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Foreign Investment In Canada and Mexico: An Agenda for Host Country Screening

by *William S. Barnes*[*]

Multinational Enterprise may be structured with full authority and centralization in world headquarters or they may allow considerable discretion and decisionmaking to the management of the national or local subsidiary. Obviously where there is significant local participation in the ownership of the subsidiary, management is likely to be appointed locally and responsible to local shareholders as well as to the foreign investor. On the other hand many wholly-owned subsidiaries only have a very general coordinated policy dictated by headquarters and are allowed to be flexible and responsive to local requirements at the operational location. The corporate form of a multinational enterprise depends in large measure upon the national law where the subsidiaries are located. Restrictions may be introduced at the time of the original foreign investment or in the course of the operations within the country. In any case, the first opportunity the host state has to impose such restrictions upon a multinational is at the entry point. That is, at the time in which the investment is screened by the appropriate host country administrative body and approved or disapproved. The threshold screening procedures may contain provisions about the composition and appointment of man-

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agement or restrict the freedom of headquarters to make management appointments and decisions. Since most multinational corporations assume that the decisions taken at headquarters are binding on its subsidiaries operating abroad, it is essential that multinationals know what restrictions, if any, are imposed by host countries on foréign subsidiaries operating within their borders. The decisions whether to invest at all or as to the most appropriate corporate form will turn upon host country's policies on long term investment, production, distribution, pricing, licensing and employment. In determining what factors should be considered in formulating the appropriate relationship between multinational headquarters and national subsidiaries, Canada is a model with its Foreign Investment Review Act.[1] Even though many countries have not yet developed a thorough and adequate system for screening investments, the trend is definitely in the direction of more oversight[2] and the Canadian experience is especially relevant.

Host countries can promote desirable types of foreign-based or foreign-controlled private enterprise only if they take steps to set up a permanent administrative agency or mechanism whose sole purpose is to determine which foreign investors are desirable.[3] Likewise, it is necessary to provide a screening procedure which will exclude those foreign enterprises having little or nothing to contribute to a host country's long-term economic objectives. *The key to effective regulation* is review. Both Mexico,[4] and Canada have instituted screening techniques.[5] While this is due in large measure to both their com-

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[1] GRAY, CANADIAN DEP'T. OF INDUS. & COMMERCE, FOREIGN DIRECT INVESTMENT IN CANADA (1972).

[2] Canada and Mexico have been in the forefront in developing screening policies due to a variety of historical and geographical factors. However, other states have begun to apply relatively sophisticated screening techniques to foreign investment proposals. *See* LE BOULANGER, LEGAL ASPECTS OF THE 1974 EGYPTIAN FOREIGN INVESTMENT REGULATIONS, 9 Journal of World Trade Law 80 (1976); ,
PANAMA AND THE MULTINATIONAL CORPORATION, TAX HAVEN AND OTHER CONSIDERATIONS, 8 INTERNATIONAL LAWYER, 626 (1974) *also see*, THE EXPERIENCE OF THE HOST COUNTRIES, (I. Litvak & C. Maule eds. 1971).

[3] *See* Gray Report, *supra* note 1.

[4] Wright, Foreign Enterprise in Mexico: Law and Policies, (1971).

[5] *See* Gray Report, *supra* note 1.

mon borders with the United States, the home of most of the multinational corporations, the Canadian and Mexican experiences are especially useful in analyzing screening techniques applicable in a variety of national economic settings.

This article will examine the legislation of these two countries to determine the features which are most effective in achieving effective screening, the threshold regulation of foreign investment. This analysis of the appropriateness and effectiveness of certain screening techniques will proceed from the perspective of a host country. By looking at foreign investors from this point of view, we must then distinguish between foreigners seeking to organize businesses in host countries *via* long- and short-term contracts for the importation of goods and services as opposed to those wishing to make a direct foreign investment and establish a local corporation to operate the production and distribution of the goods and services they have to offer. This distinction is crucial in determining what type of screening techniques should be adopted by host country governments.[6]

For example, a multinational establishing a branch sales office may not be subject to the same rules as an incorporated entity with direct foreign capital investment. Obviously the sales branch does not require formal incorporation under the local law, and foreigners may well be permitted to make sales or purchases in the country without fulfilling any formalities. In other words, the screening device will distinguish between those activities which any individual or corporation could freely undertake within the country and those which would require special or general approval. Even if the host country has a policy against foreign participation in certain sectors of the economy, such prohibitions may not apply with equal force to branches and wholly or partially-owned subsidiary corporations. However a standard requirement that all foreign entities must register in order to do business in the host country should be included in the law of the host country relating

[6] *See* Wright, *supra* note 4, 210.

to direct foreign investment. For example, the Ministry of Foreign Relations of Mexico reached both foreign investors and businessmen by requiring permits for the incorporation of any branch or local company whatever its nature or purpose.[7]

The mechanisms for review of foreign entry into Canada have resulted from governmental alarm at domination of the Canadian economy by foreign interests. The reasons leading Canada to introduce a review process could well be applied to other host countries even though they are not experiencing the same degree of foreign presence or predominance: first, that foreign investment has a role to play in future economic development where it contributes to realizing national industrial objectives; second, that special measures to deal with certain problems will be required no matter how rosy the picture in the future; third, that costs and benefits of foreign direct investment vary from industry-to-industry and from case-to-case, thereby requiring flexibility rather than fixed rules;[8] fourth, that good performance is more important than local ownership and control of a firm.[9] The Canadian Review Agency has not yet acquired other functions which might give it the kind of autonomy which has been achieved over years by its Mexican counterpart. Autonomy in the Mexican agency was emphasized in 1967 when the Mexican government decided to refer all foreign applications to incorporate to the Ministry of Industry and Commerce. As a result, applications to estab-

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[7] Wright, H.K., *supra* note 4, 104, citing the Law on Economic Powers of 1950, as amended by decree of Feb. 10, 1959.

[8] Flexibility is crucial to effective screening. Wright has emphasized the fact that Mexico has relatively few flat statutory prohibitions against foreign participation in particular industries. Wright states:

> The policy of the government (of Mexico) though not codified in a law, that most private foreign capital should take a minority interest in association with Mexican capital is becoming increasingly firm and is enforced by other but equally effective means. Because of the *flexibility* thus afforded and the effectiveness of enforcement of government policy in the absence of a general statute it seems highly unlikely that any serious attempt will be made to enact a law on the subject within the foreseeable future.

Wright, *Foreign Enterprise in Mexico: Law and Policies*, pp. 95-96 (1971).

[9] Gray Report, *supra* note 1, 451.

lish new Mexican businesses are being examined on a case-by-case basis, with the result that the proportion of foreign ownership is able to be restricted in more and more industries.[10]

It is interesting in this regard to compare the administrative screening process in Canada. There, the Canadian Review Agency registers foreign takeovers, foreign acquisition of existing Canadian companies, as well as screens foreign investment projects, including licensing arrangements involving foreign partners. Moreover, the agency assumes a general advisory role on behalf of the Canadian government by gathering pertinent economic and statistical data and carrying out investigations. Without arguing the obvious benefits of a well-administered flexible review process, screening legislation must spell out the guidelines to be followed. For example, the procedure should include information on the nature of the product line and the extent of rationalization in the corporation organization. Since this would be most relevant to determining its joint venture tolerance, such information could save the unpleasantness of applying more stringent controls to a recalcitrant foreigner.

Another factor to be taken into account is the relationship of the local subsidiary to the parent and its international affiliates, including managerial lines of reporting from subsidiary to parent. This is a clear recognition of the dual character of the foreign direct investor, an essential characteristic of multinational enterprise so often overlooked by government policy-makers. Other factors are: the technology to be employed and how it compares with technology available locally; the foreigner's plans for product innovation in the host country since the attitude of the investor on these matters is crucial in determining his commitment to local production and local research and development. Other factors which will serve as a basis for accepting or rejecting foreign applicants are the corporation's export plans and the extent to which the local subsidiary is to be excluded from certain export markets, either because of the

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[10] Wright, *supra* note 4, 110-111.

parent's global marketing strategy or because of laws and regulations of the parent's home government.[11] Local content rules, *that is*, requiring the use of local materials, equipment, components and services as well as the hiring of local managers and employees will need to be determined.

Perhaps the most significant factor is the financing of the enterprise and the opportunity for local equity participation. Government review agencies should also be aware of the possibility that firms organized by foreign investors will experience growth through borrowing and reinvestment of profits from local sales. This may however simply result in an increase in the value of foreign-owned equity without any benefit to the host country. Those industries which produce raw materials by exploiting local natural resources should be screened with respect to their plans for local processing of these resources. In Canada the agency would also investigate the economic contribution which foreign investors would make as well as their competitive impact on local industry.

The application of these guidelines suggests considerable variation in the treatment of foreign investment, depending on the case. If it fell below a certain threshold of economic significance, the *de minimis* principle might allow any type of foreign investment. The local government might negotiate terms of entry which would insure that more of the enterprise's local operations could be based locally, thereby rationalizing overall production in favor of local economies of scale and export potential. In cases where there is little distinction that the foreigner offers or can offer in the future, the terms may be limited to operating under a licensing arrangement with local

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[11] *See*, Hardari, The Structure of the Private Multinational Enterprise, 71 MICH. L. REV. 729, 749 (1973), there it is noted with respect to a multinational's presumption of direct control of its subsidiaries that:

> one of the major problems faced by the developing MNE is the necessity of allocating control over foreign operations. In general terms, MNE's tend to centralize control of basic strategies in order to operate in the most efficient manner and to exploit operations on a worldwide basis; such coordination is vital because of their multiple affiliates' operations in potentially overlapping markets.

See also Barnes, *Multilaw*, 23 AM. U. L. REV. 313 (1973).

producers or at most, a joint venture with a local firm. Where the review process turned up a would-be-foreign investment that could be downright detrimental to local interests in accordance with the guidelines, the entry would be blocked. As the Gray Report notes in its discussion of the rejection of a proposed foreign direct investment "it is more likely to occur in the case of takeovers, particularly in the resource industries where the foreign countries may contribute very little."[12]

Improved local capabilities will obviously improve the bargaining power of the review agency but there is still the problem of what to do when a foreign investor loses his attractiveness over the years and local aspirants would like to see him out. This need for some form of a nationalization policy is reflected in the first instance by a policy reserving certain industries for local firms. Where the government finds that local ownership is important or even essential to the national interest and policy objectives, then the screening process gives way to a fixed rule that certain sectors could only be developed by locally controlled firms. The review process is not designed or operated to protect local enterprise, although the Gray Report suggests that this element of protection could be added without great difficulty. The legislation in both Canada and Mexico now requires registration with the review agency of the following: (1) acquisition of majority interest in local firms by foreign interests, so-called "takeover"; (2) foreign companies making direct investment for the first time; (3) new licensing or franchise contracts; (4) existing foreign controlled companies.

Whether these host countries should also extend their control over locally-based multinational concerns which might go on to make investments abroad would depend on the balance of payments, employment, and other effects which such overseas activity might cause. (Hosts can become homes as readily as homes become hosts.) The benefits of local ownership and control may be reduced by expansion beyond the borders. There will usually be more than one agency involved in the review

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[12] Gray Report, *supra* note 1, 459.

process as has been the situation in Mexico, and will become inevitable in Canada. Acquisitions of a local firm by a foreigner would have to meet the general merger provisions and the rules applying to foreign takeovers.

The Gray Report points out that this cannot be avoided without removing all consideration of foreign mergers from competition policy and all takeovers from the jurisdiction of the review agency.

> "For example, if the review agency blocked the takeover of a Canadian firm because the foreigner would not add anything of significance to its operations in terms of technology, managerial efficiency, markets, etc., there would be nothing to stop the particular foreign direct investor from setting up a company in Canada and perhaps managing to drive the Canadian out of business." [13]

Under any review procedure, certain investments will be discouraged and the way opened to foreigners to resort to licensing, joint ventures, and management contracts, which may not be subject to review. Since export restrictions, foreign procurement and exorbitant fees can be imposed on local business by foreigners through these techniques, it behooves the watchful host to check on them as well. In fact, they may be used to exercise effective control over a local licensee or even a local majority participant. Of the four major subjects of regulation which need to be studied carefully by the review agency, the most difficult is the existing firm which has outlived the usefulness of its foreign connections.[14] The review mechanism can promote good corporate citizenship by looking at those existing foreign-controlled firms which benefit from public assistance with a view to obtaining better performance from them. Since existing foreign-controlled firms are the source of much of the growth of foreign control over the local economy, it is especially important to review major new investments by the old time foreign firms. There are cogent arguments against screening

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[13] Gray Report, *op. cit.* p. 465.

[14] *See* Neil, P., "Some Restrictions on Overseas Investment in New Zealand," 1 Auckland L. R. 53, 58 (1967).

such investments, especially if foreign controlled firms enlist the support of their home governments against the substitution of administrative judgment for the working of the marketplace. These arguments have often dissuaded host governments from taking any action against existing foreign-controlled business except where planned expansion is drawing heavily on local capital markets. In considering the detrimental results to the local economy which arise from limited review authority such as use of its internal resources or moving funds through transfer pricing techniques to avoid the review mechanism, one concludes that the review agency should have the authority to screen all the activities of existing foreign-controlled firms whether making major new investments or not.

All host states are justified in subjecting foreign-controlled firms to administrative intervention for the following reasons:

(1) Local firms benefit the local economy or else their performance is, or can be, set straight by domestic policies, whereas the benefits from foreign firms largely accrue to interests outside the host country. Therefore local policy may legitimately redress the balance so as to maximize the benefits that accrue locally.

(2) Local firms are not subject to foreign private influences as are foreign-controlled firms and are more likely to respond to local needs without special rules.

(3) Local firms are not as likely to frustrate local policy as are foreign multinational enterprises, able to go elsewhere.

(4) Foreign law and foreign public policy may use foreign investment as a vehicle for extraterritorial application.

(5) Host government review of foreign-controlled firms normally involves a relatively small part of the parent corporation's global operations.

The close connection between trade and investment policies is clear. The government might block foreign investment in key sectors where it sought to encourage local enterprise, yet reduce tariff and trade barriers so as to allow competitive pressures from abroad on the otherwise protected local industry.

As the Gray Report concludes in its final paragraph, all policies — trade, investment and other economic measures — can be used to carry out the national strategy of industrial development.[15]

[15] *See* The Gray Report, *supra* note 1, 443.