ANNEX 8

Collective Investment Institutions

1. Description of collective investment institutions

570. The term *collective investment institution* (CII) generally refers to 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 non-financial assets using the funds collected from investors by means of issuing shares/units (other than equity). Other terms referring to CIIs may also be used, *e.g. collective investment scheme, collective investment vehicle, collective investment undertaking,* and in certain cases, *investment fund*. The CII can be open-ended or closed-ended. If open-ended, there is no limit to the number of shares/units on issue and the shares/units can be, at the request of the holders, repurchased or redeemed directly or indirectly out of the undertaking's assets. If closed-ended, the number of shares/units on issue is fixed and investors entering or leaving the fund must buy or sell existing shares. The shares/units can be quoted or unquoted. The CII may pay periodic dividends, capitalise the income or a combination of those approaches, depending on the terms set out in its prospectus.

571. CIIs may be constituted: *i)* under the law of contract (as common funds managed by management companies), or *ii)* under trust law (as unit trusts), or *iii)* under a statute (as investment companies), or *iv)* otherwise with similar effect. Some CIIs invest in other similar vehicles (*e.g.* "funds of funds"). It should be noted that occupational pension funds are not CIIs; they are part of the insurance companies and pension funds subsector.

572. The prospectus also sets out the investment policy or strategy of the CII in terms of the types of financial instrument or other assets to be acquired (such as bonds, equities, real estate) and their geographical (*e.g.*, Asian, American, European, emerging markets) or currency make-up, or any other investment strategy. CIIs may have different objectives. For example, some CIIs may target capital growth and be generally characterised as "growth" funds, whereas others may be structured to produce a regular stream of income, through interest and/or dividends and be characterised as "income" funds. The prospectus indicates whether the CII can undertake any leveraging activity and how it might do so (*e.g.*, through straight borrowing, through repurchase agreements, or by using financial derivatives). The terms and conditions for redemption (for open-ended schemes) or the means of sale (for closed-ended schemes) are also set out in the prospectus.

573. CIIs are generally "brass plate" enterprises and are managed by professional investors who may offer a variety of funds with their own market orientation and who make investment decisions on behalf of investors. Administration, management, custodial

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and trustee services may be provided to the CIIs by separate service providers, some of whom may be located in different jurisdictions. For example, a CII may be domiciled or registered to operate in one country and may be managed by a service provider in another country with custodial services being located in a third country. The location or domicile of a CII may be decided by its promoter in the context of optimising its tax liabilities or of utilising preferential securities regulation arrangements in the process of asset-management. Cross-border transactions may, and frequently do, occur.

574. At the outset, CIIs may be classified broadly into two main categories: *a)* ordinary or retail type entities and *b)* other types of CII. The ordinary/retail type CII may in turn be a contract type or a corporate type. A contract-type retail CII is generally a mutual fund or unit trust or similar vehicle (see further details below) while a corporate-type CII may be an investment trust or a corporation acting as an investment vehicle. In both cases, the assets acquired tend to be highly liquid and investment subscriptions (and, later, redemptions) are made by a large number and variety of investors. The investments are made generally in order to gain a short-term interest, via contract-type or corporate-type investment trusts, in portfolio securities. There may be significant diversification of the asset classes, for example, mainly by country/economic zone, by type of financial instrument (equity, bonds, money market instruments, derivatives, etc.).

575. There is a variety of other types of CII which cannot be considered as retail in nature. The investors into these CIIs can vary from private households to corporate entities and the asset classes acquired can also vary considerably from liquid to illiquid types. Their legal structures, trading practices, investment policies and operations generally need to be considered by compilers in order to decide the classification for balance of payments statistical purposes of the entities involved and their investment and other economic transactions.

576. A number of different types of financial institution fall within the scope of the description collective investment institution (CII).[80] Included are:

- Investment funds.
- Mutual funds.
- Unit trusts.
- Variable capital companies.
- Investment limited partnerships.
- Feeder/master funds, umbrella funds/sub-funds, funds of funds.
- Hedge funds.
- Professional investor funds.
- Private equity funds.
- Distressed funds.
- Property and real estate funds.
- Money market funds.

80. The types of collective investment institutions described in this annex are for readers' information and mainly based on editors' experiences, thus details or names of each type as well as legal structures etc. could be different among countries.

577. It must be stressed that the examples of CII listed above can exist under the same or different labels in different countries. The name or label used may give some indication of the type of scheme or of its type of investment orientation, or of the main objective of the investment vehicle used (*e.g.* venture fund, futures and options capital protected fund, bond fund, balanced fund, growth fund, index fund, sector fund, international or regional funds, junk bond fund). However, caution is needed in interpreting from its title or label what a CII is and how it operates. Within the European Union (EU) and under its relevant legislation, a certain type of CII is known as a UCITS *i.e.*, an *undertaking for collective investment in transferable securities*. It may be authorised by any of the EU national financial regulatory authorities to offer its units for sale to members of the public in other member states of the EU without the requirement for further authorisation in those other countries.

578. An investment fund (IF) is a CII which issues shares (if a corporate structure is used) or units (if a trust structure is used) to the public, and which invests the capital raised in financial and/or non-financial assets.

579. A mutual fund (MF) can be defined as an entity that issues shares or units, which are purchased by investors. The basic scheme of a MF is quite common in many other CIIs. The subscriptions collected may be invested in different types of asset (non-financial as well as financial) and the investors may receive either regular income or, at redemption, holding gains (or losses) or a combination of both. The MF can be open-ended or closed-ended and the shares/units can be quoted or unquoted.

580. A unit trust (UT) operates as a CII established under a trust deed made between the fund's management company and its trustee. The legal structure of a unit trust may vary between countries but, in general, it would appear that the trustee acts as the legal owner of the fund's assets on behalf of the group of investors who are each entitled to an undivided beneficial interest in the fund. Similar to shareholders in an investment company, the unit holders are entitled to attend and vote at meetings on matters affecting the fund. The trust deed is the primary legal document which constitutes the trust and it sets out the various rights and obligations of the trustee, the management company and the unit holders.

581. A variable capital company (VCC) is normally set up to invest its funds and property with the aim of spreading investment risk. It is managed by a management company for the benefit of its shareholders who enjoy limited liability status. The characteristics of VCCs are that they can repurchase their own shares and that the issued share capital must at all times be equal to the net asset value of the underlying assets.

582. An investment limited partnership (ILP) is a partnership of two or more persons having as its principal business the investment of its funds in financial and non-financial assets of all kinds and consisting of at least one general partner and at least one limited partner. The limited partner is equivalent to the shareholder in a company whilst the general partner is generally the equivalent of the management company in a unit trust. The ILP generally does not have an independent legal existence in the way that a company does. All of the assets and liabilities belong jointly to the individual partners in the proportions agreed in the partnership deed. Similarly the profits are owned by the partners.

583. Feeder/master funds (FF, MaF), umbrella funds (UF) and funds-of-funds (FoF) are set up with one of the main objectives being the facilitation of access by investors to greater asset diversification than would be available through the more conventional CIIs. All types

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of structures exhibit the characteristic that one fund invests in one or more other funds. The arrangement must meet the statutory regulatory requirements of the authorities where the funds are domiciled (*i.e.* legally registered). In this context, the different funds in a particular investment arrangement may be domiciled in different jurisdictions and may also have different legal structures. In general, the country of registration of the entity concerned is taken to be the country of domicile of the fund.

584. Hedge fund (HF) is a term that covers a heterogeneous range of CIIs, typically involving high minimum investments, light regulation, and a wide range of investment strategies that tend to involve assets which are highly illiquid. The range of strategies include: hedging against market downturns, investing in asset classes such as currencies or distressed securities, and utilising return-enhancing tools such as leverage, derivatives, managed futures and arbitrage (*e.g.* bonds, stocks and risk arbitrage). Many HFs target consistency rather than magnitude of return as their primary goal.

585. A professional investor fund (PIF) is a fund authorised to require a relatively high level of minimum subscription from eligible investors. Borrowing restrictions applied to other more usual CIIs may also be relaxed.

586. A private equity fund (PEF) is established to enable partnerships of qualifying individual investors or groups consisting of up to 100 qualifying individual investors to participate. Such funds can include venture capital funds, as well as buying-out funds, whose investors tend to be mainly institutional investors acquiring and selling shares in order to gain a long-term interest through participation in the control or management of an enterprise for a specified period to enhance its value.

587. Distressed funds (DF) are established to invest at deep discounts in equity, debt, or trade claims, of companies undergoing or facing bankruptcy or reorganisation.

588. In a property or real estate fund (PF or REF), the term property is generally defined as a freehold or leasehold interest in any land or building, with a specified minimum unexpired lease period. Partly paid shares may be issued.

589. A money market fund (MMF) is a very special type of CII. It issues shares or units to the public that are, in terms of liquidity, close substitutes for deposits, and it invests the proceeds primarily in low risk short-term money markets instruments (treasury bills, certificates of deposit, and commercial paper), MMF shares/units, as well as in bank deposits and instruments that pursue a rate of return that approaches the interest rates of money market instruments. In some jurisdictions and depending on their set-up constraints, some MMFs are classified as monetary financial institutions.[81]

590. In general on the liability side, investment into CIIs involves the pooling of the investments of a number of investors so that the units/shares acquired by each individual account for a very small proportion (generally much less than 10%) of the total number of units/shares issued by the scheme. There are some CIIs, however, which may have a small number of investors (*e.g.* property/real estate funds, private equity funds, distressed funds) and the investors in individual cases may contribute sizeable proportions (more than 10%)

81. Monetary financial institutions cover two types of entities: *a)* credit institutions whose business is to receive deposits or other repayable funds from the public and to grant credit for their own account, and *b)* other financial institutions whose business is to receive deposits or close substitutes for deposits from entities other than monetary financial institutions and to grant credit for their own account or to make investments in securities.

of the overall capital invested. A CII may have resident investors, non-resident investors or a mixture of both.

591. On the assets side, a CII can invest in both resident and non-resident financial securities or other assets. There tends to be very little or no concentration of the pooled investment into significant proportions (10% or more) of the shares issued by individual enterprises which are acquired by the CII.

592. It should be noted that occupational pension funds (*i.e.* those schemes sponsored by employers on behalf of their employees) are generally not regarded as collective investment institutions. The main reasons for this are: firstly, the liabilities of occupational pension funds tend to be long-term and are in the form of insurance technical reserves; the liabilities of CIIs are in the form of equities, shares or units. Secondly, there are very rigid conditions concerning the encashment by investors (employees principally) of their pension funds *e.g.* the assets of these funds generally cannot be realised by the individual investor until he/she reaches a certain (retirement) age. An investor in a CII can cash in his/her investment whenever desired.

2. Categorisation of investment into a CII and by a CII under direct investment

593. The classification of CIIs can differ across countries for a number of reasons *e.g.* in the context of differences in permissible legal structures, in taxation systems or in securities investment legislation, and their classification according to functional type of investment category can present difficulties. Whether different types of CIIs, which have different features or economic natures, should be recorded as portfolio investment (PI) on either or both the inward and outward sides, regardless of the percentage of equity ownership, has been debatable. Opinion has been divided on whether the 10% voting power criterion for direct investment should be applied for the categorisation of both the assets and liabilities of CIIs. However, in line with other international recommendations, the *Benchmark Definition* recommends that, when an investor in one economy acquires at least 10% of the voting power in a CII in another economy, this investment should be regarded as direct investment. Similarly, when a CII own at least 10% of the voting power of a non-resident entity, this relationship should also be considered as direct investment. More precisely, investment in, and investment by, CIIs such as mutual funds, feeder/master funds, hedge funds and distressed funds, should be included in FDI data if the standard 10% threshold is met.

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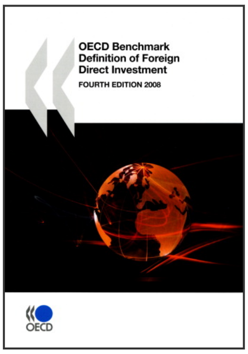

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