-19, two were permitted to proceed without further action.

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