BOPCOM-06/23

Nineteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Frankfurt, Germany, October 23–26, 2006

Issues Related to the Framework for Foreign Direct Investment Relationships (FDIR): A proposal by Canada for the Benchmark Definition

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Issues Related to the Framework for Foreign Direct Investment Relationships (FDIR): A proposal by Canada[1] for the Benchmark Definition

1. In reviewing the latest drafts of the Benchmark Definition, issues of clarification and presentation have been identified.

2. An alternative description/presentation of the FDIR is contained in the annex to this paper. Except for one small difference in the treatment of jointly owned enterprises, the two descriptions are intended to differ only in the presentation of the FDIR. In addition the description in the annex has added a diagram that shows the relationship between three FDI relationships and related enterprise groups as defined in the Globalization Handbook.

3. The following note presents the issues and material to support a focused discussion of the topics raised. There are four main issues discussed:

1. Defining Foreign Direct Investment Relationships vs. Measuring DFI
2. Terminology – controlled and non-controlled enterprises
3. Points to keep clear in describing the FDIR
4. Clarification of situations where there is "joint ownership"

Each issue is briefly described below.

1.1.1 Defining Foreign Direct Investment Relationships vs. Measuring DFI

4. Defining the FDI Relationships and measuring FDI are two distinct steps in the process and should be clearly separated. The definition of FDI relationships depends on equity positions only while FDI measures equity and debt positions

- Transactions and positions to be included in measures of FDI <u>must</u> have a resident and non-resident counterparty, one of which is in the reporting economy
- Positions and transactions that define a FDI relationship may be between
  - residents of different economies
    - the reporting economy and another economy
    - two economies other than the reporting economy
  - residents of a single economy
    - the reporting economy
    - another economy

1 . The proposal was developed by Art Ridgeway, Statistics Canada.

5. Only the first of these four classes are included in measures of FDI for the reporting economy.

- Transactions that are not part of FDI for the reporting economy but affect the definition of a FDI relationship involving at least one member in the reporting economy may result in flows in the Other Changes Account

6. As a result of the need to clearly separate these issues, it has been proposed (by Art) that reference to measures of DFI be removed from Chapter 3 of the Benchmark Definition and moved to Chapter 4. In particular this would move the content of Section 3.3 to Chapter 4. Chapter 3 would then focus only on units, residence and the framework.

(Question 1) Does the Committee agree with this proposal?

1.1.2 Terminology – controlled and non-controlled enterprises

7. While the primary description of the FDIR in the draft version of the BD uses the terminology – controlled and non-controlled enterprises, it also describes the relationships in term of subsidiaries and associates. With the expanding use of legal forms other than incorporated entities a generalization of the language is important to have a uniform application of the standards.

8. Focusing on control and influence as the means of building up FDIRs is also useful in that this vocabulary is important later in relating the FDI Relationships and Enterprise Groups.

9. It is proposed, to limit the references to the term subsidiary in the core description but to provide the links with the language more commonly used in accounting and business – subsidiaries and associates – in a separate section of Chapter 3 of the BD, possible a box.

(Question 2) Does the Committee agree with this proposal?

1.1.3 Points to keep clear in describing the FDIR

10. In describing the FDIR certain points must be kept clear or the text can become difficult to follow. These points lead to a proposal to add a new term to our lexicon – "top direct investor". It is important to recall the following three points and how they interact:

- The FDIR defines the enterprises affiliated with the entity at the top of the relationship

- FDI relationships are often overlapping

- This means that it is important for bilateral symmetry to insure that each relationship is followed all the way up to the top

11. Because there can be both direct and indirect direct investors in a single relationship, it is sometimes important to be able to clearly distinguish the top direct investor from others in the same relationship. The proposal is to refer to this direct investor as the "Top Direct Investor" for a particular DI relationship. The word "ultimate" also comes to mind but the usage of this word in the US system and the handbook is associated with majority ownership (control) which is not a required element of an FDI relationship; therefore, it may be preferable to use **top** to differentiate.

12. Given that an FDI relationship can be established with voting power of 10% or greater, it is possible to have more than one direct investor for a given direct investment enterprise (Figures 1 and 7 in the annex provide examples). In these cases of overlapping relationships, one might consider this to be one relationship with two (or more) top direct investors. However, since it is possible that the relationships will not be completely overlapping; to insure clarity, it is preferable to consider that each direct investor is the top of a separate direct investment relationship. Of course since a direct investor can also be a direct investment enterprise, it may be a member of direct investment relationships with other direct investors at the top.

(Question 3) Does the Committee agree with the clarifications in the above section and the introduction of the term "top direct investor"?

1.1.4 Clarification of situations where there is "joint ownership"

13. One of the goals of this revision is to clarify the treatment of situations where enterprises already identified as members of a FDI relationship have joint ownership of another enterprise. When should the FDI relationship include the jointly owned enterprise and when should it not.

14. The description of the FDIR in the draft BD and that in the annex to this note, differ slightly in the boundary where these jointly held enterprises would be included in the relationship.

15. The following diagram is based on Figure 3.11 from the Handbook on Globalization Indicators. Some changes have been made to allow a more complete discussion of FDI groups whereas the original figure was used to describe Enterprise Groups. The Enterprise Group with X at its head is the same as in the handbook. This Enterprise Group is comprised of X and the enterprises it controls (majority owns) which are A, B, D, E, H, I, K, J.

16. The description of the Enterprise Group allows for control to be established via a group with joint ownership just as for the FDIR. Enterprise J in this figure is controlled by I and K which are each controlled by H and ultimately X.

17. The FDI relationship with X at its head is comprised of X, the same controlled enterprises (A, B, D, E, H, I, K, J) plus the influenced enterprises C, F, G & L and possibly M depending on the treatment of joint ownership.

18. Before discussing the joint ownership issue, it is interesting to note that while thirteen (or fourteen if M is included) different equity positions define the FDI relationship, only two of these are included in measures of FDI. Of course Enterprise X alone could have FDI debt positions with as many as 9 (or 10) direct investment enterprises. This demonstrates the need to clearly separate the descriptions of the FDIR and the measurement of FDI

Joint ownership

19. The passages from the two descriptions that lead to the difference in treatment are reproduced here for convenience.

20. Draft Benchmark Definition [DAF/INV/STAT(2006)2/REV1, §104]

- Where an investor, its controlled affiliates and its non-controlled affiliates combined own more than 50 percent of the voting power of an enterprise and the owned enterprise is not otherwise a controlled affiliate, then the owned enterprise is regarded as a non-controlled affiliate of the investor.

§ 313 (Annex 4)

- Where a non-controlled affiliate and its controlled affiliates combined own more than 50 percent of the voting power of an enterprise, the owned enterprise is a non-controlled affiliate of the top investor.

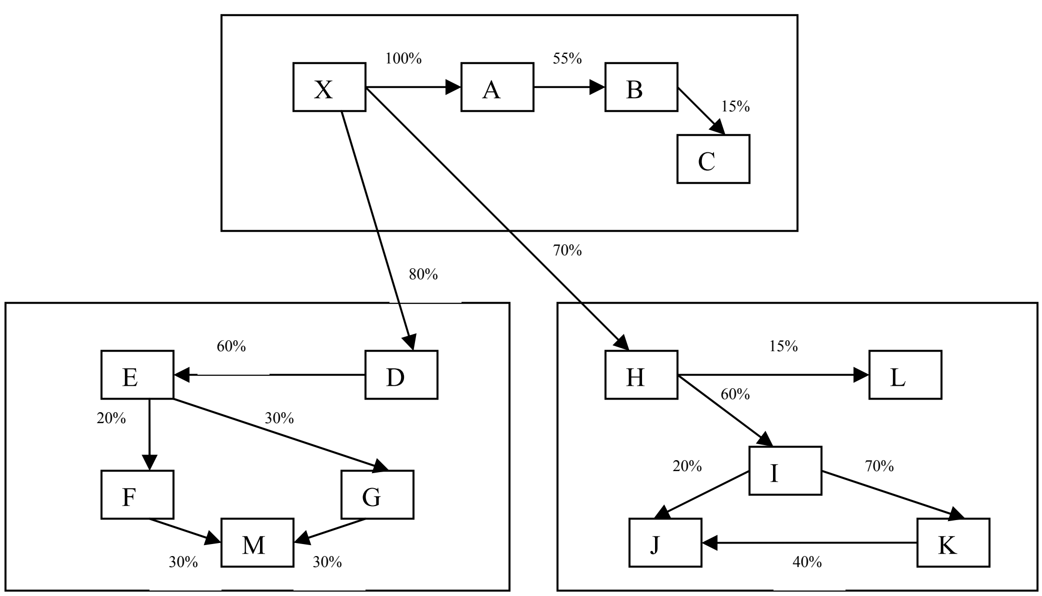
21. Enterprise M in Figure 1 would meet the requirements of the first description and be included in the FDI relationship with X at the top. However, it would not meet the requirements of the second description and thus would not be part of the relationship.

22. In the first case the joint ownership can be from any member of the FDI relationship. This would mean that the ownership shares of F and G would be summed and since this is great than 50% of the ownership of M, it would be considered a non-controlled affiliate of X.

23. The second formulation adds a requirement that to continue on a relation beyond a non-controlled enterprise the non-controlled enterprise must have control of subsequent enterprises. This parallels the requirement of a simple (non-joint) ownership chain where going beyond a non-controlled enterprise requires control at all subsequent stages. This is not the case in this example as neither F nor G has control of M.

(Question 4) Does the Committee prefer the description in the draft BD or in the Annex to this paper?

Figure 1



1.1.5 Annex: Alternate Description of FDIR

It is proposed to replace sections 3.4, 3.5 and 3.6 of the latest draft of the Benchmark Definition with the following text. This will have implications for the current draft of the Intentional Accounts Manual

The Direct Investment Relationship

24. The classification of financial positions and flows to direct investment requires that the two institutional units be resident in different economies and that they be in a *direct investment relationship*. This section presents the framework that has been developed to establish when two institutional units are in a direct investment relationship. While direct investment measures a wide variety of instruments as described in Chapter 4, direct investment relationships are based on equity only.

Foreign Direct Investor

25. A *foreign direct investor* is an entity (an institutional unit) that has acquired at least 10% of the voting power of a corporation, or equivalent for an unincorporated enterprise, of at least one enterprise resident in an economy other than its own. A direct investor could be from any sector of the economy and could be any of the following:

i. an individual;
ii. a group of related individuals;
iii. an incorporated or unincorporated enterprise;
iv. a public or private enterprise;
v. a group of related enterprises;
vi. a government; or
vii. estate, trust or other societal organisation; or
viii. any combination thereof.

In the case where two enterprises each own 10% or more of each other's equity, each is a direct investor in the other.

Foreign Direct Investment Enterprise

26. A direct investment enterprise is an enterprise in which a non-resident investor owns 10 per cent or more of the voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise.

27. The numerical threshold of ownership of 10 per cent of the voting power determines the existence of a direct investment relationship between the direct investor and the direct investment enterprise. An ownership of at least 10 per cent of the voting power is regarded as evidence that the non-resident investor has sufficient influence to have an effective voice in the management of the resident enterprise. In contrast to some other statistical measures such as those on the Activities of MNEs, direct investment does not require control by the investor (i.e. more than

50 per cent owned by the investor and/or its related enterprises). Direct investors may have direct investment enterprises in just one economy or in several economies.

28. To facilitate international comparison and to achieve global consistency of FDI statistics, the *Benchmark Definition* recommends a strict application of the 10 per cent rule. Therefore, compilers should not qualify the 10 per cent threshold further by applying other criteria. The *Benchmark Definition* does not recommend the use of other considerations such as representation on the board of directors; participation in policy-making processes; material inter-company transactions; interchange of managerial personnel; provision of technical information; and provision of long-term loans at lower than existing market rates.

Framework of Direct Investment Relationships (FDIR)

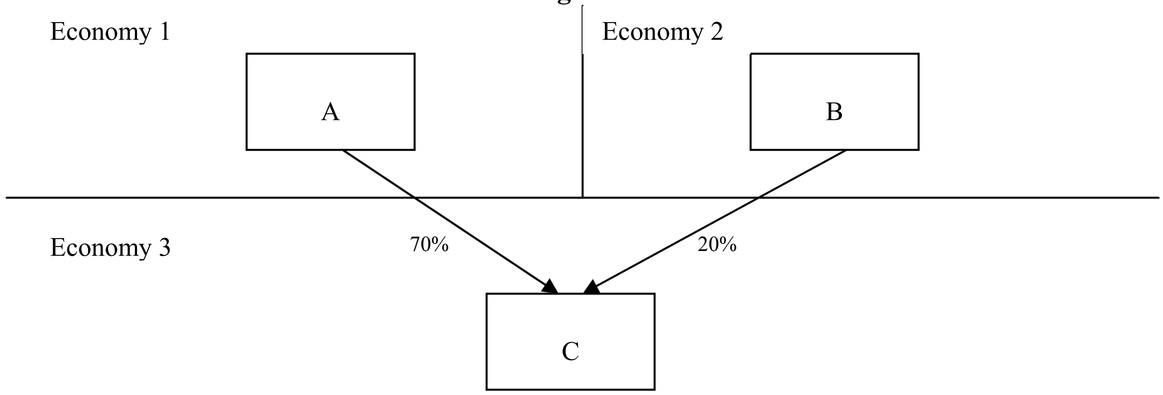
29. The Framework for Direct Investment Relationships (FDIR) is a generalised methodology for identifying and determining the extent of direct investment relationships. The FDIR identifies all enterprises affiliated with the direct investor at the top of the relationship. Three degrees of influence are recognised – controlled, influenced and not influenced. As will be demonstrated in examples to follow, direct investment relationships can be complex and overlapping. Within a given direct investment relationship, direct investment enterprises are identified as being either *controlled affiliates* or *non-controlled affiliates* of the direct investor at top of the relationship.

- A *controlled affiliate* is an enterprise in which the top direct investor of the direct investment relationship has control of more than 50 percent of the voting power.

- A *non-controlled affiliate* is an enterprise in which the top direct investor of the direct investment relationship has control of at least 10 percent of the voting power and no more than 50 percent, and any enterprise controlled by such a non-controlled affiliate.

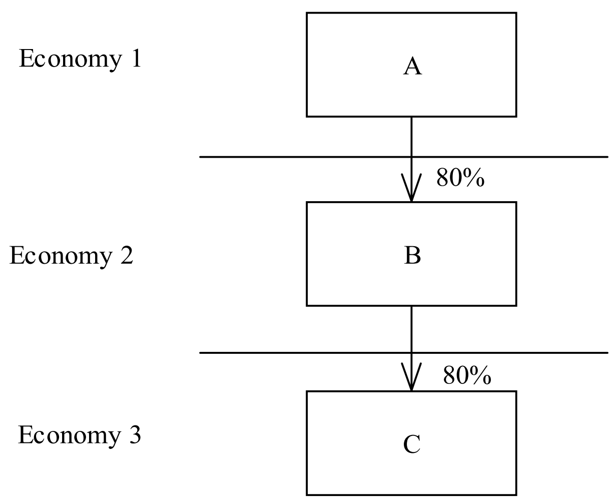
30. In Figure I, there are two overlapping direct investment relationships, one with A as the direct investor and the other with B as the direct investor. The direct investment enterprise C in economy 3 is in a direct investment relationship with both A and B. C is a *controlled affiliate of* direct investor A in economy 1, which owns 70% of the voting power of C and a *non-controlled affiliate* of direct investor B in economy 2, which owns 20% of the voting power of C.

Figure I



31. The description of direct investors and direct investment enterprises above focussed on the immediate relationship between two enterprises. As noted earlier, the legal structures of related enterprises can consist of many enterprises linked through complex ownership chains. Within these groups, it is possible that a direct investment enterprise itself owns 10 percent or more of the voting power of another enterprise, in which case the direct investment enterprise is itself a direct investor in a further direct investment enterprise.

Figure 2. Direct Investment Relationships



32. In Figure 2, enterprises A, B and C are in different economies. Enterprise A owns an 80 percent voting interest in enterprise B and is a direct investor in B. Enterprise B, in turn, owns 80 percent of C and is a direct investor in C. A has control over B, and through its control over B, has control over C. As a result, financial transactions between A and C cannot be considered at arm's length, even though A directly holds no equity in C. It is reasonable to consider A and C to be in a direct investment relationship in which A indirectly is a direct investor in C. Financial transactions and positions between A and C should be included in direct investment.

33. In relatively simple cases such as that in Figure 2, where each link in the ownership chain is a single equity holding and there is majority ownership (control) at each stage, it is clear that the direct investment relationship continues down the chain of ownership. However, when some links are non-controlling links and equity of an enterprise is held by more than one member of a direct investment relationship the extent of the relationship may be less obvious.

34. The FDIR has been developed to deal with such structures and is the recommended method to identify the extent of the direct and indirect ownership links that form a direct investment relationship. Just as the ownership shares of 10% used to establish influence and majority ownership (>50%) for control are arbitrary and reflect an effort to find a reasonable balance between the concept and the cost of measuring the complexity of modern business structures, so are the norms used to determine the extent of more complex relationships.

35. The following basic principles have been established for the transmission of control and influence in a direct investment relationship:

(i) A series of controlled affiliates can continue as long as control exists at each stage in the ownership chain, a chain such as that in Figure 2 can continue indefinitely;

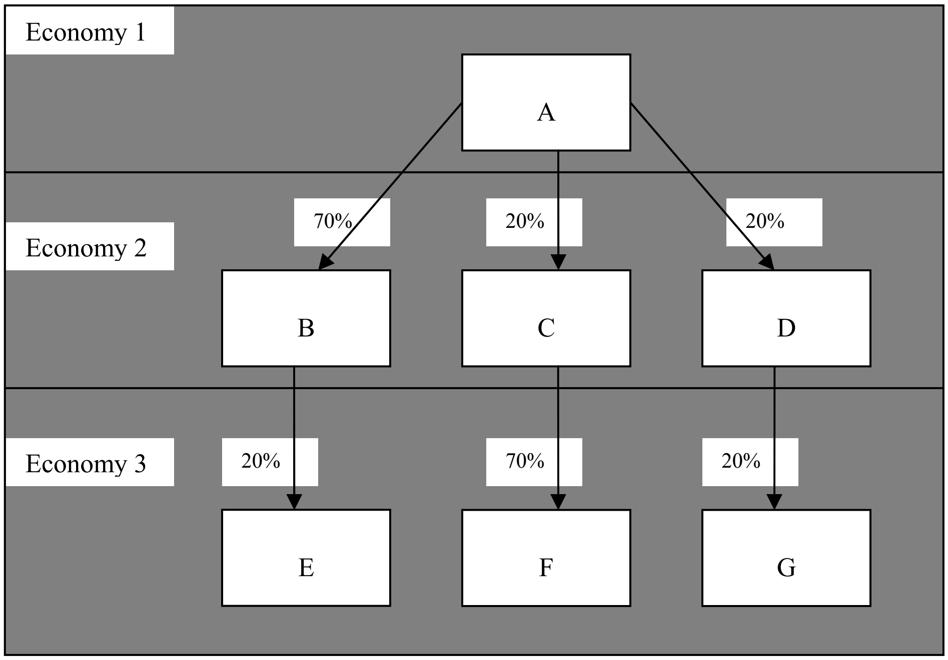
(ii) Any controlled affiliate can extend the relationship to a non-controlled affiliate by owning from 10% to 50% of the voting power of that enterprise;

(iii) A non-controlled affiliate can extend the relationship to only another non-controlled affiliate by owning >50% of the voting power of that enterprise. Such a chain of non-controlled affiliates can be extended beyond the first non-controlled affiliate as long as majority ownership exists at each stage.

36. Figure 3 presents examples of chains of ownership where unlike Figure 2, not all of the links are controlling links. The examples here still have a single direct investment position in each direct investment enterprise, cases with multiple equity positions in a single direct investment enterprise will be presented later. These demonstrate the impact of the latter two points above.

- The direct investment enterprise B is a controlled affiliate of A and as it owns from 10% to 50% of E, E is a non-controlled affiliate of A
- The direct investment enterprise C is a non-controlled affiliate of A and as it owns a majority of the equity in F, F is a non-controlled affiliate of A.
- The direct investment enterprise D is a non-controlled affiliate of A and as it owns 50% or less of G, G is not influence by A and thus not part of the direct investment relationship with A at the top

Figure 3



37. This direct investment relationship could continue through E and F but only if they had majority owned affiliates as they are both non-controlled affiliates of A.

38. There are cases where more than one member of a direct investment relationship holds equity in the same enterprise. Based on the principles presented earlier, these multiple holdings will establish one of the three degrees of influence – controlled, influenced or not influenced. Where a controlled or influence link is established the direct investment relationship will be extended to include the jointly held enterprise.

39. Figure 4 presents two cases of joint ownership by members of the direct investment relationship with A at the top. This example builds off of the example in Figure 2, with A having control of both B and C. Direct investor A and its controlled affiliate B each own 30% of enterprise E. Since A can control both its own 30% of the voting equity and the 30% owned by B, it is clear that it can control a total of 60% of the voting power of E. Generalizing this point:

- Where the direct investor at the top of a direct investment relationship and its controlled affiliates combined own more than 50 percent of the voting power of an enterprise, the owned enterprise is a controlled affiliate of the top investor. E is therefore a controlled affiliate of A.

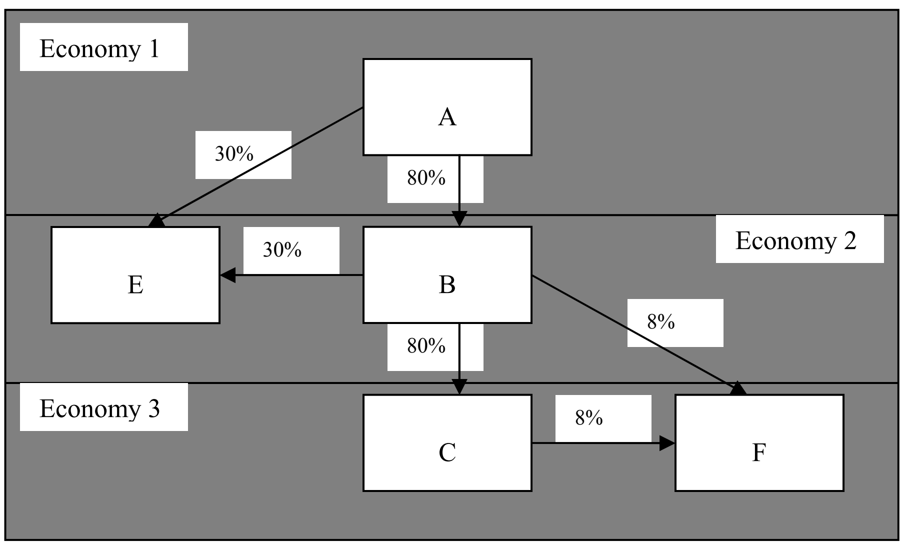
40. In the case of enterprise F, two controlled affiliates of A hold a total of 16% of its voting equity. Since A can control the voting of the 16%, A has influence over F. Generalizing this point:

- Where a direct investor at the top of a direct investment relationship and its controlled affiliates combined own at least 10 percent of the voting power of an enterprise but no more than 50 percent, the owned enterprise is a non-controlled affiliate of the investor.

F is therefore a non-controlled affiliate of A.

41. Figure 4 also highlights that equity positions within one economy may be important in determining the extent of a direct investment relationship. The equity positions between B and E and between C and F are part of the equity determining the relationship between A and E and A and F but these equity positions would not enter directly into the FDI data at market value for any of the three countries as they are resident to resident positions[2].

Figure 4



42. When joint ownership by members of a direct investment relationship include ownership by non-controlled affiliates, the criteria to be considered in determining if a controlled, influenced or not influenced relationship exists are more complex that when all joint owners are controlled affiliates (or the top of the relationship). The key criteria is that non-controlled affiliates can only add additional non-controlled affiliates to the relationship by having control of one or more enterprises.

[2] However, if data are collected at book values, the asset position in E and F held by B and C respectively may be important in estimating the market value of B and C.

43. Figure 5 provides additional examples of joint ownership but involving non-controlled affiliates. This example is similar to that in Figure 4 but A owns only 40% of B. B is therefore a non-controlled affiliate of A and, as C is controlled by B, C is also a non-controlled affiliates of A.

44. A and B both hold equity in E. In this case B is a non-controlled affiliate of A and to extend the relationship must have control of the next enterprise in the chain. As B has only 30% of the equity of E it cannot control E and influence from A cannot be extended to E via B. A has 30% of E which means it has influence but since it cannot control the 30% ownership of its non-controlled affiliate B, it is only its own 30% ownership that determines it relationship to E.

45. In the case of enterprise F, the non-controlled affiliate B has control of 16% of the voting power in F but this clearly does not provide control. Since a non-controlled affiliate can only add to the relationship via controlled enterprises, F is not part of the direct investment relationship with A at the top.

46. However, it was noted earlier that enterprises can be members of more than one direct investment relationship and that the relationships may be overlapping. Recalling this, it should be noted that in the direct investment relationship with B as the top direct investor, F is a non-controlled affiliate of B as B and it controlled affiliate C own more than 10% of the voting equity in F. This demonstrates the need to identify all of the relevant direct investment relationships for enterprises in the reporting economy.

Figure 5

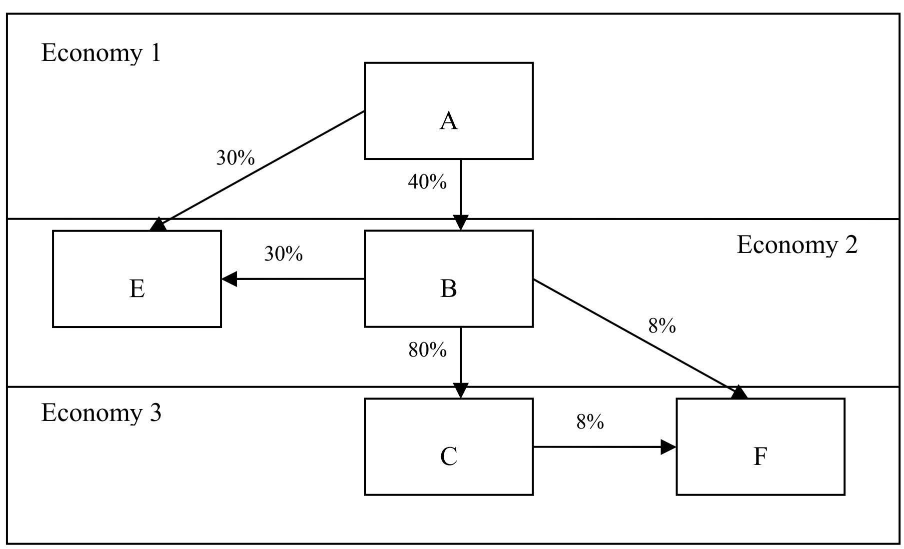
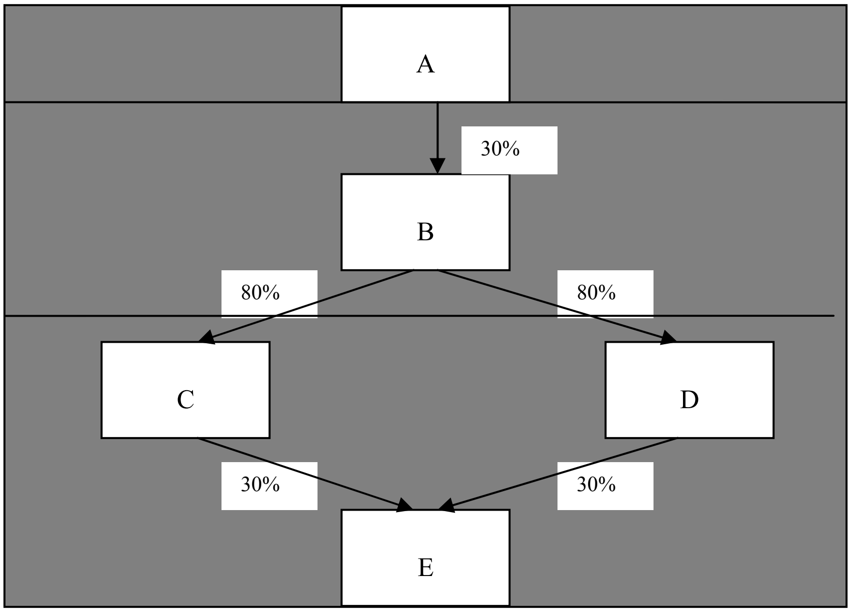


Figure 6



47. Figure 6 provides another example of joint ownership involving non-controlled affiliates of the top direct investor. In this case B is a non-controlled affiliate of A as A owns 30% of B. In turn, B has controlling positions in C and D and through them also a controlling position in E. Therefore C, D and E are all non-controlled affiliates of A. This example again show the importance of within economy positions in establish direct investment relationships. Generalizing this point:

- Where a non-controlled affiliate and its controlled affiliates combined own more than 50 percent of the voting power of an enterprise, the owned enterprise is a non-controlled affiliate of the top investor.

48. The box below summarizes the principles and norms that determine the extent of a direct investment relationship.

Basic types of affiliates:

- A *controlled affiliate* is an enterprise in which the top direct investor of the direct investment relationship has control of more than 50 percent of the voting power.

- A *non-controlled affiliate* is an enterprise in which the top direct investor of the direct investment relationship has control of at least 10 percent of the voting power and no more than 50 percent, and any enterprise controlled by such a non-controlled affiliate.

Principles for extending the direct investment relationship through indirect ownership

- A series of controlled affiliates can continue as long as control exists at each stage in the ownership chain, a chain such as that in Figure 2 can continue indefinitely;

- Any controlled affiliate can extend the relationship to a non-controlled affiliate by owning from 10% to 50% of the voting power of that enterprise;

- A non-controlled affiliate can extend the relationship only to another non-controlled affiliate by owning >50% of the voting power of that enterprise. Such a chain of non-controlled affiliates can be extended as long as majority ownership exists at each stage.

Basis for extending the relationship through joint ownership

- Where the direct investor at the top of a direct investment relationship and its controlled affiliates combined own more than 50 percent of the voting power of an enterprise, the owned enterprise is a controlled affiliate of the top investor.

- Where a direct investor at the top of a direct investment relationship and its controlled affiliates combined own at least 10 percent of the voting power of an enterprise but no more than 50 percent, the owned enterprise is a non-controlled affiliate of the top investor.

- Where a non-controlled affiliate and its controlled affiliates combined own more than 50 percent of the voting power of an enterprise, the owned enterprise is a non-controlled affiliate of the top investor.

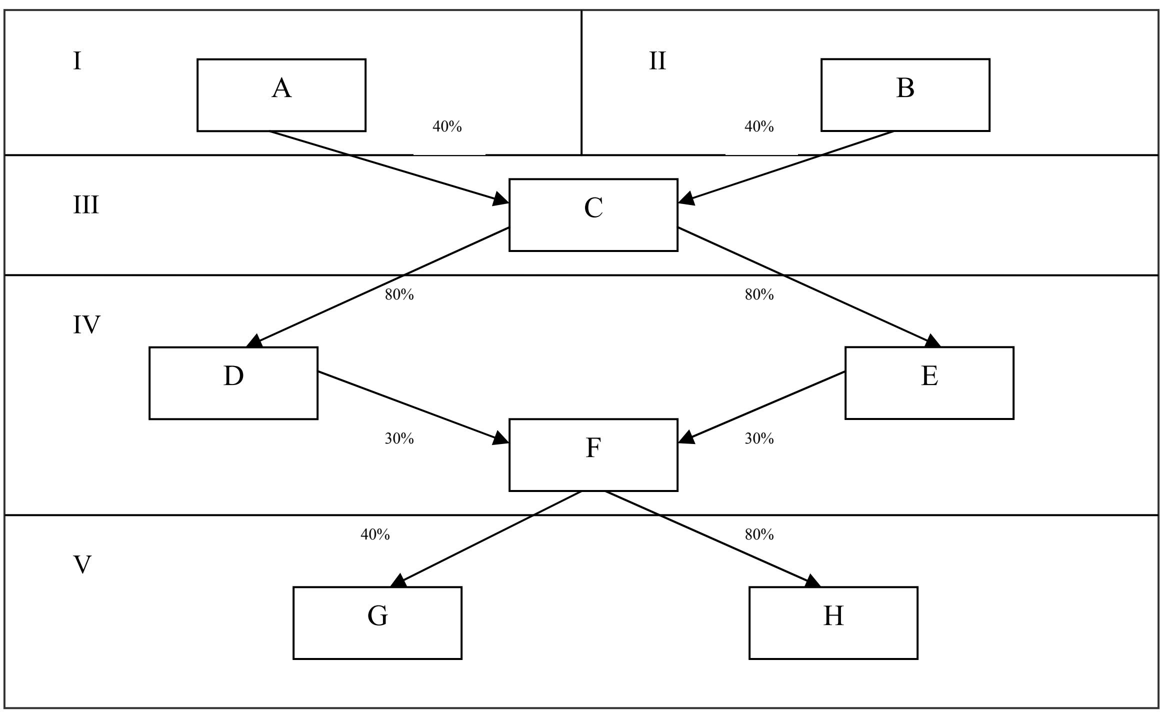
1.1.5.1 FDI Relationships and Enterprise Groups

49. Given that other statistical efforts are using the Enterprise Group as a basic unit, it is interesting to show how direct investment relationships may relate to enterprise groups. The relatively simple example below is offered to help understand these relationships.

50. In this example, there are three FDI relationships under the FDIR, one global enterprise group and one local enterprise group comprised of the following units:

- FDI Relationship A A, C, D, E, F & H (= for EU & US method)
- FDI Relationship B B, C, D, E, F & H (= for EU & US method)
- FDI Relationship C C, D, E, F, G & H (= for US method, no G in EU method)
- Global Enterprise Group C, D, E, F & H
- Local Enterprise Group D, E & F

Figure 7



51. Countries III and IV have to identify all three FDI relationships to fully articulate the potential FDI counterparties that need to be considered in measuring FDI. In the case of Country IV it is important to not stop at Enterprises C but to also identify the two Top Direct Investors A and B.

52. From the terminology used in the Globalization Handbook, one could also note that:

- C is the Ultimate Controlling Enterprise for D, E, F, & H
- C is the parent of D, E & F
- The local enterprise group (D, E & F) is the parent of H

53. Ultimate Beneficial Owner - US definition

- If country III is the US, A and B are both Ultimate Beneficial Owners of C
- If country V is the US, C is the Ultimate Beneficial Owner of G & H
    - C to G (80% X 60% (30% + 30%) X 40% = 19.2%)
    - C to H (80% X 60% (30% + 30%) X 80% = 38.4%)

54. Recognising practical difficulties compilers may encounter in applying the FDIR in full, two alternative methods are allowed: the equity multiplication method, and the influence / control method. Should compilers choose to apply either of these alternate methods due to practical difficulties, they should include this information in their metadata. However, such countries should endeavour to apply the FDIR over time.

55. Annex 4: Direct Investment Relationship provides examples of defining the extent of the direct investment relationship under the two alternate methods. It also describes the practical implementation of the FDIR for measuring investment income credits and debits, and for classifying financial account transactions and international investment positions.

Box 1. Definition: Control of a corporation and subsidiary corporation

To classify an enterprise within a country on the basis of the presence or absence of effective ***foreign control***, the criterion recommended for use is whether or not a majority of ordinary shares or voting power (more than 50% of the capital) is held by a single foreign direct investor or by a group of associated investors acting in concert, such as members of the same family of enterprises and their affiliates. Application of this criterion avoids the use of subjective concepts or case-by-case review. The advantage of this absence of subjectivity is to eliminate a potential source of bilateral asymmetry. This recommendation is consistent with MSITS. (OECD *Globalisation Handbook, p.104*)