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Simplifying the Rule Book: a Proposal to Reform and Clarify Canada's Policy on Inward Foreign Direct Investment

Canada's policies on foreign direct investment (FDI) into the country are in disarray. Reforms are needed to make the application of Canadian FDI rules more transparent, and give Canada a far better reputation as a place to invest.

A. E. Safarian

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About The Author

A. E. Safarian
is Professor Emeritus at the Rotman School of Management.

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Finn Poschmann
Vice-President, Policy Analysis

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The Study In Brief

Canada's foreign direct investment (FDI) review regime, already criticized for its vague "net benefit" test for large proposed takeovers, has become potentially even more confusing to would-be investors in recent years. This *Commentary* proposes reforms to make the application of Canadian FDI rules more transparent, and give Canada a far better reputation as a place to invest.

The author advocates an end to foreign investment economic review, leaving security to a separate committee, and closing some sectors completely or partially to foreign investment, as is now the case, but with these restrictions subject to periodic, mandatory reviews.

Under the author's proposal, Industry Canada would cease reviewing inward FDI for compliance with a "net benefit" test and would be only one participant in a committee reviewing FDI proposals for national security concerns. It would take central responsibility for monitoring federal sectoral ownership policies and would regularly review the effect of such policies, including an assessment of the ongoing need to keep in place foreign ownership limits on a sector, or to remove such limits. Clearly, there needs to be continuing analysis of sectoral limits as technology and government policies change over time.

The rationale behind such an approach rests on the rejection of the widespread idea that securing controlling ownership of a Canadian-owned firm allows a foreign investor, whether or not an SOE, to operate at will in Canada. Nothing could be further from the truth. Regarding natural resource exploration and development alone, there are myriad laws and regulations for licences and other permissions on exploration, environmental review, sourcing of supplies and other inputs, as well as many other activities requiring approvals from various levels of government.

Where improvements in such laws, regulations and policies are needed, they should be instituted and apply to both domestic and foreign firms with regard to their Canadian operations. It makes no sense to have rules that impose conditions on inward FDI but not on existing local firms.

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Canada's policies on foreign direct investment (FDI) into the country are in disarray. This is especially true for FDI by foreign state-owned entities, whose investments have raised economic governance and national security concerns in the minds of Canadian and other governments.

While these worries are legitimate, they have produced policy changes that are unclear, discriminatory or even unenforceable. These changes have made Canada's FDI review regime, already criticized for its vague "net benefit" test for large proposed takeovers, potentially even more confusing to would-be investors.

The 2008 federal Competition Policy Review Panel, chaired by L.R. Wilson, made a series of recommendations regarding proposed foreign takeovers of large Canadian firms (Government of Canada 2008). Some have been, or are being, acted upon by the Canadian government. These include the recommendation to use enterprise value, rather than the book value of assets, in setting the threshold above which government review of foreign investment proposals must take place, along with the lessening of some sector-specific restrictions. However, the key recommendation to replace the "net benefit" test with a "national interest" test, which would enable more transparently enunciated decisions on proposed investments, remains a dead letter. The Wilson panel also recommended loosening restrictions on the defensive tactics directors of a public company might use to increase their bargaining power to fend off hostile takeover bids, an issue which has recently been addressed by Canadian securities administrators.

The economic advantages of welcoming FDI have been well reviewed elsewhere (Safarian 2011, Bergevin and Schwanen 2011, and Audet and Gagné 2010, for example). At first blush, Canada seems to be doing reasonably well – though not as well as it used to – as a destination for FDI. In the three years to 2013, it ranked ninth globally on the list of destinations for FDI (Table 1). As well, Canada's share of global FDI stocks is still slightly higher than its weight in the world economy (Figure 1). A prominent global survey of direct investment intentions by large foreign firms, released just before the plunge in world oil prices, placed Canada at an all-time-high third position, behind the United States and China (A.T. Kearney 2014).

In recent years, however, FDI in Canada has grown significantly more dependent on oil and gas and related investments, and to some degree also on the growth of foreign-owned establishments falling under the rubric "management of companies and enterprises."[1] Other sectors, notably direct investments in manufacturing, have correspondingly

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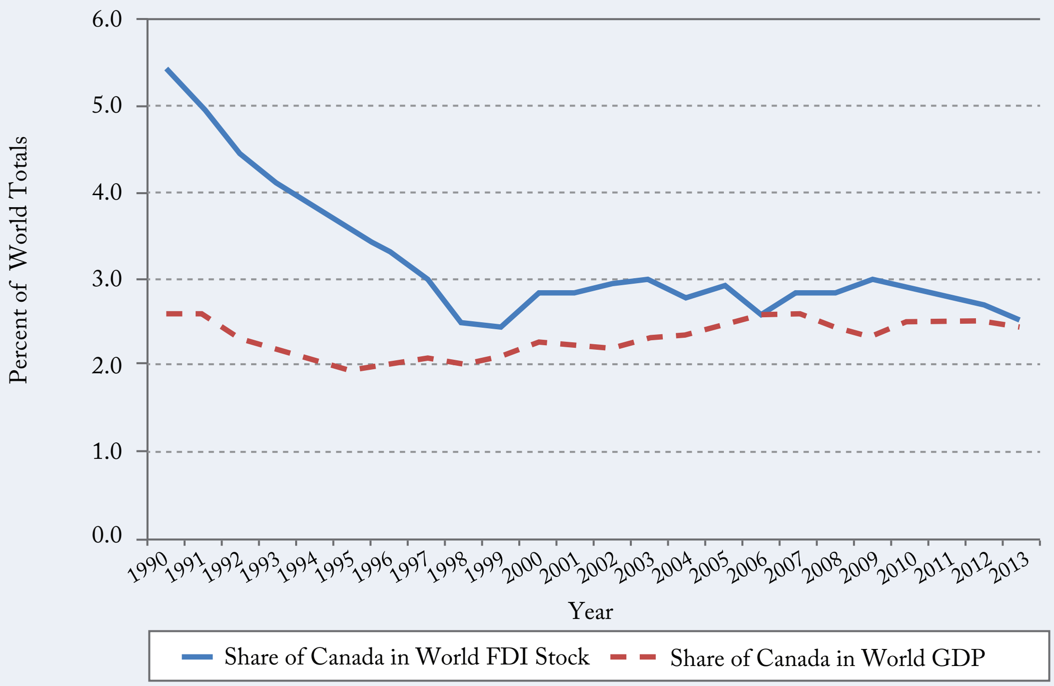
1 According to Statistics Canada, these establishments are "primarily engaged in managing companies and enterprises and/or holding the securities or financial assets of companies and enterprises, for the purpose of owning a controlling interest in them and/or influencing their management decisions."

Table 1: Countries Ranked by FDI Inflows, 2011-2013

	FDI Inflow *(US $ Billions)*	Share of GDP *(percent)*
UNITED STATES	571.9	1.1
CHINA	369.0	1.3
HONG KONG, CHINA*	247.6	29.9
BRITISH VIRGIN ISLANDS*	223.0	8177.0
BRAZIL	196.0	2.9
RUSSIAN FEDERATION	184.9	2.9
SINGAPORE*	175.3	20.5
AUSTRALIA	170.6	3.8
CANADA	**145.0**	**2.7**
UNITED KINGDOM	134.0	1.8
GERMANY	99.2	0.9
IRELAND	97.4	14.8
SPAIN	93.2	2.3
INDIA	88.6	3.4
BELGIUM	86.4	5.7
MEXICO	79.3	2.1
CHILE	72.2	8.6
FRANCE	68.5	0.8
LUXEMBOURG*	57.7	32.2
INDONESIA	56.8	2.2
NETHERLANDS	55.1	2.3
ITALY	50.9	0.8
NORWAY	46.6	3.0
COLUMBIA	45.7	4.0
TURKEY	42.3	1.7

* Indicates a destination listed as tax havens and/or financial centers in a compilation of recent lists made by the US Congressional Research Service (Gravelle 2015, Table I). Source: UNCTAD, World Investment Report (2014), Annex Table 1, and UNCTAD Stats, Nominal and real GDP, in US dollars at current prices and current exchange rates, retrieved March 11 2015 at: http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=96.

Figure 1: Canada's Share of World GDP and Inward FDI Stocks



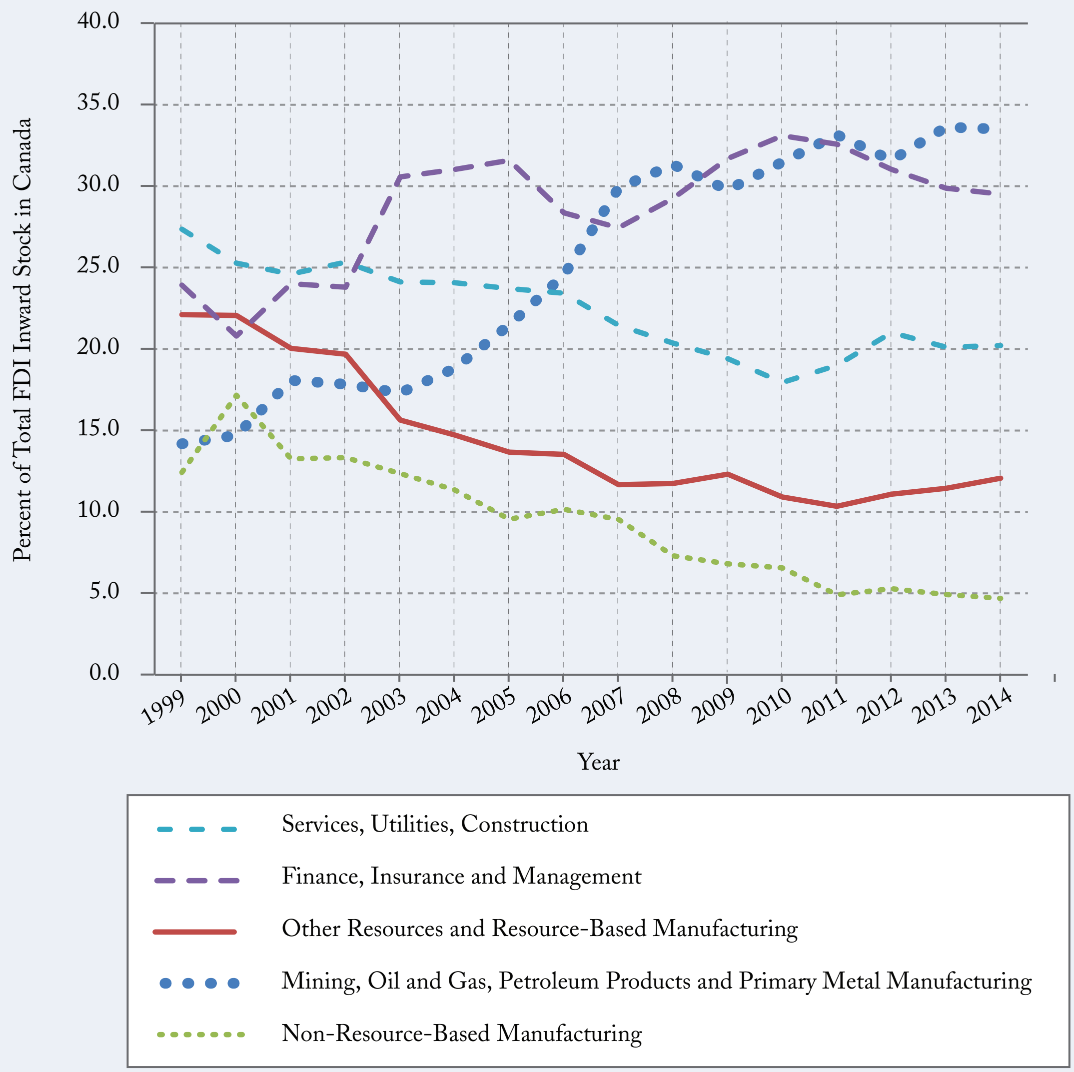
Source: UNCTAD World Investment Report 2014, Annex Table 3, retrieved at: http://unctad.org/Sections/dite_dir/docs/WIR2014/WIR14_tab03.xls, UNCTADStat Report "Nominal and real GDP, total and per capita, annual, 1970-2013" created September 19 2014, retrieved at: http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=96, and authors' calculations.

declined significantly in the portfolio (Figure 2). The sharp decline in oil prices since mid-2014 means that Canada should pay more attention to the range of factors that might make it more or less attractive than competitors as an FDI destination, across a range of sectors.

On this score, the United Nations Conference for Trade and Development (UNCTAD) reports that Canada does not figure among the 20 top destinations for investments in 2014-2016 among the 176 transnational corporations, heavily weighted toward the manufacturing sector, that responded to its survey (UNCTAD 2014, 28, Figure I.28). Canada dropped off the list after placing 16th in the 2013 survey (UNCTAD 2013, 22, Figure I.25). Canada has also remained firmly in the bottom quarter among 43 economies evaluated consistently since 2006 by the OECD for regulatory obstacles to inbound FDI. It ranked 36th in 2013 – worse than all developed economies except New Zealand – despite having scaled back and even removed restrictions on foreign ownership in some sectors. The key reason cited for Canada's relative weakness in these rankings is its FDI screening and approval process (OECD 2015).

A good case can be made that Canada does not entirely deserve this poor ranking, which is partly attributable to the fact that the country is up front about the fact that it screens proposed acquisitions of domestic firms by foreign entities, whereas competitors can impose unwritten but similarly important obstacles (Government of Canada 2008,

Figure 2: Share of Inward FDI Stock in Canada, by Industry Groupings



Source: Statistics Canada, CANSIM Table 376-0052, and authors' calculations.

29). But that is not an excuse for failing to make the Canadian screening regime easier to navigate.

In this context, we need to think anew with a long-term perspective on the regulation of inbound FDI to Canada, and about the best ways to deal with the issues that warrant scrutiny. This *Commentary* proposes four areas for reforms relating to Canada's FDI regime and examines the rationale for each. The four are:

- National security. This is the issue that raises most concern today. It would best be handled by an interdepartmental committee on national security, distinct from any economic review process.
- Dispose of the net economic benefits rule for large acquisitions. The rule was flawed from the beginning and its deficiencies have become more obvious through time. Small acquisitions and new FDI are not reviewed.

- Ongoing monitoring of sectoral policy FDI. Industry Canada should periodically review the relevance of limitations on FDI in specific sectors, except for those, such as banking and insurance, under the responsibility of the federal minister of finance.
- Defensive mechanisms. Canadians' concerns about the ability of domestic firms to fight hostile takeovers are often rooted in the widespread community impact of such firms. Takeover targets have often benefitted from considerable public support in their creation and growth, and the public remains concerned about the impact on the firm and its stakeholders following a takeover. The best way to deal with these concerns is to allow the boards of directors and management of takeover targets more time to draw up defensive plans likely to win the support of the shareholders and other stakeholders, in the event of a hostile takeover bid. Indeed, such measures have been proposed by the Canadian Securities Administrators (Janet McFarland, "Securities regulators unveil new rules for takeover bids," *Globe Advisor*, April 1, 2015).

National Security: Issues and Organization[2]

The key policy issues involving inward FDI keep changing. Before 2000, concerns about national sovereignty, the economic performance of foreign-owned firms and natural-resource ownership loomed large. In the following decade, the impact on the size of Canadian headquarters and employment were critical. National security, particularly the effects of takeovers by state-owned enterprises (SOEs), now dominates discussion and policy, along with renewed debate around issues accompanying large resource investments by foreign state-owned firms.

Most countries have long retained the power to examine and block FDI on security grounds. This authority can be exercised through an explicit national security restriction, a hands-off listing of industries considered sensitive from a national security viewpoint, or even through a broad statement on protecting public order that can be interpreted as a security measure in some cases.

For example, Germany has a review procedure for bids from non-EU and non-European Free Trade Association firms if they threaten "public security" or "public order" (Sauvant 2009). France, in 2005, announced a list of strategic industries for which FDI would be subject to special authorization; it included many clearly defence-related industries but also gambling. In 2014, France extended its power to block takeovers of defence establishments to include businesses engaged in transport, energy, telecommunications, water and health. For its part, Russia, in 2008, began to require government approval for proposed takeovers of firms involved in any activities of strategic importance to defence or security.[3]

Box 1 discusses some elements that also led the United States to establish a review process aimed at investments causing national security concerns.[4]

In Canada, however, it was only in March 2009, after Industry Canada rejected the purchase

2 I have decided to not encumber this *Commentary* with references to the many Acts and Regulations noted here. The precise listings of these are easily found by using the dates given and searching the Internet. These precise listing are also given in footnotes in my essay in Sauvant et al., 2012. notes 60-72.

3 References here are to Safarian (2012, 437, drawn largely from Sauvant, 2008-2009) except for the 2014 reference to France, which is from the *Globe and Mail*, May 16, 2014, B2.

4 See Safarian (2011, 130-132) for a brief statement on the US and other countries' approaches and Graham and Marchick (2006) for the United States alone.

Box 1: US Review of Foreign Investments

Concern over increasing FDI from Japan and oil-rich Middle Eastern countries in the 1970s (Safarian 1993, ch. 2) prompted a response from the United States. A 1975 executive order established the Committee on Foreign Investment in the United States (CFIUS), which is an inter-agency committee chaired by the Secretary of the Treasury to monitor the impact of foreign investment. In 1988, Congress gave the president the authority to review and, ultimately, block proposed or pending mergers or acquisitions by foreign firms that might pose a threat to national security, and the president delegated the review process to CFIUS. Since 1992, CFIUS is required to investigate all proposed mergers, acquisitions and takeovers when the acquirer is controlled by, or acts on behalf of, a foreign government and the deal could affect national security.

Notification to CFIUS by parties to a transaction is voluntary. Agencies that are represented on the committee may also bring forward proposed transactions for consideration. Very few notifications have led to investigation, formal withdrawal or a presidential decision, but this does not include withdrawal from the process during review. In 2007, partly because of security issues raised by Congress, the scope of CFIUS was broadened to include, for example, takeovers involving critical economic infrastructure (Jackson 2014 and Bergevin and Schwanen 2011, 12-14).

of satellite communications firm MacDonald Dettwiler and Associates by an American company, that the government amended the *Investment Canada Act* to permit denial, by the governor in council, acting upon a recommendation from the minister of industry of a proposed investment on national security grounds.[5] In 2015, recognizing the complexity of some security reviews, the minister of industry was given flexibility to extend the time allowed to conduct a security review on a proposed foreign investment by an additional 45 days beyond the inital 45-day period.

Unfortunately, alleged security problems may clash with the potential for otherwise beneficial business relationships involving a foreign firm. The Chinese firm Huawei Technologies Co. Ltd. is a case in point. It sells telecommunications network gear to more than 500 carriers globally. A US Senate Committee Report sharply criticized the firm as a security threat, following which the former head of US counter-espionage warned against it being involved in Canadian government or security networks. While these warnings appear to have been heeded by Ottawa, privately owned

5 National security appears to have been a key issue in the rejection. The Canadian company's satellite, built largely with public funding, might not have been available to the government in defending Canada's interests in the Arctic if some prohibitions on US exports applied after the sale. One cannot be sure about this because the Canadian government says little about the reasons for its decisions, presumably to protect firms' confidential information. This was the first formal rejection under the *Act* in its 23-year history. This case and security more generally are discussed in Bergevin and Schwanen (2011); Cornish (2012); Dobson (2014); Grant (2012); and Moran (2012). The federal government had been considering a new review requirement on national security grounds when this case arose, a direction supported by the Wilson report (2008, 31).

firms have been working with Huawei. Indeed, the Chinese operation has built a new Canadian wireless network with Wind Mobile and has signed contracts with both Telus and Bell (Greg Weston, CBC News, posted 15 May 2012; *Globe and Mail*, Oct. 10, 2012).

Underscoring the difficulty in assessing the balance between economic opportunities and security risks in such cases, *The Economist* noted that the Senate report presented "little hard" evidence to support its allegations that Huawei's behaviour had been influenced by links to official Communist Party operatives embedded in most large Chinese firms. Meanwhile, UK authorities worked out effective arrangements with the firm to meet its security concerns (*The Economist*, 13 October 2012, p.78). While reports about Huawei often point alarmingly to the fact that its founder was a Chinese military officer, that is too broad a brush to assess security threats since company presidents and other senior officers around the world often have a military background.

The issue I raise with this example is whether misinformation and exaggeration taint proposed investments by Chinese SOEs while detracting from a much more pervasive underlying security issue, the hacking attacks on corporations, organizations and government agencies by groups apparently closely associated with the Chinese military (*Globe and Mail*, 19 February 2013, A3 from *New York Times* News Service). Having Industry Canada responsible for navigating these national security questions is a source of confusion and, potentially, mistakes. While Industry Canada reviews rely on various security-related departments and agencies, it is important to situate national security concerns related to foreign investment more clearly within the broader evaluation of national security threats. As in the US practice, such evaluations should be conducted as far away as possible from sources of temptation to indulge in economic protectionism in the guise of national security concerns.

This requires a separate committee, independent from Industry Canada and responsible to the highest level of government, either the prime minister or a select committee of cabinet. This review committee would consider foreign direct investments identified by any number of potential sources as posing a national security threat, and would report on its conclusions in each case. Members of the review committee would be from defence- and security-related departments and agencies along with broad-based economic departments such as Finance and Industry. Such a committee would embrace the direct and continuing participation of relevant bodies as well as the accumulation and centralization of knowledge in a very complex and sensitive area.

Of course, as the US experience shows, no review system will ever be immune from protectionist influences working through the political system. One case in point is Congressional pressure that forced a reopening of the process by which state-owned DP World Limited (Dubai Ports) would have been allowed to acquire important US port management operations owned by a British firm. Another is the non-binding House of Representatives resolution calling the proposed 2005 acquisition of Union Oil Company of California (Unocal) by state-owned China National Offshore Oil Corporation (CNOOC) a potential threat to national security. Neither proposed acquisition succeeded (Rugman 299, Gordon and Niles 34, respectively, and Graham and Marchick, Chapter 5: "Politicization of the CFIUS Process").

Lest the pendulum swing too far toward accepting restrictive economic measures as a legitimate way to address security threats, the review committee I am proposing for Canada should be required to base any recommendation explicitly on the least economically damaging way possible to effectively address a potential security threat.[6] In turn, the Canadian government could, without prejudice to what it might find to be security threats at any given time, make publicly available guidelines that would help foreign investors avoid proposals which they know, or ought to know, would pose unacceptable risks to Canadians.[7]

State-owned Enterprises: Economic Issues

Recent concerns have also centred on the growing economic influence of large and, at times, controlling direct investments from abroad by sovereign wealth funds (SWFs) as well as SOEs. While they have attracted criticism on grounds of disclosure of information, governance, structure and accountability (Truman 2008), the reality is that they differ greatly among themselves on all these issues. From the recipient country's perspective, SWF and SOE investments can cause concern because they may attempt to further the political and economic agendas of home governments rather than focusing only on yield and other commercial issues (Safarian 2011, 117-118).

In particular, attempts by Chinese firms to enter Canada's energy sector prompted Ottawa to examine its policies toward SOEs.[8] The *Investment Canada Act*'s "net benefit" test for large inward FDI notionally allows any perceived negative effects to be offset against positive ones. In 2007, Industry Canada issued guidelines on assessing net benefit from FDI by SOEs. Investors would need to adhere to Canadian standards of corporate governance (disclosure, transparency, some independent board members) and also to Canadian laws and practices. There must also be some assurance the acquired Canadian firm can continue to operate on a commercial basis and be maintained in a globally competitive position. This assurance would be assessed by examining a long list of factors, such as exports, processing, the participation of Canadians in its operations in Canada and elsewhere, and support for innovation and R&D.

These guidelines, however, add performance requirements that governments would not ordinarily impose on Canadian industry. Many privately owned Canadian firms, some quite large, would fail to meet some of these tests.[9] As a result of these prescriptions – not all of which have definitive evidence linking them with economic performance – Canada's economic landscape has become an unlevel playing field.

Controversy erupted in 2012 over CNOOC's attempt to acquire Nexen, a Calgary-based, mid-sized oil and gas firm with assets in the Canadian oil sands, and over a smaller proposed acquisition by Petronas, the Malaysian state-owned energy firm, of Progress Energy, a leading natural gas development company also headquartered in Calgary. In the event, the federal government allowed both

6 During the course of producing this *Commentary*, a report emerged to the effect that a shadow committee of senior Canadian officials concerned with public safety and security was set up last year to assist with the review of proposed investments on national security grounds (Mayeda 2014). If this report is accurate, a key difference with the CFIUS in terms of impact on investment would be that the latter provides more open guidance regarding how it assesses proposed investments.

7 Indeed, the Wilson panel suggested that the scope of any review requirement in Canada on grounds of national security be aligned with that of the investment review process used by the US Committee on Foreign Investment.

8 See Shapiro and Globerman (2007) for a fuller analysis of problems arising in FDI by SOEs.

9 Indeed, one reviewer noted that it is not clear whether the FDI review procedures have even kept pace with the fast rise of "special purpose entities," established essentially for tax and other financial purposes, which account for much of what qualifies as FDI these days.

investments but also declared that, in future, the acquisition of control of a Canadian oil sands business would only exceptionally be found to meet net benefit test."

The debate around these takeovers by state-owned companies has added to our understanding of the issues surrounding such investments. Cornish (2012), for example, argues that the potential problems arising from Chinese state ownership have been exaggerated because publicly traded SOEs in China must still meet stock exchange and host country regulations. Therefore, SOEs will focus on the acquired firm's economic interests even where broad Chinese government economic objectives exist. For his part, Moran (2012) examines a number of cases and concludes Chinese SOEs that purchase natural resource companies are concerned with production for international markets rather than just locking up supplies for the Chinese market.

Meanwhile, Dobson (2013) notes that China's regulation of inward FDI is being updated and made less opaque as it develops institutions to govern competition policy and guard its own national security. Moreover, Dobson emphasizes the diversity of governance and transparency in Chinese SOEs and the growing interest in more open and competitive markets as they expand abroad.

Another issue related to SOE investment in Canada is reciprocity; that is, the notion that countries such as China should allow Canadian firms to enter a sector as a condition for access to the equivalent Canadian sector. But attempts to exercise leverage in this way are severely, and appropriately, restricted by obligations Canada and its trading partners have undertaken in various trade and investment agreements to extend "most favoured nation treatment (MFN)" to each other. For sectors and policies that are subject to MFN obligations under the WTO, NAFTA or other treaties, one party cannot give producers of another economy easier access to one of its sectors, even as part of a reciprocity agreement, without also extending it to the other parties to the treaty.

Besides, reciprocity cannot substitute for gains in access that are typically achieved through broader negotiations on trade and investment, such as Canada's recent Foreign Investment Promotion and Protection Agreement with China, ratified this past year. Such agreements are difficult to achieve, but enjoy great economic advantages over the narrowly defined view of reciprocity. After all, a look at sectors protected from inward FDI shows some similarities among countries (e.g., defence, some natural-resource sectors, some public utilities) but also large differences reflecting historical experience, economic structure, comparative advantage/disadvantage, and broad political and cultural preferences.[10]

For example, suppose the Chinese government agreed to open its banking sector to Canadian FDI, provided Canada removed all ownership limitations on its banks. Of course, we would insist China loosen state control and subsidization of its banks while China, in turn, might insist that Canada relax its requirement that major branch banks be widely held.[11] Or imagine the outcry if China stated it would greatly liberalize entry to its newspaper, magazine, book and broadcasting sectors provided Canada did the same. Merely to state the issue is to underline the historic differences between nations that make straight reciprocity an unrealistic goal.

10 See Safarian (1993) for history, lists of sectors and analysis for industrial countries.

11 The intricacies of China's banking system are spelled out in *The Economist*, 31 August 2013, pp.11-12 and 61-62, which flatly declares that the "biggest financial institutions are so closely held by the state that they are, in effect, arms of the treasury (61)."

Instead, a comprehensive treaty would provide relatively few exemptions based on such embedded particularities and trade-offs among sectors.

In December 2012 and May 2013, the federal government went some distance in clarifying the rules for investment in Canada by SOEs and how the reviews will be carried out under the *Investment Canada Act*. These guidelines added that investors would typically have to appoint Canadians as independent directors and to senior management positions, as well as to incorporate in Canada and/or list shares of the acquiring company or the Canadian target on a Canadian exchange. An SOE is now defined to include firms or individuals directly or indirectly influenced by the state, and the industry minister has been given new powers to determine which entities are, or are not, in fact controlled by a non-Canadian government.

The government also announced that thresholds triggering a review of a proposed acquisition would be determined using the target's enterprise value rather than book value. At the same time, it said that while the thresholds would be raised for firms in general, they would remain at existing levels for SOEs. In seeking FDI approval, firms must demonstrate adherence to these guidelines, as with net benefits generally.

Some of these newer tests applying specifically to SOEs, such as the degree of foreign government influence, direct or indirect, coming on top of the net benefit test already applied to all FDI above the threshold, will make it more complicated to both make and assess a foreign investment proposal. Many experts have argued that while the recent rule changes clarify some matters, they add unwelcome layers of uncertainty and complexity to Canada's foreign investment review regime (See, for example, Osler, Hoskin & Harcourt 2013, Dobson 2014).

Review of Inward FDI for Net Benefit

One way to reduce the FDI approval regime's overall complexity is by addressing the potentially arbitrary and discriminatory elements of the net benefit test. Here I describe briefly the investment review operations under the *Investment Canada Act*, some of the difficulties they have given rise to, and an alternative approach.[12]

When a foreign investor acquires control of a Canadian business whose assets exceed a certain threshold, it must apply for review. For foreign investors from WTO members, that threshold is $369 million in 2015, with lower thresholds applying to non-WTO members or acquisitions or investments in the cultural sector. In addition, foreign investors must notify Investment Canada of all other acquisitions or the establishment of new businesses in Canada. Recent amendments to the *Investment Canada Act* will see the threshold for private sector investors from WTO members rise to $1 billion of enterprise value.

Where a formal review is necessary, Industry Canada states that it will consider these six factors to determine net benefit:

- the effects on the level and nature of Canadian economic activity, including employment, resource processing and utilization of parts and services in Canada;
- the degree and significance of participation by Canadians in the business;
- the effects on productivity, efficiency, technology, product innovation and variety in Canada;
- the effect on competition;
- compatibility with national and provincial economic and cultural policies; and
- contribution to Canada's ability to compete in world markets (Industry Canada 2014, p.3).

12 For detail on administration and guidelines, see http://www.ic.gc.ca/eic/site/ica-lic.nsf/eng.

The onus is on the investor to demonstrate net benefit.

The *Act* does not set weights for the six net benefits nor indicate which factors are more important; nor does it provide for formal indicators or reports that would allow Canadians to gauge the reasonableness of the government's assessment of each factor.

The industry minister decides if the proposal is likely to be of net benefit on the basis of the unique facts and merits of each case. There is provision for a response by the investor to unsolicited and negative private representation, as well as for regular consultations by Industry Canada with other governments and federal departments. The director of investments (currently the deputy minister of Industry Canada) can advise the minister and the applicant of any matters that could delay a decision or lead to a negative one, and the applicant can respond by attempting to more clearly demonstrate net benefit. After a rejection, the applicant has 30 days to improve the proposal. There is also provision for mediation in some cases. There are also several specified points where an applicant can withdraw a proposal.

There are a number of problems with this regime. First, the approach is based on a dubious economic rationale. The premise underlying Canada's initial review process, set up under the 1973 *Foreign Investment Review Act*, is that, as laid out in the "Gray Report" (Government of Canada 1972) foreign-owned firms were "truncated" and limited in what activities they could undertake in Canada, and therefore that their significant presence hindered the country's economic development. This was never shown to be correct. Indeed, the major private study at the time concluded that Canadian and non-Canadian-owned larger firms operating in Canada performed similarly when it came to exports and research and development, although the foreign-owned firms tended to import more, especially in the initial years of establishment (Safarian 1966). US-owned firms, which were particularly criticized, had better performance than comparable locally owned firms in studies for the United Kingdom, France, Australia, New Zealand and some other more developed countries, outcomes that were at odds with the Canadian concerns.

Meanwhile, a 1968 federal task force report (Government of Canada 1968) was highly critical of FDI in terms of its effects on Canadian sovereignty and independence, but did not adopt the view that foreign-owned companies' overall performance was inferior to that of Canadian-owned companies (Azzi 1999).

While the Gray Report argued at length that there were serious economic and political costs, and recommended a review process, it did not undertake any serious new research on the former. Meanwhile, an academic examination that argued that inward FDI had crippled Canadian entrepreneurship (Levitt 1970) was ironically followed over time by a huge and lasting surge in Canadian direct investment abroad, half of it outside the United States, suggesting Canadian entrepreneurial dynamism.

There have been a subsequent series of good studies on the performance of foreign-owned firms. The most comprehensive and carefully carried out concluded that the performance of larger foreign-owned firms is generally similar to that of larger domestically owned firms while being superior to that of mid-sized Canadian-owned firms that are not multinationals or involved with them (Baldwin and Gu 2005).

While very few formal takeover proposal rejections have occurred, this observation takes no account of withdrawals at the various stages of the review process noted above. There are probably several reasons for such withdrawals, but certainly some occurred because the firms declined to make further undertakings or could anticipate rejection.

A second problem with the current foreign investment review regime is the absence of public information on withdrawals that could be helpful to both the potential investor and the Canadian public. The privilege and confidentiality requirements of the *Investment Canada Act* are very strong, but there is nothing in the *Act* that would prevent the publication of aggregate information on filings and withdrawals. Its release should be encouraged, even if the results are such that supporters of the current review system could point to low withdrawal rates in support of the position that it does not unduly discourage FDI.

Curiously, the former Foreign Investment Review Agency, (which was roundly criticized on many grounds, and renamed and repurposed with the introduction of the current *Act* in 1985), was publishing the number of applications for review, the number of applications withdrawn and the number actually rejected. Annual withdrawal rates averaged 9.6 percent up to 1984. The numbers of undertakings were available not only by broad categories of assessment and rationale, but also in detail for many individual firms (Safarian 1993, 133, 136, Appendix A).

A third problem with the current approval system is that it is very difficult for firms, let alone the public, to know what levels of performance to aim for to satisfy Industry Canada, since no weights or priorities are publicly assigned to the assessment factors. Industry Canada and the industry minister give only the most general of reasons, if any, for rejections beyond noting a failure to demonstrate net benefit. All of this sounds a bit like a game of two-handed poker where only one party knows the value of each card, while offering hints to the other on what is considered valuable. Some have argued that business is used to facing uncertainty from market experience, but having it imposed unnecessarily is a different matter.[13]

Indeed, a recent joint report by Chinese and Canadian government officials took aim at the lack of clarity and apparently capricious actions by both central governments and argued for more predictability on FDI decisions if trade and investment were to prosper (Government of Canada 2012).

There are costs to such an overall approach to inward FDI. Reputation is difficult to build on a global level and, once reduced, hard to restore where alternatives exist for foreign investors. There are elements of high uncertainty and subjectivity for government officials when complex terms such as productivity, efficiency, technology development and innovation, and global competitive effect are examined in relatively short periods as if their macro effects were clear from imposing firm-level obligations. This is particularly so when government insists each case is unique. This approach contains potential elements of industrial policy directed to particular firms.[14] Further, it is clearly discriminatory in making legally binding demands on foreign-owned firms not made on Canadian-owned firms in similar circumstances.

Since foreign direct investment plays a critical role in a firm re-organizing production to efficiently capture a share of rapidly expanding international markets, a different approval approach is worth considering. The one I advocate is to end foreign investment economic review, leaving security to a separate committee, as noted earlier, and closing some sectors completely or partially to foreign investment, as is now the case, but with these restrictions subject to periodic, mandatory reviews.

13 This is not to say that clarification on benefit requirements would make uncertainty disappear altogether, since the requirements, among other reasons, are applied to a heterogeneous set of firms and domestic circumstances.

14 One experienced reviewer noted that requiring investors to make "undertakings" before a transaction was the exception during the first 10 years of the *Investment Canada Act*, but is now almost routine, risking leaving the impression of a "shake-down culture" rather than that of an open door toward FDI .

The rationale behind such an approach rests on the rejection of the widespread idea that securing controlling ownership of a Canadian-owned firm allows a foreign investor, whether or not a SOE, to operate at will in Canada. Nothing could be further from the truth. Regarding natural resource exploration and development alone, there are myriad laws and regulations for licences and other permissions on exploration, environmental review, sourcing of supplies and other inputs, as well as many other activities requiring approvals from various levels of government. Legislation governing labour relations, competition, corporate operations, security, disclosure and a great many other activities (with attendant regulations in place at the federal, provincial, territorial and municipal-regional levels) apply to foreign-owned firms as well as domestic firms.

Where improvements in such laws, regulations and policies are needed, they should be instituted and apply to both domestic and foreign firms with regard to their Canadian operations. It makes no sense to have rules that impose conditions on inward FDI but not on existing local firms. Canada's reputation as a place to invest will improve if it adopts similar (and more predictable) standards for firms regardless of origin. Clearly, this strategy challenges current thinking predicated on bargaining with each firm to get a sufficient but unspecified net benefit. Instead, all firms should be required to meet the same standards, which many (foreign- and domestic-owned alike) will seek to exceed, given competition for sales and better inputs, community pressure and other reasons.

Closed or Partially Closed Sectors

Policies limiting foreign ownership in some sectors exist in all countries. Some broad similarities can be discerned among countries as to the reasons why (national security and the existence of public, private or mixed monopolies). There is also much variance reflecting country-specific experience and preferences. One study of 23 industrial countries showed sectoral ownership controls existing in 18 or more countries in banking and finance and also in maritime transport and related facilities. At least 12 countries had restrictions for other financial services and in air transport and related facilities. Six or more had controls in the real estate, mining and minerals, petroleum, agricultural products and water resources sectors (Safarian 1993, ch.12).[15]

In some cases, such ownership policies reflect efforts to encourage particular firms (often seen to act as "national champions" under a form of "managed internationalism") by a set of strategic trade and investment policies. However, other research suggests that such policies improve welfare only if a number of stringent conditions are satisfied, and that this is difficult to do especially in federal systems.

Under my proposal, Industry Canada would cease reviewing inward FDI for compliance with a "net benefit" test and would be only one participant in a committee reviewing FDI proposals for national security concerns. But it would take central responsibility for monitoring federal sectoral ownership policies and would regularly review the effect of such policies, including an assessment of the ongoing need to keep in place foreign ownership limits on a sector, or to remove such limits. Clearly, there needs to be continuing analysis of sectoral limits as technology and government policies change over time.

This is a demanding task as one can see from (i) the difficulties encountered by the federal government in seeking a new competitive equilibrium in the telecom industry; and (ii) in the

15 The list of favoured sectors changes over time as technology changes: telecommunications would be added now, for example, to the above list.

controversy surrounding its 2012 decision to limit further controlling investment by large-scale FDI in the oil sands. Sectoral barriers to investment require very careful historical and theoretical analysis if they are to work in sync with long-term economic policy, let alone achieve positive economic outcomes overall.

Industry Canada is well placed to play such a role, having been responsible for monitoring inward FDI to ensure sectoral policies are not circumvented. As well, it has considerable sectoral knowledge and a substantial research capacity.

Foreign Takeovers of Larger or Strategic Firms

Even though Canadian direct investments abroad exceed foreign direct investment in Canada, concerns will likely always remain about foreign firms acquiring some large and well-known firms headquartered in Canada, whether it is because these firms enjoy iconic status as exemplars of entrepreneurship, or play particularly important roles within a regional economy or a community. For example, a firm may have been supported by public funds or grown under the umbrella of protectionist legislation. Much of this unease centres on fears of the "hollowing out" of domestic economic activity in Canada, especially in terms of the loss of corporate headquarters.[16]

If, as I recommend, review of FDI ceases except for national security and designated sectors, should governments still have the tools to cope with proposed acquisitions of privately owned firms that have some special or strategic economic status? My answer is grounded in the general approach I advocate above, which is that applicable laws and regulations governing takeovers should apply to all firms regardless of nationality of ownership. Not all the approved takeovers of large and well-known firms in recent years – particularly in the resources sector prior to the global financial crisis of 2008 – have worked as well as expected for either the acquirers or the company being acquired.

While lessons need to be drawn from those experiences, the outcome for Canadians overall would not likely have been improved by changes to the FDI screening mechanism. The boards of takeover-target firms could have taken steps, under provincial securities legislation and regulations, to make themselves more difficult targets, or indeed to convince their shareholders that they could raise the company's performance. Depending on circumstances, there would have been opportunities to issue shares with different voting rights, to buy out shares, to take the firm private,[17] to buy out other firms and "bulk up," thus reducing attractiveness as a target, or to find a more friendly buyer as well as taking still other defensive steps.

Some firms took defensive action, but many of the controversial hostile bids that drew strong negative public comment did not draw such responses from the targeted Canadian firm. Typically, the board of directors would recommend approval of the takeover bid or perhaps try to negotiate a somewhat higher price. There was not much tendency to consult other stakeholders (senior management aside, which would work with the board) or to seek a longer period than ordinarily allowed by the Ontario Securities Commission (which in this respect set the pattern) to improve the company's performance before a shareholder vote was taken.

For these firms, "just saying no" was also not an option, as may be allowed under Delaware law.

In this respect, an extension of the ability of Canadian firms to fend off hostile bidders – without

16 See Safarian (2011, 127-129) for a review and some references.

17 Morck et.al. (2005) have documented the decline of freestanding widely-held firms in Canada.

at the same time entrenching management that does not deliver value for firms' owners – rests with Canadian provincial securities regulators, not with the FDI screening procedure. Some observers maintain that the time available to put forward an alternative proposal, particularly to improve the target's performance, is too short under current rules. Indeed, the Canadian Securities Administrators have proposed that bids be opened for a minimum of 120 days (except where the target board wishes to reduce it), compared to the current 35-day standard (CSA 2014).

Meanwhile, the courts have ruled that directors must treat stakeholders equitably and fairly as distinct from the earlier view that simple maximization of shareholder returns was their overriding objective (*Globe and Mail*, 20 December 2008).[18] These types of approaches, broadening and improving the context in which boards and managers can take action, are more desirable than potentially extending the state's protection to every large firm facing a hostile takeover on the grounds it is deemed strategic or iconic or special in some other sense.

The answer to concerns about a foreign investor's treatment of an acquired Canadian operation lies in ensuring that laws and regulations – including those concerning shareholder rights and board of directors' duties – promote efficient economic decisions, whether by Canadians or a proposed foreign acquirer.

Conclusions

A dedicated committee should be established to deal with security issues raised by inward FDI, whether or not the investor is a SOE. It could be modelled partly on US experience with such a committee, modified to take account of Canadian law and practices.

Review of inward FDI for an ill-defined net benefit should cease, with the emphasis shifting from ownership to conformance by all firms, domestic and foreign, including SOEs, to Canada's laws and regulations. Industry Canada should bear broad responsibility for advising government on (i) sectors that would remain partly or wholly closed to FDI, (ii) research on firm performance and (iii) adding to or subtracting from the list of such sectors.

The Canadian securities regulators' proposal to give publicly traded firms more time, if desired, for boards and management to provide shareholders an alternative to a hostile takeover should lead to more opportunity for larger Canadian firms to deal with unwanted takeovers, while reducing the administrative burden falling on foreign investors. These changes would make the application of Canadian FDI rules more transparent, and give Canada a far better reputation as a place to invest in a world where competition for high value-added industry is a fact of modern life.

18 One reviewer noted that the case law simply states that directors' obligations are to the company and provide no clear guidance about how the claims of different stakeholders rank against each other; in some respects, arguably, *BCE Inc. v. 1976 Debentureholders* leaves business takeover law less clear than before.

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