

**COMMUNICATION FROM THE EUROPEAN COMMUNITY  
AND ITS MEMBER STATES**

The following communication, dated 15 April 2002, has been received from the Permanent Delegation of the European Commission.

**CONCEPT PAPER ON THE DEFINITION OF INVESTMENT**

1. WTO Ministers have recognized at the Doha Ministerial Conference the case for a multilateral framework to secure transparent, stable and predictable conditions for **long-term cross-border investment, particularly Foreign direct investment**. Paragraph 22 of the Doha Ministerial Declaration mentions scope and definition among the issues to be clarified in the Working Group on the Relationship between Trade and Investment, in the period until the Fifth Ministerial Conference. The issue of definition has already been addressed in a number of papers presented in this Working Group since 1997.<sup>1</sup> Moreover, UNCTAD has devoted one of its international investment agreements issues papers to the question of scope and definition. In this context, this submission aims at outlining the EC view on some of the elements that could be used for the definition of investment in a multilateral framework on investment. Clearly, the specific definition that will eventually be adopted will have to be drafted in light of the substantive provisions that WTO members will agree to include in such a framework.

2. The inter-dependence and complementarity between trade and FDI has been consistently recognized in the economic literature, in a number of empirical studies and also in discussions within this Working Group. Around 50 per cent of world trade today takes place between affiliates of multinational enterprises. This figure underestimates the importance of FDI activities for trade since it only includes intra-firm trade. If rules have been usefully developed for trade, there is no reason why rules should not be devised for FDI, which is an important generator of trade, as the WTO Ministers have recognized. It should also be emphasized that a significant proportion of world FDI operations are already addressed in the WTO system of rules, since, for instance the provision of services through commercial presence, as provided for in mode 3 of the GATS, is a form of FDI. UNCTAD calculates that FDI in services sectors accounts for around half of world FDI stocks.<sup>2</sup>

**I. THE EXACT DEFINITION DEPENDS ON THE SUBSTANTIVE RULES**

3. Discussions in this Working Group have confirmed that most existing Bilateral Investment Treaties (BITs), which are mainly aimed at protecting existing and future investment between the

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<sup>1</sup> See, inter alia, WT/WGTI/W/43 and WT/WGTI/W/92 from Japan; WT/WGTI/W/49 from Korea; WT/WGTI/W/60 from Costa Rica; WT/WGTI/W/61 from the IMF; WT/WGTI/W/71 from India; WT/WGTI/W/76 from the WTO Secretariat; WT/WGTI/W/77 and WT/WGTI/W/78 from UNCTAD; WT/WGTI/W/80 from Australia.

<sup>2</sup> UNCTAD World Investment Report, 2001.

parties, contain a wide, “asset-based” definition and coverage of investment, including both FDI and portfolio. Some of these BITs, in particular when they contain additional provisions, for instance on the admission of foreign investments, specify that their coverage “...does not include capital movements that are mere financial transactions for speculative purposes, commercial contracts for the sale of goods or services, credits granted to a State, or loans that are not directly related to an investment...”<sup>3</sup>

4. An alternative to the asset-based definition is, for instance, the approach used in the OECD Code of liberalization of capital movements which adopts a “transaction-based” definition of capital movements. Since the main purpose of the OECD Code is the liberalization of capital movements, rather than the protection of assets, it lists all forms of transactions covered by the Code. Among the other forms of capital movements, FDI is described as the form of investment for the purpose of establishing lasting economic relations and which gives the possibility of exercising an effective influence on its management.<sup>4</sup>

5. Other agreements include an “enterprise-based” definition of investment, which comprises the establishment or acquisition of a business enterprise, as well as a share that provides the investor control over an enterprise.<sup>5</sup>

6. It has been said that developing countries would better preserve their interests with a narrow definition rather than in a broad definition of investment. In our view, this is too simplistic, as the interventions of some developing countries in this Group have confirmed.<sup>6</sup> The need to preserve the development objectives of host countries in a multilateral investment framework should not be addressed by merely narrowing the scope and definition but rather by including substantive provisions that allow all countries, and in particular developing countries, to pursue their development policies. As the UNCTAD has noted, development policy objectives are not necessarily incompatible with a broad definition, since the coverage of an investment agreement can be adapted and eventually narrowed through its substantive obligations and existing commitments of individual parties.<sup>7</sup>

7. In any case, WTO Ministers have agreed in Doha that a multilateral investment framework should focus on long-term cross-border investment, particularly foreign direct investment. It is under this understanding that the EC presents its views in this paper.

## II. THE KIND OF INVESTMENT COVERED BY THE NOTION OF FDI

8. Foreign direct investment is the category of international investment that reflects the objective of a resident entity in one economy (“direct investor”) obtaining a lasting interest in an enterprise resident in another economy (“direct investment enterprise”).<sup>8</sup> The two criteria incorporated in the notion of “lasting interest” are:

- the existence of a **long-term relationship** between the direct investor and the enterprise and,

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<sup>3</sup> WT/WGTI/W/60.

<sup>4</sup> For the broadly similar EC definition see Annex I to directive 88/361/EEC of 24/06/1988 (Official Journal of the European Communities L 178/8 of 8.7.1988).

<sup>5</sup> E.g. the Canada-US Free Trade Agreement of 1988.

<sup>6</sup> See interventions of Costa Rica and Peru, inter alia, in WT/WGTI/M/5 and WT/WGTI/M/6, which support a broad definition. The fear of a broad definition of investment by other countries is linked to the idea that a multilateral framework would liberalize all forms of capital movements and increase the risk of destabilising short-term flows. As the EC has stated on a number of occasions, a multilateral framework should firstly increase transparency, and stability of conditions for long-term investment world-wide, in the interest of all host and home countries. Liberalization should be pursued following a gradual, GATS-type approach.

<sup>7</sup> UNCTAD, IIA series “Scope and Definition”, as noted by WTO Secretariat paper WT/WGTI/W/108.

<sup>8</sup> IMF Balance of Payments Manual, Fifth Edition, para. 359; OECD Benchmark definition of Foreign Direct Investment, Third Edition.

- the **significant degree of influence** that gives the direct investor an effective voice in the management of the enterprise.

9. Having said this, it is important to bear in mind what are the **direct investment enterprises** and **direct investment capital transactions** involved and included in the concept of FDI, according to well-known and established definitions.

#### A. DIRECT INVESTMENT ENTERPRISES

10. According to the above criteria, direct investment enterprises are those in which the foreign direct investor owns an amount of shares<sup>9</sup> or voting power that allows him to participate effectively in the management of the enterprise or in its control: (i) subsidiaries (in which the foreign investor owns between 100 and 50 per cent); (ii) associates (less than 50 per cent owned by the foreign investor), and; (iii) branches (unincorporated, wholly or partially owned by the foreign investor) are included in the concept of FDI if the criteria are met.

11. There could be cases in which a foreign investor controls a company even owning a rather small amount of shares or when an investor owns a significant amount of shares but does not have an effective voice in the management of the enterprise. The IMF Manual on Balance of Payments explains that “most direct investment enterprises are either (i) branches or (ii) subsidiaries that are wholly or majority owned by non-residents or in which a clear majority of the voting stock is held by a single direct investor or group. The borderline cases are thus likely to form a rather small proportion of the universe”.<sup>10</sup>

#### B. DIRECT INVESTMENT TRANSACTIONS

12. The concept of direct investment includes the capital funds that the direct investor provides to a direct investment enterprise as well as the capital funds received by the direct investment enterprises from the direct investor.

13. The components of direct investment capital transactions are equity capital<sup>11</sup>, long-term loans, reinvested earnings<sup>12</sup> and other capital associated with various inter-company debt transactions.<sup>13</sup> In sum, direct investment capital transactions include those operations that create or liquidate investments as well as those that serve to maintain, expand or reduce investments.

### III. WHAT IS NOT INCLUDED IN THE NOTION OF FDI

14. Portfolio investors, as a general rule do not expect to obtain additional benefits derived from the management control of the enterprise in which they invest. Their main concern is the appreciation of the value of their capital and the return that it can generate regardless of any long-term relationship consideration or control of the enterprise. This is the main rationale behind portfolio investment, that makes it substantially different from FDI.

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<sup>9</sup> The IMF threshold is 10 per cent ownership of the ordinary shares or voting power or the equivalent for unincorporated enterprises. The OECD also recommends to follow the 10 per cent numerical guideline of ownership of ordinary shares or voting stock to determine the existence of a direct investment relationship.

<sup>10</sup> IMF Balance of Payments Manual, para. 364.

<sup>11</sup> Equity capital comprises equity in branches, all shares in subsidiaries and associates, and other capital contributions.

<sup>12</sup> Reinvested earnings comprise the direct investor's share of earnings not distributed as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor.

<sup>13</sup> Intercompany debt transactions includes the borrowing and lending of funds – including debt securities and suppliers' credits – between direct investors and subsidiaries, branches and associates.

15. Portfolio investment includes equity securities, debt securities in the form of bonds and notes, money market instruments, and financial derivatives that include a variety of new financial instruments.<sup>14</sup> However, it should be clear that if any of those instruments complies with the criteria of FDI capital transactions they are considered part of FDI.

16. All other financial transactions not covered in direct investment and portfolio investment are classified in the balance of payments as *reserve assets* or *other investment*.

#### IV. POSSIBLE ELEMENTS OF A DEFINITION OF INVESTMENT IN A MULTILATERAL FRAMEWORK ON INVESTMENT

17. In sum, the EC believes that the following elements could be taken into account, as a starting point for discussions in the Working Group, for the definition of FDI:

- **Direct investment enterprises:** all incorporated (subsidiaries and associates) or unincorporated (branches) enterprises in which a direct investor owns 10 per cent or more of the ordinary shares or voting power or the equivalent.

Should a direct investor control the company with less than 10 per cent of the ordinary shares the following criteria could be taken into account to determine whether a direct investment relationship exists: (a) representation in the Board of Directors; (b) participation in policy-making processes; (c) inter-company transactions; (d) interchange of managerial personnel; (e) provision of technical information; (f) provision of long-term loans at lower than existing market rates.

- **Direct investment capital transactions:** as defined by the IMF and the OECD, it comprises both the initial transaction between the direct investor and the direct investment enterprise and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated. This includes all operations that create or liquidate direct investments as well as those that serve to maintain, expand or reduce investments, such as equity capital, long-term loans, reinvested earnings and other capital associated with various inter-company debt transactions.
- **Foreign direct investors:** this concept could include all natural persons and companies of WTO Members, including public or private incorporated or unincorporated enterprises, which engage in a direct investment enterprise - such as a subsidiary, associate or branch - in a country other than the country or countries of residence of the foreign direct investor or investors.

18. Having said this, we also recognize that some ideas put forward in this Working Group and summarized in the Secretariat note WT/WGTI/W/108, could also be useful. In particular, as the Secretariat note points out, some Members have suggested that it is important to address the definition of investment in light of the nature of the substantive obligations within an investment agreement. For instance, as the EC has acknowledged in several occasions, we believe that applying a basic definition for the admission of foreign investment and a wider definition as regards the protection of established investment, is one of the possible options. This option has also been mentioned in UNCTAD's IIA issue paper "International Investment Agreements: Flexibility for Development".

19. We look forward to hearing other Members' views on this and other questions in order to find the most appropriate definition that responds to the basic challenge, particularly for developing countries, as identified by UNCTAD, of "...creating an appropriate stable, predictable and transparent FDI policy framework that enables firms to advance their corporate objectives, while, at the same

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<sup>14</sup> IMF Balance of Payments Manual.

time, retaining a margin of freedom necessary (*for developing countries*) to pursue their particular national development objectives”.<sup>15</sup>

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<sup>15</sup> UNCTAD IIA series International Investment Agreements: Flexibility for Development, p. 149.