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CANADIAN MINORITY EQUITY PARTICIPATION
IN FOREIGN CONTROLLED SUBSIDIARIES
WORKING PAPER NUMBER 1990-I
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Canadian Minority Equity Participation in Foreign Controlled Subsidiaries was researched and written by Zulfi Sadeque, of the Investment Research Division of Investment Canada. This paper is being circulated for discussion purposes only, and the views expressed in the paper reflect those of the author and not necessarily those of Investment Canada or the federal government.

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EXECUTIVE SUMMARY

* The report deals with the various issues related to the question of Canadian minority equity participation in foreign-controlled subsidiaries. In particular, the reasons why a foreign-controlled subsidiary may, or may not, wish to make public or private offerings of equity to Canadians is explored in depth.

  Among the factors behind a foreign company's decision to have Canadian shareholders are the benefits to the company of the enhanced market awareness of the company, and of its products, that such equity participation could create; the benefits from establishing a market value for possible merger and acquisition activities; access to competitive sources of financing; the positive impact of such equity participation on the company's earnings per share, etc.

* In general, a foreign-controlled company's decision to operate in Canada will be driven by considerations of the Canadian market's size and growth potential, the market shares for the company's products, and the relative competitive strengths of the Canadian economy. Whether a company opts for Canadian minority equity participation will hinge on the relative advantages and disadvantages to the company of floating equity here. The parent's corporate philosophy will also be an important determinant of the subsidiary's status.

* The benefits to Canada of having Canadian minority shareholders in foreign-controlled companies include the dilution of the adverse effects of "truncation" (the lack of autonomy for subsidiaries to make their own policy decisions, independent of the parent); improving the portfolio choices for Canadian investors, both individual and institutional, affording them the opportunity to share in profits; and, raising the level of awareness and appreciation of Canada's interests and long-term socio-economic goals among these subsidiaries.

* In terms of costs, Canadian shareholders might end up contributing to the transfer payments and management fees that parents will extract from their Canadian subsidiaries. Moreover, the equity capital going to these foreign-controlled subsidiaries might be seen as funds that would have otherwise gone to Canadian companies. The rationale behind these perceived costs are not overwhelmingly convincing since these subsidiaries will, in all probability, have made payments to their parents irrespective of whether or not they had Canadian shareholders; similarly, Canadian investments that have difficulties attracting capital are typically the "juniors", implying that equity capital going to foreign subsidiaries were not likely to have displaced any potential investment in a Canadian concern.

* There does not appear to be a clear cut case for public policy in ensuring Canadian minority equity positions in these subsidiaries. The sensitive sectors (oil & gas, uranium, cultural industries) are generally protected from foreign control anyway. In the aftermath of the Free Trade Agreement (particularly, section 1602 of the Agreement), US companies will be exempted from the requirement of Canadian equity participation. If, as a result of the ongoing negotiations in the GATT (particularly, those on TRIMs), such exemptions are extended to non-US companies as well, the whole

question might become academic. In any case, in the current global atmosphere of deregulation and freer trade and investment, any equity participation might be viewed as infringing on the ability of corporations to remain flexible, and thus adversely affect the inflow of foreign capital for investment in Canada.

* Finally, the related issue of minority shareholders' rights, in the context of recent developments in mergers and acquisitions, particularly in the area of defense against hostile takeovers, are discussed at length in the report. The need for some sort of policy action, designed to protect the rights of minority shareholders, is analyzed and conclusions are drawn.

CANADIAN MINORITY EQUITY PARTICIPATION IN FOREIGN CONTROLLED SUBSIDIARIES: AN ANALYSIS OF THE ISSUES.

Introduction:

The Foreign Investment Review Act stipulated that in reviewing applications for foreign acquisitions or, new businesses, a relevant criterion should be "... the degree and significance of participation by Canadians in the business and in the industry of which the business would form a part."[1] The Gray Report[2] also asserted that given the extent of foreign ownership of Canadian businesses, and particularly to counter the problem of "truncation"[3], increased Canadian equity participation in foreign controlled subsidiaries was desirable. Subsequently, the Principles for International Business Conduct for foreign subsidiaries operating in Canada urged foreign-controlled firms to "create a financial structure that provides opportunity for substantial equity participation in the Canadian enterprise by the Canadian public."[4]

The policy ramifications of encouraging Canadian equity participation in foreign-controlled subsidiaries have to be viewed against the fact that roughly 60 per cent of the the Canadian manufacturing sector's output comes from these subsidiaries.[5] The question is whether maintaining a public float in Canada contributes to these subsidiaries becoming less of a "tariff factory", and helps them to adapt to changing circumstances by increasing the scales of their operations through specialization, strategic diversification, and world product mandates.

Commitments to this Agency -- since the early days of FIRA -- involving Canadian participation, took two main forms:

(a) making equity shares available to Canadians, including the maintenance of certain levels of Canadian shareholdings; and

(b) participations by Canadians in the direction and management of the Canadian business enterprise.

Our study revealed that the means used to sell shares to Canadians varied according to the circumstances that the company in question found itself in. Some investors undertook to make

1 Investment Canada: "Canadian Participation", Mimeo. p.1.

2 Foreign Direct Investment in Canada", known commonly as the Gray Report.

3 Defined as the lack of autonomy for subsidiaries to pursue policies on its own that would allow it to develop independently of the parent.

4 New Principles for International Business Conduct, Department of Industry, Trade and Commerce, July 18, 1975. These principles replaced the earlier "SomeGuiding Principles of Good Corporate Behavior for Subsidiaries in Canada of Foreign Companies", introduced on March 31, 1966.

5 MacCharles, Donald C. "Do Foreign-Controlled Subsidiaries Have a Future?", Canadian Business Review, Spring 1984. p. 21.

public offerings of shares while others sought to identify local partners privately. Under FIRA, typically, an investor whose shares were already listed, could undertake to sell x number of shares, or a certain percentage of its equity holding, within a stipulated number of years, provided the price per share for a certain number of months prior to such a sale had a daily closing value on the TSE (or, any of the other Canadian exchanges) above a certain amount, or that the shares could be sold above a certain price-to-earnings ratio. Alternately, an investor could undertake to make available to the Canadian public a certain percentage of its shares subject to "suitable" economic conditions, to a "satisfactory" earnings record, and to an affirmative opinion from two of the seven largest Canadian underwriters on the feasibility of the offering. Other methods included the sale of stock or the provision of stock options to management or other employees, issuance of quasi-equity securities such as convertible debentures or debt with warrants attached

In cases where the commitment to offer equity participation to Canadians was not feasible at that particular juncture, foreign investors were asked to commit themselves to the undertaking of a study by a Canadian underwriting house regarding the feasibility of issuing shares to Canadians, to submit such a report to this Agency, and to act upon its recommendations. It was also made clear to the foreign investors that if such studies were undertaken, the companies were expected to carry out the recommendations.[6] Appendix A describes the various forms of equity participation that Canadians had the recourse to, as well as, a copy of a specimen undertaking.

This report is aimed at analyzing the various issues that are relevant to this question and attempts to identify the principal costs and benefits associated with a policy of encouraging minority equity holdings by Canadians in the subsidiaries. In discussing minority equity holdings in foreign controlled subsidiaries, we do not make the distinction between stocks purchased by individual or institutional investors through the stock market and those that were purchased by the employees of these companies through their respective stock purchase plans. It should also be noted at the very outset that the question might not have much relevance for future policy actions since Article 1602 of the Canada-United States Free Trade Agreement (FTA) prohibits Canada from requiring minority equity participation in a Canadian business by a U.S. investor, although certain "niche" sectors such as oil and gas, uranium, and cultural industries have been exempted from that provision. It is also likely that having agreed to this provision for the largest foreign investors in Canada, similar concessions may eventually be made to other countries so that no discrimination is practiced against third country investors. Similarly, given the worldwide trend towards encouraging a less-regulated environment, Canadian subsidiaries of foreign controlled companies may not particularly care for equity participation by Canadians.

Having made the caveat above, the study is presented in the following manner. Section I reviews the broad question of why Canadian subsidiaries of foreign controlled companies may opt to go public. In section II, the major benefits and costs of encouraging minority equity participation are discussed. The company-specific rationale for why companies may or may not wish to have local shareholders is discussed in section III while the question of who owns these minority stocks -- institutional investors or individuals -- is examined with respect to the largest subsidiaries with Canadian minority equity participation in section IV. The public policy aspect of minority equity participation and Canada's experience in this context is covered in section V. Section VI deals with the increasingly topical, and somewhat contentious issue of minority shareholders rights in Canada, with a few cases being highlighted. The note concludes with some observations.

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6 "Canadian Participation", ibid. p. 8

Section I: Why Canadian Subsidiaries of Foreign Controlled Companies Go Public.[7]

The reasons why a Canadian subsidiary of a foreign-controlled company may make a public offering of its equity in Canada are varied and would depend on specific circumstances of the industry, the issue's stage of development, the company's product life cycle, and its plans for expansion in Canada, size, financial condition, and need for capital. A comprehensive list of these reasons are presented below:

1. The subsidiary may be at an earlier stage of development than the foreign parent. It may therefore be on a steeper earnings growth curve than the parent, for which investors may be willing to pay a higher premium.

2. The sub may be involved in a narrower line of business than the parent. Depending on the stage of the sub in the business cycle, investors may be willing to pay a higher premium on the shares of the sub if its narrower line is perceived to have greater growth potential than the parent's diversified operations.

3. In some areas, the degree of competition is less intense in Canada than in the parent's domestic market, implying relatively easier market penetration and higher earnings potential in Canada. Depending on the product life cycle, the sub's stocks may thus be a more attractive acquisition than the parent's stocks.

4. In cases where the parent has a lower rate of return on equity than the Canadian sub, a higher relative market capitalization could then be achievable by the sub.

5. Raising capital in Canada to finance local expansion may be preferable to joint financing, venture financing or retention of 100 per cent ownership, since the latter may result in the overstretching of resources or undercapitalization.

6. Offering equity to the Canadian public could be a good public relations exercise, in that it would diffuse the perception of the sub as a branch plant operation. This would facilitate the marketing of the company's products, as well as raise the company profile and its public awareness.

7. By becoming a partly Canadian-owned company, the sub may put itself on an equal footing with other Canadian companies as far as bidding on federal, provincial, and municipal government contracts.

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7 This section is taken heavily from an earlier study done by Nesbitt Thompson entitled "Canadian Subsidiaries of Foreign Companies Going Public in Canada".

8. Bankers generally regard listed shares as better collateral for a bank loan than unlisted shares. This is because in the event of a default, the securities can be sold relatively more easily. If the market places a premium on the equity in excess of the book value, a lender may feel that the firm is entitled to more credit than would otherwise be the case.

9. A listing encourages a wide shareholder base. This will have the effect of increasing the price stability of the stock which may facilitate further equity financing.

10. Listing helps in establishing a visible value for a company's stock in mergers and acquisitions and thus facilitate such negotiations.

11. A listed common stock can ease subsequent financings using convertible debt or preferred shares or using warrants, thereby broadening the company's financial flexibility and possibly lowering its cost of capital.

12. It is generally accepted that stock options and stock purchase plans help to attract top rate personnel to a firm. A current public quote and a ready market adds to the value of these plans. In this context, it can be argued that the attraction of stock purchase plans are enhanced when based on equity of a Canadian subsidiary since they would be linked to the performance of the subsidiary to which the employee is directly contributing rather than being based on the performance of the parent company.

13. With the coming into being of FIRA, it may have been felt that Canadian subsidiaries with some public ownership in this country would be treated more favorably than wholly-owned ones. This may have affected the decision of foreign-controlled companies to go public since FIRA was known to encourage a commitment to some Canadian ownership. In practice, however, there is little to suggest that such was the case.

14. In a similar vein, the Principles of International Business Conduct, issued by the federal government, recommended that foreign-controlled enterprises should create a financial structure which provided opportunity for substantial equity participation by the Canadian public in these enterprises. This may also have induced foreign-controlled companies to go public in Canada.

15. The Canadian market may, at times, have been perceived as more receptive to a particular issue and was thus considered to be the preferred route for raising equity capital. At times too, the Canadian market may have placed a higher valuation on future earnings growth. This would be reflected in the differential between price/earnings ratios between the TSE on the one hand, and the Dow Jones Industrial Average or the S&P 500. Such differentials would also induce foreign subsidiaries to go public in Canada.

16. A strong factor behind the decisions of foreign-controlled companies to issue equity to Canadians was tax incentives. For instance, the Income Tax Act has a provision relating to companies with a degree of Canadian ownership (minimum 25 percent) for which the withholding tax rate was reduced. This provision induced a number of foreign companies, e.g. Union Carbide, to issue shares to Canadians.

    Tax-related advantages may also have played a part in this process. For example, a wholly-owned subsidiary was treated as a private company, requiring it to pay federal income tax equal to 25% on any dividends it received from other Canadian taxable corporations in which it owned less than 10%. This tax was refundable if the subsidiary paid out an equivalent dividend to its parent. Where the subsidiary had portfolio investments in dividend-paying common or preferred equity of Canadian taxable corporations, and where the subsidiary was not paying any dividends to its parent, this tax was not refunded. The parent did not get any offsetting tax credit for the tax paid by its subsidiary. Since public corporations were exempt from this taxation, going public was deemed attractive from the tax point of view.

17. Canadian listed shares were eligible investments for Canadian tax deferral schemes such as RRSPs but the common shares of the foreign parent were not.

18. Most Canadian listed shares were eligible investments for Canadian institutional investors without recourse to the so-called "basket clause" while foreign shares were not. Moreover, institutional investors tend to prefer large blocks of shares that are listed because of the liquidity that these stocks enjoy. To attract these institutional investors, foreign-controlled companies would go public in Canada.

Section II: Rationale for Minority Equity Participation, its Benefits and Costs.

A commonly-used argument in favor of minority equity participation is that it is a good thing for Canada in almost the same way as a "merit good" is -- i.e. one that is desirable because it not only increases an individual's welfare, but also the welfare of the population as a whole (e.g. education and health obviously increases an individual's well-being, but they also contribute towards a more productive citizenry). In this vein, it is argued that there are positive externalities associated with this form of equity holdings since Canadian equity participation is presumed to make foreign controlled corporations take more cognizance of our national interests.

II.1. Benefits: Reduces the Adverse Effects of Foreign Ownership.

This would thus help to reduce the adverse effects of foreign ownership. The line of reasoning is as follows: companies seek to maximize the profits of the enterprise as a whole, not that of any particular subsidiary. For a multinational company operating in various countries, the pursuit of this profit-maximizing goal may contribute little to the furtherance of objectives considered important by the host country. This can lead to the problem of "truncation", defined as the lack of autonomy for a subsidiary to determine its own future, to follow policies and practices that could promote it as a viable enterprise, independent of the parent. The establishment of "truncated" subsidiary operations undermines the development of a full range of activities normally associated with a mature business enterprise, including the generation and marketing of in-house technology.

The presence of Canadian shareholders and directors in a subsidiary is thought to improve foreign investors' understanding of Canadian goals and objectives, promoting the two-way flow of communications between it and the parent. It will also alleviate the adverse effects of "truncation", although obviously not eliminating it altogether. One positive way this could benefit Canada is through greater reinvestment and higher sourcing in this country, thus expanding the economic benefits of the company's presence here.

II.2. Benefits: Access to "Blue-Chip" Stocks.

A major benefit associated with such equity holdings by Canadians is the access it gives Canadians, in particular, institutional investors, to industries that might otherwise be not available. For example, when a number of well-publicized buy-out of minority shareholders in Canadian subsidiaries of foreign-controlled companies took place in 1988 (e.g. Nabisco Canada, ICI-CIL, etc.), representatives of institutional investors complained that the increasing trend towards "privatization" of these subsidiaries deprives these investors of "blue chip" stocks, forcing them to go to other, cyclically-vulnerable stocks. Since institutional investors are required to have no more than 10 per cent of their portfolios in foreign assets, the absence of sufficient high-quality, liquid stocks like those offered by the subsidiaries of well-known multinationals, severely restricts their effective portfolio choice.

II.3. Benefits: Share in Profits and Economic Rent.

Similarly, since most foreign-controlled companies tend to be profitable, Canadian equity participation will assure us of a share of the profits. Since economic rents are associated with the exploitation of natural resources, a case can be made that the presence of Canadian shareholders will result in some of this rent staying in Canada. Economic rent, in this context, represent a return to the owner of a resource in excess of the minimum rate of return the owner requires, and are generated when the market price of a commodity increases for reasons unrelated to its cost of production. This is particularly relevant because our resources sector tends to have a very high proportion of foreign ownership relative to other sectors. For example, according to the latest CALURA data, the share of foreign controlled assets in mining was over 32 per cent in 1985, that in mineral fuels was 38 per cent, and in petroleum and coals 42 per cent.[8] The Petroleum Monitoring Agency estimated that foreign ownership of the petroleum sector in 1987 was 56.2 per cent (up from 54.9 per cent in 1986) while foreign control was as high as 62.6 per cent (compared to 59.6 per cent in 1986).[9] The financial disclosures that publicly-traded companies are required to make will help to monitor the activities of foreign controlled companies in Canada, if such monitoring is considered desirable. However, it should be borne in mind that if the dissipation of economic rent is desired, various tax measures can be effectively employed to bring that about in a way that will attack the distortion at its root.

II.4. Benefits: Having Canadian Directors Help Acquire Management Skills.

If Canadians are appointed to the boards of these companies on the strength of their share holdings, they will obtain valuable management and strategic expertise, stimulating their entrepreneurial capabilities. This will be particularly true if significant Canadian minority ownership in these companies acts to lower the degree of "truncation", and thus making for a more challenging corporate environment which will give Canadian managers and directors the opportunity to hone their management skills, while at the same time, making them knowledgeable about state-of-the-art technology and marketing techniques. This argument is however greatly weakened by the provision in the Canada Business Corporations Act that any federally incorporated company in Canada, including private corporations that are 100 per cent owned by a foreign parent, has to have a majority of its directors that are "resident Canadians" (except where a company is a holding corporation which earns in Canada directly or through its subsidiaries less than 5 per cent of the total gross revenue of the corporation and its subsidiaries).[10]

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8 Statistics Canada: Corporations and Labour Unions Returns Act, 1985. Spring 1988.

9 Petroleum Monitoring Agency:"Canadian Petroleum Industry: 1987 Monitoring Report", August 11, 1988.

10 Iacobucci, Frank, Marilyn L. Pilkington & J.R.S. Prichard: "Canadian Business Corporations", 1977. p.245.

II.5. Costs: Transfer Payments & Levies.

On the cost side, such equity participation might result in Canadian shareholders contributing to transfer payments[11] and management fees that parent companies generally extract from their subsidiaries. In some instances, e.g. Goodyear Canada Inc.'s so-called "superbonus", such costs can be substantial.[12] Goodyear Canada, owned 88.8% by Goodyear Tire & Rubber Co. of Akron, Ohio, pays a levy to its parent which can be set as high as 5 per cent of net sales. This is debatable, however, since the presence of minority shareholders does not in any way preclude such transfer payments and levies.

II.6 Costs: Deprives Other Potential Canadian Investors the Funds That These Subsidiaries Receive.

It is also argued that equity participation in foreign subsidiaries deprives Canadian firms of the funds that they might have received otherwise (the case of venture capital is specially stressed in this vein). However, in these days of global trading, Canadians can trade in the stocks of the subsidiaries as well as their parents anyway; hence, their impact is likely to be minimal. In other words, since individual shareholders can buy Ford Motor Company shares. Ford Canada shares are not likely to displace shares of Canadian-controlled companies.

Moreover, Canada does have a well-diversified domestic capital market -- one that cannot be said to lack depth or liquidity commensurate with the size of the domestic economy. Potential Canadian investments that find it hard to attract funds are, typically, the so-called "juniors" -- investments that a large number of investors would shun in any case.

II.7 Costs: Reduces the Attractiveness of Doing Business in Canada and Introduces Inefficiencies.

To the extent that such equity participations are the results of governmental requirements, they could lower Canada's attractions as a place for doing business. In general, foreign investors, particularly the large multinationals, tend to view such a requirement in a negative light. The decision to invest in Canada, for a foreign-controlled company, could thus be adversely affected by having such a requirement in place.

Similarly, if Canadian equity participation, brought about as a result of governmental intervention, is deemed to be a "negative", it could distort the investment and production decision-making processes, thus introducing significant inefficiencies. The deviations of actual investments and productions, from those attainable in an unregulated environment, would thus constitute a cost that can, in part, be attributed to the presence of the requirement of Canadian equity participation.

Both of the above points are covered in greater details in the next section.

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11 An illustration of the way transfer payments work in this context is furnished in appendix B.

12 Mark Lisac of the Edmnonton Joumal estimated that over the last ten years, Canadian subsidiaries of U.S. firms made a net remittance of $23.3 billion in business service payments (Edmonton Journal, November 20, 1988; p. F6).

Section III: The Perspective of Foreign-Controlled Companies.

Economic theory tells us that if economic efficiency for any firm is served better by having minority shareholders, the company is expected to follow that route unless, of course, non-economic considerations predominate. There is, therefore, a need to examine the case for or against minority equity participation by Canadians in foreign-controlled subsidiaries from the perspective of these companies. One needs to analyze why such a company may or may not wish to have Canadian minority shareholders. In section I, we already looked at the various reasons why a Canadian subsidiary of a foreign parent company may opt to go public. As we noted, some of these reasons are driven by long-term considerations such as enhanced market awareness, the establishment of a market value for merger and acquisition activities, improved relations with Canadian governmental authorities, etc. Then there are strictly economic considerations such as the effect on earnings per share and access to further sources of financing, etc. Hence, the question of floating shares in Canada is, at bottom, a matter of company preference. For example, Mobil and Texaco Inc. are both U.S.-based multinationals whose primary concentration is in the oil and petroleum refining sectors. Yet, while Mobil set up a wholly-owned subsidiary (Mobil Oil Canada Ltd.) in Canada, Exxon opted for a subsidiary that is publicly-traded in this country (Imperial Oil Ltd.), with about 30 per cent Canadian ownership. Similarly, while General Motors of Canada Ltd. is a wholly-owned subsidiary of General Motors, Detroit, Michigan (as it is with Chrysler Canada), Ford Motor Co. of Canada Ltd. is owned 94 per cent by its parent with the balance remaining in Canadian hands.

A foreign-controlled subsidiary faces a number of options in deciding how to finance its operations in Canada. It could:

a. Use its own retained earnings, and other financial resources at its disposal, including bank- and other financial institution borrowings in the parent's country;

b. Raise equity capital in Canada, in conjunction with (a) above; or,

c. Raise bank- and other financial institution borrowings in Canada, in conjunction with (a) and/or (b) above.

For a company to opt for raising equity capital in Canada, the cost -- both economic and non-economic have to be balanced against the costs and benefits of going with the other options. They will weigh a number of factors -- both positive and negative -- before deciding on whether or not to pursue the the option of selling shares to Canadians.

III.A. Positive Factors:

III.A.1. Employee Stock Ownership Plans:

One major reason why a company may wish to issue shares in Canada is the employee stock ownership plans that various companies have. It is generally accepted that such stock plans have the effect of attracting top quality management and professional cadres to these firms. In addition, it acts as a powerful work-incentive for its workforce. In the case of Campbell Soup, industry analysts believe that employee stock ownership plan was one of the three factors that contributed to the turnaround in the company's fortunes in recent years -- the other two factors being the granting by the parent of greater autonomy to the subsidiary, and the installing of Canadian personnel in top management.

III.A.2. Visibility of Publicly-Traded Companies:

The visibility that comes with being a publicly-traded company is often used as an argument in favor of having minority shareholders. This gives their products a greater profile in the market place and improves customer awareness. However, this type of visibility can also act to deter some companies from going that route.

III.A.3. Investment Returns on Stocks:

An economically tangible incentive such as strong performance of their stocks in Canada could induce such firms to go public here. In this context, it has been found that the stocks of Canadian subsidiaries of such major US multinationals as Texaco, DuPont, Ford and Scott Paper outperformed the stocks of their parents over the 1946 to 1986 period.

III.B. Negative Factors:

III.B.1. Public Disclosure of Financial Statements:

In early-1988, when Nabisco Canada bought out the 20 per cent of its shares that it did not already own, one major factor that knowledgeable analysts cited was the requirement of having to make public the company's financial statements -- a process that was considered cumbersome by the company. However, this aspect of having to make public disclosures of financial statements are becoming less significant since the Canada Business Corporations Act requires even private corporations, whose revenues are greater than $10 million, or whose assets exceed $5 million, to make public disclosure of its financial statements.

III.B.2. Need for Corporate Flexibility:

Given the increasing globalization of the industrialized economies, and the need to stay competitive in a rapidly-changing world, it is sometimes argued that having a wholly-owned subsidiary gives the parent company the necessary degree of flexibility to pursue the needed rationalization of its worldwide operations. As large multinational companies shift their focus from narrowly-defined specialization -- in terms of product lines and geographical locations -- to balanced diversification dictated by market shares and changing patterns of trade, flexibility in operations is deemed essential. In this environment, the need to justify rationalization measures to regulatory authorities and minority shareholders may be perceived to hamper the ability of these companies to retain the flexibility that they may feel they need.

III.B.3. Lack of Depth and Liquidity in the Canadian Capital Market.

When there was a number of well-publicised cases of share buy-backs and buy-outs in early 1988 (e.g. Nabisco, ICI-CIL, etc.), there was some speculation that it was a response, in part, to the perception of the lack of depth and liquidity in the Canadian capital market. However, our investigation of the question convinced us that such is not the case. Canada boasts a sophisticated and diversified domestic capital market where Canadian corporations, both foreign- and Canadian-controlled, can raise funds with relative ease. An historically high savings rate, and the development of institutions and mechanisms which ensure an efficient allocation of savings through the capital market, has contributed to a strong environment for bonds and equities trading.

For one thing, with the fifth largest market capitalization (US$199 billion at the end of 1987, just below the US$206 billion market in Germany), our capital market cannot be said to lack depth.[13] At 45 per cent, Canada's market capitalization-to-GDP ratio compares favorably with 16 per cent in both Germany and France, marginally below the 50 per cent prevailing in the U.S., but considerably below Japan's 102 per cent, or the U.K.'s 88 per cent.[14] With respect to the viability of a sizable public or private sale of a company in Canada, financial analysts believe that the lack of depth in the Canadian capital market.is not a major factor....Given the rapid growth in the total volume of trading on Canadian capital market for new equity issues, market analysts feel that a reasonably-priced, effectively-marketed initial public offerings of equity of senior public stocks would be eagerly received by the Canadian equity market

In sum, a foreign controlled subsidiary will consider yielding partial equity holdings in Canada if it is cost-effective for the company to do so, if it is consistent with its short- and long-term corporate goals in Canada, and if it coincides with its corporate philosophy and style of management. However, the subsidiary will also clearly take into account the potential for operational restraints that having Canadian shareholders, and the requirement of public disclosures, will entail. Most corporations value highly the need for corporate flexibility. Therefore, the usefulness of floating equity in Canada will have to outweigh the perceived loss of flexibility that might arise from being a publicly traded company in Canada.

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13 Morgan Stanley Capital International Perspective, September 1988. p.5.

14 Ibid.

Section IV. Ownership of Minority Stocks in Foreign Controlled Subsidiaries:

In this section, we selected a number of well-known foreign controlled Canadian subsidiaries and identified the owners of their minority stocks. The companies selected were from the Financial Post 500 (Summer 1988) which lists the top 50 foreign-owned companies in Canada. In the latest such list, 20 of the top 50 subsidiaries were shown to have some Canadian held equity positions, with the parent's holding ranging from 50 per cent in the case of Total Petroleum (parent: Total Petroles of France) to 98 per cent for Pratt & Whitney Canada (parent: United Technologies of the U.S.). The remaining 30 companies were, of course, 100 per cent foreign-owned. Since the publication of that list, three other companies have bought out their Canadian minority shareholders and thus become wholly-owned subsidiaries -- CIL (parent: Imperial Chemical Industries PLC, U.K.), Nabisco Brands (parent: Nabisco Brands of the U.S.), and Indal (parent RTZ PLC of the U.K.). That leaves 17 companies, in the top 50 foreign companies, that have Canadian minority shareholders. These companies are listed in Table 1 below.

Table 1

<u>Top Foreign-Owned Companies with Canadian Minority Shareholders.</u>

Company	1987 Sales ($mln)	Rank in FP 500	Foreign Ownership (%)	Parent/Country
Ford Motor of Canada	13,978	3	94	Ford Motor U.S.
Imperial Oil	7,562	7	70	Exxon U.S.
Shell Canada	4,819	16	71	Shell Netherlands/U.K.
Sears Canada U.S.	4,035	22	60	Sears, Roebuck.
Total Petroleum	2,317	45	50	Total Petroles France.
Anglo-Canadian Telephone	1,782	55	86	GTE U.S.
United Westburne	1,728	56	70	Dumez SA France.
General Electric Canada	1,689	57	92	General Electric U.S.
Rio Algom	1,533	63	53	RTZ U.K.
Suncor	1,364	76	75	Sun Co. U.S.
Du Pont Canada	1,341	77	74	E.I. du Pont de Nemours. U.S.
Cargill	1,114	96	91	Cargill U.S.
Crown Forest Industries New Zealand.	1,030	107	96	Fletcher Challenge.
Xerox Canada	997	110	79	Xerox U.S.
Pratt & Whitney Canada	987	111	98	United Technologies. U.S.
Weldwood of Canada	741	143	72	Champion International. U.S.

Table 2

Distribution of Minority Equity Holdings in Top Foreign-Controlled Subsidiaries (Percentage).

Company	Minority Equity (%)	Held by Institutional (%)	Held by Corp. Insider (%)	Held by Widely Held (%)
Ford Motor Co. of Canada	6.0			
Imperial Oil	30.0	4.0	7.0	19.0
Shell Canada	29.0	16.0	0.0	13.0
Sears Canada	40.0	N.A.	N.A.	N.A.
Texaco Canada [3]	15.0	1.8	0.2	13.0
Total Petroleum	50.0	16.2	N.A.	N.A.
Anglo-Canadian Telephone [3]	14.0			
United Westburne [3]	30.0			
General Electric Canada	8.0	N.A.	N.A.	N.A.
Rio Algom	47.0	5.6	15.7	N.A.
Suncor	25.0	25.0 (1)	0.0	0.0
Du Pont Canada	26.0	14.0 (2)	0.6	12.0
Cargill	1.0	N.A.	N.A.	N.A.
Crown Forest Industries	4.0	N.A.	N.A.	N.A.
Xerox Canada	21.0	14.0 (2)	0.6	7.0
Pratt & Whitney Canada	2.0	N.A.	N.A.	N.A.
Weldwood of Canada	15.4	N.A.	N.A.	N.A.

Source: CALURA, Various corporate databases.; N.A. - Not applicable

(1) Held by Ontario Energy Resources Limited;
(2) Held by Canadian Depository for Securities Limited;
(3) Currently privatized;

The preceeding table confirms that the institutional investors hold substantial portions of the equity of these subsidiaries held in Canada, with most of the remainder being held by small public investors.

Section V. Is There a Role for Public Policy?

As we noted earlier, the financial or economic rationale for a foreign controlled Canadian subsidiary to float equity in Canada is far from being conclusive. There are no overwhelming reasons why such a subsidiary will necessarily consider diluting its ownership to Canadian shareholders. There will obviously be cases where the particular circumstances for a company will warrant their raising equity capital in this country. It is equally likely that for other companies, it's internal and corporate dynamics may be such that as to keep the subsidiary a wholly-owned operation. That is why we find companies of similar size and area of concentration adopting different approaches to this question , e.g. Texaco and Mobil, Ford and GM. In other words, factors that are internal to the company will generally determine whether a company decides to float shares here or not.

However, as we have alluded to earlier, a policy maker ought not to be guided solely by considerations that are purely economic or financial. Most governmental interventions in the workings of the market place are justified on the grounds of correcting for "market failures" or to counter negative "externalities", and/or to foster positive "externalities". The pursuit of non-economic objectives can be deemed desirable in the context of wider public policy if the said action is perceived to better welfare for a section of the population that outweighs any loss of welfare that another section of the population may have suffered. For example, it is an article of faith in Canadian politics that substantial Canadian ownership -- in the sense of being in effective control-- of the cultural industries, and of the oil & gas and other resource industries, is an objective that is well worth pursuing.

In the area of publishing, the policy stance of the Canadian government is outlined through the so-called "Baie Comeau policy" which states that in any takeover of a Canadian-based publisher or subsidiary, either directly or indirectly through an international merger, a foreign buyer must find majority Canadian partner (or, sell to a Canadian buyer) within two years.[15] In this light, when Longmans of the U.K. required the U.S.-based text book publishing firm, Addison-Wesley, the Canadian subsidiary of Addison-Wesley underwent a management buy-out, ensuring effective control of the firm to be in Canadian hands.

Equity undertakings were sought and received in a wide range of resource industries as well.. In some cases, stocks of the foreign parent were listed in Canada as a way of ensuring equity participation in the company.[16]

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15 Canadian sensitivity in the area of publishing has to be seen in the light of the fact that as of December, 1988, only 30 per cent of the Canadian industry was controlled by Canadians, highlighting the dominance of the mainly U.S.-based firms. In Quebec, however, the situation is quite different with almost the entire French-language publishing in local hands.

As a corollary, is it therefore justifiable, to maintain or foster, the right to equity for Canadians in all foreign subsidiaries? Was it ever envisioned that all foreign subsidiaries be required to sell partial equity positions to Canadians. The answer is possibly, no. However, where such commitments were required, it was clearly understood that the company was expected to fulfill these undertakings. These undertakings were, therefore, deemed legally enforceable. During the FIRA years, the policy was selectively pursued, with the primary focus being on "cultural" and resources industries (the latter including the uranium industry). The record of the foreign investors has been somewhat mixed. For example, while commitments concerning Canadian participation occurred in a large majority of the cases, investor realization of equity commitments were not greatly successful. Very few instances can be found in which investors successfully met equity commitments while continuing to retain control. There was little relationship between the percentage of planned equity float and degree of success in achieving the issue. "The plans to issue equity were usually heavily qualified, and in many cases applied to firms too small to warrant a public issue" (ibid, p.8).

Interestingly, the study found a high degree of success in fulfilling commitments made by the investors in respect of participation by Canadians in the direction and management of these subsidiaries. This apparent success (the rate of fulfillment exceeded 90 per cent) could be traced to compliance with federal and provincial incorporation requirements of having Canadians as a majority in the boards of directors.

Failure to comply with equity commitments were often ascribed to financial problems, e.g. inadequate returns on investment or insufficient profitability. Market conditions were also cited as reasons for failure, in the sense of capital market conditions being such as not to guarantee a "fair" price for their stocks. The lack of Canadian buyers were also furnished as a factor why equity commitments could not be complied with.

It should be noted that to-date, this agency has not taken any foreign-controlled company to court for failure to fulfill an undertaking of floating shares to the Canadian public. Individual cases were perceived usually as unique, and across-the-board treatment of failure to comply with undertakings was never recommended or envisioned. In general, the agency has preferred a case-by-case approach with respect to investor compliance with undertakings and has demonstrated a great deal of flexibility in requiring the fulfillment of commitments.

As we noted earlier, the implementation of the Free trade Agreement will exempt most U.S.-based companies from having to give an undertaking of floating shares in their subsidiaries, publicly or privately, to the Canadian public. Since the vast majority of these subsidiaries are based in the U.S., the range of future cases are likely to be narrow. However, even with Free Trade, companies in sectors such as cultural industries (publishing, broadcasting, etc.) and resources (particularly, oil & gas and uranium) will still be subject to restrictive regulations, including the requirement of Canadian equity participation. In addition, companies that are currently subject to this kind of undertaking will need to be monitored on an ongoing basis, with the understanding that each case will be dealt with on its own merit.

Section VI. Rights of Minority Shareholders & Ramifications of some Recent Cases of Actual or Perceived Conflict:

One of the most extensively debated topic of current interest is the issue of minority shareholders' rights. It is also a topic that provokes strong feeling from opposing camps. On the one hand, there are those who maintain that Canada, on a relative scale, has one of the best records in the world in the area of protecting the interests of minority shareholders. They argue that our stock exchanges have been less prone to corporate malpractices, relative to other major industrial economies. At the same time, regulatory bodies like the OSC and the QSC, responding to the lobbying of small and institutional investors, have been active in asserting the rights of minority shareholders. On the other side, a group of institutional investors feel that "greenmail" or the abuse of minority shareholders' rights are quite commonplace and should be dealt with. Stephen Jarislowsky, Canada's largest pension fund manager and the President of Jarislowsky, Fraser & Co, (a firm that administers more than $10 billion -- one-eighth of all the assets in trusteed pension funds in the country) said that "In Canada, too many things that should be illegal are not. Too often, managers and their high-priced consultants put the manipulation of the law ahead of morality..."[17]

The current controversy about Inco's recapitalization plan, known as a "poison pill", is an illustration of the strong feelings that the question arouses. There has already been a court action taken by Caisse de depot et Placement du Quebec against Inco's takeover defense tactic. Inco's action, overwhelmingly approved by its shareholders on December 09, 1988, combined two common defensive features -- a diluting share issue that makes any potential takeover more expensive by forcing the raider to buy many more shares, and a large dividend payout that both sweetens the pill and raises Inco's debt, making it less attractive to would-be raiders. Poison pills and related corporate restructurings have become a common occurrence in the U.S. market. More than 700 U.S. companies, including most mining groups, are already covered by protective anti-takeover plans. In Canada, such has not been the case and Inco was the first known case of the successful use of a poison pill. Since then, Pegasus Gold Inc. of Vancouver, unveiled a poison pill that will also require board approval for any purchase of more than 20 per cent of the company's stock. There was also a precedent to Inco's case when, in 1985, Southam Inc. proposed poison pill by-laws that were denounced by minority shareholders and eventually diluted before approval. Soon after that, Southam engineered a share-swap with Torstar Corp. that had the same effect of removing Southam from the takeover market for a certain number of years.[18]

The champions of minority shareholder rights argue that a takeover of a company, even a hostile one, need not be a bad thing. A takeover affords shareholders the opportunity to realize the full value for their shares, while the blocking of such a bid ensures the continued entrenchment of existing executives even if they were operating the company in a laggard fashion. This problem is particularly felt in Canada where most big companies are either controlled by other companies, or beholden to a single shareholder group that freezes out competitive bids and thus deprive minority shareholders of any effective say, or of making significant capital gains. Moreover, if a large number of other companies follow Inco's example and load up on debt, it could have the effect of draining the stock market of liquidity -- to the detriment of all shareholders. In suing Inco, the Caisse argued that the company violated Canada Business Corporations Act because it (the company) does not treat all shareholders equally and, it transfers certain rights from

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17 Olive, David:"Keeping the Swine in Line", Globe & Mail, November 13, 1987.

18 The original package pegged it at ten years which was subsequently shortened to five years when federal authorities threatened legal action on behalf of minority shareholders.

shareholders to Inco's board of directors, and will have the effect of giving the directors the powerto decide on the appropriability of a takeover bid.

As it currently stands, Canadian law does not require shareholders' approval for poison pills. Many companies in the U.S. have adopted such plans without a vote. On December 13, 1988, the Toronto Stock Exchange announced that all future poison pill defenses will have to be approved by the shareholders. The TSE and the OSC have stated that their policy will be to ensure that shareholders vote on such plans.

In recent weeks, there have been at least two more instances of minority shareholders taking legal action against companies that tried to squeeze them out. In the case of Lornex Mining Corp. of Vancouver -- 92.6 per cent held by Rio Algom of Toronto and Teck Corp. of Vancouver -- a minority shareholder has sought legal redress to prevent the amalgamation of Lornex with a subsidiary of Rio Algom. Rio Algom and Teck, in announcing the proposed amalgamation, had sought an exemption from Ontario securities law that required them to obtain the approval of a majority of the minority shareholders. If the proposed deal falls through, Lornex will continue to be a publicly traded company. The second instance of legal action was that of Camindex Mines Ltd. of Toronto which MVP Capital Corp. -- a merchant bank -- is trying to buy out. In this case, minority shareholders are seeking a higher value than what the buyer is offering them.

The defenders of the interests of minority shareholders assert that the lack of clarity vis-a-vis security laws in Canada, and the fact that the responsibilities of of the directors (of boards) do not seem to include fiduciary responsibilities, have exposed minority shareholders to abuses by unscrupulous dealers and corporations. Institutional investors, with the backing of the Ontario and the Quebec Securities Commissions have repeatedly challenged some of the most powerful corporate entities in the country (e.g. Seagram, Dome Petroleum, Canadian Tire, etc.) to uphold the rights of minority shareholders to be treated in an equitable manner. As a result of the intervention of institutional investors, the minority shareholders of Domglas Inc. had their original $14 per share offer raised to $36 by the Quebec Supreme Court in 1980. Conrad Black's Argus Corp. had to considerably improve upon their original offer to the shareholders of Labrador Mining & Explorations when the latter was taken over in 1983. Fund managers also successfully blocked plans by Seagram Co. Ltd. to create a new class of multiple-voting shares, which would have had the effect of reducing the common stock to non-voting status. In 1986, the institutional investors prevented members of the Billes family from selling off part of their 60.9 per cent interest in Canadian Tire to a group of the company's dealers in a manner that would have circumvented the "coattail" provision which the company itself had instituted a year earlier to assure equitable treatment to minority shareholders. The "coattail" provision stipulated that if an offer is made for all the voting shares, and a majority are tendered, the nonvoting shares become voting equity. The dealers offered Billes family a stunning $160.24 per share, four times the market value, but intended to purchase only 49 per cent of the common stock. They thus hoped to get control of the company without triggering the "coattail" provision, cutting out 13,819 nonvoting shareholders from enjoying the benefits of the takeover. The independent investors challenged the dealers' offer, and a joint decision of the OSC and the QSC ruled against the deal, a decision that was subsequently upheld by the Supreme Court of Ontario.

It is clear from the discussions above that the issue of protecting the minority shareholders' interests, and the prevention of the abuse of their rights -- real or perceived -- has become a major area of concern in corporate dealings. In the current super-charged business environment, brought about in large part by the sharp increase in the number and size of debt-driven buy-outs (MBOs, LBOs, etc.) and hostile takeovers, the charges of unfair treatment of minority shareholders, and calls for regulatory and other governmental actions to protect these shareholders, will become more and more strident.

Concluding Remarks:

We have outlined a good many persuasive reasons for a Canadian subsidiary of a foreign-controlled company to want to float its shares to the Canadian public. Among other reasons, a company can benefit from the enhanced market awareness of itself and of its products that such equity participation could create. The subsidiary can also potentially benefit from the establishment of a market value for possible merger and acquisition activities. In addition, tangible economic benefits such as the positive effects on earnings per share and access to competitive sources of financing can induce the subsidiaries to offer its equity to Canadians. The net result for the subsidiary might be a lower cost of equity capital in Canada compared to other alternatives, e.g. being wholly-funded by the parent, through various combinations of retained earnings or borrowings.

At the same time, it is clear that there are convincing reasons why a foreign-controlled subsidiary may not wish to have Canadian shareholders. Each decision by a subsidiary, on whether or not to float equity here, is influenced by the unique circumstances that the company operates in, and the corporate philosophy that it follows. In fact, the favorable image of the Canadian economy in general, and of its capital market in particular, may induce a parent to dilute its equity holdings in Canada to local shareholders, even though its corporate philosophy may dictate otherwise. An example of the latter is Shell Canada, where 29 per cent of its equity is Canadian-owned, although its parent (Royal Dutch Shell of Netherlands and Britain) does not have local equity participation in any of its other subsidiaries throughout the world.

For a foreign-controlled company, its decision to come to Canada will have been dictated by its perception about the size and growth potential of the Canadian market, the possible market share for its products in Canada, and the relative competitive strengths of the Canadian economy, i.e. the cost of production, and of doing business, in Canada. In operating their subsidiaries, the parent's preference for a wholly-owned operation, or for one with Canadian equity participation, will necessarily be dictated by its corporate philosophy and mode of operation, and the relative advantages and disadvantages of floating equity here.

However, the benefits to the Canadian economy of having equity participation in foreign-controlled subsidiaries by the Canadian public has also been shown to be significant. For one thing, the deleterious effects of "truncation" can be countered to an effective extent through equity participation. It is argued that having Canadian shareholders will have the effect of raising the level of awareness and appreciation in these companies of Canada's interests and long-term social and economic goals. Moreover, the trading of the stocks of these subsidiaries enhances the portfolio choice for Canada's investors -- both individual and institutional. This will also contribute towards a more stimulating business environment in the country.

Of equal importance is the fact that encouraging Canadian equity participation in these subsidiaries allows the government to exercise the desired degree of control, or at least the ability to monitor, sectors that are considered sensitive from the point of view of Canadian national interests. Political objectives may dictate the maintenance of some form of a policy that can help to achieve such an end. It should, however, be remembered that monitoring sensitive sectors can be achieved through a number of other, viable methods and minority equity participation is, by no means, the most effective way of exercising any degree of control over the operations of these subsidiaries. In fact, it is probably one of the least effective ways of achieving this end.

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Appendix A

FORMS OF EQUITY PARTICIPATION

JOINT VENTURES

In many instances, the target company or the proposed new Canadian business enterprise is not of sufficient size now, nor will it be in the foreseeable future, to warrant an issue to be listed on the stock exchanges. Accordingly, it is suggested that, in such instances, Assessment Officers should aim for an undertaking to seek a Canadian joint venture partner. That undertaking can be linked to a specific project, the expiration of a period of time, or a specific expansion of the business.

An important point to bear in mind in this connection is the maintenance of the Canadian participation in the joint venture. The foreign joint venturer, and the Canadian joint venturer in the exceptional cases, should be asked to give undertakings in this respect.

SHARE OFFERINGS

As to Canadian equity participation, there are several considerations which should be borne in mind. For the purposes of FIRA, the sale of shares should relate to voting shares and not to non-voting shares (preferred shares or shares carrying special preferences and restrictions) as the holders of non-voting shares do not ordinarily participate in the affairs of the company. The legal status of the company whose shares are to be sold must also be considered, as follows:

1. Private Companies

   In case of an issue of shares of a private company, the issuer either by its charter or pursuant to the laws under which it is incorporated, it is prohibited from issuing its shares to the public generally, and the total number of shareholders is restricted (the maximum usually is 50).

   If a prospective investor approaches the principal shareholder to buy shares of the private company, or if the principal shareholder knows of the existence of an interested investor, then a sale of shares can be effected quickly and at very little expense. It is a breach of the private company's charter and the Canadian securities laws, however, for anyone to search out and solicit potential buyers for the shares of a private company and it is therefore improper for us to seek an undertaking to do so. Therefore, the seeking of undertakings for the issuances of a private company must be approached with caution.

2. Public Companies

   As to public companies, there is no restriction on the number of shareholders or the transferability of outstanding shares. However, public companies have to comply with the provisions of their charters and/or the requirements of the companies acts under which they are incorporated before they can distribute their shares to the public. In addition, any issue of securities to the public must comply with the provisions of the laws of the provinces in which the shares are to be distributed and, if the shares of the company are already listed or are to be listed on the stock exchange, with the listing requirements of that exchange. There are two ways in which shares of public companies can be distributed to the Canadian public:

(a) By means or private placement (which involves a small number of purchasers); and

(b) By a distribution to the public generally (which involves many hundreds of purchasers).

A private placement does not require the preparation or filing of a prospectus. As a result, a private placement can be facilitated at a reasonably low cost to the issuer. A private placement generally speaking, is a distribution to a limited number of sophisticated investors or to a group of knowledgeable persons by way of private contract and, for the purpose of the Securities Acts, includes individual trades of no less than $l00,000.

In the case of a distribution of shares to the public, a prospectus must be drafted and cleared by the provincial securities commissions and considerable preparation made by the issuer involving substantial lega, auditing, printing and financial costs (the costs of a public issue frequently run as high as $l00,000 and are seldom less than $50,000). Furthermore, a public distribution will require the service of a professional underwriter and may well involve a syndicate and marketing group. An underwriter will normally insist that the issue be of sufficient "float" (number of shares available for day-to-day trading) to ensure an active trading market. In addition, if the shares are listed on a stock exchange, the issue must be of such a size to meet the listing requirements of the relevant stock exchange. This also can be a relatively costly requirement as there is an initial listing fee and an annual sustaining fee based upon the capitalization of the company and the number of shares listed on the stock exchange. As a rule of thumb, an initial public offering would need to be in the order of $5 million or more and a subsequent primary or secondary offering should amount to at least $2,500,000 in size.

Therefore, for a successful distribution of shares to the Canadian public, the issuer would have to have a shareholder equity capitalization of at least $5 million, and in the case of an initial public offering, at least $l0 million, if 50% of the stock is to be offered. (Twenty-five percent is more common, which implies an equity capitalization of at least $l0 million and, in the case of an initial public offering, at least $20 million.) The assessment officers will have to take into account the net worth of the company to determine the feasibility of an undertaking relating to either the private placement or public distribution of equity shares of the CBE, and should not seek Canadian equity participation if the company's actual or projected balance sheet makes it apparent that the CBE will be unable to achieve the required size of an issue to justify a public distribution of its securities.

CANADIAN PARTICIPATION

SPECIMEN UNDERTAKINGS

NOTE: The assessment officer should direct his questions to seeing what applicants can offer in respect of autonomy and equity participation, and use these specimen undertakings as a guide in drafting suitable undertakings to fit the circumstances of the investment he is assessing.

1. Autonomy of the Canadian enterprise

(a) The applicant shall incorporate a subsidiary company in Canada in accordance with the laws of the Province of .... (or in accordance with the provisions of the Canada Business Corporations Act) to implement the Investment.

(b) The applicant shall cause the subsidiary to operate in Canada in accordance with the Principles of International Business Conduct issued by the Minister of Industry, Trade and Commerce on July 18, 1975 and in particular the objective set out in Clause 1 of the said Principles.

(c) The applicant shall cause the Board of Directors of the subsidiary to have autonomy in the conduct of the day-to-day business of the subsidiary, and the Board of Directors of the subsidiary shall only have to refer matters which require an expenditure of more than $................. for approval by the Board of Directors of the applicant.

To cause the management of the subsidiary (acquired business) to have autonomy in seeking export markets anywhere in the world, hiring and dismissing personnel, sourcing raw materials (as appropriate) in Canada and generally in conducting the day to day conduct of the business of the subsidiary (acquired business). (And to cause the Board of Directors of the subsidiary (acquired business) to have complete autonomy in all decisions involving an expenditure of not more than $................).

(d) To cause the nomination and election of persons who are not non-eligible persons to the subsidiary's (acquired business's) Board of Directors.

To cause the nomination and election to the subsidiary's (acquired business's) Board of Directors of not less than ..... resident Canadian citizens (of whom ..... shall be independent of the applicant and its affiliated and associatead companies other than the subsidiary).

Note: A subsidiary cannot elect its own directors and the undertaking must be given by the parent. The Federal and some Provincial Companies Acts require a majority of the directors to be resident Canadians. Assessment officers should bear this in mind when negotiating and encourage more than a simple majority.

(e) To cause the subsidiary (acquired business) to appoint only persons who are not non-eligible persons as officers of the subsidiary (acquired business).
That a majority of the officers of the subsidiary will be resident Canadian citizens.

(f) To cause the subsidiary to hire resident Canadians for senior management positions. To staff all management on an exclusively Canadian basis. The cause the subsidiary to appoint a majority of resident Canadians as executives, supervisory and technical personnel.

2. Equity participation

(a) Prior to .... the applicant will cause the subsidiary to locate a person who is not a non-eligible person and who is otherwise appropriate as a partner in the development of the property (mine, quarry, etc.) to acquire a .... interest in the property (mine, quarry, etc.) and will sell to such partner up to a .... interest in the property (mine, quarry, etc.) if such sale can be arranged on an appropriate commercial basis and on terms which fairly reflect the value of the property (mine, quarry, etc.) and its state of development at that time.

The applicant will cause the subsidiary to seek out a person who is not non-eligible to participate as a joint venture partner in the development of (project). Such joint venture partner shall have not less than a ...... interest in the said project. (In the event that the applicant, through its subsidiary, is unable to find a joint venture partner within .... years of the commencement of the (project) the applicant shall advise the Agency of the steps it has taken to find such a joint venture partner and the applicant undertakes to enter into a further Agreement of Undertakings with Her Majesty as to obtaining a joint venture partner for such further period and upon such further conditions as the applicant and the Minister shall mutually agree.)

(b) The applicant will cause within .... years of the date of allowance .... per cent of the voting shares of the subsidiary to be acquired by resident Canadians and such level of Canadian ownership will thereafter be maintained. The applicant undertakes within ..... years of the date of allowance to make available to Canadians by public offer or private placement through Canadian underwriters not less than....... per cent of the subsidiary's voting shares. The applicant undertakes within .....years of the date of allowance to make available to Canadians, by public offer or private placement through Canadian underwriters, not less than........ per cent of the subsidiary (investment's) voting shares. And if it is not feasible to make such an offer to the public within the period referred to above, the applicant will immediately thereafter institute a study by a recognized firm of Canadian underwriters to ascertain why such an offering could not be made; to determine alternatives and to make such study available to the Agency together with the applicant's plans to implement the results of such study.

Appendix B

TRANSFER PRICING IN A VERTICALLY-INTEGRATED MULTINATIONAL [1]

The figure on the opposite page represents a multinational corporation consisting of a chemical affiliate located in a low-tax country (say, the U.S.) and a drug manufacturer located in a high-tax country (Canada). Assume that one unit of C, the chemical, is used to produce one package of X, the drug. The multinational holds the sole patent on X, and behaves like a monopoly, maximizing global profits net of taxes. At the margin, the last unit of X sold should add as much to revenue as it does to costs. In other words, the marginal revenue from the sale of X should equal the marginal cost of producing C and of converting it into X:

$$MR_X = MC_C + MC_X \text{ or, } MR_X - MC_X = NMR_X = MC_C$$

The multinational maximizes global profits by equating the marginal cost of producing the chemical (MC_C) to the net marginal revenue from sales of X (NMR_X).

Let us make the following assumptions:

- MC_C is a $9;
- marginal and average costs are the same; and,
- the transfer price is set equal to MC_C;

NMR_X is determined by vertically subtracting MC_X from MR_X. Therefore, the initial maximum profit occurs where NMR_X and MC_C intersect. Output will be 14 million packages at $23 a unit. Gross profit (the area under the NMR_X curve and over the MC_C curve) will be $147 million. If Canada imposes a 40% tax while the U.S. has no tax, net profit will be $88.2 million.

By overinvoicing chemical imports, the multinational can shift profits to the U.S. affiliate. This distorts output but raises net profit. For example, if the transfer price (P_C) is doubled from $9 to $I8, final output falls to 8 milion packages but the product price (of the drug) rises to $26. In this outcome, the Canadian affiliate declares a `gross profit of $48 million, while the U.S. parent declares a gross profit of $72 million. What that implies is that gross global profits fell from $147 million to $120 million. However, net profit rose from 88.2 million to 100.8 million -- an increase of 20.6 million. In this illustration, overinvoicing of imports is clearly profitable for the multinational company.

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1. Taken from Eden, Lorraine: "Pharmaceuticals in Canada: An Analysis of the Compulsory Licensing Debate". Carleton Industrial Organization Research Unit, CIORU 88-05. Carleton University, Ottawa. September 1988.

FIGURE I

Transfer Pricing in a Vertically-Integrated Multinational.