New Canadian National Security Rules will Impact M&A Deal Timing and Risk Allocation

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The Canadian government is enhancing its national security scrutiny of foreign investments, and pending changes to the *Investment Canada Act* (ICA) are likely to impact deal timing and risk allocation in transactions with a nexus to Canada.

Key considerations for dealmakers

- Canada is proposing that certain transactions be subject to a mandatory pre-closing national security notification requirement and observance of a 45-day waiting period (which can be extended unilaterally by the regulator) during which a national security review may be initiated. This regime will be similar to "covered transaction" reviews by the Committee on Foreign Investment in the United States (CFIUS). The new waiting period could become the "long pole in the tent" of certain transactions with a nexus to Canada.
- The possibility of pre-closing Canadian national security reviews presents new risks to transacting parties. Parties and their counsel will need to assess and allocate these risks in transaction agreements.
- The Canadian government is bolstering its national security review powers, giving the regulator the ability to impose interim conditions, expanding penalties for non-compliance, limiting avenues of appeals and allowing for greater coordination between Canada and its allies.
- While the changes are mainly directed at assisting the Canadian government in reviewing investments from countries that are not aligned with Canada, US investors should expect greater scrutiny of their holding structures and financing sources (including the identities of LP investors in private equity funds), among other things.

The present state of Canadian national security reviews

Canada's national security reviews of foreign investments generally resemble CFIUS reviews before Congress passed the *Foreign Investment Risk Review and Modernization Act of 2018* (FIRRMA).

Under the ICA, the Canadian government can review any investment by a non-Canadian that it believes could be injurious to Canada's national security.

Canadian national security reviews may occur when, among other factors, a transaction raises the following issues:

- Investments that may be motivated by non-commercial interests that could harm Canada's national security, including investments by state-owned enterprises of countries not aligned with Canada.
- Investments in sensitive technologies, including aerospace, artificial intelligence, biotechnology, medical technology, digital infrastructure, quantum science and robotics and weapons. This includes technologies that have the potential for military or intelligence applications.

- Investments in Canada's critical infrastructure and supply chains, including in particular, investments in critical minerals and energy, and investments that could enable access to sensitive personal data of Canadians.

Like the CFIUS review process, in a Canadian national security review, the regulator has the power to disallow a transaction, order divestitures, and authorize a transaction on the condition of written undertakings or other negotiated mitigation. The Canadian government will only accept mitigation undertakings that fully address its national security concerns. However, investors may experience little direct feedback regarding the nature of the regulator's concerns, making it more difficult for investors to propose and negotiate mitigation undertakings.

Non-Canadians are required to notify the Canadian government when acquiring control of a Canadian business, or establishing a new Canadian business in the form of ICA filings. Presently, the large majority of ICA filings are permitted to be filed post-closing, and pre-closing notification and approval is only required in a small subset of transactions.[1]

After an ICA filing is made, the Canadian government has 45 days to either take steps towards a national security review, or otherwise be barred from taking further action.

The Canadian government may also review minority interest transactions, though ICA filings are only required in specific instances (e.g., the acquisition of more than one-third of the shares of a corporation with a Canadian business). When no ICA filing is made, the Canadian government has up to five years from closing to commence a national security review. However, minority interest investors may make voluntary ICA filings, and in such cases, the government may only commence a process within 45 days of that filing. In other words, investors that choose to make voluntary ICA filings gain the benefit of significantly reducing the government's opportunity to challenge a transaction (i.e., from five years post-closing to 45 days post-filing). As a practical matter, voluntary notifications raise strategic questions for parties to minority interest transactions: purchasers can de-risk the possibility of a post-closing national security review by making voluntary filings followed by refraining from closing for 45 days, however, a voluntary ICA filing risks drawing the regulator's attention to a transaction that may otherwise have gone unnoticed.

The length of a national security review can vary depending on the nature of the Canadian government's concerns. Between April 2021 and March 2022, the Canadian government launched in-depth reviews of 24 investments, lasting an average of 133 days. While some reviews can be resolved in less than 90 days, other in-depth reviews may last 200 days or longer.

Recent trends in national security reviews

Consistent with trends in the US and Europe, Canada is trending towards greater enforcement of its national security review laws in respect of countries with which Canada is not aligned, and, in particular, investors from, or with close ties to, Russia and China.

In March 2022, in response to Russia's invasion of Ukraine, Canada announced a new policy to apply the ICA in a manner that puts greater scrutiny on investors owned or influenced by the Russian state.

[1] Certain very large **direct** acquisitions of Canadian businesses (e.g., deals with US buyers that have an enterprise value of more than CAD $1.931 billion in 2023, or lower thresholds for investors from certain other jurisdictions) require pre-closing approval from the Canadian government that the transaction is of "net benefit to Canada". The same is also true of acquisitions of certain Canadian cultural businesses (e.g., book publishers, film production companies).

In October 2022, Canada announced a further new policy to apply the ICA in a manner that restricts the ability of certain state-owned enterprises to invest in Canadian businesses participating in the critical minerals sector. Days later, the Canadian government ordered three Chinese companies to divest their recently acquired interests in Canadian lithium mining businesses. Notably, these included:

- orders to divest from Canadian public companies whose lithium mining assets are exclusively located outside of Canada; and
- orders to divest non-controlling interests (in one case, a minority interest of less than 6%).

In December 2022, the Canadian government introduced proposed legislation that significantly expands its powers relating to national security reviews.

Pending Changes to the ICA

Bill C-34 is a draft amendment to the ICA that proposes two significant changes: (1) mandatory pre-notification of certain foreign investments, which will require parties to observe a minimum 45-day waiting period before closing transactions; and (2) an array of new enforcement powers for the regulator.[2]

While presently, ICA filings are commonly made post-closing, Bill C-34 proposes to require that investors pre-notify the Canadian government of investments in Canadian businesses that participate in certain sectors and activities, regardless of the size. The proposed changes resemble US rules expanded under FIRRMA relating to "covered transactions" that require pre-notification of certain transactions to CFIUS.

The Canadian government has not specified which sectors and activities will be subject to pre-notification. However, regulators have signalled that they expect these to include critical minerals, access to personal data of Canadians, critical Canadian infrastructure (including relating to supply chains) and sensitive technology areas.

Minority (non-controlling) investors in Canadian businesses active in specified sectors will be subject to mandatory pre-notification if their investment allows them access to sensitive information and assets, and if they have special minority investor rights such as the right to nominate or appoint directors.

Importantly, transactions subject to mandatory pre-notification will be prohibited from closing for at least 45 days. There is a likelihood that this new waiting period will be the "long pole in the tent" of many transactions with a nexus to Canada. For example, the waiting period under Bill C-34 will extend beyond the 30-day antitrust waiting periods that are observed for US HSR filings (where no Second Request is issued) and Canadian *Competition Act* filings (where no Supplementary Information Request is issued).

The impact on deal timing will be particularly acute if the Canadian government prescribes sectors and activities in a broad or vague manner. For example, the Canadian government's current list of sensitive technology areas (which regulators have signalled may bear resemblance to the sectors that will require pre-notification) includes categories such as advanced manufacturing, digital infrastructure, medical technology and robotics, which might capture a very large number of transactions, including those that do not raise obvious national security concerns.

[2] While Bill C-34 is merely proposed legislation, it is expected that Bill C-34 will become law in the coming months. The legislation is supported by all of Canada's federal political parties, and is presently at a committee phase undergoing technical amendments.

In addition to pre-notification, Bill C-34 proposes to enhance powers available to Canadian regulators in conducting national security reviews and implementing orders and conditions. These include:

- **Sweeping powers to impose interim conditions and extend reviews**. Under Bill C-34, the Canadian government will have the ability to impose interim conditions to both unconsummated transactions and closed transactions if the government believes it is necessary to prevent injury to national security.
- **New and expanded penalties**. Bill C-34 will permit a court to impose a monetary fine on a party to a transaction for failing to notify, and increase the limits that can be imposed for other contraventions of the ICA. The new penalty for failing to file is up to CAD $500,000 or another amount that the government could prescribe by regulation.
- **New limits on court appeals**. Presently, there are few avenues available to bring court challenges to Canadian government decisions in respect of ICA national security orders. Canadian courts give significant deference to the government in determining matters of national security. Bill C-34 proposes to further limit any challenges by allowing the government, with court authorization, to withhold from disclosure in litigation any evidence and information that could injure Canada's international relations, national defence or national security. Under this process, investors and their counsel would receive only summaries of the withheld information.
- **Coordination with foreign allies**. The Canadian government will have express discretion to communicate confidential information obtained from an investor with the agencies of foreign governments responsible for national security reviews of investments. This formalizes, and provides greater discretion for, cooperation that the Canadian security services already undertake with agencies in allied jurisdictions (e.g., CFIUS).

Strategic considerations for dealmakers

Transacting parties and their counsel will need to consider how Bill C-34 could impact deal timing and risk allocation in transactions with a nexus to Canada.

- **Observing the 45-day waiting period**. Transactions involving businesses participating in sectors or activities designated by the Canadian government will need to observe a new 45-day pre-closing waiting period. This period risks becoming a source of delay in some transactions, and that risk will be greater if the Canadian government defines the covered sectors and activities in a broad or vague manner that captures many transactions.
- **Impact on the interim period**. When a national security review is launched, the Canadian government will have the ability to make orders during the interim period. Such orders could impact not only investors, but also the business interests of targets or vendors before closing. The Canadian government will also have a near-total ability to extend the period of its review. Parties to transactions that risk national security scrutiny will need to allocate these risks in transaction agreements, including rethinking the drafting of interim operating covenants. As well, such orders could have the effect of inhibiting integration planning during the interim period.

- **Risks relating to undertakings and divestitures**. Whereas previously, Canadian national security reviews commonly occurred post-closing, Bill C-34 will result in many occurring pre-closing. To obtain approval, investors in transactions that raise national security issues may need to offer mitigation undertakings to the Canadian government or commit to divestitures. Such commitments may affect the economics of transactions. Parties and their counsel will need to consider and negotiate the allocation of this risk (similar to how antitrust risk is allocated).
- **Greater scrutiny of investors and key personnel**. The proposed changes are largely aimed at increasing Canada's capacity to review transactions involving investors from countries with whom Canada is not aligned. US investors are not the target of these changes. However, US investors should expect greater scrutiny of their holding structures, sources of funding, key personnel and indirect investors (including passive LP investors in private equity funds). Transacting parties should expect particularly greater scrutiny in respect of investors from China and Russia (as well as individuals and institutions with ties to the governments of China and Russia, wherever located).
- **Greater risk relating to non-compliance**. Presently, there is some degree of non-compliance with the obligation to make ICA filings – particularly in 'foreign to foreign' transactions with minimal nexus to Canada. Bill C-34's enhanced powers increase the risks associated with non-compliance.

For further information on Canada's foreign investment regime, including national security review laws and the proposed amendments, please contact any member of Goodmans Competition and Foreign Investment Group.

The discussion in this Guide is confined to current and proposed federal laws of Canada as of September 1, 2023. Because the laws and policies of governments and regulatory authorities change, some of the information may not be accurate after that date. This Guide provides general information only and should not be relied upon as legal advice.

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