BOPCOM-05/60

Eighteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Washington, D.C., June 27–July 1, 2005

Mutual Funds

I. DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)
II. OUTCOME PAPER (DITEG) # 30

April 8, 2005

1. Topic: Mutual funds (units, sectorization, residence, transactions)

2. Issues: See DITEG Issue Paper # 30 by Japan (November 2004); Background document by ECB (October 2004)

3. Recommendations:

(i) DITEG discussed the issue paper on whether there are circumstances when mutual funds, hedge funds, distressed funds, and feeder/master funds might be considered to be in direct investment relationships.

(ii) DITEG felt that the existing standards are less than clear, appear to conflict between direct investment and portfolio investment, and do not specify what sort of investment involving mutual funds should be classified to portfolio investment. The group felt that the wording in *BPM5* needed to be clarified for the new balance of payments manual.

(iii) The discussion revolved around what constituted "direct investment" and what, if any, exceptions there might be to the 10 percent equity ownership rule. The group felt that mutual funds, and similar collective investment schemes, were a rising international phenomenon, in particular, the growing importance of master/feeder funds (fund of funds), hedge funds and distressed funds.

(iv) DITEG felt that, in recommending that mutual funds should be included in portfolio investment, *BPM5* would appear to address only retail mutual funds. Generally, the group felt that, were the "10 percent" rule to be reached, investment in hedge funds and distressed funds should be considered to be direct investment.

(v) Regarding retail mutual funds, there were divided views. Some supported the application of the "10 percent" rule. Others felt that there was generally a different type of motivation for these type of funds: that there was no genuine interest in exerting influence on the management of the entity in which there might be more than 10 percent equity ownership. Accordingly, those of this opinion felt that investment in these types of mutual funds should be regarded as portfolio investment.

(vi) With regard to master/feeder funds, most members of DITEG felt that the "10 percent" rule should be applied. Others pointed out that were "feeders" to be treated as direct investors (should their ownership meet the "10 percent" rule for equity holding in the "master") this treatment would be an inversion of the standard direct investment relationship: the "feeders" would be direct investors even though the "master" would control them.

(vii) The group discussed how such funds might be identified, with some members proposing that industrial activity classification might be used.

4. Rejected Alternatives:

None

5. Questions for the Committee and the Workshop on International Investment Statistics

(i) Do the Committee and the WIIS agree, when mutual funds, hedge funds, and distressed funds have equity ownership in another entity of 10 percent or more, such relationships should be considered direct investment, or do they think that there may be some exceptions to the "10 percent" rule?

(ii) What are the views of the Committee and the WIIS on whether feeder funds should be treated as direct investors in their master funds, should they hold 10 percent or more of the equity in the master?

(iii) What are the views of the Committee and the WIIS if equity investment by mutual funds, hedge funds, etc. in a nonresident entity meets or exceeds 10 percent of equity on issue?

(iv) Do the Committee and the WIIS have any views on how these funds might be identified?

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUE PAPER #30

MUTUAL FUNDS

The views expressed in this paper are those of the authors and do not necessary reflect those of the Bank of Japan

Prepared by the Bank of Japan

November 2004

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)
ISSUE PAPER #30: MUTUAL FUNDS

1. Current international standards for the treatment of the direct investment item
Mutual funds are not clearly defined in the IMF *Balance of Payments Manual, fifth* edition *(BPM5)* or the OECD *Benchmark Definition of Direct Investment, third edition (BD3)*. Related descriptions are as follows;

(a) "Direct investment is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise" (*BPM5*, paragraph 359).

"The benefits that direct investors expect to derive from a voice in management are different from those anticipated by portfolio investors having no significant influence over the operations of enterprise. Portfolio investors will evaluate, on a separate basis, the prospects of each independent unit in which they might invest and may often shift their capital with changes in these prospects, which may be affected by short-term developments in financial markets" (*BPM5*, paragraph 361)

"A direct investment enterprise is defined in this Manual as an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10 percent or more of the ordinary shares or voting power or the equivalent" (*BPM5*, paragraph 362).

"Mutual funds and investment trusts also are included" (*BPM5*, paragraph 388<Portfolio Investment>).

(b) *BD3*, paragraphs 5, 7 and 109

2. Concerns of the current treatment
According to the above descriptions shown in the *BPM5* and the *BD3*, mutual funds could be classified in two ways. Thus the way of classifying these funds might differ across countries, and result in bilateral asymmetries and international discrepancies where counterpart countries apply another way of classification. Two criteria for classifying mutual funds are as follows;

(a) 10 percent criterion; investment in/from mutual funds is recorded as equity capital of Direct Investment, if the percentage of ownership is 10 percent or more.

(b) Actual control criterion; investment in/from mutual funds is recorded as equity capital of Direct Investment, regardless of the percentage of ownership.

3. Possible alternative treatments

According to the distinguishing features of Direct Investment, i.e. significant influence of direct investors on management, it is desirable to classify investment in/from mutual funds as equity investment of Portfolio Investment, not as equity capital of Direct Investment, regardless of the percentage of ownership.

However, the way of classifying specific types of mutual funds needs to be examined further. They are hedge funds[1], distressed funds[2], and feeder/master arrangements[3].

4. Points for discussion

1. Do DITEG members consider that it is appropriate to classify mutual funds and hedge funds into Portfolio Investment, regardless of the percentage of ownership?

2. Do DITEG members consider that it is appropriate to classify distressed funds and feeder/master funds into Direct Investment as an exception of above treatment, if the percentage of ownership is 10 percent or more?

5. Supplementary information

NA

6. Annex of the most relevant documents

IMF [2001], *Mutual Funds and "Fund of Funds": Portfolio Investment or Direct Investment?*, BOPCOM-01/22
R. Kozlow [2002], *Exploring the Borderline Between Direct Investment and Other Types of Investment: The U.S. Treatment*, BOPCOM-02/35
Bank of Japan [2002], *The Treatment of Corporate-type Mutual Funds*, BOPCOM-02/36
R. Kozlow [2003], *Investment Companies: What are they, and Where Should they be Classified in the International Economic Account?*, BOPCOM-03/22

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1 Investors generally invest in hedge funds to obtain investment returns in a short-term asset management, not a lasting interest based on the control or management, and thus these funds could be regarded as de-fact Portfolio Investment.

2 As for distressed funds, investors are willing to participate in the control or management of the enterprise for a specified period, in order to redevelop or enhance the enterprise value. Their controlling or managing attitudes in a long-term relationship are features of Direct Investment.

3 In many cases, feeder/master funds are set up in different jurisdictions as different legal structures to acquire preferential treatments related to taxation or securities regulations in the process of asset-management, thus result in a certain amount of cross-border transactions. Since a common fund manager is delegated to set up these arrangements and make investment decisions on behalf of investors (the purpose of investors is to gain a short-term interest by investing in portfolios through feeder/master funds), it could be seen that these is a direct investment relationship among feeder/master funds.

IMF Committee on Balance of Payments Statistics

Direct Investment Technical Expert Group (DITEG)

BACKGROUND PAPER ISSUE #30

RETAINED EARNINGS OF MUTUAL FUNDS, AND REROUTING OF INVESTMENT INCOME OF TECHNICAL RESERVES OF LIFE INSURANCE ENTERPRISES AND PENSION FUNDS

European Central Bank[1]

October 2004

[1] These definitions have been approved by the European System of Central Banks in the framework of defining the coverage of statistics on other financial intermediaries.

Definitions of institutional units belonging to sub-sector S.123

Investment funds (IF)

"Investment funds shall mean all collective investment undertakings (CIU) investing in financial and non-financial assets to the extent that their sole objective is the investment of capital raised from the public. [2] For the purpose of this definition, CIU shall include those undertakings the units/shares of which are, at the request of the holders, repurchased or redeemed directly or indirectly out of the undertaking's assets and those undertakings, the shares of which are fixed, and the holders entering or leaving the fund have to buy or sell existing shares. CIU within the meaning of this definition shall be constituted either: (i) under the law of contract (as common funds managed by management companies, or (ii) trust law (as unit trusts), or (iii) under a statute (as investment companies), or (iv) according to any other statement with similar effects.

This definition shall exclude pension funds. This definition shall also exclude investment funds issuing highly liquid liabilities of a monetary nature. The latter institutions, known as money market funds, would be classified in the sub-sector 'other depository corporations' (S.122).

Financial vehicle corporations created to be the holders of securitised assets (FVC)

"Financial Vehicle Corporations created to be the holder of securitised assets" (FVC) shall mean an undertaking that predominantly carries out one or more securitisations, the structure of which serves to isolate the FVC and the credit risk of the originator from each other.

FVC within the meaning of this definition shall be constituted either: (i) under the law of contract (as common funds managed by management companies), or (ii) under trust law, or (iii) under a statute (as a public limited company3), or (iv) according to any other arrangement with similar effects.

Within and for the purposes of this definition, securitisation means a financial transaction or scheme involving the transfer of assets or of risks underlying assets to a FVC created to hold securitised assets and to issue securities. In case of transferring government assets, these have to exist in the government's balance sheet before the arrangement starts and the transfer has to cover all risks contained in these assets. In case of a transfer of future receipts or in case when a full risk transfer does not take place, the respective securitisation vehicle would remain classified within the government sector.

Securities issues by FVC shall be open to the public or the securities are sold on the basis of a private placement.

This definition shall exclude depository corporations

Financial holding corporations (FHC)

"Financial holding corporations (FHC) shall mean entities principally engaged in controlling financial corporations or groups of subsidiary financial corporations that are not conducting business of such financial corporations themselves. For the purpose of this definition, an FHC secures control over a corporation by owning more than half of the voting shares, or by controlling more than half of the shareholders' voting power, or by otherwise being able to determine the general corporate policy, or by controlling entities which control financial corporations or groups of subsidiary financial corporations. The criteria applied in order to identify FHC shall be derived from the instruments of incorporation, established statutes or by-laws, contracts, statutory financial reports or any other statement with similar effect of the FHC according to national regulatory provisions."

Security and derivative dealers (SDD)

"Security and derivative dealers", classified as OFI, shall consist of all investment firms which provide investment services for third parties by investing in securities on own account as their main business. For the purpose of this definition, investment services are defined as follows:

Trading of new or outstanding financial instruments through the acquisition and sale of those financial instruments for the account and/or risk of the "Security and derivative dealer" for the exclusive purpose

[2] Investment funds can be set up as "funds" and as "companies".
[3] The term public applies here in the meaning of commercial law, different from the statistical concept of public sector.

of benefiting from the margin between the acquisition and selling price; this also includes market making activities;

These Security and Derivative Dealers shall be constituted according to national regulatory provisions[4]."

Financial corporations engaged in lending (FLC)

"Financial corporations engaged in lending (FCL) shall mean entities specialised in lending. For the purpose of this definition, lending activity comprises financial leasing[5], factoring, mortgage lending, mutual guarantee, consumer lending and other type of lending as defined according to national regulatory provisions. FCL may be constituted under the legal form of a joint-stock company or limited liabilities company subject to a specialised legal national framework. Alternatively, the criteria applied in order to identify FCL shall be derived from the instruments of incorporation, established statutes or by-laws, contracts, statutory financial reports or any other statement with similar effect of the FCL.

This definition shall exclude intermediaries classified as depository corporations."

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[4] This definition shall exclude depository corporations

[5] For statistical purposes, leasing is defined as financial leasing when the leasing period covers all or most of the economic lifetime of the durable good. At the end of the leasing period, the lessee often has the option to buy the good at a nominal price (ESA 95, Annex II).