A Billiton Dollar Investment

Canada and the Global Regulation of Foreign Direct Investment

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In what would have been the biggest foreign takeover in Canada, BHP Billiton (BHP), was denied the acquisition of Canadian Potash Corp. in November, 2010. This has been the second takeover denial since 1985, when the Investment Canada Act (ICA) was enacted (CTV, 2010). Although there is a divergence of opinion on the impact of denying a nearly 40 billion dollar investment, the question of whether the takeover evaluation criteria serve their purpose is asked by all, including the Minister of Industry Tony Clement who authorized the denial.[1] Foreign direct investment (investment, FDI) can be defined as a transfer of assets from one country to another for the purpose of producing profit.[2] In BHP's case, Canada would have had access to imported capital in exchange for profit collected by BHP shareholders through the share ownership of Potash Corp. Although FDI is not without negative externalities, The Conference Board of Canada, joined by a substantial number of economists, disregard them as "phantom fears," describing the overwhelming benefits of FDI including job creation, technology import, and increased tax revenue.[3] In light of overall benefits and support the take-over had, this paper will seek to understand why Clement denied the deal. After a short overview of the attempted Potash takeover, this paper will describe the current political economy issues in Canada, which as this paper infers, were largely responsible for Clement's decision. This paper will further examine how the ICA is structured, and argue it is purposefully vague as a defense mechanism against risks associated with FDI. This paper will finally examine the FDI risks and summarize why they are not currently addressed on a global multilateral level.

In November 2010, Australia-based BHP was denied a buyout of the majority of Saskatchewan-based Potash Corp. shares. Under the ICA, FDI can be denied if it does not "benefit Canada's long term economic interests,"[4] otherwise known as the 'net benefit' test. During the existence of ICA, out of 1,639 cases brought forward for approval, this is the second takeover to be denied.[5] The Minister of Industry Tony Clement is legally empowered to interpret and enforce the act.[6] Certain critics blame Clement for basing his decision on concerns over civil backlash and securing Conservative ridings in Saskatchewan for the next election, rather than evaluating tangible economic benefits of the deal.[7] The issue was exacerbated by the fact that no rationale for the decision was provided at the time. On November 15, BHP officially withdrew its offer claiming 'net benefit' section under ICA went against "creating shareholder value" and was therefore, no longer economically feasible.[8] Apart from a nearly 40 billion dollar investment, the takeover would have provided Canada with nearly 400 million for infrastructure development, and would have increased current employment at Potash Inc. by 15 percent in the next five years.[9] These recent events bring forward the question: "exactly how do foreign takeovers not benefit Canada's interests?"

The ongoing court case brought forward against U.S. Steel by Tony Clement may very well explain Minister's hesitation, and eventual refusal of the Potash takeover. In 2007, struggling Hamilton-based Stelco agreed to be bought out by U.S. Steel for just over a billion dollars.[10] By agreeing to pay off over 800 million in Stelco's debts, U.S. Steel would "re-establish Stelco as a competitive steel company."[11] Although ICA undertakings (legal obligations undertaken as part of the takeover) specified by Clement were never made public, U.S. Steel agreed to maintain employment levels, production levels, and Stelco's pension obligations.[12] Then, in October 2008 amid the recent economic downturn, U.S. Steel shut down most Hamilton and Lake Erie mills, affecting 1,500 jobs.[13] The company argued the collapse in demand for steel "left it no choice."[14] The company argues that the "future of the entire company was in jeopardy if it kept … Canadian mills running." [15] In May 2009, after requesting U.S. Steel to justify cutbacks, Clement said he was not satisfied with the justification for non-compliance.[16] The formal prosecution case that was launched in July of the same year, is still open and untried.[17] U.S. Steel faces potential prospects of a nearly $15 million fine under the ICA.[18] In 2010, U.S. Steel was once again under fire after locking out 900 Hamilton workers for failing to come to an agreement on a pension contract. Ken Neumann, Steelworkers National Director, described U.S. Steel's net benefit as "plant shutdowns, production cuts, lost jobs and labour disputes."[19] Although U.S. Steel was the only company prosecuted for ICA non-compliance, both Brazil's Vale Inc. and Switzerland's Xstrata cut over a thousand jobs in their Canadian subsidiaries during the fall of 2008, breaking their employment level undertakings.[20] These recent controversies help understand Clement's decision; however, it is important to examine the ICA provisions in more detail.

The ICA emerged in Canada in 1985 with Brian Mulroney's optimistic statement "Canada is open for business again."[21] Its predominant purpose was to increase the flow of investment to Canada by streamlining the process to make it easier and more attractive. The monetary threshold for official takeover review was raised and the process was made more timely. The criteria for determining the 'net benefit' are outlined in Section 20, and divided into six subsections. Further specification is provided such as effect on industry, technological development, and competition.[22] Lalonde explains that these factors are considered as a whole, and given "different weight in different circumstances." [23] He concludes that the process is flexible to allows its application to be tailored to fit each scenario, as opposed to sweeping formulaic application.[24] The highly partisan nature of the review was criticized by Jack Layton as "lack[ing] transparency" which, as MDC Partners CEO Nadal further voiced "increase[d] uncertainty among investors." [25] In response, Harper acknowledged that the act needed to be reviewed. Clement followed, saying he was prepared to address the claims against the lack of procedure transparency.[26]

Jim Stanford, Canadian political economists critical of the upcoming review. According to him, the lack of transparency plaguing the ‘net benefit’ test has given the government “enough leeway to veto any proposed takeover.”[27] A premise that the vagueness of the act is a political defense mechanism is sensible, after considering the burden U.S. Steel put on the Canadian government. Stanford explains that after the 2007 refusal of MDA’s space division sale, ICA was also updated, but only to the extent of adding “national security” as a “post-hoc justification.” He concludes that the proposed review is an “intellectual cover” and, instead of “play[ing] “wordsmith,” a more honest examination needs to take place.[28]

Empirical observation of recent FDI policies in the U.S. seems to support Stanford’s position. The U.S. regulation of investment began with the formation of the Committee on Foreign Investment in the United States (CFIUS) in 1975, which was designated with monitoring and implementing U.S. policy concerning FDI.[29] In 1988 the Exon-Florio Amendments (EFA) were passed which gave the president the power to block FDI if “the foreign interest … action … threatens to impair the national security.”[30] The president delegated this authority to CFIUS which, from then on, was responsible for determining FDI’s potential threat to U.S. national security. Enforcement of EFA was largely discretionary given the term ‘national security’ was never actually defined.[31]

The Foreign Investment and National Security Act of 2007 (FINSA), set out to make the FDI review process “more transparent and predictable without making the business climate less friendly to foreign investors.”[32] FINSA included the introduction of specific standards in the FDI review process which gave CFIUS a significantly wider domain of application, including areas such as “critical infrastructure and … technologies.” [33] Critics of FINSA argue that CFIUS’ newly broadened domain now encompasses over 65% of U.S. business sectors as a matter of national security.[34] While the U.S. evaluated FDI on national security grounds instead of ‘net benefit,’ it’s designated purpose was clear: when increased transparency no longer allowed significant leeway in regulatory policy, the policy was further altered to be as broad and all-encompassing as possible.

This pattern of behavior can be further applied to Canada’s FDI regulatory framework. In the absence of a developed regulatory system, the Canadian government pursues vague FDI policy, which allows it to reject specific cases of FDI without stating the rationale explicitly. This is necessary as, such as in the case of the U.S. Steel, the effect of FDI cannot be effectively evaluated beforehand. Multinational corporations (MNC) do not always follow through on their commitments implicating the host government into prolonged legal action. Further accusations of preferential bias and partisan politics exacerbate the issue.[35] Because ICA is intentionally vague, companies struggle with conducting regular business as they cannot account for how ICA will affect them. U.S. Steel’s lawyer Barrack raised a yet to be answered question regarding ICA: “how do I behave in an acceptable way?” Barrack further called the act flawed as it does not describe how investors can justify non-compliance.[36] In the current situation, both sides find themselves at a loss.

Vague FDI regulation results in a system with an information asymmetry problem. Prosecution risks imposed on MNC, like the U.S. Steel court case, threatens monetary profits. Inability to properly plan FDI profits further raise the cost of investment. In the end, some prospective FDI which would benefit both sides does not take place, as risks associated with non-definitive regulation make the costs too high for one of the sides – the MNC. Can this information asymmetry problem be reduced?

Removing the information asymmetry would require establishing a clear regulation procedure but a number of changes would need to occur for the government's support. Examining current FDI challenges, three aspects of FDI regulation need to be established for the possibility of regulation clarification. First, precise and elaborate entrance criteria to legally account for the majority of possible hindrances and loopholes would give the government a transparent legal output through which it could reject FDI it does not support. Second, an established and 'preferable' code of conduct for MNC to follow (for example, general acceptance of union authority) would reduce the risk of costs arising from unexpected and unpredictable MNC behavior. Third, a standardized penalty determination and enforcement system is needed to make infraction prosecution inexpensive and timely.

The current international regime for investment regulation can be described as fragmented, uneven, and decentralized.[37] Lacking a cohesive, multilateral system, it is defined by over 2,000 highly divergent bilateral investment treaties (BIT) between different countries.[38] First FDI challenge, establishing clear entrance criteria, can theoretically be achieved through the current system. For example the investment provisions of the Free Trade Agreement in effect since 1987, although leaving much to be desired, established equal, non-discriminatory treatment for the U.S. and Canadian investment.[39]

Two other FDI challenges are problematic to address in the current system: setting a corporate code of conduct, and standardizing penalty enforcement. A preferable, universal code of conduct cannot be established as there is no universal definition of 'preferable,' while there is a possible consensus on what constitutes favorable and unfavorable behavior, BIT value various MNC behavior to different extent; as a result, host countries still face a high risk of 'unpreferable' and costly MNC behavior. Standardized penalty determination and enforcement system is further unfeasible in a bilateral agreement. An establishment of a separate body is far too costly, and domestic legal systems, as proved to be the case with U.S. Steel, cannot be easily universalized to act as an international court. To remedy two FDI challenges outlined above, a universal, multilateral investment regulatory agreement needs to be in place. Further, this paper will examine the development and ultimate failure to establish such an agreement, and the reasons behind it.

Multilateral Agreement on Investment (MAI) was the multilateral investment regulatory agreement developed by the Organization for Economic Cooperation and Development (OECD).[40] It was discussed from September 1995 to its abandonment in October 1998,after France decided to no longer participate in the discussion (1998). The MAI attempted to establish a comprehensive, multilateral framework on investment by "setting clear, consistent and transparent rules on liberalization and investor protection.[41] The MAI's strength in particular, came from its 'top down' approach. If every country acceded it as was planned, nearly all actors and activities would have been covered.[42] The MAI, would have enforced global national treatment: for example discrimination between foreign and nationals investors would be forbidden.[43] It would further establish an arbitral panel with binding resolution powers.[44] The MAI had a strong potential of establishing a multilateral code of conduct and penalty enforcement mechanism, why was it abandoned?

Although failure of the MAI involved a diverse multitude of factors, two strong opposing forces played a key role: international NGOs and developing countries. Developed in a closed OECD forum the MAI came under fire as NGOs criticized its lack of transparency. By 1996, the MAI faced significant opposition from environmental and human rights non-governmental organizations, claiming the pro-business agreement failed to acknowledge labor and environmental regulations.[45] Overwhelming number of grassroots movements joined the NGOs in criticizing MAI for failing to account for the interests of the developing nations.

Unwilling to displease electorates, European governments began to withdraw from negotiations, with France's resignation marking the end.[46] Why did some developing countries oppose the MAI?

Although a multilateral FDI agreement offers developing countries a mutual economic benefit by reducing competitive price undercutting and maximizing profit, it is offset by the increased sovereignty cost due to extended foreign ownership.[47] Crystal isolates two economic outlier groups in the developing world: East Asia that is very attractive for FDI; and parts of Africa that does not attract significant FDI.[48] The former stands little to gain from multilateral regulation as it already occupies a privileged position, and the latter is indifferent to FDI concerns. AFL and UFL groups will refuse the *fait accompli* imposition of the agreement as it does not benefit them economically but does impose sovereignty costs; the remaining developing world cannot establish a sustainable economic cooperation without their involvement, as artificially high profits enjoyed by non-members will attract competition which will break apart the cooperation.[49] In short, given the current economic structure of the developing world, a universal multilateral agreement is not enforceable. As the latter two criteria (universal code of conduct and standardized penalty enforcement) cannot be currently satisfied in the *ad-hoc* international arena, it is unlikely that any significant change in FDI policy will occur.

In conclusion, this paper introduced a premise that the ICA is purposefully vague to protect itself from FDI it cannot dismiss for explicit legal reasons. The paper further outlined the current investment regulation regime, and concluded that it is constrained by the vagueness of the act, further elaborating that both MNC and Canada would benefit from its clarification. Proposing criteria that would reduce FDI risks and allow Canada to clarify ICA, the paper found that some form of multilateral investment regulatory agreement is necessary to fully realize the criteria it set out. By analyzing the structure of MAI, followed by the reasoning behind its failure, this paper came to the conclusion that, given the current composition of the developing world, a multilateral investment agreement is not feasible. Assuming no significant advancement in the direction of a multilateral FDI regulatory agreement takes place, the upcoming review of the ICA is unlikely to introduce significant changes as the prospective FDI threat posed by BHP Billiton has not been addressed.

Notes

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[15] Keenan, "U.S. Steel plans lockout in Hamilton."

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[23] Lalonde, "Dubai or not Dubai," 1487.

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[43] Sornarajah, *The International Law on Foreign Investment*, 233-237.
[44] OECD, "Main Features of the Multinational Agreement on Investment."
[45] Sornarajah, *The International Law on Foreign Investment*, 281.
[46] Ibid.
[47] Crystal, "Sovereignty, bargaining and the international regulation of foreign direct investment," 236, 288.
[48] Ibid., 240.
[49] Ibid., 236.