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From Investment Screening to Investment Development: The Impact of Canada's Foreign Investment Review Agency (FIRA) and Investment Canada in Canada's Technological Development

*by Gordon Dewhurst * and Michael Rudiak***

I. INTRODUCTION

Of increasing importance in Canada, as elsewhere, is the question of technological development. Increasing global interdependence, with growth in world trade outpacing that of individual economies, and the problems stemming from over-capacity and convergent industrial structures among OECD countries, have made the question of "global competitiveness" very central. The development and application of new technologies and processes is fundamental to the process of becoming and/or remaining globally competitive in most industrial and many service sectors.

Technology has also become increasingly internationalized over the past two decades, spurred by the growth of "world products" and new patterns of international investment flows. The United States has also become a net importer of international direct investment and Japan a major new source of capital exports. Paralleling these changes is the shift in corporate strategies which has seen much of the concern over product development and market expansion replaced by efforts directed towards process development, and the identification of market segments and product niches.

Today the introduction of foreign technology into Canada frequently occurs through a range of entirely different avenues than it did fifteen to twenty years ago. Cooperative strategies, such as joint-ventures, licenses and other types of non-equity relationships are increasingly replacing the truncated foreign manufacturing subsidiaries of the 1950's and 1960's as mechanisms for the diffusion of technology into the Canadian economy.

The establishment of the Foreign Investment Review Agency (FIRA) in 1974, took place before the periods of slow and negative growth which followed, though were not entirely related to the oil shocks of 1973-74 and 1979-80. Traditionally much of Canadian industry had been set up behind high tariff barriers and was designed to serve domestic

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needs. As a result, production runs were small and product lines diverse. Lack of specialization reduced the need for significant R&D expenditures. Domestic sales were generally insufficient to support the development of new products or techniques and, furthermore, the subsidiary's access to cheaper foreign technology made any such development unrealistic from the parent company's perspective.

The decade following the FIRA's establishment was a period in which tariff barriers were lowered. The persistent structural problems and high levels of technological dependence in Canadian industry were reinforced, despite the establishment of the FIRA as a screening agency. The decade was a very sobering period. Clearly, given the FIRA's limited mandate (which did not extend to the expansion of established firms operating in traditional areas) and the fact that policy-makers chose not to adopt an accompanying industrial strategy, an alternative scenario would have been highly unlikely.

In the 1980's, the emphasis on investment review has become less central to the concern over future technological development. Two major trends are responsible for this. The first relates to the structure of the multinational firm (MNE), the second to the competitiveness of the overall technology environment. Together they suggest that a set of positive policy instruments is required to address Canada's technology needs.

Most large American MNEs are already established in Canada. Canadian subsidiaries have increasingly become one component in a larger system of manufacturing, marketing and financial management. The design of the subsidiary—as a semi-autonomous unit using cheap foreign-developed technology—is becoming inappropriate and counterproductive to new global strategies. Research and development, the one function almost totally centralized in the MNE's home country, is increasingly being conducted internationally. It is also generally recognized that there has been a decrease in the importance of strategies designed, through foreign direct investment, to extend the advantages that firms derive from their technological lead.¹ Less and less, new investments take the form of 100% owned subsidiaries. Simply stated, the MNEs monopoly on technological advance has decreased.

Recognizing this, the new Investment Canada Agency seeks to promote new strategic technology-bearing investments and relationships which contribute to competitiveness. This development function is reflected in the legislation governing the Agency's mandate as well as in the structure of the organization itself.

II. ESTABLISHING A REVIEW AGENCY

During the 1960's Canadians became increasingly concerned about

¹ See generally ABONYI, FOREIGN INVESTMENT POLICY: THE GRAY REPORT IN THE CONTEXT OF THE EIGHTIES (Aug. 1984) (This was a major theme in this Foreign Investment Review Agency internal working document).

the levels and potential negative effects of foreign direct investment (FDI) in Canada, including its impact on Canada's technological development. The economic environment of the 1960's and growing evidence of the pervasive influence of foreign ownership and control over Canadian industry fuelled these concerns.

The tremendous post-war growth in the Canadian economy was coincident with large inflows of direct investment, mostly from the U.S., and managerial/entrepreneurial inputs. While it was recognized that this growth required capital financing that extended beyond that which was generated internally in Canada, instances of the extraterritorial application of U.S. law through Canadian subsidiaries, as well as the more specific actions taken to correct the balance of payments problems in the U.S., increased the pressure on the Canadian government to develop an appropriate response to these concerns.

An immediate Canadian response to the U.S. balance of payments measures was the issuance in March, 1966 of "Some Guiding Principles of Good Corporate Behaviour for Subsidiaries in Canada of Foreign Companies." The so-called "Winters' Guidelines"—after Trade and Commerce Minister Robert Winters—enjoined foreign-owned subsidiaries, among other things, "to develop as an integral part of the Canadian operation wherever practicable, the technological, research and design capability necessary to enable the company to pursue appropriate product development programs so as to take full advantage of market opportunities domestically and abroad."²

The issuance of these guidelines and the adoption of a voluntary reporting program to monitor performance under them was the first attempt by a Canadian government to influence, in a general way, the behaviour of MNEs operating in Canada.

The effects of the high degree of foreign ownership and control in Canadian industry have been extensively studied. Not surprisingly, these studies have invariably given prominent focus to the effects on Canada's technological development and the level of R&D spending in Canada. Conversely, virtually all studies of Canada's performance as an industrial innovator accord a prominent role to the behaviour of MNE subsidiaries in Canada.³ It is not the purpose of this paper to assess the conclusions of such studies, but they are mentioned merely to underscore the link between foreign ownership and technological development in the minds of Canadian policy-makers and politicians.

In 1970, Prime Minister Pierre Trudeau designated Revenue Minister, Herb Gray, to lead a task force to study the implications of foreign

² Letter from the Honourable Robert H. Winters, Minister of Trade and Commerce, Canada, to Foreign Companies' Subsidiaries in Canada (tabled in the House of Commons on March 31, 1966).

³ See, e.g., Globerman & Meredith, *The Foreign Ownership—Innovation Nexus in Canada*, 19 COL. J. WORLD BUS. 53 (Winter 1984).

investment for the Canadian economy and to recommend policies that would ensure that such investment would be responsive to Canada's economic and social goals in the future. The report of that task force, *Foreign Direct Investment in Canada*,—better known as the Gray Report—was released in 1972. It recommended, among other things, the establishment of a review agency for FDI entering Canada.

Central to this report was the view of foreign “truncated” subsidiaries operating according to logic, motives, and principles which entailed costs for the Canadian economy. Studies had shown convincingly that foreign firms relied heavily on imported products and services, conducted little R&D and generated few export earnings. The report concluded that foreign-controlled subsidiaries hampered indigenous technological development in Canada due to the characteristics of the parent-subsidiary relationship. For obvious reasons of cost, efficiency and control, multinational firms (MNEs) tended towards centralized research and development. The R&D conducted by their subsidiaries in Canada was done according to proportions far inferior to that of the parent—and then, often only to modify existing technologies to the local market needs rather than to generate innovation as such.

There was no implicit dogmatic in the logic of the report. It recognized that “the essential need for economic development is not necessarily extensive indigenous technological output, but rather a capacity to use technology effectively, whether it is domestic or imported.”⁴ Given Canada's maintenance of an exogenous rather than internally generated dynamic of technological development and the fact that Canada was likely to remain an important importer of technology, measures were needed to ensure that value was received for the price Canadians paid for imported technology. The rationale of the report's findings was expressed in very clear terms. “[T]hrough both tax and grant incentives, the government has explicitly encouraged expenditure on research and development in private business. Notwithstanding these measures, the record of indigenous technological output has remained poor and Canada's dependence upon the outside world has, in fact been increasing.”⁵ The report also stated that:

In general, as stated, the benefits have been such that Canada could not have realistically lived without them. But this does not mean that the imported technology has necessarily entered Canada in the best form In other words the main question at issue is not whether, on the whole, the benefits outweigh the costs, but whether, in particular cases, direct investment is the best form for Canada to obtain the foreign technology and whether the price being paid is a reasonable one.⁶

It was emphasized that importing technology may have been very

⁴ GOV'T OF CANADA, FOREIGN DIRECT INVESTMENT IN CANADA at 120 (1972).

⁵ *Id.* at 116.

⁶ *Id.* at 116.

economical for Canada in certain circumstances, depending on the relative costs and benefits involved. Given that Canada tended to import proportionately more technology than virtually all other OECD countries, it was recognized, however, that Canadian interests were not shared by the foreign firms active in Canada:

[The MNE's] concern is to maximize his return and this will not necessarily result in a transfer at a fair price or in an appropriate form for Canada. While the availability of foreign technology has, in general, clearly been essential for the Canadian economy, the method of transfer has typically been dictated largely by the objectives and interests of the foreign proprietor. Nothing in the Canadian environment militates against this procedure.⁷

The Gray report recognized that Canada's low technological output was a reflection of the economic history and environment, a legacy of traditional Canadian policies of high tariffs.

The report also expressed the fear that the absence of an indigenous technological capacity would lead to an industrial structure which further reflected the priorities of those outside Canada.⁸ Therefore, to help reduce the truncation of Canadian business decision-making and business operations in general, and bearing in mind the fact that Canada could not afford significant R&D expenditures in all areas (referred to as "lines of production" in the report), the report recommended that it be the task of an industrial development strategy to identify those areas where Canada's efforts could be concentrated. Industry, Trade and Commerce Minister, Alastair Gillespie, explained the government's interpretation:

The [review process] is a necessary part, I submit, of over-all industrial strategy or industrial policy. General economic policies or incentives are not enough. They cannot by themselves, adequately ensure fulfillment of certain of our economic goals such as diversification of exports and export markets, and increased Canadian innovativeness and decision-making capability. To rely solely on investment incentives seems to me to be ingenuous and extremely naive.⁹

Of the many proposals considered by the government during the 1970's, which were aimed at addressing the problems of truncated manufacturing in Canada, the establishment of the FIRA in 1974 was one of the few carried out.

FIRA was established with a view to increasing the benefits of FDI in Canada and decreasing the costs which accompany it "getting a better deal." The underlying assumption was that, through negotiation, firms could be persuaded to alter their investment plans (such as R&D spend-

⁷ *Id.* at 117.

⁸ *Id.* at 130.

⁹ HOUSE OF COMMONS, *Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs*, June 5, 1973, (Issue 26) at 6. [Hereinafter *Minutes from the Committee on Finance, Trade, and Economic Affairs*.]

ing) if, as formulated, they did not measure up to the test of "significant benefit" to Canada. Five performance oriented factors were established to enable the agency to determine what constituted "significant benefit." As Minister Gillespie explained before a committee of the House of Commons, they were economic and the judgement was to be made on these, not on cultural, social or political grounds.¹⁰ The five criteria, or factors—which included the effect of an investment on "productivity, industrial efficiency, technological development, and product innovation"—were aimed at the long-term restructuring of the Canadian economy, recognizing the important role FDI had to play in this process.

The legislation creating the FIRA proposed to extend the screening mechanism into three areas: foreign takeovers, the establishment of new businesses by foreigners not presently doing business in Canada, and the establishment of new businesses in other sectors by foreign-controlled firms already in Canada. This excluded the Gray Report's recommendation that the expansion of already established firms in related activities be screened. The Minister explained the reasons behind this. "The government did consider expansion of existing businesses and rejected it on the basis that it would be such a massive intervention in the economy, that it was not acceptable."¹¹

Uniquely, Canada is a country with the fastest growing labor force in the world and it would not want to adopt a set of policies which would inhibit the expansion of business. We have been doing everything we can to try to get firms to expand their business and to support them in new markets. If we introduce the screening process as far as expansion in existing foreign-controlled business in Canada is concerned, we would impede that objective.¹²

III. ASSESSING FIRA'S IMPACT

In any assessment of the FIRA's impact on Canada's technological development, it is useful to begin by clarifying the scope of the Agency's mandate and the nature of the review process as both of these had an important bearing on the potential impact.

As noted above, the FIRA review process applied only to investments by non-Canadians to establish new businesses in Canada or to acquire existing Canadian businesses. It did not apply to investments to expand existing foreign-owned businesses which account for by far the larger part of the growth of foreign investment in Canada. Of course the legislation did not apply to investments by Canadians. Thus, in terms of total investment activity in Canada, the FIRA was operating at the mar-

¹⁰ *Minutes from the Committee on Finance, Trade and Economic Affairs, supra* note 9, (June 7, 1972) at 17.

¹¹ *Minutes from the Committee on Finance, Trade and Economic Affairs, supra* note 9, at 19.

¹² *Minutes from the Committee on Finance, Trade and Economic Affairs supra* note 10, at 27.

gin and for this reason along the potential impact was probably quite limited.

A second important qualification concerns the nature of the investments reviewed. During the eleven year period that the Foreign Investment Review (FIR) Act was in force, FIRA reviewed (allowed-disallowed) a total of 6,599 investment proposals. Roughly 58% of these investments were in the service and construction sectors of the economy. Only a relatively small percentage of investments were in technology-intensive manufacturing sectors, where the review process might have offered significant scope for influencing the level of R&D spending. Moreover, most of the investments reviewed under the Act were relatively small. Of all proposals to establish new businesses, 91% involved investments of less than two million dollars (Can). Of acquisitions reviewed, 73% involved businesses with assets of less than five million dollars (Can).

The review process has been widely perceived as a negotiating process in which the FIRA sought to increase benefits to Canada as a condition of government approval. In reality, the agency was primarily engaged in screening investments to determine whether or not they were likely to be of benefit to Canada. While the FIRA frequently engaged in negotiations with investors, those negotiations were often primarily concerned with clarifications of the investor's plans and the translation of these plans into specific written commitments. Less frequently, the negotiations were directed towards changing an investor's plans to increase technological or other benefits of the investment. A further qualification on the impact of the review process was noted in a published assessment of the first five years of operation under the FIR Act.

Even more difficult problems of measurement arise in attempting to assess the effects of the review process itself on the benefits to Canada of allowed investments. In essence this involves a judgement, in each case, as to what would have happened if there were no screening and negotiation of investment conditions: what differences would there have been in the investor's plans and the manner in which they were implemented? These are hypothetical questions and the answers are clearly not susceptible to positive verification. Experience with the review process indicates that, generally speaking, its greatest impact is in reducing the degree of truncation and increasing the autonomy of Canadian subsidiaries.

But, since the purpose of the review process is not to persuade investors to pursue unprofitable courses of action . . . there can be no certainty that changes in an investor's plans made as a result of negotiations during the review process would not have been made anyway, at least in part, in response to ordinary market forces, as the investment matured.¹³

¹³ GOVERNMENT OF CANADA, FOREIGN INVESTMENT REVIEW ACT, SUPPLEMENT TO THE 1978-79 ANNUAL REPORT, at 2 (available from Supply and Services, Canada, Ottawa).

With these important reservations about both the potential and actual impact of the FIRA, one may turn to the extent and scope of technological benefits that accompanied investments reviewed by the FIRA. These have taken a variety of forms. They included the expansion of existing R&D facilities in Canada on the establishment of new ones, access to the R&D and technological "know-how" of a foreign parent, the introduction of advanced technology associated with new production processes, new machinery or new products and support for research institutes in Canada.

In assessing an investor's plans for technological development, the agency sought to ensure that the Canadian business would be permitted to use the results of its R&D in the most effective way. Thus, important elements of R&D plans and commitments concerned the authority given to the Canadian company to explore new high-technology product opportunities, to manufacture any products it developed, and to market them on a world-wide basis. In some instances, where corporate technology-sharing arrangements precluded complete R&D autonomy, investors were encouraged to give their Canadian subsidiary exclusive corporate responsibility for R&D, manufacturing, and world-wide marketing of specific products, groups of products, or product lines.

In other cases, where the Canadian company's operations did not warrant the establishment of separate R&D facilities, similar benefits were obtained through commitments to engage independent Canadian research laboratories to undertake research on a contract basis. Through its access to government computerized listings of specialized R&D capabilities in Canada, FIRA was able to assist investors in locating research facilities to best meet their needs.

A particularly important arrangement through which technological benefits accrue to the Canadian economy is in the assignment to the Canadian subsidiary of a "world product mandate" (WPM). A WPM involves specialized production for the global market by a subsidiary in Canada. Typically, the benefits of a WPM are of two sorts: On the macro level, the granting of a WPM contributes to increased competitiveness in the economy through a more efficient utilization of domestic resources and a shift into higher value-added production. On the micro level, a WPM requires individual firms to take on an expanded and outward orientation and in doing so, also encourages supplier firms to become cost-effective vis-a-vis foreign-based component suppliers.¹⁴

The assignment of a WPM increases the specialization and scale—and hence the overall efficiency—of production operations. Such activity is important to technological development because, unlike branch plants, firms granted some form of product or process mandate tend to have significant product modification for international markets. This usually

¹⁴ SCIENCE COUNCIL OF CANADA, *MULTATIONALS AND INDUSTRIAL STRATEGY: THE ROLE OF WORLD PRODUCT MANDATES II* (1980).

requires the establishment of specific R&D facilities with engineering, design and marketing capabilities.¹⁵ This latter benefit is significant because it has the potential of offering a high degree of autonomy to the subsidiary in the research area. It also increases the scope for spin-offs related to new technologies developed.

Among the investments reviewed by FIRA, roughly fifty involved plans to assign a world or regional (e.g. North American) product mandate to the Canadian subsidiary. Production arrangements of this kind were noticeably more frequent in the past five years than they were in the first five years of investment screening by FIRA. The majority of the WPM's were in the automotive, electronics, aerospace, and machinery sectors.

Technological benefits in one form or another were identified in roughly two-fifths of all investments approved under the FIR Act. This figure is not surprising since, as noted above, many of the investments reviewed were very small and a large percentage were in the service sectors of the economy, offering little scope for technology-related benefits. Very little quantitative data is available on the technological benefits that accompanied investments reviewed by the FIRA. In part this is because such benefits are not readily quantifiable. The agency did compile data on planned R&D expenditures by investors whose proposals were allowed. During the FIRA's existence—from April 1974 to June 1985—such planned R&D expenditures amounted to just under \$940 million (Can). Over the same period, R&D spending by all businesses in Canada was estimated at about \$16.7 billion (Can) according to Statistics Canada.

The New Thrust of Investment Policy

As already noted, the international investment environment has changed substantially over the last ten years. Many, if not most, of the changes had a basis in new applications of technology and increased international competition. Investment in Canada, as in other OECD countries, has become increasingly concentrated in production and trade in sectors dominated by product and systems innovations, both of which result from organized research, development and design. The innovations which result are not limited to the introduction of exotic technologies:

They also permit a shift in emphasis within sectors: towards product novelty, quality and reliability, and automated assembly in durable consumer goods; towards high value added materials in chemical and other intermediate products; and towards the growing incorporation of electronics in capital goods.¹⁶

¹⁵ *Id.*

¹⁶ ABONYI, *supra* note 1, at 10.

Established manufacturing processes, emphasizing long product life-cycles, are declining. High volume systems, using robotics and computers, are being built to give factories increased flexibility. Custom products are in demand and, as mentioned earlier, the number of cases where a given firm enjoys a substantial technological lead over its competitors are becoming less frequent. The rationale for establishing 100 percent-owned subsidiaries is no longer current. The capital intensity of R&D has prompted firms to share costs and pool their human resources. The emerging trend in international investment, according to a recent OECD study, "seems to be a tendency towards flexible and pragmatic forms of ownership, management and control inside increasingly complex arrangements, often involving several forms of control, cross-control or joint activities."¹⁷

Joint ventures, in particular, allow knowledge-intensive firms to market their technology abroad, earning the necessary revenues for new R&D. Joint ventures are attractive because they provide immediate access to other technologies and permit greater control over exports than other arrangements, such as licensing. With new emphasis on cost reduction rather than activity expansion and the search for market generating new processes and product innovations, they are often the only competitive avenue for new investment.

The application of new technology is fundamental to increased competitiveness. Given existing trade barriers and global marketing of products and sourcing of components, there is a need to encourage joint international R&D and commercial ventures. As the share of manufactured exports represented by technology-intensive products increases, the measure of R&D expenditures as a percentage of total value added will progressively increase.¹⁸ A recent internal study conducted by Canada's Federal Department of Science and Technology "showed that for both industry groups and individual industries in Canada the increase in value added, total shipments, employment, and labor productivity are greater the higher the research intensity of the group or industry."¹⁹

The application of new and existing technologies to the area of Canada's historical comparative advantage (i.e. resources) will also permit, through greater productivity and flexibility, increased value-added production and strengthened competitiveness. A stronger high-technology sector and a more specialized and competitive manufacturing sector will also lessen Canada's dependence on the resource sector in maintaining a

¹⁷ OECD, INTERNATIONAL INVESTMENT AND MULTINATIONAL ENTERPRISES GROUP, RECENT INT'L. DIRECT INVESTMENT TRENDS 33 (1981).

¹⁸ See OECD, TRADE IN HIGH TECHNOLOGY PRODUCTS: AN INITIAL CONTRIBUTION TO THE STATISTICAL ANALYSIS OF TRADE PATTERNS IN HIGH TECHNOLOGY PRODUCTS, DSTI/Spr/84-66, DSTI/IND/84.60 (Jan. 1985).

¹⁹ MINISTRY OF STATE FOR SCIENCE AND TECHNOLOGY, CANADIAN TRADE IN HIGH TECHNOLOGY: AN ANALYSIS OF ISSUES AND PROSPECTS (Aug. 1985) at 25.

healthy balance-of-payments position during the current period of low demand and high supply.

By 1985, those changes indicated the need for a new Canadian investment policy. The FIR Act with its underlying emphasis on the costs of foreign investment, and some suspicion of its motives, was replaced by Investment Canada Act (IC Act), which explicitly recognized the benefits that can accrue from investment, particularly when accompanied by new technology. This IC Act established a new agency, Investment Canada, with a mandate to encourage and facilitate investments. Although a review mechanism was retained under the new Act, it applies only to a small proportion of foreign investment. For example, the establishment of new businesses is exempt from review, except in specified culturally sensitive activities. For the few significant investments by non-Canadian that are subject to review, the review process has been substantially simplified.

It may be of some interest to note that when the new Act was being introduced, there was some considerable pressure, particularly from the scientific and high tech communities, to extend the review to small high tech. Such an extension was rejected on the grounds that it would defeat the purpose of attracting new technological investments.

For those investments still subject to review, the effect of the investment on "productivity, industrial efficiency, technological development and product efficiency" remains a factor in the assessment of benefit, just as under the FIR Act. Indeed, the importance of that element was emphasized in two recent cases. In approving the acquisition of Mitel Corporation, a Canadian electronic telecommunications equipment manufacturer, by British Telecom, Investment Canada Minister Sinclair Stevens noted that Mitel's R&D activities would remain in Canada.

Similarly, when Deere & Company acquired the agricultural equipment group of Versatile Corporation, the Minister emphasized that "all existing technologies, patents and licenses as they relate to products manufactured in Canada, as well as the responsibility for research and development and product design would continue to reside in Canada." The emphasis in the Minister's statement on those commitments to maintain technological development in Canada raises the question of whether the transactions would have been readily approved without them.

However, as noted above, the ability of the review mechanism to influence technological development is limited to the few cases that are subject to it. Generally it is through its positive mandate to exploit opportunities for investment and technological advancement that a significant contribution will be made by Investment Canada.

In carrying out its positive mandate, Investment Canada acts as a catalyst to the efforts of federal, provincial and private sector initiatives. Recognizing that the application of new technology is fundamental to increased competitiveness, not only in manufacturing, but also in the re-

source and services sectors, a priority of the agency is to encourage greater innovation and the use of more technology in Canada. It accomplishes this objective through a variety of means, including promotion, the identification of new sources of competitive technology-bearing investment, and the encouragement of new investment articles, such as licensing or joint ventures. In connection with joint ventures, it might be noted that the rules for determining the status of an investor under the new Act exempt many such arrangements from review.

The net effect of Investment Canada's proactive measures are, of course, yet to be measured. However, its emphasis on the role of technology and benefits, as well, rather than on the costs of foreign investment, will surely contribute to the goal of making Canadian business more competitive and efficient.