

D.3 Treatment of Collective Investment Institutions

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The Balance of Payments and International Investment Position Manual, sixth edition, *recommends that investments in and by collective investment institutions (CIIs) that meet the operational definition of direct investment (DI) be included in DI. CIIs cover a wide variety of undertakings in which the main focus of managers tends to vary from passive management of the investment portfolio to active management of the day-to-day operations and/or long-term strategy of the companies in which they invest. There is also the question of who is undertaking these investments: is it the fund managers or is it the individuals invested in the funds? This note discusses these issues with the inclusion of CII in DI and offers several alternatives for recording investments in and by CIIs. The Direct Investment Task Team agreed that there was justification for modifying the operational definition of direct investment to exclude some investments in and by CIIs.*

SECTION I: THE ISSUE

BACKGROUND

1. **Current guidelines offer a clear prescription for measuring direct investment (DI) in and by collective investment institutions (CIIs).** Nevertheless, the guidelines also acknowledge the possibility of practical and conceptual difficulties with this treatment and characterize the suggested guidance as “debatable.”²
2. **Paragraph 570 of the OECD Benchmark Definition of Foreign Direct Investment, fourth edition 2008 (BD4) defines CIIs³** as “incorporated investment companies and investment trusts, as well as unincorporated undertakings (such as mutual funds or unit trusts), that invest in financial assets (mainly marketable securities and bank deposits) and/or nonfinancial assets using the funds collected from investors by means of issuing shares/units (other than equity).” The paragraph goes on to recommend that when an investor in one economy acquires at least 10 percent of the voting power in a CII in another economy, this investment should be regarded as DI. Similarly, when a CII owns at least 10 percent of the voting power of a nonresident entity, this relationship should also be considered as DI.
3. **The significance of CIIs in countries’ DI statistics is difficult to quantify.** In a survey of WGIIIS member countries conducted in May 2016, 12 countries indicated that they cover CIIs in their DI statistics as direct investment enterprises, 17 countries did not, and 3 countries covered them only partially.⁴

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² Paragraph 593 of the *OECD Benchmark Definition of Foreign Direct Investment, fourth edition 2008*.

³ The *BPM6* does not specifically define or refer CIIs but rather refers to collective investment schemes.

⁴ https://qdd.oecd.org/data/FDI_Metadata_ComparativeTables/Q18+C_Q18_EXC.

4. **For the United States, international investment by CIIIs that involve (directly or indirectly) a 10 percent or greater equity stake in an operating company are included in DI statistics.**⁵ Likewise, 10 percent or greater nonresident equity stakes in CIIIs that make such investments are treated as DI. The United States has not attempted to identify all CIIIs in its outward DI universe but, based on exploratory research, it found that foreign affiliates of the largest U.S. private equity firms accounted for at least 2.3 percent of employment by all foreign affiliates, but it is a lower-bound estimate of the presence of CIIIs in the U.S. direct investor universe [presentation by the United States at the November 2020 WGIIIS meeting, (OECD, 2020)].

5. **In the European Union (EU) context, CIIIs mostly refers to investment funds that are principally engaged in financial intermediation.** EU countries considered that DI relationships are only meaningful in closed-end funds, that is, funds where no additional shares are issued, and the fund itself won't redeem—buy back—shares. Closed-end funds were estimated as 0.6 percent of the total market capitalization of CIIIs at end-2016 in the EU. Based on that outcome, EU countries exclude CIIIs liabilities from their DI statistics, classifying them instead as portfolio investment. However, CIIIs may be direct investors when the 10 percent rule on equity (SNA Financial Asset/Liability F51) applies, including the specific case of other equity investment (F519), including real estate.⁶ For Luxembourg, CIIIs assets classified as DI are a very small part of both aggregate balance sheet and external assets of CIIIs.

6. **For Brazil, any relevant international investment in or by CIIIs that conveys a voting interest of at least 10 percent by the investor is included in DI, although these investments have not been separately identified in the statistics.** This is in line with IMF's *Balance of Payments and International Investment Position Manual*, sixth edition (*BPM6*) guidance on standard components. The available source data for positions and transactions would nonetheless allow for separate identification of CIIIs.

7. **For South Africa, national laws prohibit mutual funds from holding more than 10 percent of an unlisted company or more than 5 percent of a listed company.** Therefore, DI by mutual funds is essentially nonexistent. DI in CIIIs is classified in portfolio investment, partly for practical reasons, including those mentioned for the EU, and partly for conceptual reasons, which are discussed below.

8. **There are conceptual and practical difficulties raised by this topic, which do not consistently point to a preferred solution.** Conceptually, it is not clear that the motivations and effects of DI by CIIIs are consistent with those of traditional direct investors. An academic paper examining venture capital firms put it this way: "The cross-border expansion of venture capital firms presents an interesting case of internationalization, because they are at variance with both conventional portfolio and DI models" [Guler and Guillén (2010): p. 185]. A fundamental question is the extent to which the decision makers within the firm are concerned with managing the strategic and day-to-day operations of the individual businesses they own versus with managing their portfolio return.

⁵ The term "equity stake" is used throughout this note to denote an equity stake that conveys a 10 percent voting interest. Many private equity firms have partnerships in their ownership structures. In partnerships, the notion that equity stakes convey voting rights does not apply. Limited partners are presumed to have equity stakes without voting rights, while general partners are presumed to have all of the voting rights with little or no equity stakes. An "operating company" is a business that is neither a CIIIs nor a special purpose entity.

⁶ See Annex IV for conceptual guidance from the European Union.

9. **An exploratory study by the United States suggests that U.S. parents that are CII show little evidence of providing headquarters services to their foreign affiliates**, have a higher tendency to use financial leverage, and are less focused on the long-term growth of their affiliates [presentation by the United States at the November 2020 WGIIS meeting, (OECD, 2020)]. On the other hand, even if these firms have motivations and strategies that differ in some respects from traditional direct investors, they can bring the kinds of benefits to economic growth and stability to their host countries that policymakers seek from DI. For example, the funding provided by certain CII might fill an important funding gap that is available to young, fast-growing, innovative businesses.⁷ For a discussion of practical challenges for compilers, see Annex II.

ISSUES FOR DISCUSSION

10. **In order to address the conceptual and practical issues outlined above, three major alternatives, and three sub-alternatives have been identified for the treatment of CII.** All five alternatives are described below.

11. **In developing these alternatives, the authors sought to integrate the recommendations here with those in the guidance notes on the sectoral breakdown of direct investment (GN D.7) and nonbank financial intermediation (F.6), but this was not always easy to do.** See Annex III for details.

A1. Alternative 1

12. The **methodological and presentational status quo** is supported by current operational guidelines for measuring DI and in concept as well, to some extent. Operationally, DI is defined in the *BPM6* as based strictly on the 10 percent equity criteria (*BPM6*, paragraph 6.13). Conceptually, by virtue of these significant equity stakes, CII investors can influence the management of the companies in which they invest, whether or not they choose to do so. Therefore, there is no need to distinguish DI in or by CII from other DI.

A2. Alternative 2

13. The **methodological status quo** is supported by current operational guidelines for measuring DI but there are valid conceptual reasons for presenting separate statistics on DI in or by CII. Conceptually, it is not clear that the motivations of CII are like those of traditional direct investors. Whereas traditional direct investors tend to be concerned with managing the strategic and day-to-day operations of the individual businesses they own, CII direct investors tend to be more, or entirely, focused on managing their portfolio return. Therefore, **compilers should be encouraged to separately identify and present additional detail on DI in or by CII.**

A3. Alternative 3

14. **Given that the motivations of CII for acquiring 10 percent or greater equity stakes in businesses can differ, to varying extents, from those of traditional direct investors, there is**

⁷ These businesses are sometimes referred to as gazelles or unicorns. See, for example, Del Sorbo et al. (2018). The authors thank Sami Hamroush of the U.K. Department for International Trade for this insight.

justification for modifying the operational definition of DI to exclude certain investments in or by CII. Nevertheless, from a conceptual perspective, the extent to which the owners of CII are concerned with managing the strategic and day-to-day operations of the individual businesses they own, arguably, varies by class of CII. Against this backdrop, we offer three sub-alternatives: A3.1, A3.2, and A3.3.

A3.1. Alternative 3.1

15. **The operational definition of DI should be changed to exclude investments in or by CII:** This alternative takes the most aggressive stance toward changing current standards to account for the non-traditional nature of 10 percent or greater equity stakes in or by CII. Conceptually, the motivations of investors in CII and CII for acquiring 10 percent or greater equity stakes in businesses often differ from those of traditional direct investors. Some CII hold more than 10 percent of foreign listed shares, which should, under Alternative 3.1 be re-classified to portfolio investment. From the DI enterprise side, the compiler should spot ex ante those particular CII investors and exclude them from their DI liability figures. Besides, some CII hold foreign land or real estate.⁸ The *BPM6* paragraphs 4.34 to 4.39 details that those foreign assets should be recorded under DI—Other equity, as notional units. **This alternative may trigger an unwished amendment in the link between Financial Assets Classification and Functional Categories (*BPM6* table 6.1) if foreign land or real estate held by CII should be recorded under Portfolio Investment; otherwise could be reported under Other investment.**

A3.2. Alternative 3.2

16. **Investments in investment funds shares (F52) will be considered always Portfolio Investment while investments by Investment Funds may qualify as DI in accordance with the *BPM6* current DI rules.** This alternative focuses on institutional sectors MMF (S.123) and non-MMF investment funds (S.124). This alternative offers a streamlining of CII's liabilities where investment shares/units are generally classified as Portfolio Investment. As such, it might also improve the comparability of CPIS and CDIS. The operational definition of DI would remain for the rest of CII. Conceptually, it could be argued that the collective legal nature of the investment funds, that is, more than one investor, suggests that no single foreign resident has a direct control on the investment strategy and day-to-day operations of the fund. Therefore, 10 percent or greater equity stakes in investment funds should be treated as portfolio investment. However, in the case of DI by Investment Funds, the fund as statistical unit should be viewed as the investor that takes investment decisions, suggesting the possibility of control over the strategic and day-to-day operations of the individual businesses it owns. Therefore, 10 percent or greater equity stakes held by investment funds in operating company abroad would be recorded as DI. This alternative is the current EU approach.

A3.3. Alternative 3.3

17. **Under this alternative, the operational definition of DI would remain only for Private Equity funds or real estate funds and should be changed to exclude investments in or by CII that are not private equity funds or real estate funds.** It questions the assumption, in alternative 3.2 that CII

⁸ Or even mobile equipment, ships, aircraft, gas and oil drilling rigs, etc. Nevertheless, the practical need for consistent recording of foreign land or real estate is mitigated by the fact that many compilers are not able to separate these investments, which are often a small share of total foreign holdings.

owners of 10 percent or greater equity investments are individual investors rather than in some cases only managers of those CIIIs and recommends consistently treating investments in and by CIIIs. It recognizes the fact that control is unlikely to be exercised by the managers of all types of CIIIs. It is likely that only private equity funds and, perhaps, real estate funds, tend to operate this way. Therefore, this alternative would record only the 10 percent or greater equity stakes held in private equity funds and real estate funds if the funds have a 10 percent or greater equity stake in operating companies as DI liabilities. Those assets would also be recorded as DI. (See Annex V for a discussion of the question of identification of the institutional unit in a private equity fund.) However, this proposed treatment may create some world asymmetries if the DI enterprise does not identify the investment fund as a private equity fund or a real estate fund and therefore consider the investment under portfolio investment. On the other hand, this issue is not unique to alternative 3.3. There is a need for coordination of the collection of data on DI and on portfolio investment under any alternative. Additionally, the compiler of the country investing in the private equity fund should look through the investment of the fund and collect details of the companies where the fund is investing to identify if its investment in the CIIIs qualifies as direct or portfolio investment. This alternative is similar to the current US approach.

SECTION II: OUTCOMES

18. **Consultation within the Direct Investment Task Team (DITT) showed a preference for Alternative 3, for diverse reasons, with a slight majority for option 3.3.**⁹ It was recognized that the primary motivation of some investments in or by CIIIs differs fundamentally from that of traditional direct investors. Support was to revise the *BPM6* definition of DI accordingly. As noted in paragraph 6.2 of the *BPM6*, functional categories “take into account some aspects of the relationships between the parties and the motivation for investment.” Paragraph 6.4 describes the distinguishing characteristics of a DI relationship this way:

DI is related to control or a significant degree of influence and tends to be associated with a lasting relationship. As well as funds, direct investors may supply additional contributions such as know-how, technology, management, and marketing. Furthermore, enterprises in a DI relationship are more likely to trade with and finance each other.

19. **The DITT members strongly agreed that some 10 percent or more equity investments in CIIIs should be classified as portfolio, rather than DI.** The rationale is that the primary motivation of investors in these cases seems to be more focused on managing their portfolio return than on managing the strategic and day-to-day operations of the individual businesses they own.

20. **Among the alternatives offered, there was a majority preference for alternative 3.3 but also considerable support for alternative 3.2.** Alternative 3.2 offers a streamlining of CIIIs liabilities where investment shares/units are always classified as portfolio investment. As such, it might also improve the comparability of Coordinated Portfolio Investment Survey (CPIS) and Coordinated Direct Investment Survey (CDIS). Yet the preference of the majority for alternative 3.3 rests primarily on three factors. First, among CIIIs, private equity funds seem unique in their dual focus on managing their portfolio return and

⁹ Thirteen of 15 DITT members expressing a preference preferred alternative 3. Among those preferring an alternative 3, seven preferred alternative 3.3 and five preferred alternative 3.2.

on providing at least some guidance on the strategic direction, although there is lack of the day-to-day control of the operations, of the individual businesses they own. Second, unlike alternative 3.2, this option recognizes that 10 percent or greater equity stakes in CII by entities abroad are more likely to be an associated group making collective decisions than like individual investors passively letting others manage their investment. Clear definitions of CII categories that are in-scope for direct investment (here, private equity funds and real estate funds), as well as guidance on the BPM/SNA institutional sectors in which they should be classified, should be included in the update of the manuals.¹⁰

REJECTED ALTERNATIVES

21. **Alternative 1** and **Alternative 2** were rejected because they do not recognize that the motivations of at least some classes of investment in or by CII are only weakly, or not at all, consistent with the distinguishing characteristics of DI described in paragraph 6.4 of the *BPM6*. **Alternative 3.1** was rejected because it seems to go too far in demanding strict adherence to those distinguishing characteristics.

Questions for Discussion:

1. *Do you agree that adhering to current guidelines on DI in or by CII are challenging and somewhat impractical such that further/clearer guidance is needed?*
2. *Do you agree that the motivation for at least some 10 percent or greater equity investments in or by CII is so different from the description of the functional category of DI in the *BPM6* that the definition of DI should be modified?*
3. *Taking into consideration the strengths and weaknesses of alternative A3.2 and A3.3, which one of the two, would you support?*

¹⁰ Guidance on sectoring might be provided under the auspices of the Financial Issues Task Team guidance note F.1 (More disaggregated definition of the financial sector and financial instruments) or guidance note F.6 (Non-Bank Financial Intermediation).

Annex I. Supplementary Information

TITLE OF REFERENCED DOCUMENT

Del Sorbo, Maria, Vértessy Daniel, Damioli Giacomo (2018), *An EU-US Statistical Overview: Business Demography and Scaling up Comparisons*, European Commission, Joint Research Centre, Ispra, 2018.

European Central Bank (2017), *Manual on Investment Fund Statistics* (December 2017)

Guler, Isin, and Mauro F. Guillén (2010), *Institutions and the Internationalization of US Venture Capital Firms*, *Journal of International Business Studies* 41.2 (2010): 185–205.

OECD (2020), *Private Equity in the Outward Direct Investment Statistics of the United States: A Preliminary View*, presented by the United States at the WGIIS November 2020 meeting (reference “DAF/INV/STAT/WD(2020)3”), Virtual Meeting.

OECD (2016), *OECD Metadata Survey on BMD4: Metadata Tables*, presented at the WGIIS March 2017 meeting (reference “DAF/INV/STAT(2016)10/REV1/ADD1”), Paris.

Annex II. Practical Challenges for Compilers

1. **The challenge of ensuring universe coverage.** Practically speaking, tracking and identifying CIIIs can be difficult. They greatly outnumber traditional multinational enterprises. Based on the 2020 edition of Pratt's Guide to Private Equity and Venture Capital Sources, there are over 14,000 private equity firms worldwide. Based on data from the International Investment Funds Association, there are over 100,000 regulated open-end mutual funds worldwide.¹¹ In contrast, the 2020 World Investment Report from UNCTAD estimates that the top 5,000 MNEs account for most of global DI.
2. **In some countries CIIIs are well identified and regulated while in other jurisdiction the borderline between investment funds and other financial institutions is not so well defined.** In addition, the number of hybrids as venture capital and private equity entities is growing making the life of the compiler much more difficult as they need additional information to identify them as CIIIs. For example, the existence of day-to-day control over the assets in which the capital is invested will indicate that they are not CIIIs.
3. **The challenge of ambiguous terminology.** For compilers, identifying CIIIs in the DI universe is difficult, because it is an ambiguous term to many practitioners and therefore providing survey respondents with clear definitions of CIIIs, especially their subclasses, can be difficult.¹² A starting point here may be the definitions offered in the European Central Bank's Manual on Investment Fund Statistics.
4. **The challenge of measuring ownership.** Investments by CIIIs often using complex chains of ownership, including the use of master and feeder funds, which can make it difficult to identify the decision-making unit in the CII organization structure.¹³ Also, in those lines of ownership, there can be differences between the level of equity control and the level of voting control. This complexity can make it difficult to determine the ultimate investing economy or the ultimate statistical unit within an economy. Looking through the investment of the fund and collecting details of the companies where the fund is investing would pose an additional heavy burden upon compilers and/or reporting entities. In addition, countries/compiler with limited capacity regarding staff and resources might be unable to cope with this requirement. Compilers may even face national or supranational statistical regulations prohibiting them from following investments to the entity within an economy that ultimately receives the funds.

¹¹ See International Investment Funds Association, "Worldwide regulated open-fund assets and flows, first quarter 2020" (https://cdn.ymaws.com/iifa.ca/resource/collection/BD2DD483-21F4-4BA5-97D2-FFDD152D23ED/Worldwide_Regulated_Open-End_Fund_Assets_and_Flows_-_First_Quarter_2020.pdf). Number counts exclude funds of funds.

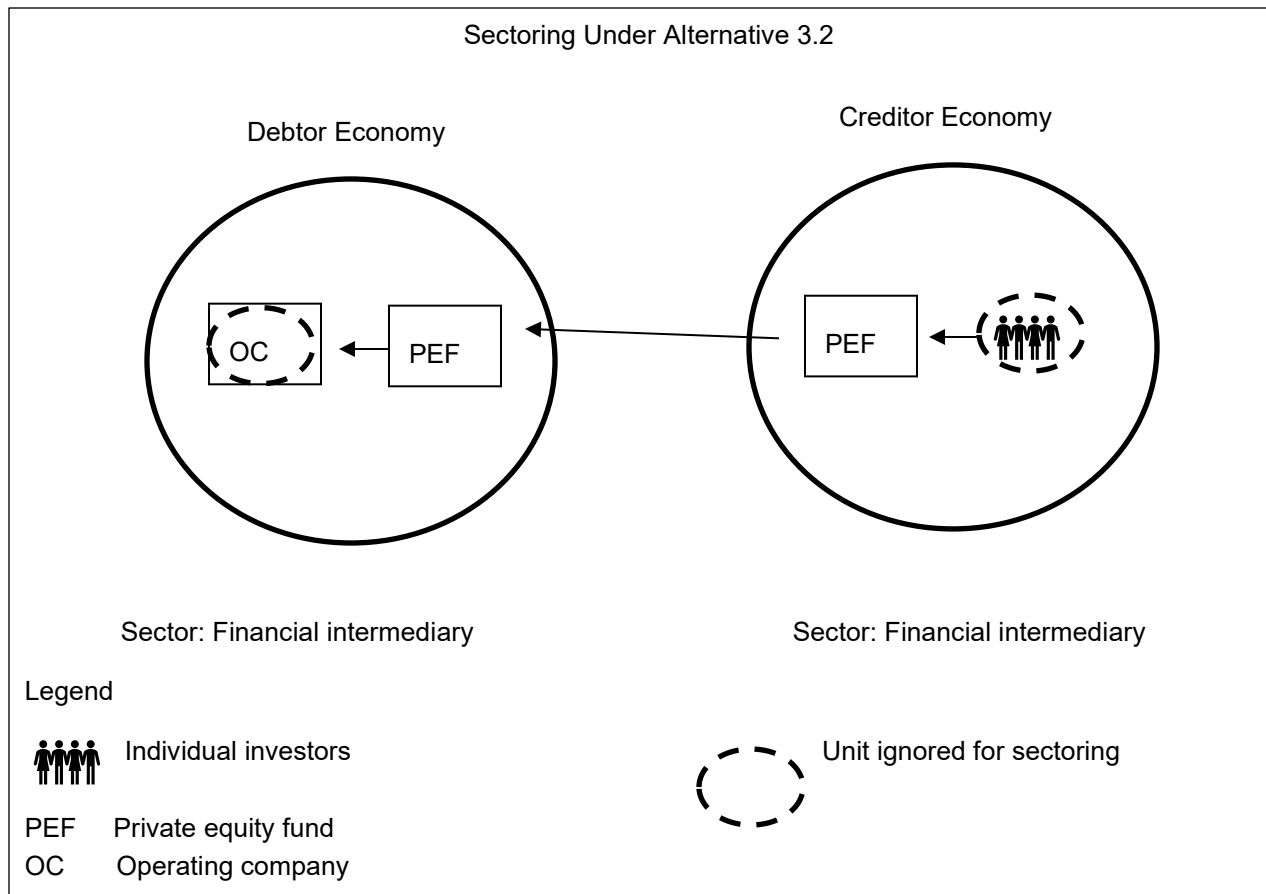
¹² For a typology of CIIIs, see chapters 3–5 of European Central Bank (2017).

¹³ For an explanation of master and feeder funds, see chapter 6 of European Central Bank (2017).

Annex III. Sectoring

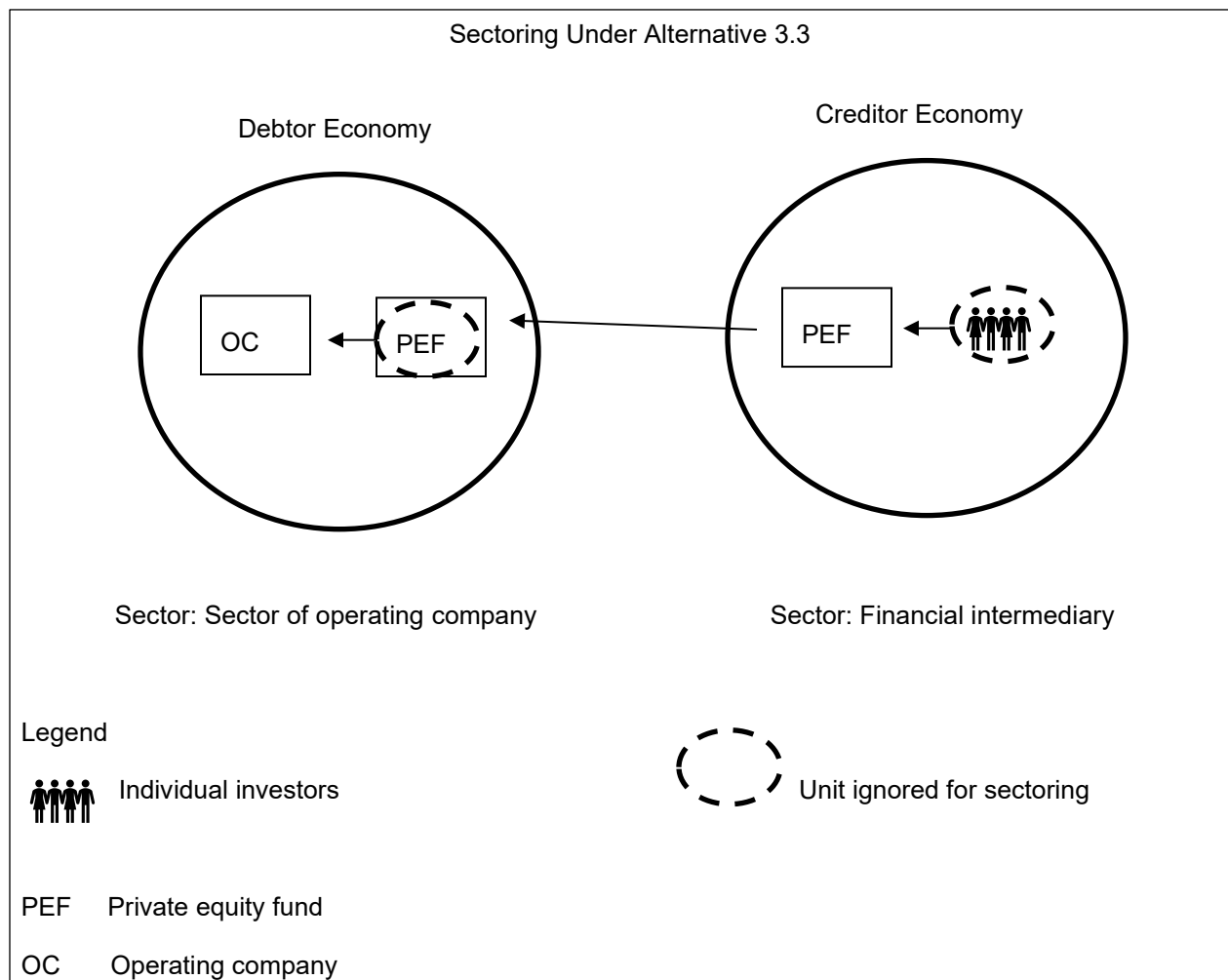
1. **The authors of this note sought to integrate the recommendations here with those in the guidance note on the sectoral breakdown of direct investment (GN D.7) and nonbank financial intermediation (F.6),** but this was not always easy to do. First, the recommended level of sectoral breakdown in those other notes is not nearly as detailed as would be needed to implement or illustrate the proposed guidance here. Second, CII could involve more than one institutional sectors, this note already identified investment funds (S124), other financial intermediaries (S125) and other financial auxiliaries (S126). Third, even if the necessary detail were available, its utility toward facilitating the recommendations here varies by alternative.

2. **The proponents of alternative 3.2 believe that classification by sector upholds their proposal in both a conceptual and a practical sense.** Conceptually, alternative 3.2 treats 10 percent or greater equity stakes in CII as portfolio investment based on the notion that these are “collective” investments so that even if the group of investors has an equity stake of that size, it is unlikely that any individual investor in the group does. It treats 10 percent or greater equity stakes by CII as direct investment based on the notion that the fund managers, rather than the individual fund participants who should be viewed as the investors. Practically, once the sector of the entity making or receiving the investment is identified and, in the case of assets, once the size of the equity stake is identified, it becomes easy to implement the suggested guidance of alternative 3.2.



Note: This simple example is not meant to be detailed nor exhaustive, but only to roughly illustrate some of the possible sectoring differences between alternative 3.2 and alternative 3.3.

3. **Aligning the purposes of sectoring with the purposes of alternative 3.3 is not as straightforward.** First, the proponents of alternative 3.3 do not believe that identifying the sector of the entity making or receiving the investment is enough information. It is also necessary that the 10 percent or greater equity investments be in an operating company, rather than a holding company or another investment fund. This is because the conceptual basis of alternative 3.3 is the intent of the investor to influence the strategy and/or day-to-day management of the target company. Second, and for the same reasons, proponents of alternative 3.3 favor including in direct investment only classes of CIIIs where there is at least some evidence of an intent to be an active business manager, namely, private equity funds and real estate funds. Third, even if sector detail were available for CIIIs (and perhaps sub-sectors therein), on the liability side, if a foreign CII invested in a nonfinancial domestic business, the sector of the inward direct investment would provide no information about the role of foreign CIIIs in supporting domestic investment.



Note: This simple example is not meant to be detailed nor exhaustive, but only to roughly illustrate some of the possible sectoring differences between alternative 3.2 and alternative 3.3.

Annex IV. Conceptual Guidance from the European Union

For the European Union, discussions on the analytical meaning of DI in CII occurred in 2017 in the context of the Working group of External Statistics (WG ES). In the EU context, CII are exclusively investment funds which are principally engaged in financial intermediation. Their business is to issue investment fund shares or units, and, on their own account, to make investments primarily in financial assets and in nonfinancial assets (usually real estate). The conclusion was that a DI relationship could only be meaningful in closed-end funds, that is, funds where no additional shares are issued, and the fund itself won't redeem—buy back—shares; where the logic of control could be more easily established taking into account the usual reduced number of shareholders. On the contrary, in open-end funds, the investment policy is fixed in advance and hence the concept of control is rather blurred. Moreover, the 10 percent would be changing continuously what would make very difficult to track in practice and link the investment decision with the idea of getting influence or control in the fund. CII may also grant intragroup loans, which would also be classified as DI, unless granted to certain SNA financial institutional sectors—S122 to S125 (*BPM6* paragraph 6.28).

Annex V. Identification of the Institutional Unit in a Private Equity Fund

Who should be treated as the resident institutional unit for investments by private equity funds? Some might argue that it should be the investors in the fund themselves because these funds are typically legally structured as partnerships. Others might argue that it should be the fund managers because the individual investors cede all decision-making regarding the portfolio composition and the day-to-day and strategic management of the target investments to the managers of the funds. In either case, it seems that a private equity firm should be considered a quasi-corporation, which is a separate institutional unit from its investor (*2008 SNA*, paragraph 4.42–4.46). By this argument, it seems that the collective unit, headed by the fund managers, should be considered the resident institutional unit for investment by private equity funds.