

REVIEW OF SAMUEL WEX, INSTEAD OF FIRA - AUTONOMY FOR CANADIAN SUBSIDIARIES?"*

From one perspective, this study has been overtaken by events. In December of course, Bill C-15, the Investment Canada Act, was introduced in Parliament. Industry Minister Sinclair Stevens indicated that a new agency would replace the Foreign Investment Review Agency, that entirely new investment would cease to be screened, and that even takeovers would be subject to screening only if the company absorbed had assets of \$5-million or more. The Government is unlikely to adopt any basic changes in policy at this stage.

From another perspective, however, some of the proposals made by Mr. Wex may be thought timely. The Bill to replace FIRA would leave the screening of foreign takeovers above the \$5-million threshold open to many of the criticisms that have been directed against the existing regime. The new test of "net benefit" remains vague and difficult to measure. Government officials are unlikely to be very good at judging the potential of the firms involved, and therefore are unlikely to bargain effectively. The process is essentially arbitrary because reasons will not be given for decisions - even if guidelines may be published - and therefore precedents cannot be relied upon. The system will remain politicized since there is no appeal from a decision by the Minister. It will likely be impractical to remedy breaches of undertakings - to increase employment for example, or to improve Canada's ability to compete in world markets, etc. Limits on disclosure will make it impossible to evaluate the performance of the whole screening process and thus will preclude accountability.

A significant attribute of the option offered by Mr. Wex is that it would allow for the phasing-in of a different approach, and for the phasing-out of the screening process. For this reason, some parts of his proposal may eventually appeal to the Government.

The author does not deal at length with the criticisms which have been levelled against FIRA. His principal complaint is that apart from the vagueness of the rules and their associated costs, the FIRA process does not address the real problem - that control in fact resides with a foreign decision-maker. He argues that a focus on the autonomy of the subsidiary would avoid the need for negotiation of detailed undertakings.

Mr. Wex believes that the competitiveness of Canadian manufacturing has been slipping. One reason for this, he thinks, is that foreign subsidiaries often lack the entrepreneurial spirit that breeds innovation and success in international competition. He believes this spirit can flourish only if a subsidiary has sufficient autonomy. Many readers will find this argument plausible, but will not necessarily be convinced by the evidence cited. He acknowledges that absolute freedom for foreign-controlled subsidiaries is

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unlikely, but suggests a number of things that can be done to enlarge the decision-making authority of such firms.

Mr. Wex distinguishes four kinds of foreign parent/Canadian subsidiary relationships: 1) where the subsidiary is a "miniature replica" of the parent; 2) where product "rationalization" has been undertaken, so the subsidiary concentrates on higher-volume production of a limited range of products; 3) where the subsidiary is given a world product-mandate; and 4) where the subsidiary is autonomous in the sense that it shares in all key decisions: about territory to be served, about product renewal (including R&D), and about capital expenditures. The objective of Mr. Wex' proposals is to upgrade as many foreign subsidiaries as possible, moving from 1) to 4).

The full presentation by Mr. Wex of his scheme is somewhat convoluted. However, the following represents the core of his proposal:

1. Canadian law should follow European precedents and recognize an autonomous subsidiary interest. The law should develop the concept that a parent can abuse its right to participate in the decision-making process of a subsidiary, by failing to protect the separate interests of that subsidiary.
2. As a transitional measure, the screening process of FIRA should be retained but with the test redefined. The foreign investor, instead of focussing on specific performance-related guarantees, would give undertakings about the degree of autonomy allowed its subsidiary.
3. All general laws touching upon intra-enterprise activities, including notably company, tax, bankruptcy, labour and anti-combines laws should be reviewed over a period of time to ascertain what approach would encourage increased subsidiary autonomy.
4. Rules of the game should be enunciated as voluntary and non-binding guidelines. These would vary according to sector and other circumstances. Mr. Wex anticipates, however, that such guidelines would provide useful direction at an enforcement stage to any tribunal charged with determining whether a subsidiary's autonomous interests had been abused by a parent company.

Accordingly, company law would be changed to provide: 1) greater disclosure of information, 2) protection for the subsidiary against disadvantageous instructions from the parent, and 3) a reformed role for directors. Greater disclosure, Mr. Wex believes, should involve appropriate reports on an annual basis about the assets, liabilities and financial position of the global parent and of its Canadian subsidiary, and of intra-enterprise activities. A good case can be made that more disclosure by all Canadian companies would be in the public interest, and that broadening the requirement would make Mr. Wex's proposal more palatable to foreign investors.

Subsidiaries in Belgium, France, Germany, Norway and Switzerland apparently, are entitled to protection against disadvantageous instructions from their parent companies that might affect the capital base and viability of the subsidiary as an independent concern. Mr. Wex believes that such provisions could equally be adopted in Canada.

As for the responsibility of directors, Mr. Wex would like to see Canadian law amended to reject the idea that directors of a wholly-owned subsidiary are excused from responsibility where the parent signs a unanimous shareholders agreement. He argues that once a subsidiary is recognized as having an autonomous interest, the potential for conflict of interest between the subsidiary and the parent is the same, whether the subsidiary is wholly-owned or partially-owned. Following in part the Royal Commission on Corporate Concentration, Mr. Wex argues that the law should provide for a large number of outside directors to protect the autonomous interests of the subsidiary, that an audit committee with a majority of outside directors should oversee any matter involving parent/subsidiary intercourse, and that there should be disclosure in annual reports filed with a monitoring agency of the audit committee's investigations. The non-binding guidelines referred to above, he thinks, should provide suitable guidance to directors in cases of disadvantageous instructions.

As to tax law, Mr. Wex rather more diffidently proposes a tax incentives program that would entitle any business unit, whose fully-autonomous subsidiary status was recognized, to a reduced tax rate. Thus, where the full range of activities from R&D to marketing are housed within a Canadian firm, whether foreign-owned or not, that business unit might be entitled to preferential tax treatment. As an alternative, Mr. Wex suggests that a unitary tax system might be imposed in Canada in those cases where analysis of its functions demonstrates that a Canadian subsidiary is not an independent business unit. (Under the unitary tax system adopted by various American states, a subsidiary can be taxed on the basis of the share of the worldwide activities of the firm that takes place within the state, irrespective of the profit earned in that state). Mr. Wex acknowledges that more data may be needed on this proposal to determine its feasibility.

The author makes no specific recommendations about how laws relating to bankruptcy or labour might be amended in order to promote an autonomous subsidiary interest. He does, however, make reference to certain European experience where the parent and subsidiary have been held jointly liable for payments to creditors, or terminal payments to employees, arising out of decisions imposed on the subsidiary by the parent.

With reference to competition policy, Mr. Wex believes that sections 31.5 (on foreign judgments) and 31.6 (on foreign laws and directives) of the Combines Act already provide a precedent for the proposition that the right of the foreign parent to give instructions to its Canadian subsidiary is not absolute. In recognition of an autonomous subsidiary interest, he believes that

competition policy should concern itself with barriers that deny to the subsidiary the opportunity to innovate or otherwise to improve its economic conditions.

Mr. Wex would widen Section 31.6 to protect a foreign-controlled subsidiary against any disadvantageous instructions, subject to a rule of reason. He would do this by incorporating the test in Section 31.5 which deals with adverse effects on efficiency and on foreign trade as well as adverse effects on competition.

The author would also revive the proposal made in former Bill C-42 of 1977 to amend the Combines Act, that was intended to block instructions from parent companies to their subsidiaries limiting exports or imports, where the purpose of the parental restriction was to protect price levels in Canada, or to protect the price level in a market outside Canada from the influence of lower-priced exports from Canada.

In addition, where there is a foreign take-over of an existing Canadian business, Mr. Wex would ensure that the autonomous interest of the newly acquired manufacturing firm was protected. He would do this by adding to the competition/efficiency test for mergers proposed in the 1977 Bill to amend the Combines Act, a reference both to international competitiveness and to the opportunity to make innovations.

As for enforcement, a specialized tribunal like the Competition Board in the 1977 Bill, would hear all cases involving an alleged infringement of a particular subsidiary's autonomous interest. Specific laws would be amended to provide support for autonomous subsidiaries. The Combines Act, for example, as indicated above, would be expected to provide sanctions against directives that adversely affect Canada's foreign trade without offering some compensating advantage.

The major problem with his approach, as Mr. Wex recognizes, is that an MNE normally minimizes the cost of doing business, by virtue of the common control exercised over all its activities. The common control allows the MNE to allocate resources and tasks to the subsidiaries, and to minimize transaction costs. (The sale of components by the parent company to the subsidiary, for example, does not require lengthy negotiations.) Where control is shared with the subsidiary, transaction costs may increase and the efficiency of the MNE decline. The extent to which host-state rules can impose such transaction costs without discouraging investment, is limited. Inefficiency may arise in other ways. It is quite unlikely that the MNE would invest in or transfer know-how to a foreign subsidiary that competed directly with it, perhaps causing both to lose money in particular markets. At the more human level, it is easy to see how quickly the career possibilities of Canadian management in a subsidiary, could come into conflict with a too-vigorous assertion of autonomy.

The problem with Mr. Wex's scheme is compounded by the fact that it would apply to existing foreign investment and not just to takeovers. Much would be made of the retroactive aspect of any legislation.

The other side of the coin is that the MNE has many options - it is not limited to a choice between producing in Canada and producing at home. Mr. Wex acknowledges that competing carrots abound. He recognizes that MNEs need an incentive to prefer a Canadian base over some other base, whether this takes the form of natural resource endowment, an educated and industrious work force, investment incentives, compliant unions, lower taxes, etc. As tariff barriers fall, of course, one of the most obvious options open to the MNE is to serve more foreign markets from its home base.

In sum, although a number of the specific recommendations made by Mr. Wex have merit, and could be implemented separately, the program as a whole would almost certainly drive away substantial foreign investment.

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