

D.10 Defining the Boundaries of Direct Investment

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This guidance note (GN) explores three issues that relate to the boundaries of direct investment (DI). In particular, it aims to (A) evaluate the extent to which there is inconsistency regarding the criteria to determine subsidiary corporations between the Balance of Payments and International Investment Position Manual, sixth edition (BPM6), the Benchmark Definition of Foreign Direct Investment, fourth edition (BD4), and System of National Accounts 2008 (2008 SNA), and if so, whether this leads to inconsistent application by compilers; (B) re-examine the DI threshold value (i.e., shifting the DI threshold from 10 percent to 20 percent) by highlighting previous international discussions on the threshold and providing a contemporary view; and (C) explore the compendium of research issue, “whether direct investment relationships can be achieved other than by economic ownership of equity (e.g., through warrants or repos)” (BPM6, paragraph 1.43). Regarding (A), this GN proposes to retain the numerical only DI threshold of the current definition in BPM6 and support the aims of GN G.2 “Treatment of MNE and Intra-MNE Flows” with respect to bringing the SNA definition into alignment with the BPM6. Regarding (B), based on the feedback from the Direct Investment Task Team, the drafting team found little appetite to shift to a 20 percent threshold. This position is further bolstered by a minority of members who caution against moving away from the 10 percent criterion. Finally, on (C), this GN suggests, removing from the research agenda the question of “whether direct investment relationships can be achieved other than by economic ownership of equity” and retaining the current treatment of warrants and repos.

SECTION I: THE ISSUE

BACKGROUND

1. **The *Balance of Payments and International Investment Position Manual, sixth edition (BPM6)* sets a strict numerical threshold that defines DI as investment where an investor holds 10 percent or more voting power to its investee.**² Referring to *BPM6*, paragraph 6.12, it mentions that “Control or influence may be achieved directly by owning equity that gives voting power in the enterprise, or indirectly through having voting power in another enterprise that has voting power in the enterprise. Accordingly, immediate direct investment relationships arise when a direct investor directly owns equity that entitles it to 10 percent or more of the voting power in the direct investment enterprise” (*BPM6*, paragraph 6.12). Also, *BPM6*, paragraph 6.13 notes that “In practice, effective control or influence may arise in some cases with less than these percentages. These definitions should be used in all cases, however, for international consistency and to avoid subjective judgments” (i.e., as per *BPM6*, paragraph 6.12, control is determined to exist if the direct investor owns more than 50 percent of the voting power in the DIE).

2. **In line with this determination, the definition of subsidiaries and associates follow a numerical threshold.** *BPM6*, paragraph 6.15 notes that regarding its relationship with a direct investor, a

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² The 10 percent criterion has been applied since from *Balance of Payments Manual, third and fourth editions*.

DIE is either a subsidiary or an associate with control or significant influence, respectively (see *BPM6*, paragraph 6.12).

3. **The *Benchmark Definition of Foreign Direct Investment, fourth edition (BD4)* also sets the same 10 percent numerical threshold as *BPM6*.** *BD4*, paragraph 117 states “foreign direct investment reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the enterprise. The direct or indirect ownership of 10 percent or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is evidence of such a relationship.” The identification of associates and subsidiaries as per the Framework for Direct Investment relationship (FDIR) is further detailed in *BD4*, Annex 4, in concordance with *BPM6*.

4. **Furthermore, *BD4*, paragraph 117 mentions that “some compilers may argue that in some cases an ownership of as little as 10 percent of the voting power may not lead to the exercise of any significant influence, while on the other hand, an investor may own less than 10 percent but have an effective voice in the management of the enterprise. Nevertheless, the methodology does not allow any qualification of the 10 percent threshold and recommends its strict application to ensure statistical consistency across countries.”**

5. **The 2008 SNA, paragraphs 4.73 and 4.75 define an entity subject to control or a significant degree of influence by a direct investor as follows:**

“Subsidiary corporations

Corporation B is said to be a subsidiary of corporation A when:

- a. Either corporation A controls more than half of the shareholders’ voting power in corporation B;
- or
- b. Corporation A is a shareholder in corporation B with the right to appoint or remove a majority of the directors of corporation B.

Associate corporations

Corporation B is said to be an associate of corporation A when corporation A and its subsidiaries control between 10 percent and 50 percent of the shareholders’ voting power in B so that A has some influence over the corporate policy and management of B.”

6. **While there is broad consistency among the three manuals, the 2008 SNA allows an option to define a subsidiary corporation as one where an investor may control its investee via shareholding and where it has the “right to appoint or remove a majority of the directors”.** As a result, the criteria for subsidiary corporations as defined in the 2008 SNA goes beyond the prescribed numerical approach in the *BPM6* and *BD4*.

7. **Considering another aspect of DI boundary, the *BPM6* research agenda includes the question, “whether direct investment relationships can be achieved other than by economic ownership of equity (e.g., through warrants or repos)” (*BPM6*, paragraph 1.43 b).** Similarly, *BD4* includes “Acquiring voting power without purchasing equity (e.g., swaps, repurchase agreements)” in its research agenda.

8. **Regarding warrants and voting power**, *BPM6*, paragraph 6.19 notes “*voting power is not recognized if temporarily obtained through the holding of warrants (because the warrant holder does not possess voting power until the warrants are exercised)*”. Owning warrants currently does not equate to having voting power and the investor is unable to influence the issuer of warrants.

9. **Regarding the treatment of repos and voting power** (repurchase agreements), *BPM6*, paragraph 6.19 mentions “*voting power is not recognized if temporarily obtained through repurchase agreements (because no change in the economic ownership of the shares has occurred)*”. However, voting power can be transferred in legal terms without a change in the economic ownership of the shares in the case of repurchase agreements or securities lending.

ISSUES FOR DISCUSSION

Issue A: Definition of a Subsidiary Corporation

10. **The drafting team considered whether balance of payments compilers could utilize the 2008 SNA option to classify a subsidiary corporation** as a result of an investor being able to remove or appoint the majority of the directors regardless of whether a 50 percent equity stake is held.

11. **To evaluate the subsidiary issue specifically, the drafting team surveyed Direct Investment Task Team (DITT) members on the use of the SNA option to classify a subsidiary, or cases where it may be relevant.** The majority of DITT members were unable to identify a case of this type. One member highlighted instances of golden shares and where the effective control of an investment fund remained with a single unit.

12. **However, the majority view of DITT members is to retain the current guidance, which is aligned with the proposal in GN G.2 “Treatment of MNEs and Intra-MNE Flows” as prepared by the Globalization Task Team (GZTT).** GN G.2 recommends the SNA adopt the definition of control as defined in *BPM6* and *BD4* (see GN G.2, pages 23–24 at [Joint Globalization Task Team \(GZTT\) \(imf.org\)](#)).

13. The drafting team proposes the following alternatives for consideration:

- a. **Alternative 1 (A1): Status quo** – A1 retains a numerical threshold as the current definition in *BPM6* and supports the aims of GN G.2 with respect to bringing the SNA definition into alignment with the *BPM6*.
- b. **Alternative 2 (A2): Modify the current subsidiary criterion within the *BPM6*** – A2 suggests a change to the *BPM6* criterion to include 2008 SNA references (i.e., the “*right to appoint or remove a majority of the directors*”).

Issue B: DI Threshold

14. **The second element of DI boundaries is a re-evaluation of the 10 percent FDI threshold, by highlighting previous international discussions on DI thresholds and providing a contemporary perspective.** The boundary of DI was discussed at the 2004 IMF Committee on Balance of Payments Statistics meeting and OECD Workshop on International Investment Statistics Direct Investment

Technical Expert Group (DITEG). In the DITEG outcome paper #2,³ the group endorsed the proposal to move the threshold of the operational definition for a DI relationship from 10 to 20 percent of voting power or ordinary shares. However, this proposal was ultimately unsupported due to the consideration of data discontinuity and the Committee rejected DITEG's proposal to move the threshold for establishing a direct investment relationship from 10 percent equity (or equivalent) to 20 percent.⁴

15. **Regarding a current treatment of the threshold, the OECD in its 2016 metadata survey on *BD4* indicates that 20 out of 34 respondents strictly apply a numerical threshold, that is, the 10 percent voting power criterion when identifying DIES.** Nine respondents apply a *value threshold* in addition to the voting power criterion. The remaining (five) respondents also include enterprises that do not meet the 10 percent voting power criterion but have influence on the management and/or they exclude enterprises that meet the criterion but do not have influence on the management.⁵

16. **The drafting team sought to re-evaluate the DI threshold in terms of alignment with *International Accounting Standards (IAS)* as a basis and guideline for compilers.** In this regard, the *IAS* include similar concepts compared to *2008 SNA*, so definitions of subsidiary and associate corporations in *IAS* seem suitable for reference.

17. **A contemporary evaluation finds:**

- a. There have been sufficient changes in the economic environment that call for this decision to be revisited given that under recent expanding Portfolio investment (PI) activities, some investors own 10 percent or more voting power even if they do not intend to control their investee. These investments should be classified as PI conceptually, but they are recorded as DI based on *BPM6*. Transactions by institutional investors that repeat investments around the 10 percent criterion lead to fluctuations in the data. Referring to accounting standards, holding 20 percent or more voting power is considered as owning significant influence on investees, and this standard implies the recognition of general enterprises to own significant influence. In order to capture investment that aims to control and own significant influence, it seems preferable to reconsider the current 10 percent criterion.
- b. The threshold used in financial accounting, which is about informing investors and analysts about the status and value of a company, is suited to the reasons that we distinguish DI from PI in the accounts. This is because 20 percent does serve the purpose of financial stability analysis and identifies capital flows that are likely to be less volatile and less likely to reverse in a crisis.
- c. Other standards that identify when investors have influence, such as those used by regulators of stock markets, were deemed not to be relevant because regulators of stock markets sometimes aim to protect domestic enterprises from foreign investors.

³ [Direct Investment: 10 Percent Threshold \(BOPCOM-04/31\)—Seventeenth Meeting of the IMF Committee on Balance of Payments Statistics, Pretoria, October 26–29, 2004.](#)

⁴ See at [IMF Committee on Balance of Payments Statistics Annual Report 2004](#), Box 1 in page 8.

⁵ More details are available in the [OECD metadata database on *BD4*](#).

18. **The drafting team considered how this assessment would resonate with the broader DITT and surveyed members on this topic.** Though some members of DITT responded that moving to 20 percent threshold would have little impact, the majority of DITT members had not undertaken analysis on the topic. From this feedback, the drafting team sensed little appetite to shift to a 20 percent threshold, which was further bolstered by a minority of DITT members who cautioned against moving away from the 10 percent criterion.

19. The drafting team proposes the following alternatives for consideration:

- a. **Alternative 3 (A3): Status quo (holding 10 percent or more voting power)** – This alternative suggests retaining a 10 percent threshold.
- b. **Alternative 4 (A4): Holding 20 percent or more voting power** – This alternative suggests applying a 20 percent threshold to determine the DI relationship.

Issue C: DI Relationship other than by Equity

20. **The drafting team considered whether DI relationships can be achieved other than by economic ownership of equity.** Consideration of warrants and repurchase agreements (repos) formed the initial investigation, which then expanded to cover the extent to which holdings of debt securities could influence managerial decision-making in a similar way to holding equity. In that context, the drafting team is aware of the potential for influential relationships to exist where debt holders influence managerial behavior, such that the links between financial risk and managerial influence exist. A question remains whether this influence is to a significant enough degree and prevalent enough to be thought of in the same way as economic ownership of equity within DI.

21. **To explore the extent to which global activities that may be associated with a DI relationship do indeed exist beyond economic ownership of equity,** the drafting team posed some questions (see Annex III) to the DITT.

22. **The responses from the DITT unanimously indicated that DI relationships could not be practically identified beyond the economic ownership of equity.** Specific responses noted that “*direct investment relationship achieved other than by economic ownership of equity*” seems rare or “*logically exists but difficult to recognize in the current data compilation framework*”.

23. **The drafting team propose the following alternatives for consideration:**

- a. **Alternative 5 (A5): Maintain status quo and remove the item from research agenda.** This proposal seeks to *remove from the research agenda the question of “whether direct investment relationships can be achieved other than by economic ownership of equity (e.g., through warrants or repos)”*.
- b. **Alternative 6 (A6): Retain the item within the research agenda for future evaluation.**

SECTION II: OUTCOMES

SUMMARY OF DISCUSSIONS WITHIN THE DITT

Issue A – Definition of Subsidiary Corporations

24. **The proposal to include a subjective element to define subsidiary corporations, as per 2008 SNA, was unanimously rejected by members.** While acknowledging that a numerical indicator is often somewhat arbitrary, all members disagreed with the proposal on principle. Consideration of a definition for subsidiary that included a subjective, non-numerical approach had several detractors as it would not ensure:

- a practical and unambiguous (transparent) methodology for DI compilers and analysts;
- reduction to responder burden for potentially minimal gain;
- comparability across countries, promote consistency or homogeneity;
- a defined separation between DI and non-DI reducing occurrence of bilateral asymmetries;
- reconciliation of DI and Activities of Multinational Enterprises (AMNE) statistics and on both Coordinated Direct Invest Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS) databases.

25. **Seventy-nine percent (11 members) did not agree with the proposal to apply a criterion to determine effective control or influence, preferring to retain a numerical threshold.** Only a small minority agreed with the proposal to include a subjective element in addition to a numerical element.

26. **This stance supports related elements within GN G.2.** GN G.2 recommends the SNA adopt the definition of control as defined in *BPM6* and *BD4* with the following rationale “...in general effective minority control is not easily discernable and is subject to information that is not readily accessible to national compilers, such as the voting power of the entities within the group...the 2008 SNA notes the general alignment with *BPM6* and *BD4* but allows for some flexibility. For consistency, and to avoid any subjective judgement, the GZTT proposes defining control [as per *BPM6*, paragraph 6.12]. This definition of control is aligned with the Framework of Direct Investment Relationship (*FDIR*)”. (GN G.2, paragraphs 23–24)

27. **The drafting team agreed that the concept of subsidiary should be defined for where it is widely and consistently applied (i.e., within the remit of *BPM6*).**

Issue B – DI Threshold

28. **Thirty-six percent (five members) said moving to 20 percent threshold would have little impact, while 64 percent (nine members) said no analysis had been undertaken.** Four members commented on the merits of moving the DI threshold from 10 to 20 percent. Three of the four wished to maintain the status quo and noted caution around a threshold change. One member saw merit in a shift to a 20 percent threshold in terms of greater coherence with “company’s rules but also to be more realistic with the possible influence”.

Issue C – DI Relationship, other than by Equity

29. DITT members unanimously agreed with removing the question from the research agenda and retaining the current treatment of warrants and repos. Further investigation was requested regarding the cases of SPVs that take the form of orphan entities.

RECOMMENDATIONS

30. The drafting team recommends
- a. **Accept A1: Status quo** – A1 retains a numerical threshold as the current definition in *BPM6* and supports the aims of GN G.2 with respect to bringing the SNA definition into alignment with the *BPM6*.
 - b. **Accept A3: Status quo (holding 10 percent or more voting power)** – This alternative suggests retaining a 10 percent threshold.
 - c. **Accept A5: Maintain status quo and remove the item from research agenda** – This proposal seeks to remove from the research agenda the question of “*whether direct investment relationships can be achieved other than by economic ownership of equity (e.g., through warrants or repos)*”.

Questions for Discussion:

- 1) *Do you agree with the DITT recommendation to retain a numerical threshold as the current definition of subsidiary corporation in BPM6 in line with A1?*
- 2) *Do you agree with the DITT recommendation to retain the current 10 percent threshold for the definition of associate corporation (proposal A3)?*
- 3) *Do you agree to remove the question “whether direct investment relationships can be achieved other than by economic ownership of equity (e.g., through warrants or repos)” from research agenda (i.e., accept A5 and reject A6)?*

Annex I. Supplementary Information

TITLE OF REFERENCED DOCUMENT

IFRS Foundation (2018) "Use of IFRS Standards around the world (2018)", London

IFRS Foundation "IAS28"

IFRS Foundation "IFRS10"

IMF (2008), *Balance of Payments and International Investment Position Manual, sixth edition*, Washington, DC.

OECD (2008), *Benchmark Definition of Foreign Direct Investment, fourth Edition*, Paris

OECD and Luxembourg (2004) "DITEG Issues Paper # 2 Direct Investment – 10 Percent Threshold of Voting Ower/Equity Ownership, Employment"

Annex II. List of Chapters to Update

STATISTICAL MANUAL – CHAPTER AND PARAGRAPH(S)

Balance of Payments and International Investment Position Manual, sixth edition: 1.43 A research agenda has been identified for possible future work. It includes the following:

Remove

(b) whether direct investment relationships can be achieved other than by economic ownership of equity (e.g., through warrants or repos) (see paragraph 6.19)

Annex III. Survey – DITT

DITT members have answered the following survey during the preparation of this note.

Q1 Have DITT members observed cases when an investor acquires influence by purchasing warrants that would convert to more than 10 percent equity ownership once exercised?

Q2 Have DITT members observed the following cases related to repurchase agreements or securities lending? If yes, please mention the frequency of the cases observed (e.g., very rare to frequently observed).

- a) The case where an investor accumulates more than 10 percent voting power of an entity via repurchase agreements or securities lending and vice versa.
- b) Any other cases involving influence as a result of warrants and repurchase agreements.

Q3 Moving beyond equity, have DITT members observed cases when an investor, regardless of equity holdings in an enterprise acquires significant influence through the purchase of other financial instruments?

If yes

- a) Did the investor company have an up or down stream customer relationship with the investee company?
- b) Did the investor company have an up or down stream customer relationship with the investee company and lend on favourable terms?
- c) Did the investor have a traditional commercial (arm's length) relationship (e.g., where the investor counterparty is a financial institution)?
- d) Did the investor company already have a minor equity stake (i.e., below 10 percent)?
- e) Any other scenario? Please describe: