THE BUSINESS TRUST AND ITS ROLE AS AN ENTITY IN THE FINANCIAL ENVIRONMENT

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BY

EBENHAÉSER CORNELIS NEL

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PROMOTER: PROF VA LAWACK
CO-PROMOTER: PROF JA VAN DER WALT

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“The world is a trust; but, of course, this author is biased.”

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DECLARATION

In accordance with Rule G4.6.3, I hereby declare that the abovementioned thesis is my own work and that it has not previously been submitted for assessment to another University or for another qualification.

_______________________
Ebenhaéser Cornelis Nel
December 2012
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EXECUTIVE SUMMARY

The trust figure in South Africa has undergone an interesting process of evolution during the last century – from a mere gratuity or private tax evasion tool to a proper family protection, business entity, investment, and structured finance vehicle. Its flexibility and multi-functionality positioned the trust as an ideal legal institution for many innovative ideas in the search for holistic business structures, economic empowerment transactions, general estate planning and risk protection initiatives, and ultimately, its application as a financial instrument and structured finance entity.

The development of both traditional and synthetic securitisation schemes in South Africa has been investigated, with some emphasis on the application of the special purpose institution, which may be in trust form. It is submitted that the application of the trust figure has developed without any significant contribution from the local legislator. A sound legal and regulatory framework is crucial for the creation of a strong future environment for legal and financial vehicles. The question is, however, whether the current South African legal framework for the application of the business trust, and also as a vehicle for financial instruments, is adequately sound and robust in light of the standards set in the international business and financial environment.

It is submitted that the hybrid nature of the South African legal landscape is conducive for the development of sound legal systems in an ever-changing legal and economic reality. It is further submitted that in the development of proper legal frameworks, South Africa should position itself particularly in its context as a Southern African developing democracy. The South African trust development is compared with that of some foreign jurisdictions as well as with international conventions and treaties of relevance.

Some recommendations for necessary changes are made and it is submitted that such future development of the trust figure should not take place haphazardly, but within the context of a structured regulatory model.

**KEY TERMS:** trusts; enjoyment and control; juristic person; fiduciary relationship; collective investment scheme; special-purpose institution; securities; securitisation; structured financing; regulatory arbitrage; regulatory model; soft law.
Die Suid-Afrikaanse trustfiguur het gedurende die afgelope eeu 'n interessante proses van ontwikkeling ondergaan – vanaf 'n blote welwillendheids- of belastingontduikingsmeganisme tot die rol van regsvoertuig wat beskerming oor generasies heen kan bied -- en selfs verder as effektiewe besigheidsentiteit, beleggingsvoertuig en gesofistikeerde finansieringsmodel. Die vlegbaarheid en meerdoeligheid van die trust, het dit geposisioneer as 'n regsfiguur wat uiting kan gee aan 'n verskeidenheid van innoverende idees, wat strek van holistiese besigheidstrukture, algemene boedelbeplanning- en risiko-bestuursinisiatiewe, tot by ekonomiese bemagtigingstransaksies en gestruktureerde finansiële instrumente.

In hierdie navorsing is die ontwikkeling van beide tradisionele en sintetiese sekuritasie-skemas in Suid-Afrika onder die loep geneem, met nadruk op die aanwending van die spesiale doelwit-instelling, welke in die vorm van 'n trust kan voorkom. Daar word voorgestel dat die aanwending van die trustfiguur ontwikkel het sonder noemenswaardige inmenging deur die wetgewer. ’n Gesonde juridiese en regulatoriese raamwerk is noodsaaklik vir die daarstelling van 'n sterk omgewing vir regs- en finansiële entiteite. Die vraag is egter of die huidige Suid-Afrikaanse regsomgewing gesond en robuust genoeg is, in die lig van internasionale standarde, vir die effektiewe aanwending van die trust as besigheids- en finansiële voertuig.

Daar word voorgestel dat die hibriede aard van die Suid-Afrikaanse regsomgewing voordelig is vir die ontwikkeling van gesonde regsisteme binne die ewigdurende veranderende juridiese en ekonomiese werklikheid. Daar word verder aanbeveel dat Suid-Afrika geposisioneer behoort te word as voorkeur-jurisdiksie binne die konteks van die Suider-Afrikaanse Ontwikkelingsgemeenskap.

In hierdie proses word die trust in Suid-Afrika vergelyk met geselekteerde buitelandse jurisdiksies, asook die wisselwerking met relevante internasionale verdrae. ’n Aantal aanbevelings vir toekomstige veranderinge word gemaak en daar word voorgestel dat die ontwikkeling van die trustfiguur nie lukraak moet geskied nie, maar binne die konteks van ’n weldeurdagte, gestruktureerde regulatoriese model.
CHAPTER ONE
INTRODUCTION

1.1 INTRODUCTION

South African legal and political systems have undergone major changes over the past two decades and are in many ways operating in a whole new legal reality. A legislative state, based on a largely common-law legal system, became a constitutional state, driven by a constitution which included a Bill of Human Rights.¹ These political changes allowed South Africa to return to the global arena of business and finance, amongst other concerns.

This return to the international playing field resulted in new challenges for the South African business and financial instrument environment. Major changes were necessary during the last decade and South Africa is operating in a new financial legislative dispensation. The reasons for these changes are manifold, such as compatibility with international trends in an effort to keep abreast, global economic realities, competitiveness, technological advancement, the introduction of constitutionalism and human rights, stricter governmental controls, taxation and fiscal needs, expectations of the public to be better protected, and the nucleus of modern financial products and national and international regulatory requirements.²

The two major aspects to be included in this thesis are the trust as business entity, and the specific application of this concept as a legal vehicle in structured finance.

¹ See Chapter 3 of the Constitution of the Republic of South Africa, 1996. A parliamentary sovereignty has been replaced by a constitutional democracy.
² The Basel Accords and the emphasis on minimum liquidity requirements have developed an universality without national borders in the milieu of international financial instruments. The three Basel Accords were introduced by the Basel Committee on Banking Supervision between 1988 and 2010. The general purposes of the Accords’ requirements were to strengthen the stability and consistency in the international banking environment. The minimum regulatory capital requirements of Basel I was strengthened by the supervisory review processes and market-discipline mechanisms of Basel II. The Basel III requirements, focusing on capital reserves, risk coverage, leverage ratios and capital build-up measures, will be implemented between 2013 and 2015. See 7.9 for more details on these Accords and their application in South Africa.
and more specifically in securitisation transactions. The investigation will include an evaluation of the South African position in a broader international context.

The trust has undergone interesting developments in South African law during the last century. It first became a popular tax-evasion tool in certain business and estate planning exercises, until the tax legislator decided to target trusts effectively. The uniqueness of what the trust as legal concept can offer has guaranteed its survival, irrespective of apparent antagonism from the local legislator – often inspired by controversial techniques applied by legal, accounting and financial advisors.

In Honoré it is stated that the

“flexibility of trusts contributes greatly to their popularity and the multifarious purposes to which they are put”.

De Waal and Paisley go even further in submitting that

“(t)hey are so multi-functional and polymorphic in their nature that they may be regarded as protean”.

This flexibility and multi-functionality positioned the trust as an ideal legal institution for many innovative ideas, in the search for holistic business structures, general estate planning and risk-protection tools, and ultimately, the application of it as a financial instrument entity.

The aforementioned role of the trust in South Africa was officially established by the Unit Trusts Control Act of 1947 and the Participation Bonds Act of 1964. These pieces of legislation were replaced by the Unit Trusts Control Act 54 of 1981 and the

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3 The trust has been used as financial instrument entity since the enactment of the Unit Trusts Control Act of 1947, but only became a popular vehicle after the Unit Trusts Control Act 54 of 1981 came into operation, which was replaced in 2003 by the Collective Investment Schemes Control Act 45 of 2002 (CISCA). The Securities Services Act 36 of 2004 (SSA) came into operation on 1 January 2005 and replaced the Stock Exchange Control Act of 1985, the Financial Markets Control Act of 1989, the Custody and Administration Act of Securities of 1992, and the Insider Trading Act of 1998.

4 The flexibility and adaptability of the South African trust contributed largely to its popularity. See Hyland & Smith “Abuse of the Trust Figure in South Africa: An Analysis of a Number of Recent Developments” 2006(1) Journal for Estate Planning Law, and their reference to the SA Law Commission Report of 1987.


Chapter One: Introduction

Participation Bonds Act 55 of 1981 respectively, and were both ultimately replaced by the Collective Investment Schemes Control Act 45 of 2002 (CISCA).\(^7\)

The advent of structured financial innovations and specifically securitisation\(^8\) required regulators to come up with fresh solutions to the existing legal and regulatory systems. When the securitisation\(^9\) concept was born in the minds of financial strategists, the various jurisdictions had to address the lacunas by way of new legislation.\(^10\) The formal regulation of securitisation activities in South Africa was introduced by way of Government Notice R153, dated 3 January 1992.\(^11\) These regulations excluded all securitisation activities from falling within the definition of “the business of a bank” as defined in section 1 of the Banks Act 94 of 1990.\(^12\)

In 2001 the second set of regulations\(^13\) followed and it allowed non-banking institutions to become involved in securitisation schemes. Government Notice R681\(^14\) was the next regulatory step and was also issued in terms of the Banks Act.

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\(^7\) The Unit Trust Control Act 54 of 1981 was amended by a number of subsequent Acts before Act 45 of 2002 came into operation. See in this regard the Inspection of Financial Institutions Act of 38 of 1984 and its amendments, the Financial Services Board Act 97 of 1990 and Unit Trusts Control Amendment Acts 53 of 1996 and 12 of 1998. The Collective Investment Schemes Control Act has been amended by the Revenue Laws Amendment Act 35 of 2007, the Taxation Laws Amendment Act 3 of 2008 and the Financial Services Laws General Amendment Act 22 of 2008, and will hereafter be referred to as CISCA.


\(^9\) Van Zyl, Botha, Skerritt & Goodspeed (eds) Understanding South African Financial Markets (2009) 488 define “securitisation” as “(a) process through which non-traded assets, such as bank loans or the cash-flows from such assets, become tradable”. The concept will be discussed in detail in Chapter 6.

\(^10\) The term “securitisation”, which will be discussed in detail in Chapter 6, refers to the process of creating asset-backed securities by transferring illiquid assets into insolvency-remote special-purpose vehicles. These vehicles then issue debt securities by using these assets as collateral.

\(^11\) This Notice was published in GG 13723, in terms of the Deposit-Taking Institutions Act 94 of 1990. In this notice a “securitisation scheme” was defined with reference to a “deposit-taking institution” and the definition of last-mentioned was deleted and replaced with the term “bank” by way of s 1 of the Deposit-Taking Institutions Amendment Act 9 of 1993. See Itzikowitz & Malan “Asset Securitisation in South Africa” 1996 SA Mercantile Law Journal 175.

\(^12\) Hereinafter referred to as the Banks Act.


\(^14\) Published in GG 26415 of 04-06-2004 and repealed the 2001 Regulations in its entirety. According to Prinsloo Real Estate Securitisation the first South African securitisation issue was undertaken in 1989 by the then United Building Society. See also the discussion by Itzikowitz & Malan 175-183.
These regulations fulfilled an important role as they formally introduced the regulating of synthetic securitisation in South Africa, but were repealed and replaced with new regulations on 1 January 2008, under the heading “Designation of an Activity not Falling within the Meaning of ‘the Business of a Bank’ (Securitisation Schemes)”.

Although the 2008 regulations replaced the 2004 regulations in its entirety, it did not change the definitions materially, but did address certain aspects which were not previously addressed. Some of these amendments, together with the Banks Amendment Act 20 of 2007, were largely the result of the acceptance of the Basel II Accord by the South African Reserve Bank.

Both traditional and synthetic securitisation schemes have been properly regulated in South Africa since 2004 and it also makes provision for the definition of the special-purpose institution (SPI), as

“a company or trust, insolvency remote, incorporated, created or used solely for the purpose of the implementation and operation of a traditional or synthetic securitisation scheme”.

Although the term “special-purpose vehicle” is commonly used internationally, the South African legislature has opted to use “special-purpose institution”. For purposes of this thesis, the term “SPI” will be used.

Coupled with other relevant legislation, the process was undertaken to incorporate the latest invention in international financial instruments into the South African market. Norman Muller, head of Capital Markets at the Financial Services Board, stated that the Securities Services Act 36 of 2004 “has been drafted to increase confidence in the South African financial markets; promote the protection of regulated persons and clients; reduce systemic risk; and promote the international competitiveness of securities services in South Africa”.

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15 GN R2 in GG 30628 of 01-01-2008 repealed and replaced the 2004 Regulations in its entirety. GN R1 and R3 were also published on 01-01-2008 in Gazettes 30627 and 30629 respectively and regulate, together with Notice R2, the current regulatory environment of securitisation.

16 Amended the Banks Act of 1990 dramatically and was published as GN R1080 in GG 30474 on 15-11-2007. It came into operation on 01-01-2008.

17 As defined in the Exemption Notice regulating Securitisation Schemes R2 of 01-01-2008 (GG 30628). The legislated definitions of traditional and synthetic securitisation schemes will be quoted and discussed in another Chapter.

Chapter One: Introduction

In the process of retaining relevance in the international financial sphere current legal concepts and entities have to be utilised by both the financial product developers and the legislator. In many foreign jurisdictions the trust has been used as SPI for the past 20 years or more.\(^1\)

It can, therefore, be submitted that the trust as a business entity is still as popular as ever, but the emphasis is now no longer only on the traditional utilisation of the trust any longer, but on issues such as business management and structuring, asset protection, ownership perpetuity, estate planning, and the trust as a structured financial instrument, with tax-splitting and estate duty minimisation as distant possible advantages.\(^2\)

In a world without technological and monetary boundaries, the business realities are forever changing and even relatively small players can take part in the big league.\(^3\) South Africa’s legal, business and financial regulatory environment were always relatively advanced in a global perspective, as South Africa has a well-developed legal framework with respect to the business and financial sector, as well as a huge number of financial instruments which are available for the astute local and offshore investor.\(^4\)

It will be submitted that South Africa should, however, not necessarily find its inspiration solely from developed nations, but should rather position itself in its real context of a developing Southern African democracy, with the potential to become an

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\(^1\) In some jurisdictions it is referred to as a “special-purpose vehicle” (SPV) or a “special-purpose entity” (SPE). See Schwarz “Commercial Trusts as Business Organizations: Unravelling the Mystery” 2003 The Business Lawyer 559-564. Wood Law and Practice of International Finance (2008) 38-39 submits that the global harmonisation of financial law is not necessary as the division of the world into legal families on the basis of financial law criteria is reasonably clear and non-confusing.

\(^2\) Zimmerman et al Mixed Legal Systems 825-827 identify the following major uses of the trust as investment and financial planning purposes, protective purposes, benevolent purposes, commercial purposes and fiscal purposes, but then add less common uses such as, trusts for enabling purposes, trusts for adjudicatory purposes, and trusts for purposes involving the balancing of a multiplicity of interests. To these one can add trusts as financial instruments and special-purpose vehicles. See further Watt Trusts and Equity (2006) 52 submitting that the trust “occupies the significant sphere of home, employment, and commerce.”

\(^3\) Historically smaller jurisdictions, such as Cayman Islands, Bahamas, Guernsey, Mauritius and Malta, became the tax havens and money-protection centres of the world. To be able to compete in this environment they had to, amongst other instruments, provide for well-regulated trust tools.

\(^4\) South Africa is even a player in the hedge fund industry, which is widely regarded as the most robust structured finance instrument. Trusts are also applied as legal vehicles for some of these funds.
important financial innovator in a world of economic turmoil. Moyo argues convincingly that many developed countries have lost the plot, both financially and economically. The 2008 financial crisis originated in the developed West and spread throughout the globe, while creating new opportunities for developing nations. With China moving closer to a position of a superpower, South Africa should capitalise on its position as a BRICS country.

In light of the above a sound legal and regulatory framework is crucial. International best practice requires a definite and effective regulatory environment for economic expediency. Although the South African legal system is traditionally based on the common law, legislation became more important as the regulatory environment developed. The business needs of the 21st century cannot be addressed satisfactorily by the traditional common-law sources alone and the last-mentioned must be complemented with well-drafted, responsible legislation and regulations, as well as self-regulatory and soft law interventions.

It is submitted that a hybrid system, such as ours, is better suited to adapt to the challenges of an ever-changing legal and economic reality.

The general commitment of the legal fraternity to the acknowledgement of the role and co-existence of the trust as a business entity is sometimes questionable. Sitkoff claims the business trust to be somewhat

“of an orphan in the domestic (United States) legal academy”.

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23 South Africa as part of the Southern African Development Community (SADC) will be referred to in 8.6 and 9.2.6.
24 Moyo How the West was Lost – Fifty Years of Economic Folly and the Stark Choices Ahead (2011). The writer refers to “the west” and “the rest”. It is submitted that the South African financial system is more part of “the rest” than that of “the west”.
25 The BRICS countries are Brazilia, Russia, India, China and South Africa, with last-mentioned the smallest economy by far. See Paulson On The Brink – Inside the Race to Stop the Collapse of the Global Financial System (2010), and Turner The Credit Crunch (2008) for more details on the 2008 financial crisis.
27 In Zimmerman et al 825 it is submitted that if trusts are not subjected to academic scrutiny “useless technicalities and obscurities will develop in the law and the teaching of the law of trusts may degenerate into the dictation of mere lists of their application and occurrence”.
He further submits that the business lawyers assume it to be a subject for the trust scholars and the academic products of trust scholars as a subject of business law, resulting in a

“scholarly and teaching lacuna”.29

The fields of research in this study would include trust law, banking law, general corporate law, law on financial instruments, investment law, empowerment law, succession law, tax law, law of insurance, family law and international law - as far as these different fields of law have an effect on the trust as a vehicle for business operations, investments and financial instrument structuring. The South African developments will be compared with those in a number of foreign jurisdictions and reference will be made to international conventions and treaties of relevance.

In the context of lessons to be learned from the international economic meltdown, which was driven by financial instrument ingenuity in larger nations, the final emphasis will not so much be on the developed world only, but will focus on two small island states which have positioned themselves, partly with trust law, as offshore financial centres.

1.2 MOTIVATION

In South Africa a variety of legal forms for business entities are known,30 namely the sole proprietorship, the partnership,31 the private and public company,32 the close corporation, the co-operative and the trust.33 The trust has never been recognised

29 Sitkoff 34.
30 The universitas personarum is based on a legal fiction and has been described as “an aggregation of individuals forming a persona or entity”. The universitas has the capacity "to acquire certain rights as apart from the rights of the individuals forming it". See Gibson South African Mercantile and Company Law (2003) 259 and the reference to Webb & Co Ltd v Northern Rifles 1908 TS 462 464-5.
33 Havenga et al General Principles of Commercial Law (2007); Collier-Reed & Lehmann (eds) Basic Principles of Business Law (2006), and Davis & Cassim (eds), refer to the “business trust” specifically as if the business trust were a separate type of entity from the trust in general.
as a juristic entity in the technical, legal sense and is clearly also not a corporation, although it is defined in section 1 of the Companies Act 71 of 2008 as a “juristic person”, for purposes of that Act. Practically speaking, however, of all the non-corporate legal concepts, the trust has the closest connection with the corporation and it sometimes functions in such a corporate manner that the business person may even confuse it with the traditional corporation.

Although the testamentary trust (mortis causa) as well as the living trust (inter vivos) are known in South African law, the focus of this thesis will be on the last-mentioned only and then particularly on the application of the inter vivos trust in the corporate sphere, with emphasis on its role as instrument in the financial markets. This is motivated by the fact that, although the trust concept in general has been extensively researched, the specialised application of the trust as a business and financial tool has not received the same attention.

During the last few decades the inter vivos trust has become an important tool in the business milieu of many jurisdictions. The main reason for this popular application of the trust may be found in the flexibility of the concept. In many instances, however, is one specific aspect of the trust as business tool over-emphasized, while other equally important consequences are overlooked or ignored.

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34 Although it has no independent juristic personality, it has been treated as a “person” for tax purposes in terms of the Income Tax Act 58 of 1962, the Transfer Duty Act 40 of 1949 and the Value Added Tax Act 89 of 1991.

35 Hereinafter referred to as the Companies Act. It has also been included as a “person” and/or “juristic person” in a number of other pieces of legislation, such as the Income Tax Act 58 of 1962, the Consumer Protection Act 68 of 2008 and the recent Credit Rating Services Bill of 2011.

36 It is, however, clear in terms of the definition of “company” in s 1 of the Companies Act 71 of 2008 that the trust is not included, as trusts are not “incorporated in terms of the Act”.

37 The testamentary or mortis causa trust is created by way of a will, and although the founding act takes place during the life of the founder, the trust only becomes a fact at the death of the founder. The living or inter vivos trust is established during the life of the founder by way of a contract. See Strydom Die Aansprake van ’n Trustbegunstigde in die Suid-Afrikaanse Trustreg LLD thesis Potchefstroom University (2000) 109-113.

38 In Land and Agricultural Development Bank of SA v Parker and Others 2005 2 SA 77 (SCA) 87D Cameron JA states that “(t)he great virtue of the trust form is its flexibility, and the great advantage of trusts their relative lack of formality in creation and operation”. In reference to Zimmermann and Visser Southern Cross – Civil and Common Law in South Africa (1996) 850, he quotes: “the trust is an all-purpose institution, more flexible and wide-ranging than any of the others”. See Hyland & Smith 1.
Moffat\textsuperscript{39} states that

“the trust concept has today also penetrated more directly into many and varied areas of commercial activity”.

Amongst others does it play a significant role in collective investments, as a security or holding device, and even as a business corporation. While the trust is regarded as an important feature of many common-law jurisdictions, most civil-law countries are unfamiliar with it.

Hansmann and Mattei\textsuperscript{40} submit that trust law should be evaluated from a functional, rather than a doctrinal, perspective, as a better understanding of the functionality of the trust has “substantial practical importance today”. Because of the demand for suitable legal forms of fund management, many civil-law jurisdictions have adopted trust-like institutions. The traditional role of the private trust as a family wealth transfer device became rather trivial, as the importance of the financial and corporate roles of trusts increased. Trusts are not only prevalent in securitisation and other investment roles, but also fulfil an increasingly important role in organisational law,\textsuperscript{41} which includes a variety of business legal fields, such as company law, employment law, competition law, trade mark and patent law, consumer law, information protection law, and environmental law.

Honoré\textsuperscript{42} defines the trust as:

“a legal institution in which a person, the trustee, subject to supervision, holds or administers property separately from his or her own, for the benefit of another person or persons or for the furtherance of a charitable or other purpose”.

Honoré\textsuperscript{43} further distinguishes between the trust in the \textit{wide} and \textit{narrow} (or \textit{strict}) senses respectively. A trust in the \textit{wide} sense exists when someone is “bound to hold or administer property on behalf of another” (own emphasis).

\textsuperscript{39} Moffat \textit{et al} \textit{Trusts Law: Text and Materials} (1996) 481.
\textsuperscript{40} Hansmann & Mattei “The Functions of Trust Law: A Comparative Legal and Economic Analysis” May 1998(2) \textit{New York University Law Review} 435. They refer to the following roles in more particular: pension funds, mutual funds, and asset securitisation.
\textsuperscript{41} Hansmann & Mattei 436. It is submitted that since these observations were made, the role of trusts in the corporative and financial spheres have increased dramatically. It is submitted that in South Africa it has an important function to fulfil in economic empowerment processes.
\textsuperscript{42} 1. It can be argued that this definition is really a definition of the trust in the narrow sense only. See also Smith \textit{Authorisation of Trustees} 4-5 in this regard.
\textsuperscript{43} 3-4. See Pace & Van der Westhuizen \textit{Wills and Trusts} (2007) 15 and their reference to Olivier \textit{Trust Law and Practice} (1990) 4 and 108. Olivier at 2 describes the trust in the wide sense as
and it exists in the *narrow* sense when the founder is

“bound to hand over to another the control of property which is to be administered or disposed of by the other for the benefit of some person other than the trustee as beneficiary, or for some impersonal object”. (Own emphasis.)

In *Conze v Masterbond Participation Trust Managers (Pty) Ltd* 44 the court held that

“the term ‘trust’ in the Trust Property Control Act related to a trust in the strict or narrow sense, that is, where the trustee becomes the owner of the trust property for the purposes of the administration thereof for the benefit of the beneficiary”.

The important factor was, therefore, whether or not the property vested in the trustees. 45

From the discussion in Honoré it can be deduced that the trust in the wide sense includes structures that are not really trusts at all, such as trustees acting as administrators, tutors or curators. 46 The trust in the narrow sense is the form of trust largely used in the business environment. These trusts are usually administered and controlled in terms of the Trust Property Control Act (TPCA). 47 The first indication of such a trust is the fact that the trust deed is handed in to the Master of the High Court and letters of authority are issued to appoint the trustees.

The trusts used in the financial environment, however, are usually trusts in the wide sense and are not regulated by the abovementioned legislation. 48 It seems as if little

**Footnotes**

44 1996 3 SA 786 (C) 794G. In the *Conze* case the trusteeship was held in the wide sense which included that the trustees never became owners of the property they administered. The trustees held the property only *jura in re aliena* and the debenture-holders remained the owners of the claims (property). See 794D-E, read with 794H-J.

45 The same holds true for the definition in the Trust Property Control Act 57 of 1988. The concepts “narrow” and “wide” are discussed in par 2.5 in more detail.


47 Act 57 of 1988, hereinafter referred to as the TPCA. Under this Act “trust property” means “movable or immovable property and includes contingent interests in property which in accordance with the provisions of a trust instrument are to be administered or disposed of by the trustee”. The term “trust property” is defined in the Financial Institutions (Protection of Funds) Act 28 of 2001 as “any corporeal or incorporeal, movable or immovable asset invested, held or kept in safe custody, controlled, administered or alienated by any person, partnership, company or trust for, or on behalf of, another person, partnership, company or trust”. This definition is also used in the Financial Services Board Act 97 of 1990, which referred to the Financial Institutions (Investment and Funds) Act 39 of 1984, which was repealed by Act 28 of 1990.

48 The trust in the *Conze v Masterbond* case is an example of such a trust.
research has taken place to understand the intricacies of the trust in this wider sense. Although the trust was formally introduced to the financial sphere by way of unit trust legislation, its further development as a vehicle for financial instruments took place largely by default. In this thesis the trust in both the narrow and wide senses are, therefore, of relevance.

The legislative definition of the trust for administrative purposes and control is found in the TPCA,\(^{49}\) namely:

\[
\text{“the arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed –}
\]

(a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of a person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or

(b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument,

but does not include the case where the property of another is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act, 1965 (Act No 66 of 1965”).

The Income Tax Act,\(^{50}\) however, defines a trust as

\[
\text{“any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person”. (Own emphasis.)}
\]

It is clear from the above two legislative definitions of “trust” that the TPCA refers mainly to the trust in the narrow sense and the Income Tax Act refers to trusts in both the narrow and the wide sense.

The business trust has been categorised by Theron\(^{51}\) into the private and the public business trust respectively. The author further distinguishes the public business trust as an enterprise in which a large number of beneficiaries deposit capital in exchange

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\(^{49}\) Act 57 of 1988 s 1. This Act repealed the Trust Moneys Protection Act 34 of 1934 as well as Chapter III of the Administration of Estates Act 64 of 1965. According to the Conze case 794 (G) this definition only includes the trust in the narrow sense.

\(^{50}\) Act 58 of 1962 (as amended) s 1.

\(^{51}\) Theron “Die Besigheidstrust” 1991 Tydskrif vir die Suid-Afrikaanse Reg 268.
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for transferable share certificates. The private business trust is described as a trust in the normal sense of the word, but has a specific characteristic, namely the operation of a business with the making of profit as its main objective. Pace and Van der Westhuizen describe the business trust as

“any trust (in the narrow or wide sense) which is primarily used for carrying on a business for profit”.

They further submit that it is not always so obvious to determine whether a specific trust is actually conducting a business for profit. A number of surrounding circumstances may need to be investigated to establish whether this requirement has indeed been satisfied or not. The writers refers to factors such as the contents of the trust deed, the relationship between the founder, the trustees and the beneficiaries, the position of the beneficiaries (including vesting or not), the nature of the assets and the nature of the transactions in the trust, to mention but a few.

In the South African context the classification of a trust as a business trust has no legal consequence as there is no specific legal or tax dispensation for the business trust compared to the family or other non-business trust. Nor is there any specific regulatory framework for the trust as a financial instrument.

The most common historical application of the trust as a public business trust is in the form of a unit trust. In terms of the CISCA, which replaced the Unit Trusts Control Act 54 of 1981, a collective investment scheme can now be structured to be in the form of either a public or a private business trust, depending upon whether members of the public have been invited or permitted to invest money or other assets

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52 Reference is made to the characteristics mentioned by Klopper in Suid-Afrikaanse Handelsreg (1988) 595-597, namely: (a) a large number of beneficiaries; (b) no relationship between the founder and the beneficiaries; (c) the beneficiaries can freely transfer their interests; and, (d) the beneficiaries provide the capital and receive share certificates in exchange.

53 Theron 1991 TSAR 1; Langbein “The Secret Life of the Trust: The Trust as an Instrument of Commerce” 1997 Yale Law Journal 165-167 differentiates between the commercial trust as a trust “that implements bargained-for exchange” and the non-commercial trust that make use of “a donative transfer”.

54 7.

55 8.

56 The TPCA and the Income Tax 58 of 1962 both only refer to the “trust” and make no differentiation between business and non-business trusts. There is, however, provision for the special tax treatment of trusts for certain categories of individuals (special trusts), for instance the disabled and for non-profit organisations and public benefit organisations in the form of a trust.

57 Unit Trusts were first regulated by way of the Unit Trusts Control Act 54 of 1981 (as repealed) and are now regulated by the CISCA.
in the portfolio, or not. In terms of the repealed Unit Trusts Control Act a “unit trust scheme” was defined as

“any scheme or arrangement in the nature of a trust”,

while in CISCA a “collective investment” is defined as

“a scheme, in whatever form”,

which was a major amendment as far as the utilisation of trusts was concerned. Before March 2003 all unit trust schemes had to be in the form of a trust, but after that date it could be in whatever form, of which the trust form is but one.

Although the role of a trust as a unit trust instrument has been touched on by some writers on the subject of trusts in the South African context, the role of the trust as a structured financial entity did not receive much notice from legal and financial analysts, irrespective of the central role it fulfils in many financial transactions.

In the structured financial milieu, and particularly in securitisation, a variety of legal entities are used to make the scheme work effectively. Some of the main parties are the borrower and the originator, the special-purpose institution, the investor, the rating agency, the servicer and the trustee, of which both the SPI and the servicer or the trustee may be housed in a trust as juristic institution.

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58 Act 45 of 2002 s 1: definition of “collective investment scheme”, read with definition of “members of the public”.  
59 Honoré 618.  
60 See Locke Aspects of Traditional Securitisation in South African Law (2008) LLD thesis Unisa 37 and further on the use of the trust in securitisation. This aspect will be discussed in more detail in Chapter 4 of this thesis.  
61 Van Vuuren “The Awakening of Securitisation in South Africa” http://www.sasf.co.za (accessed 20-10-2010) defines securitisation as “the conversion of a pool of assets with a regular and predictable cash income”. In this process a company sells some assets, which would otherwise not be attractive as individual purchases, to a specially formed legal entity (the special-purpose vehicle), and last-mentioned funds the purchase by issuing debt securities in the capital markets. Another way to define securitisation is as “a structured finance process, which involves pooling and repackaging of cash-flow producing financial assets into securities that are then sold to investors” http://www.sasf.co.za/aboutsecuritisation/definition.htm (accessed 19-10-2010).  
Very little attention, however, has been given by trust analysts to this application of the trust concept.\footnote{O’Hagan “The Use of Trusts in Finance Structures” 2000(2) Journal of International Trust and Corporate Planning 85 states that “(u)ntil very recently there has been no discussion in trust textbooks and very little in specialist journals upon the use of trusts in financial and commercial transactions.” Hayton Modern International Developments in Trust Law (1999) claims that “over 90% of the value of trust funds is found in commercial or financial trusts, about which little has been written.”} It is submitted that this thesis can contribute to a better understanding of the trust in the financial environment and hopefully help to steer South Africa in the direction of becoming a more effective player in the global financial context.

1.3 CATEGORIES OF TRUSTS

From the above it is clear that the trust is applicable in a variety of roles in the business and financial environment.\footnote{These categories will be discussed in more detail in Chapter 2. Pace & Van der Westhuizen states in Wills and Trusts 1 that “it is given for consideration that because of its sui generis nature and because of the fiduciary capacity in which trustees find themselves, a trust may never have been meant to be utilised for business purposes.”} In the first instance, it plays an integral part in estate planning structures, as holders of shares in private companies and memberships in close corporations, as well as share- and asset-holders in general, especially of business assets and fixed property. The main purposes of trusts in these structures are those of asset protection and the successful management of succession and generational planning.

Trusts are, in the second place, often used as vehicles of business operation, in which case it comes closest to the traditional corporation. The reasons for the use of the trust in this sense are manifold, of which the lower level of accountancy compliance and resulting costs, and the potential of income-splitting, may be some of the main drivers.\footnote{With the advent of the Companies Act of 2008 and the ineffectiveness of the Companies and Intellectual Property Commission to register new companies and affect changes to existing companies, trusts have become even more popular as business entities.} Many business people anticipate that trusts will in future become more popular as business entities to replace the cost-effective close corporation, which has been disbanded by the Companies Act of 2008.\footnote{It is submitted by accountants that the costs of the review or audit processes for existing close corporations and small companies will in future be much higher than the historical costs for financial statements in terms of the Close Corporations Act.}
Thirdly, trusts are becoming more and more important in the South African context of broad-based black empowerment transactions. It is one of the most affordable mechanisms to use for the allocation of shares to previously disadvantaged employees in private and public companies, especially in the case of broad-based black empowerment transactions.

The fourth category of trusts in the business environment is in the field of financial instrument structuring and financial system management. Many investment and risk funds held on behalf of third parties, such as unit trust funds, structured finance schemes, retirement funds and medical aid funds are held in the form of a trust. In this field the trust has become a major tool in the business and financial world and billions of rands have been invested through structures involving trusts in one form or another, either as a mere holder of units or as a special-purpose institution.68

The individual estate planner or business person may be unnecessarily confused by the many different schools of thought amongst financial advisors, fiduciary consultants, academics, lawyers and accountants, about the desirability or not of inter vivos trusts as a planning or business tool. These, often non-holistic arguments, may result in the individual being left with serious questions regarding the future of the trust.

It is submitted, however, that the trust concept, which was inherited from English law by South African law, was never intended to be an estate planning or business tool as such, but was merely a way of managing assets on behalf of third parties.69 Hansmann and Ugo70 submit that the property-like aspects of the trust, compared to the contract-like aspects, are the main contributors to trust law in the modern age, as the trust creates an entity which is separate from the parties thereto.

The manner in which the concept has been utilised in South African law, however, has culminated in a few interesting developments, as well as unique operational mannerisms. In the absence of alternate legal tools to achieve the purposes raised above, it is foreseen that the trust will remain a very important mechanism in

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69 Pace & Van der Westhuizen Wills and Trusts 1.
business management and structuring, estate planning and succession, and as a financial instrument vehicle and special-purpose institution in future structured and non-structured finance and empowerment transactions. 71

1.4 THE BUSINESS TRUST

The trust is no newcomer to commercial activity and Moffat 72 indicates how unincorporated “deeds of settlement companies” have been used since the eighteenth century to subvert the prohibition of the 1720 Bubble Act (to prevent people from “presuming to act as a corporate body”) and how trusts fulfilled an essential role in these structures. An unincorporated group of people could not hold property, but the property could be held in trust for them. This later resulted in joint stock companies and limited liability settlements.

The trust has also established itself as a commercial vehicle in the South African business and financial market. The problems faced by trusts in South Africa are numerous, such as the fact that their registration and control are still not well managed, that most trusts which are used as financial instruments do not have to be registered, that the Masters’ offices of the different jurisdictions of the High Court do not apply a uniform system with respect to the registration of and control over trusts and that no comprehensive national databases for registered trusts and appointed trustees exist. 73 These and other contributory factors do create a recipe for uncertainty and even possible exploitation, which is somewhat euphemistically referred to as “regulatory arbitrage”. 74 The business world does not appreciate instability and unqualified risks and it is, therefore, submitted that these aspects are not conducive to the promotion of international business competition.

In light of the hundreds of thousands of inter vivos trusts in South Africa, to which many thousands of new ones are added annually, it is necessary to evaluate the

71 Pace & Van der Westhuizen states on 1-2 that while “the trading trust compares very favourably with other business forms”, the trust is also “a versatile holistic estate planning tool”.
72 Moffat et al Trusts Law 481-482.
73 In Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk 2004 3 SA 486 (SCA) 493H Harms JA says, in reference to a business trust, that it is troubling “that there is no central register for trusts or trustees as one has in respect of companies and close corporations”.
74 Regulatory arbitrage is discussed in 5.9.
future of this somewhat enigmatic and unique legal concept within the business environment.

Many trusts are unfortunately structured according to a “one-size-fits-all” philosophy. Most lawyers do not specialise in the formation of trusts and they lose sight of the fact that the trust is the result of its own deed. This often results in an inflexible, rigid, and sometimes inappropriate trust deed, which has not been customised and adapted according to the needs of the individual client or business transaction.

According to certain audits, as many as 85% of inter vivos trusts registered in South Africa are not legally valid, appointments of trustees are often done in conflict with the prescriptions of the deed, and may result in personal liability for the estate planner or business person and may, therefore, frustrate the effectiveness of his estate plan or business transaction.\footnote{This statistic was referred to by Prof Willie van der Westhuizen as a personal observation during a seminar called “How do I . . . “ on trusts in October 2009 in George. \textit{See} Olivier, Strydom \& Van den Berg \textit{Trustreg en Praktyk} (2006) 2-20, as well as Joffe H “Sham Trusts” \textit{De Rebus} 2007(1) 25-26 for discussions on the so-called sham trust in comparison to the invalid trust.}

It seems, however, as if this new lease on life for the trust is not limited to the South African domain, but is in fact an international phenomenon. The past decade has seen a revival of the trust concept in many jurisdictions. At least some of the interest in trusts was awakened by the need for a reliable business, financial, investment or succession tool for foreigners who wanted to diversify their investment portfolios to offshore jurisdictions.\footnote{Sitkoff \textit{“Trust as Uncorporation} 31. Compare Schwarcz \textit{“Commercial Trusts as Business Organizations} 559; Langbein 1997 \textit{Yale Law Journal} 165.} The application of trusts in the investment world has been also extended during the last decade from mutual funds to the structured financial milieu. In this sense trusts were in the middle of the international financial crisis.

As far as can be ascertained, no formal research has as yet been done on the use of trusts as legal vehicles in structured finance processes and more specifically in securitisation transactions in South Africa. It is, therefore, submitted that this thesis will focus on a novel aspect as far as the application of the South African trust is concerned.
1.5 PURPOSES OF THE STUDY

The trust has been used internationally for many years as a business entity, irrespective of the fact that it has not been acknowledged and regulated as a corporation. During the last two decades it has also developed as a special legal entity in the world of financial instruments.

In many jurisdictions, this unincorporated status of the trust concept did not receive much attention from either the legislature or the academic researcher. A proper understanding of the unique manner in which trusts developed into so-called “uncorporations”, and their practical application in the business, investment and financial spheres, may prove to be of some value in the future structured development of this legal phenomenon – elsewhere and in South Africa.

It is submitted that the trust has developed as a specialised legal vehicle in the South African business, investment and financial system environment. All relevant current legislation, such as the TPCA, the Banks Act, CISCA, the Companies Act, and the Securities Services Act 36 of 2004, will be evaluated to determine the legislative environment in which the trust concept functions in the business, financial and investment world.

Trust legislation in a number of foreign jurisdictions, such as the Massachusetts Trust model and the Delaware Business Trust Act in the United States, as well as the recent proposals on trusts by the Law Commission in the United Kingdom, will be examined briefly. The South African environment will also be evaluated in terms of the international dispensation, such as the Hague Convention on the Law Applicable to Trusts and on their Recognition.

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78 Hereinafter referred to as the SSA.
79 Other legislation, such as the Financial Institutions (Protection of Funds) Act 28 of 2001, the Financial Services Board Act 97 of 1990 and the Mutual Banks 124 of 1993, in as far as it relates to trusts, will also be investigated. The Financial Markets Bill will also be evaluated.
80 Law Commission Paper No. 315, dated 6 May 2009, dealt with the capital and income requirements of trusts and is an apparent direct result of the 2008 financial crisis in which securitisation played a major role. The Malta Securitisation Act of 2006 will also be analysed in Chapter 8 as an example of recent international legislative interventions.
81 Hereinafter referred to as The Hague Convention.
In the final instance the South African context will be measured against two more comparable jurisdictions, namely that of Malta and Mauritius. While Malta is in the European Union, Mauritius forms part of the Southern African Development Community.\(^82\) Both these countries are small offshore jurisdictions with modern trust legislation. Their focus area is wealth preservation across national borders. It will be submitted that more synergy may be found in legal and financial jurisdictions with smaller economies, less financial muscle, and less historical baggage.

The pertinent question to be answered in this thesis, with reference to foreign jurisdictions and international law, is whether the current South African legal framework for the application of the business trust, with emphasis on the trust as vehicle for financial instruments, is sound and robust in light of the recent developments of the international business and financial environment.

The question shall be asked whether the common law, combined with the TPCA, is adequate for the new roles of trusts and whether South Africa needs specific legislation on business trusts to address the uncertainties which have developed because of the ever-changing local and international business, financial, tax, legal and investment milieu.

It will be submitted that future actions by the legislator, if any, and the decisions of the courts regarding the trust concept, should be approached holistically and should recognise and incorporate the trust in all its different forms of application.

In light of the examples of Malta and Mauritius the question will be asked whether South Africa should not position itself better as an offshore financial jurisdiction of choice in the larger African context. The South African government has already decided to market the country as a gateway to investment in Africa, by enhancing its attractiveness as a viable and effective investment location.\(^83\) A country’s competitiveness has once been defined as “the degree to which it can, under free and fair market conditions, produce goods and services that meet the test of

\(^{82}\) Hereinafter referred to as the SADC.

international markets while simultaneously expanding the real incomes of its citizens". 84

Some proposals will be made for appropriate regulatory and soft law interventions.

1.6 RESEARCH METHODOLOGY

The study shall commence with a historical analysis by placing the South African trust as a business instrument in context. The origins of the trust as a business entity and investment and financial vehicle in our legal system and the development thereof will be investigated and contextualized. The origin of securitisation as a financial instrument in South Africa, as well as its utilisation of the trust as a special-purpose institution, will be investigated.

The desktop method will be included in all aspects of the research. Relevant literature and legislation, 85 and the specific applicability thereof in addressing the research question, will be reviewed throughout the study. Qualitative measures will be used to determine the extent to which the current legal framework addresses the contentious questions under review.

A comparative analysis will be conducted, with specific reference to international conventions and treaties, as well as some foreign jurisdictions, determining any synergies with the development of trust law in the business and financial environment in South Africa. The utilisation of the trust as a legal entity in the collective investment schemes arena, and more specifically in the securitisation process, will be evaluated, with reference to some foreign jurisdictions.

The current legal framework in South African trust law will be measured against the practical utilisation of the trust as a business, investment and finance structuring legal entity. This method will be used on a continuous basis throughout the study.


All discovered information will be considered on a continuous basis, the relevance thereof will be determined, the value of all relevant information weighted and its application determined in a critically analytical manner, before accepting it and integrating it as part of the study.

This thesis will culminate in a proposed legal framework for the application of the trust as a business vehicle in general, and specifically as a legal entity in structured finance transactions.

1.7 TERMINOLOGY

The following terms, some of which are exclusively familiar to the world of structured finance, are used in this thesis:86

- **Beneficial ownership or interest** in a financial context is the entitlement to receive some or all the benefits of ownership of a security or other financial instrument.87

- A **collective investment scheme** is a scheme where funds from various investors are pooled together for investment purposes, with each investor entitled to a proportional share of the net benefits.88

- **Insolvency remoteness** is a characteristic indicating that the assets cannot become subject to any claim by a third party as a result of the linked institution’s insolvency.89

- **An issuer** is “the entity which is obliged on a security or other financial instrument”.90

- **Off-balance sheet transactions** are financial transactions that “are not reflected on the balance sheet of the financial institution conducting them”.91

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86 A more detailed glossary is available at the end of this thesis. See Van Zyl et al 467-492 for a complete glossary on financial terms.

87 It is usually distinguished from “legal ownership”, which is associated with legal title. See “A Glossary of Terms Used in Payments and Settlement Systems by the Bank for International Settlements” (March 2003) 29 – hereinafter referred to as “Glossary” www.bis.org. The difference between legal ownership and beneficial interest is discussed in more detail in Chapter 2.

88 See Van Zyl et al 471. See s 1 of CISCA for a more detailed definition on collective investment schemes. See 7.2.1 on collective investment schemes.

89 See GN R2 in GG 30628, published on 01-01-2008. See 6.8.2 for discussion on this concept.

90 Glossary 28. It is sometimes used to refer to a financial institution that issues credit or debit cards.
Chapter One: Introduction

- An **originator** is an individual or legal entity transferring assets to a special-purpose institution. Most originators are banks, but may also be any other company that wishes to raise capital against its own debtors’ book.  

- **Regulatory arbitrage** is the process in which parties manipulate a transaction by taking advantage “of a gap between the economic substance of a transaction and its regulatory treatment”.  

- **Securitisation** is the process of packaging untradeable assets in such a manner that predictable cash flows are produced, which in turn transform the assets into tradable instruments through which new capital can be raised.  

- **Securities** are shares, stocks and depository receipts in public companies, notes, debentures, bonds, derivative instruments, participatory interests in a collective investment scheme, offshore units and index instruments, but excludes money market instruments.  

- A **special-purpose institution** (SPI) is a specially created legal entity, in the form of a company or a trust, which is created for the purpose of a securitisation scheme, in that it purchases assets from an originator, by financing the purchase by way of issuing securities against those very assets.  

- **Structured finance** is a sector of finance that is used to transfer risk by way of unconventional and often complex legal entities.

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91 Glossary 35. Compare Van Zyl et al 484. See Chapter 6 for more details on this aspect in securitisation in general and 6.8.3 in particular.


93 Fleischer *Regulatory Arbitrage* 2010(2) *Texas Law Review* 227. The general term “arbitrage” usually refers to the profiting from a difference in price when the same security, currency or commodity is traded on two or more markets. See 5.9 for discussion on this aspect.


95 See definition in s 1 of the Securities Services Act 36 of 2004. See 5.4.


1.8 CONCLUDING REMARKS

The trust, as well as the business trust, has often been the topic of research in South Africa. In this study, however, the focus will be on a very specialised and limited application of the trust as a business entity.

Most South African research done to date on structured finance has been from a technical, legalistic angle and not from a practical, commercial perspective. In light of the above, I trust that this work will contribute towards both the legal jurisprudence and the commercial application thereof.

In the next Chapter the focus will be on the history and general development of the trust concept, while the application of the trust in the South African context will be investigated in Chapter Three. Chapter Four will focus on the application of the trust in the business sphere.

Chapters Five to Seven will consist of a study of the financial environment, securitisation as a financial instrument, and the operation of the trust as a financial instrument respectively.

In Chapter Eight the international trust environment will be evaluated against the background of some foreign jurisdictions. Certain major, as well as certain small offshore jurisdictions, will be investigated in a comparative manner.

In Chapter Nine the focus will be on the local and international regulatory environment in which trust law must develop. Specific regulatory models will be included in this investigation.

In the last Chapter recommendations for intervention in support of the trust as a business and financial instrument in South Africa will be made.
2.1 INTRODUCTION

In this Chapter the origin, history and development of the trust concept will be explored, before an investigation of the trust in the South African context will be undertaken in the next Chapter. The legal nature of the trust and some unique elements of the concept, together with the crystallised requirements for a valid trust, will be analysed. In the last part the parties to the trust, and their roles, will be evaluated.

The legal term “trust” is in a way the translation into legal terms of the word “trust”, which refers to a conceptual starting point meaning “a confidence reposed in some other”. It has been submitted that this “confidence” “gives rise to moral obligations to which the courts, aided by legislation, have purported to develop legal parallels.”1

Pettit2 states that it is

“commonly observed that no one has succeeded in producing a wholly satisfactory definition of a trust”.

This observation, however, does not discourage academics in all trust jurisdictions to regularly try their hands at the ultimate definition. In the modern idiom the legal term “trust” in a wide sense implicates that someone holds or controls assets on behalf of another party, or for an impersonal purpose.3

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3 Van der Merwe & Rowland Die Suid-Afrikaanse Erfreg (1990) 343; Honoré 3. See Olivier, Strydom & Van den Berg Trustreg en Praktyk (2009) 1-7 referring to the Anglo-American position, where a trust is defined as “a fiduciary relationship in which one person is the holder of the title to property subject to an equitable obligation to keep or administer the property for the benefit of another”, and the trust is “an equitable obligation, binding a person to deal with
Chapter Two: History and Development of the Trust

The notion of a trust may refer to a number of different legal constructions and can, therefore, be classified according to the discretion of the trustees, the source of origin, the purpose of the trust, or the vesting of rights. All of these aspects are of some importance, but none of them necessarily explains the legal nature of the trust at all times and under all circumstances.

In the South African trust-law context most writers will commence any discussion on the nature of the trust by differentiating between the trust in the wide and narrow sense, aspects which will be discussed later on in this Chapter.

The trust has developed in many jurisdictions, because of certain distinctive features and qualities, as a very useful vehicle of enterprise and planning for both the individual and the business person. Its inherent flexibility positions it as a legal concept with an extraordinary variety of application possibilities. This characteristic of flexibility is, however, also the source of the many uncertainties about its true nature and will be elaborated upon later in this Chapter.

For a proper evaluation of the particular nature and application of the business trust, it is necessary to understand the source and development of the trust in general.

2.2 HISTORICAL OVERVIEW OF THE TRUST

The institute of the trust concept was born in medieval England where the Chancellor was empowered with a vague and undefined jurisdiction. When a landowner went on crusades and feared for his life and wanted to manage the succession of his wealth, he could convey his land to a third party.

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4 Olivier et al Trustreg 1-3.
5 In the Draft Common Frame of Reference for European Private Law a trust is defined in Book X, ch 1, s 2, as “a legal relationship in which a trustee is obliged to administer or dispose of one or more assets (the trust fund) in accordance with the terms governing the relationship (trust terms) to benefit a beneficiary or advance public benefit purposes.”
6 See 2.5.
7 Olivier et al Trustreg 1-2.
8 In the medieval period the Chancellor was the most important person in the country next to the King and acted as a type of prime minister or secretary of state. According to Pettit 4 the Chancellor did not originally have a clearly defined jurisdiction, but was tasked with remediying common-law defects on grounds of conscience and natural justice. This led to him being referred to as the “Keeper of the King’s Conscience”.

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returned he could continue using the land. The third party came to be regarded as the owner at law (the feoffee to uses) and the crusader as the owner in equity (cestui que use). The common law originally ignored the fiduciary position of the feoffee and the right to benefits of the cestuis que use, until the Chancellor started intervening during the late fourteenth century. The aforementioned compelled the feoffees to uses to carry out the directions received from the landowner, but also understood that the feoffees were the legal owners of the land.

The common law, however, treated the feoffees to uses as the unfettered owners of the property and disregarded the claims of the cestuis que use. This situation was unsatisfactory and compelled the Chancellor to intervene, without denying the legal ownership of the feoffees. The Chancellor could force the feoffees to uses to manage a crusader’s property in his absence and in accordance with his wishes. The feoffees had to hold the land for the exclusive use and benefit of the crusader and if he failed to carry out the orders of the landowner, the feoffee was liable to imprisonment. Although this was an administrative mechanism only, the Chancellor would also effectively enforce the crusader’s rights against all other persons who wanted to take control of the land.

The use was utilized in different forms. The communities of Franciscan monks, after a vow of poverty, made use of the use to transfer land that they could continue to use, to third parties. The use concept was also utilised to avoid the results of feudalism when vassals could take ownership of land if there was no heir. The feoffees of use are seen as the forerunners of today’s trustees and were required to hold the land for the benefit of the cestui que use (or cestui que trust), today known as the beneficiary, while aforementioned retained the right to obtain the use of the property. The trustee’s obligation with regard to the property was, therefore, co-

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9 Martin 8-9. See also Stephenson & Wiggins Estates and Trusts (1973) 68.
10 Pettit 12-13. The term used for this legal structure was “use”, a corruption of the Latin phrase *ad opus*.
11 Martin 8-9. Pettit 13. Moffat *et al* 25 describes this feudal landholding as “a complex amalgam of personal relationships – manifested particularly in the subordination of tenant to lord through homage, services and incidents – and proprietary rights”.
relative to the beneficiary’s right to it.\textsuperscript{14} The \textit{feoffee} himself could also be a \textit{cestuis que use}.\textsuperscript{15}

One of the main considerations for holding land in \textit{use}, as described above, was “to evade some of the feudal dues”, which led to a legislatory attempt by the King in 1535 to put an end to \textit{uses}.\textsuperscript{16} This Statute effectively removed the \textit{feoffees} and granted the \textit{cestui que use} legal ownership of the asset. Practitioners circumvented the prohibition on \textit{uses} and developed the “use upon a use”, which was in effect a \textit{use} upon a leasehold or by requiring the legal owners of freehold land to collect the rents on behalf of the beneficiaries.

This second \textit{use} was not prohibited, and by the middle of the 17\textsuperscript{th} century this practice became known as a “trust”, which was drafted as “unto and to the use of B and his heirs in trust for C and his heirs”. The result was a duality of ownership – B as the legal owner and C as the equitable owner.\textsuperscript{17}

Equity is described by Watt\textsuperscript{18} as

“a body of principles, doctrines, and rules developed originally by the old Court of Chancery in constructive competition with the rules, doctrines, and principles on the Common Law Courts.”

The two concepts remained “distinct but mutually dependent aspects of law.”\textsuperscript{19} The end result is that the distinction between equity and law in the English context can only be understood “at the level of function and not form”.\textsuperscript{20}

South African law can be regarded as a hybrid, partly codified, legal system, based on a mix of Roman, Roman-Dutch and English common-law principles, largely dominated by its European heritage. Although Roman-Dutch law was first introduced to the Cape of Good Hope by the Dutch East India Company, the legal system at the

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\textsuperscript{14} Oakley (ed) \textit{Trends in Contemporary Trust Law} (1996) 1.
\textsuperscript{15} Pettit 13.
\textsuperscript{16} \textit{Ibid} 13. Martin 10. The Statute of Uses 1535 was instituted by King Henry VIII.
\textsuperscript{17} Pettit 13. Martin 10. See Watt 11-35 for detailed discussion on the concept of equity.
\textsuperscript{18} Watt 11.
\textsuperscript{19} Watt 12.
\textsuperscript{20} \textit{Ibid}.
\end{flushleft}
Cape did not escape English law, which greatly influenced the mercantile, company and insolvency law spheres.21

The trust concept never formed part of Roman-Dutch jurisprudence, but was an integral part of English law for many centuries.22 In English law different persons can simultaneously be the carriers of different forms of ownership over the same property – something that is hard for Roman-Dutch-orientated jurists to contemplate. As the English draw a difference between the legal owner and the equitable owner, these two ownerships can operate simultaneously over the same property. This approach to ownership fitted the trust concept well, as the trustee could act as the legal owner while the beneficiary is regarded as the equitable owner.23

The Roman-Dutch jurists operated with the concept of dominium, which does not allow two types of ownerships in one and the same thing.24 For this reason it was imperative for the South African legal system to develop its own trust law in line with Roman-Dutch jurisprudence.25 Fiduciary institutions were known to the Romans and have been transferred to civil-law jurisdictions influenced by Roman law.26 Civil-law countries consider ownership in absolute terms, and although there are legal concepts such as deposit, usufruct, curatorship and fiduciary mandate (negotium gestor) which contain elements akin to trust mechanisms, there is no real equivalent.


22 The trust was once referred to as “the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence”. See Pettit 12 in this regard. The trust was developed by the English Court of Chancery from the Germanic “Salman” or “Treuhand” institution according to Coertze Die Trust in die Romeins-Hollandse Reg LLD thesis University of Stellenbosch (1948) 54 and confirmed by Joubert JA in Braun v Blann and Botha NNO 1984 2 850 AD 859. See also the discussion by Olivier et al 1-11 on the role of the “Truehand”.

23 See 2.3 for the difference between legal ownership and the rights of beneficiaries.

24 It did, however, know two levels of ownership over the same asset as mentioned by Van der Merwe & Rowland 346 in reference to the dominium ex iure of the ius strictum and the dominium bonitarium of the ius praetorium.

25 Van der Merwe & Rowland 347. See the reference to Hahlo “The Trust in South African Law” 1961 South African Law Journal 195, where it was stated that “(a)mong the fundamental civil-law concepts which South African law has retained in its pure form, perhaps the most important one is the Roman dominium. There cannot be two ownerships or two kinds of ownership in one and the same thing at one and the same time, with the result that the English form of trust is ruled out.”

The *fiducie* developed next to the trust and is also based on Roman law, although it never resulted in such a useful and flexible instrument as that of the trust. Many civil-law jurisdictions that had to do without the trust concept in the past wanted an alternative for the trust and followed one or more of a number of routes to develop either a trust or a *fiducie*:

(a) Quebec brought the trust into its civil code;
(b) Luxembourg ratified the Hague Convention of the Law Applicable to Trusts and on their Recognition\(^{27}\) and thereafter created a legal framework for the *fiducie*;
(c) Switzerland ratified the Hague Convention without any local legal framework;
(d) France adopted the *fiducie*, without ratifying the Convention; and,
(e) Germany has decided not to ratify the Convention, neither to accept the trust or to expand the *fiducie*.\(^{28}\)

In English law the term “trust” is also used in a variety of other applications, which do not necessarily equate to the formal institution of a trust. Public (or charitable) trusts are distinguished from private trusts,\(^{29}\) which can be divided into express, resulting and constructive trusts.\(^{30}\)

The “express trust” is one intentionally created by the settlor or testator with certain minimum formalities having been adhered to.


\(^{29}\) Moffat *et al* 18 subdivides trusts into two main categories, namely “express trusts” and “imputed trusts”, and last-mentioned into “resulting” and “constructive trusts”.

\(^{30}\) The Trustee Act 2000 is the central legislative instrument for Trusts in the United Kingdom, but other regulating devices are the Public Trustee Act 1906, the Trustee Act 1925, the Trustee Delegation Act 1999, the Trusts of Land and Appointment of Trustees Act 1996, the Variation of Trusts Act 1958, the Trustee Delegation Act 1999, the Trustee Investments Act 1961, the Public Trustee (Custodian Trustee) Rules 1975, the Judicial Trustees Act 1896, the Administration of Justice Act 1985 (s 50 dealing with substitution of trustees) and numerous other Acts regarding the remuneration of Trustees and other issues.
According to Martin a “resulting trust” exists where a transferee is required to hold property on trust for the transferor or for the person who provided the assets for the transfer. The beneficial interest returns to the transferor and the resulting trust is, therefore, the basis of a claim to recover your own property. An example is where the property reverts back to the settlor because the sole beneficiary has died before it vested in him.

The “constructive trust” is where a person holds property under circumstances in which it should be held or enjoyed by another, and he is compelled by law to hold the property on trust for the other party, and he would be unjustly enriched if he retains it. Examples are the obligation of a trustee who has made a profit through his office, to hold such profit for the benefit of his beneficiaries, or the relationship of vendor and purchaser between the contract and the execution of the conveyance.

A “bare trust” is a further category and refers to the situation where the trustee holds property in trust for a beneficiary who may call for the conveyance of the property to him at any time, and the trustee must comply. The trustee deals with the property only according to the instructions of the beneficiary. Included in this is the practice where a lawyer holds money in trust for a client to dispose of as per the instruction of the client.

It is questionable whether these distinctions added any value to the trust instrument as it has developed in South Africa. Much of these attempts to categorise have been included in the understanding of the trust in the wide and narrow senses, as will be discussed later on in this Chapter.

2.3 THE TRUST IN SOUTH AFRICA

The trust concept in South Africa is of English origin and was introduced here in the 19th century by the British who used the trust concept in their wills and contracts, including antenuptial agreements. Over the last 200 years South African trust jurisprudence had to develop its own character, as the dual ownership concept in

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31 70, 71, 240, 302 and 306. He admits that there is an overlap between the two concepts, but also submits that it is problematic to merge the two categories.
32 Martin 71-72.
33 See 2.5. Compare also 1.4.
Chapter Two: History and Development of the Trust

English law was not reconcilable with Roman-Dutch law, wherefrom the South African legal system largely originated.\(^{34}\)

In *Braun v Blann and Botha* \(^{35}\) the Appeal Court stated that

“(o)ur Courts have evolved and are still evolving our own law of trusts by adapting the trust idea to the principles of our law.”

Custom, judicial decision and legislation have all contributed to the establishment of the trust concept in the South African legal dispensation since the first part of the 1800s.\(^{36}\)

De Waal\(^{37}\) states that

“(t)he conventional view is that the trust is a special institution of the English common law and that one cannot, therefore, talk of a proper trust law in legal systems where private law is based on civilian principles.”

This view has been shown to be an oversimplification and South Africa provides an excellent example of a mixed jurisdiction with a developed trust law, which aforementioned at times even referred to as a fallacy.\(^{38}\)

It is largely accepted that the trust concept originated as a means of transferring wealth within the family and remained up to the twenty-first century “an intergenerational wealth transmission” device.\(^{39}\) Most scholars historically focused almost exclusively on the trust as a gratuitous concept. It is clear, however, that trusts in the South African context were used as business entities from the very beginning. The first reference to a grant in a gratuitous trust for a missionary

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34 See Olivier *et al* (2009) 1-17, fn 76. This aspect is discussed in more detail below.

35 1984 2 850 AD 859 F in reference to *Crookes NO and Another v Watson and Others* 1956 1 SA 277 (A) 297E, where the following was submitted: “(r)eds is ’n begin gemaak met die ontwikkeling van ’n eie trustreg, ooreenkomsstig die grondbeginsels van ons eie regstelsel.”

36 See Honoré 21. It was submitted by Honoré in Zimmerman & Visser (eds) *Southern Cross: Civil Law and Common Law in South Africa* (1996) 850 that the British Settlers “brought the trust with them as part of their legal and intellectual baggage”.


38 Van der Merwe & Du Plessis (ed) *Introduction to the Law of South Africa* (2004) 187. Compare Olivier *et al* (2009) 1-18. De Waal states in Zimmermann *et al* 820 that the view that the trust is an institution found only in jurisdictions based on the English common law and that systems where the law of property is based on civilian principles cannot have proper trusts in the true sense of the word, can be regarded as a fallacy. He refers to Langbein 1995 *Yale Law Journal* 669 as an example of the abovementioned faulty submissions.

institution was in 1817 and the first reference to a business trust as legal entity for a trust company administering deceased estates took place as early as 1834.  

The development of the trust concept in South Africa was influenced by English as well as Roman-Dutch law – resulting in a distinctly South African law of trusts. The South African form of the trust was influenced by both the English and the Dutch forms of fiduciary arrangements. In the English concept the fiduciary owned the property, while Dutch law was familiar with the bewind, in which the beneficiary had ownership and the fiduciary only acted as administrator. The common-law development resulted in an enactment for the first time in 1989. The South African Law Commission, however, opposed total codification for a fear of inhibiting the natural development of trust law. This resulted in legislation that purposely addressed some problematic trust property issues, and did not affect all forms of trusts in South Africa.

Geach and Yeats define the trust as:

"the arrangement through which control and ownership in property is by virtue of a trust instrument made over or bequeathed to another person or persons (the trustee(s)) for the benefit of beneficiaries".

40 See Honoré 21 in reference to grants made to the Missionary Institution of the United Brethren at Groenkloof (1817) and the South African Association for the Administration and Settlement of Estates (1834). The Board of Executors (BOE) was formed as a trust in 1838. The first South African court case referring to a trust was decided in 1833 (Twentyman and Another v Hewitt) and the first Appeal Division litigation occurred in 1912 with the first express recognition by the highest court of the trust as part of the law of the Union of South Africa in Sherriff v Greene and Another 1913 AD 240. The words “trust” and “trustee” were used by the British Settlers in wills, deeds of gift, antenuptial contracts and land transfers during the nineteenth century South Africa, but largely transformed by the courts to reflect an indigenous institution with civilian principles.

41 In Estate Kemp v McDonalds’ Trustee 1915 AD 491 the court ironically rejected the trust as such but excepted it as far as it was a form of fideicommissum.

42 Honoré On Fitting Trusts 10-11.


44 The 1987 report stated in paragraph 1.10 that any attempt to codify the law of trusts “would result in an undesirable rigidity and (would) hamper further development”. See Strydom Aansprake van ’n Trustbegunstigde 26, and Smith Authority of Trustees in the South African Law of Trusts LLM dissertation University of the Free State (2006) 43. De Waal described the TPCA in “Authorisation of trustees in terms of the Trust Property Control Act” 2000 Tydskrif vir Hedendaagse Romeins-Hollandse Reg 472 as an “revolutionary, rather than a revolutionary, step in the development of the South African trust”.

45 Geach & Yeats Trusts: Law and Practice (2007) 1. This definition only refers to the trust in the strict sense and excludes the bewind trust, as ownership is not passed to the trustees in the bewind trust.
Chapter Two: History and Development of the Trust

Honoré distinguishes more clearly between the trust in the strict sense and the trust in the wide sense.

According to Honiball and Olivier three different kinds of trusts can be distinguished in South Africa, namely:

(a) the ownership trust, with the founder transferring ownership of property to a trustee to be held for the benefit of defined or determinable beneficiaries;

(b) the bewind trust, with the founder transferring ownership of property to the beneficiaries but control over the property is given to the trustees;

(c) agents with fiduciary duties (often office bearers), being entrusted with the affairs of another.

The term "ownership" in English law is not synonym with the South African idea of ownership, as the English draw a distinction between the legal right of ownership and an equitable right of ownership. "Ownership" is sometimes only "something better than mere possession" in English law. Olivier et al submit that for the English jurist the interest in the asset is of more importance than the ownership of the asset.

The uniqueness of the trust concept is locked up in the separation between ownership of the assets and the enjoyment of the assets. In common-law countries it is easier than it is for civil-law jurists to understand the concept of an owner without the right to enjoy his own property and without the right of his creditors to take possession thereof.

The interest of the beneficiary in the property is not one of ownership (except in the case of the bewind), but a right against the trustees that they shall comply with their

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46 See 1.4 for the definitions used by Honoré. See Joubert “n Kritiese Beskouing van Honoré se Opvattings oor ons Trustreg” 1969 Tydskrif vir Hedendaagse Romeins-Hollandse Reg 124 for a critical analysis of this classification. The trust in the “narrow” and “wide” sense is discussed in more detail in 2.5.

47 Honiball & Olivier The Taxation of Trusts in South Africa (2009) 3. The first two kinds of trusts ((a) and (b)) are regarded as trusts in the strict or narrow sense respectively.


49 See Olivier et al (2009) 1-18 and their reference to Hahlo 1961 SALJ 195 about the dominium principle in SA law. Olivier submits that it is not correct to compare the dual ownership concept of the English law with dominium.

50 1-17.

51 See Honoré On Fitting Trusts 10-11.
contractual and fiduciary duty to distribute any income or capital that the beneficiary has a right (or spes) to because of either the contents of the trust deed, or the exercise of a discretion by the trustees.\textsuperscript{52} While the trustees’ private creditors have no access to these assets, the beneficiary’s position is that of concurrent creditor.\textsuperscript{53}

The “gratuitous trust” and the “non-gratuitous commercial trust” are both part of the original development of the trust as a legal concept in the South African trust dispensation,\textsuperscript{54} but the application of the Trust Property Control Act (TPCA) is limited to the definition of “trust” in section 1 of the Act.\textsuperscript{55}

The legislature clearly had the gratuitous nature of the trust in mind and made no attempt to include the notion of a trust for commercial purposes, irrespective of the fact that the original development of the trust already indicated the applicability of the concept to the business world. As a gratuitous donation is mostly used by founders to form even business trusts, they are often covered by the TPCA.

\subsection*{2.4 THE NATURE OF THE TRUST}

De Waal and Theron\textsuperscript{56} admit that it is no easy task to explain the true nature of the trust in South African law. Honoré\textsuperscript{57} elects the following as the essential structural features of the trust concept: a trust requires (a) assets separately from that of the founder or trustee; (b) a trustee to administer these assets; (c) a defined purpose; and, (d) a court or administrative authority that may intervene to ensure that the purpose is put into effect.

The trust concept must be distinguished from other legal phenomena which may resemble the trust, like the agency or the contract, but which are different in nature.\textsuperscript{58}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{52} Honoré 13 refers to this right as a “protected right”.
\item \textsuperscript{53} Ibid 13-14.
\item \textsuperscript{54} According to Strydom \textit{Aansprake van ’n Trustbegunstigde} 23, the trust became a popular instrument in the commercial world since an early stage in its development.
\item \textsuperscript{55} See Act 57 of 1988. The section is quoted later in 2.5. The Act itself will also be discussed in more detail in Chapter 3.
\item \textsuperscript{56} De Waal & Theron “Die Aard van die Trust in die Suid-Afrikaanse Reg – Skikking na Aanleiding van Behoefte?” 1991 \textit{Tydskrif vir die Suid-Afrikaanse Reg} 499.
\item \textsuperscript{57} Honoré \textit{On Fitting Trusts} 4.
\item \textsuperscript{58} Martin 48 proposes a threefold test in this regard, namely: (a) compare the legal consequences of both concepts; (b) identify the circumstances under which each concept exists; and, (c) identify the circumstances in which a trust may co-exist with the related concept. Pettit 28
\end{itemize}
\end{footnotesize}
Chapter Two: History and Development of the Trust

The fact that many *inter vivos* trusts are indeed created by way of contract and that beneficiaries often acquire their rights (or hopes) as a result of a contractual commitment often lead to the misconception that a consensual trust is merely a contract.\(^{59}\)

Comparing the trust to the contract confuses the *nature* of the trust with the *process of its creation*, and similarly, to associate the trust with the agency is to compare the *nature* of the trust with the *function of the trustee*.\(^{60}\)

In *Peterson and Another NNO v Claassen*, with reference to *Administrators, Estate Richards v Nichol*, it is stated by Bozalek J that “(a) trust is usually created by a contract”, but this “does not mean that such entities and their relations with third parties are invariably dealt with in terms of contractual principles”.\(^{61}\)

The real nature of the trust is that which makes it distinctly different from any other legal institution and is not necessarily inseparably linked to the manner in which it is formed.

In *Crookes NO v Watson*\(^{62}\) the Appellate Division decided that “a trust deed executed by a settlor and a trustee for the benefit of certain other persons is a contract between the settlor and the trustee for the benefit of a third person”. This

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59 This simplification of the nature of the trust was reinforced in *Joubert v Van Rensburg* 2001 1 SA 753 (W) 768A-B. It is submitted that it was not necessarily the intention of Watermeyer CJ in *Commissioner for Inland Revenue v Estate Crewe* 1943 AD 656 673 to implicate that a trust is a contract when he suggested that the principles of our law of contracts should be applied to address certain trust problems.

60 See Honoré 3, 73. See *Crookes NO v Watson* 1956 1 SA 277 (A) 305F, where it was confirmed that the South African trust “is not entirely governed by principles of contract” and 306A-C, where it was decided by the majority that the trust *inter vivos* is in effect a contract for the benefit of a third person. This interpretation was supported by the court in *Hofer and Others v Kevitt NO* 1998 1 SA 382 (SCA) 386E, but slightly qualified in *Doyle v Board of Executors* 1999 2 SA 805 (K) 812I when the court referred to the limitation of the equation of the trust *inter vivos* with the *stipulatio alteri*. Pettit 29 states that the main communality between the trust and the agency is that both hold a fiduciary position which imposes on them certain obligations.

61 *Peterson and Another NNO v Claassen* 2006 5 SA 191 (C) 196F-G; *Administrators, Estate Richards v Nichol* 1996 4 SA 253 (C) 258E-G.

62 1956 1 SA 277 (A) 285F. The court relied upon De Wet “Die Ontwikkeling van die Ooreenkomste ten behoeve van ‘n Derde”, which was applied in *Commissioner for Inland Revenue v Estate Crewe* 1943 AD 656. In last-mentioned decision the court stated on 673 that “there is no reason why the problems presented by trusts in our law should not be solved by the application of the principles of our law of contracts”. Compare also *Joubert v Van Rensburg* 2001 1 SA 753 (W) 768A-B. In *Van der Merwe et al Contracts: General Principles* (2007) 265 it is stated that the *stipulatio alteri* must also comply with all the general principles of contract law.
apparent conclusion about the nature of the inter vivos trust was largely based on the submission that the beneficiary, in the case of the stipulatio alteri, “obtains no right on the mere execution of the agreement between the settlor and the trustees. The agreement constitutes and offers a donation by the settlor to the beneficiary through acceptance of which the beneficiary obtains a jus perfectum against the trustees”.  

The correctness of the Crookes case has been questioned by many. The uncertainty regarding the true construction of the stipulatio alteri continues and Smith submits that the stipulatio alteri is also “not the correct vehicle for the inter vivos trust”.  

The trust can indeed manifest in many forms, such as by way of an agreement between the founder and the trustees, in the form of a statutory trust (regulated by a specific statute), a judicial trust (in adherence to a court order) and the testamentary or mortis causa trust, which is the making of a testamentary disposition.  

To better understand the nature of the inter vivos trust it may be useful to start with the contract. The contract is based on an obligatio, which represents an intentional personal relationship between two or more persons, in terms of which some have rights and others duties (or obligations).  

The foundation of a contract in South African law is that the parties must have consensus about their intention as far as all material aspects of the agreement are concerned – the so-called concursus animorum. The parties involved must be ad

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63 Some argued that there is often not consensus about the contents of the trust deed between the founder and the trustee. Compare Honoré 35, and Van der Merwe et al Contracts 265. See Smith Authorisation of Trustees 34.  
64 Smith Authorisation of Trustees 35. See also Smith’s reference to Kerr’s “two contract” theory, which supports a contract between the settlor and the trustee and a second contract in terms of which the settlor is required to make an offer to the beneficiary.  
65 See Zimmerman et al Mixed Legal Systems 237, where it is stated that “it is doubtful whether South African law actually recognises a true stipulatio alteri”, as “South African courts require acceptance by a third party before he will acquire benefits from a third-party contract”. Compare the recent decision on the stipulatio alteri by the Supreme Court of Appeal in PPS Insurance Company Ltd v Mkhabela [2011] ZASCA 191 case no 159/11 (14-11-2011) (SCA).  
66 The fact that it is sometimes by way of an agreement does not necessarily make it a contract. See Honoré 35 in this regard. The opinion in Commissioner for Inland Revenue v Estate Crewe 1943 AD 656 673 clearly relates, as Honoré 35 suggest, to “the formation and revocation” of the trust and the acquiring of rights by beneficiaries. It does not necessarily explain the nature of the trust. See also Zimmerman et al Mixed Legal Systems 824, and De Waal “The Core Elements of the Trust: Aspects of the English, Scottish and South African Trusts Compared” 2000 South African Law Journal 548 556.  
67 Fouché 33.
idem about their respective duties; their intention to be bound; and, their mutual consensus.\textsuperscript{68}

The contents and formalities of a contractual trust are, therefore, determined by the parties themselves and in certain instances by the TPCA. The parties are free, within certain legal limits (like the TPCA, the \textit{boni mores}, etc.), to arrange this mutual relationship as they deem fit.

A contractual agreement is terminated when one of the following has taken place:

(a) when the required performance has been delivered;
(b) when the parties have agreed to it; or,
(c) by legal working.\textsuperscript{69}

A contractual trust is mainly terminated in terms of the vesting requirements of the trust deed, but can also be terminated under the following circumstances:

(a) when there are no beneficiaries or assets left;
(b) by decision of the trustees (and sometimes the founder and/or beneficiaries);
(c) in terms of a court order;
(d) when the trust is sequestrated; or,
(e) when the object has been fulfilled.\textsuperscript{70}

All of the above can similarly be one of the causes of termination of a contract.

Smith\textsuperscript{71} identifies the following differences between the contract and the trust:

(a) a trust is a public law institution because the courts have a general protective supervisory jurisdiction over the parties and in the case of a contract do not.\textsuperscript{72}

\textsuperscript{68} Van der Merwe et al \textit{Kontraktereg} 20-27.
\textsuperscript{69} \textit{Ibid} 542–588.
\textsuperscript{70} Geach & Yeats 180 – 184.
\textsuperscript{71} Smith \textit{Authorisation of Trustees} 37-38.
\textsuperscript{72} See Honoré 35. They refer to \textit{Bank of Lisbon v De Ornelas} 1988 3 SA 580 (A).
Chapter Two: History and Development of the Trust

(b) a party under a contract is not placed under a fiduciary duty, while the trustee is;

c) a party under a contract does not act in an official capacity, and a trustee does.

It may have been unnecessary to search for a match for the trust concept in Roman-Dutch law. Many suggest that the trust \textit{inter vivos} can also be regarded as a \textit{stipulatio alteri}, as is the case with the testamentary trust. In \textit{Braun v Blann and Botha} it was stated that “(i)n its strictly technical sense the trust is a legal institution \textit{sui generis}”. As this case dealt with a trust \textit{mortis causa}, some commentators were of the opinion that this remark only had reference to the testamentary trust. When Combrinck AJA, however, referred with approval in \textit{Badenhorst v Badenhorst} to the abovementioned remark in \textit{Braun}, apparently in the context of an \textit{inter vivos} trust, it seemed as if this became the positive law position.

From the \textit{Braun} case it became clear that the South African trust \textit{mortis causa} is not the same as the \textit{fideicommissum}. Joubert JA submitted that “any attempt to identify the trust with the \textit{fideicommissum} can only lead to confusion. The two institutions as they exist at the present day are quite distinct, and complementary rather than either identical or conflicting.”

Some commentators are of the opinion that the granting of legal personality to the trust concept will address this issue effectively and it can be argued that the legislature has taken a major step forward in that direction by defining the trust as a juristic person in the Companies Act 71 of 2008.

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\begin{footnotesize}
\begin{enumerate}
\item See Strydom \textit{Aansprake van die Trustbegunstigde} 119. He submits on 404 that the interest of beneficiaries can be explained with reference to the “vesting of rights doctrine” and the “subjective rights doctrine” respectively.
\item \textit{Braun v Blann and Botha} NNO 1984 2 SA 850 (A) 859F-G. See also Pace & Van der Westhuizen (2007) 18(1).
\item 2006 2 SA 255 (SCA) 260H. It seems to be irrational to differentiate between the testamentary and the living trust when the nature of the trust concept is investigated. See Strydom \textit{Aansprake van die Trustbegunstigde} 125 in this regard.
\item \textit{Braun v Blann and Botha} NNO 1984 2 SA 850 (A) 865H. Olivier \textit{et al Trustreg} 1-20, 1-25. In \textit{Estate Kemp v McDonalds’ Trustee} 1915 AD 491 the trust is accepted in South Africa on the back of the \textit{fideicommissum}, but now it was made clear by the Appeal Court that it is not the same thing.
\end{enumerate}
\end{footnotesize}
Chapter Two: History and Development of the Trust

It is submitted that Smith is correct in as far as he is of the opinion that it is not necessary to differentiate between trusts mortis causa and inter vivos in the quest to find the nature of the trust concept. He submits that the South African trust ‘is a hybridised institution which ... has ... developed and adapted into a unique and distinctively South African law of trusts’.\(^78\)

It is indeed widely accepted that the South African inter vivos trust is often created by way of a contract ‘that contains a stipulation in favour of the beneficiary, who on acceptance acquires an indefeasible right under the trust’.\(^79\)

The original idea of the trust was quite different from some of its current applications. As a common-law concept it was never properly regulated and the first instances of trusts in South Africa were a combination of charitable trusts, grant trusts and so-called trust companies, administering deceased estates and private assets at a fee.

The trust concept in South African law has, according to Honoré,\(^80\) developed into a legal entity, but is still not a juristic entity.\(^81\) It is trite law that the assets and liabilities vest in the trustees and not in the discretionary trust itself.\(^82\) Appeals for the acknowledgement of the trust as a legal persona have fallen on deaf ears for the last two decades.\(^83\)

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\(^78\) Smith Authorisation of Trustees 40-41. He supports the submission in Honoré 23, who in turn refers to Corbett CJ in explaining that this unique character of the SA trust has developed through a process of “jurisprudential osmosis”, from other institutions such as fideicommissum, fiducia, stipulatio alteri, tutorship, curatorship, administratorship and agency. De Waal in Zimmerman et al Mixed Legal Systems 824 refers to it as the “cross-pollination” between fideicommissum and trust when comparing the similarity in requirements between the two institutions, and submits that it may be a matter of legal policy to determine whether a particular fideicommissum principle will extend to the trust or not. See Corbett, Hofmeyer & Kahn The Law of Succession in South Africa (2001) 393.

\(^79\) 35, supported by De Waal in Zimmerman et al Mixed Legal Systems 824, who emphasizes that, even if the trust is created by way of a stipulatio alteri, the moment it is in existence it becomes a trust and cannot remain a contract. The rules of contract do, however, fulfil a role in certain actions regarding the trust. See Doyle v Board of Executors 1999 2 SA 805 (C) 812J, where the court stated that “the equation of a trust inter vivos with a stipulatio alteri has limits beyond which it may not be pressed”.

\(^80\) Honoré 67-72. See Commissioner for Inland Revenue v Friedman NO 1993 1 SA 353 (A).

\(^81\) The trust is regarded as a “person” for income tax and insolvency purposes and as a “juristic person” in terms of the Companies Act 71 of 2008.

\(^82\) Braun v Blann & Botha NNO 1984 2 SA 850 (A); Kohlberg v Burnett NO 1986 3 SA 12 (A). In the case of the bewind trust the assets and liabilities vest in the beneficiaries.

\(^83\) See De Waal & Theron “Die Aard van die Trust in die SA Reg – Skikking na Aanleiding van Behoeftes?” 1991 Tydskrif vir die Suid-Afrikaanse Reg 504. The Hague Convention on the Law Applicable to Trusts and on their Recognition (1986) promoted the adoption of trusts as sui
Chapter Two: History and Development of the Trust

Although the highest court missed the opportunity in *Braun v Blann* to clarify the real nature of the South African trust, the court did make some important remarks, the most important being that it was wrong to identify the trust with the *fideicommissum* and to equate the trustee with a fiduciary. The court accepted that the trust idea was still developing in the South African legal system and could best be understood as a legal institution *sui generis*.

Olivier *et al* state that the uniqueness of the trust is located in the separation between the formal ownership and the benefits of enjoyment. The universality of the trust concept between different jurisdictions is also locked up in this aspect. Without this characteristic the trust may not have survived in the corporate environment. Although this does not clarify the nature of the trust, it does justify its existence and co-existence with other entities.

The nature of the trust concept also includes the *juristic nature* thereof. The established position in South African trust law that the trust has no juristic personality is under serious threat and the question should be asked whether it is still the absolute truth. De Waal referred to some anomalies in this regard, namely the registration of fixed property and shares; insolvency; tax; the limited liability of trustees; the trust as a beneficiary; and, the trust estate at death of the trustee. To this can be added the amendment of the Deeds Act in 2003 to include a trust as a “person” for purposes of the registration of immovable trust property and the recent

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*generis* institutes in an attempt to reconcile diverse legal cultures and different concepts of ownership. South Africa is not a party to this Convention. See Honoré 660 in this regard.

84 *Braun v Blann and Botha NNO* 1984 2 SA 850 (A).
85 This reference on 859E may only be applicable to the testamentary trust as proposed by many, but it is submitted that it may also be relevant to the *inter vivos* trust. The trust has developed very peculiarly in South Africa and it is most probably not justifiable to force it into a specific known mould. Olivier *et al* Trustreg 1-25 states that the trust concept is indeed strong enough to operate on its own without being in the shadow of the *fideicommissum* or the *stipulatio alteri.*
86 Olivier *et al* Trustreg 1-18.
87 The separation of control and enjoyment is comparable with the separation of management and ownership in the company form, although for different purposes. This aspect will be discussed in 2.7.
inclusion of the trust in the definition of “juristic person” in the recent Consumer Protection Act 68 of 2008 and the Companies Act 71 of 2008. Strydom submits, with reference to the interests of the beneficiary, that it was never necessary to call on the stipulatio alteri or the fideicommissum in finding the true nature of the trust. The trust is a mature legal concept and the “vesting of rights” and the “subjective rights” doctrines are adequate in explaining the right of existence of this phenomenon.

2.5 THE TRUST IN THE NARROW AND WIDE SENSE

When investigating the nature of the trust concept in a South African context it is sensible to first distinguish between the trust in the wide sense and in the narrow (or strict) sense.

In Goodricke Muller J stated that the two essential elements for the trust in the narrow or strict sense are “the segregation of the trust assets by the founder, and the creation of an obligation to administer otherwise than purely for oneself”, which implies that the trustee in the wide sense includes the tutor acting on behalf of a pupil and the agent representing a principal. In these cases there cannot be mention of ownership of the property vesting in the trustee. In the narrow sense, however, the trustee has a fiduciary obligation and more often than not takes up ownership of the property for the purposes of administration.

The TPCA deals with the trust in the strict sense only, as is the position of the majority of business trusts. In this study the focus will be on trusts in both the narrow and wide sense. The common business trust is usually a trust in the narrow sense and is registered with the Master in terms of the TPCA. In the financial services environment the terms “trust” and “trustee” are, however, commonly used in

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89 The amendment to the Deeds Act was a direct result of the obiter remarks by the court in Joubert v Van Rensburg 2001 1 SA 753 (W). See De Waal “The Strange Path of Trust Property at a Trustee’s Death” 2009 Tydskrif vir Suid-Afrikaanse Reg 84-101.
90 Strydom Aansprake van Trustbegunstigdes 404.
91 See Honoré 3-4 for the definitions they used, as quoted in 1.4 and referred to in 2.3.
92 Goodricke & Son (Pty) Ltd v Registrar of Deeds, Natal 1974 1 SA 404 (N) 408D.
93 The exception is the case of “bewind”. Compare Honoré 6-7; Olivier et al Trustreg 1-4–1-6.
94 See Conze v Masterbond Participation Trust Managers (Pty) Ltd 1996 3 SA 786 (C) 794G.
95 As will be indicated in Chapter 4 most trusts used in the financial services environment are usually trusts in the wide sense and are not regulated by the TPCA.
both the narrow and wide senses. These trusts are usually not registered with the Master and their content can differ substantially.

In the TPCA\textsuperscript{96} a “trust” is defined as:

“the arrangement through which the ownership of property of one person is by virtue of a trust instrument made over or bequeathed –

(a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or

(b) to the beneficiary designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument,

but does not include the case where the property of another is to be administered by any person as executor, tutor or curator or in terms of the provisions of the Administration of Estates Act 1965.”

The trust in the strict sense, as defined by Honoré,\textsuperscript{97} conforms to the definition of the trust term in the Hague Convention.\textsuperscript{98} Although South Africa is not party to the Convention, it is well aligned with the international development of the trust concept in the strict sense.\textsuperscript{99}

The trust in the wide sense, however, goes much further. In \textit{Conze v Masterbond}\textsuperscript{100} the investors transferred funds to Masterbond who, as agent, had to invest them in debenture schemes. A bond and debenture trust deed existed with Masterbond and Fancourt as parties thereof. The court decided that even “(a) trustee for debenture-holders in whose favour a mortgage bond is registered pursuant to the provisions of the Companies Act is not necessarily a trustee as defined in the Trust Property Control Act”.

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\textsuperscript{96} Act 57 of 1988 s 1. Although this definition has been quoted in Chapter 1, it is repeated here for the sake of clarity. According to the court in \textit{Conze v Masterbond Participation Trust Managers} 1996 3 SA 786 (C) 794G, this definition only includes the trust in the narrow sense. See also the discussion in Hyland & Smith 2006(1) \textit{Journal for Estate Planning Law} 3. As generalisation, it is submitted one can argue that sub-paragraph (a) refers to the trust in the strict or narrow sense, while (b) refers to the trust in the wide sense.

\textsuperscript{97} See Honoré 3-4 for the definitions they used, as quoted in 1.4 and referred to in 2.3.


\textsuperscript{99} See Chapter 8 for a discussion of South African trust law in the international context.

\textsuperscript{100} 1996 3 SA 786 (C) 794D-795B.
A person can, therefore, be a trustee in the wide sense even if he does not become vested with the ownership of the property to be administered by him subject to the trust. The rights as mortgagee constituted at most *jura in re aliena* and not ownership. Brand J ruled that Masterbond acted as nothing more than an agent or nominee of the debenture-holders.

The facts of the case were that Masterbond was regarded, and defined in terms of the trust deed, as a trustee. The nature of Masterbond’s trusteeship was thus something well beyond the definition in the TPCA. As indicated by Friedman JP, Masterbond was for all intents and purposes a trustee and the transaction took place in terms of a trust deed, although they really acted only as an agent or nominee.

The classical statement in *Estate Kemp v McDonald’s Trustee* summarizes the narrower meaning of the trust concept as follows: “The underlying conception in these and other cases is that while the legal *dominium* of property is vested in the trustees, they have no beneficial interest in it but are bound to hold and apply it for the benefit of some person or persons or for the accomplishment of some purpose.”

From the above definition it is clear that two of the core features of a trust are, (a) the handing over of control of the trust property from the owner of the property to the trustee or to the beneficiary, by way of a transfer of ownership, which property (b) must then be dealt with according to the provisions of the trust instrument.

### 2.6 THE TRUST AND OTHER LEGAL CONCEPTS

Irrespective of the warning by Schreiner JA in the *Crookes* case that “... our modern law of trusts should not be unduly hampered by views regarding its association with other branches of our own law which may not be historically justified and which, in any event, should not govern, though they may sometimes assist, the development of the law of trusts”, there are ample examples of efforts to cast the trust concept into some historical legal form.

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101 The court referred to *Zinn NO v Westminster Bank Ltd* 1936 AD 89 at 96-97 as authority.
102 795B.
103 1915 AD 491 508. Compare the remarks by Innes CJ in *Lucas’ Trustee v Ismael & Ahmod* 1905 TS 239 at 244.
104 *Crookes NO v Watson* 1956 1 SA 277 (A) 292D.
To adapt the trust concept to the South African legal context, it was originally moulded into familiar concepts. The testamentary trust was clothed as a *fideicommissum* and the *inter vivos* trust as a *stipulatio alteri*, which is a contract in favour of a third party. In *Braun v Blann and Botha NNO*\(^{105}\) the notion of a testamentary trust, as being based on the *fideicommissum*, was finally rejected. In Honore\(^{106}\) it is stated that the South African trust-law principles are clearly the developmental result of

> “such institutions as the *fideicommissum*, *fiducia*, *stipulatio alteri*, tutorship, curatorship, and common-law administratorship.”

The nature of the *stipulatio alteri* has been formulated by our courts as follows:

> “What is required is an intention on the part of the original contracting parties that the benefit, upon acceptance by the beneficiary, would confer rights that are enforceable at the instance of the beneficiary against the insurer”,\(^{107}\)

and it

> “. . . is not simply a contract designed to benefit a third party; it is a contract between two persons that is designed to enable a third person to come in as a party to a contract with one of the other two.”\(^{108}\)

It is trite law that the *stipulatio alteri* must comply with all the standard requirements of a contract, to which consensus is central.\(^{109}\)

Kernick\(^{110}\) argues strongly against the *stipulatio alteri* explanation for the *inter vivos* trust, as suggested in *Crookes NO v Watson*\(^{111}\) and submits that the *inter vivos* trust “arises from a contract of donation *sub modo*.” His argument is quite convincing and as pointed out by him, does not put the beneficiary in a worse position, but may in

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\(^{105}\) 1984 2 SA 850 (A). The court states on 859C that “historically and jurisprudentially the *fideicommissum* and the trust are separate and distinct legal institutions, each of them having its own set of legal rules.”

\(^{106}\) 23.

\(^{107}\) *Pieterse v Shrosbee NO; Shrosbee NO v Love* 2005 1 SA 309 (SCA) 313H.

\(^{108}\) *Joel Melamed & Hurwitz v Cleveland Estates (Pty) Ltd; Melamed & Hurwitz v Vorner Investments (Pty) Ltd* 1984 3 SA 155 (A) 172A.

\(^{109}\) See *Van der Merwe et al Kontraktereg* 285.

\(^{110}\) Kernick “Another Look at the *Inter Vivos Trust*” 2008(5) *De Rebus* 49.

\(^{111}\) 1956 1 SA 277 (A) 291B-F.
fact even improve his position, as would have been the situation in *Hofer v Kevitt NO*. ¹¹²

Instead of being able to rely on the validity of the changes to the trust deed only, the *modus* concept would have also tested whether the fiduciary duty had been complied with. Kernick¹¹³ further argues that if the protection offered by the *stipulatio alteri* is lost by the beneficiary, he will

“gain the right to hold the trustees to account from the very inception of the *modus* and the inception of his fiduciary duty”.

The *modus* is a term attached to an agreement, in terms of which one party burdens another to give something to a third party, or to do something or to refrain from doing something. It is often part of a donation agreement. In some instances the *modus* takes on the form of a *stipulatio alteri*. The *modus* creates an unconditional agreement¹¹⁴ and in the case of a *modus* in a will, the vesting of rights is not postponed because of the existence of the *modus*.¹¹⁵ The modus, therefore, qualifies the rights of the creditor (e.g. the trustee) and this limitation can be for the benefit of either the debtor (e.g. the donor) who instituted it, or a third party (e.g. the beneficiary), or for a purpose not directly related to a specific person.¹¹⁶

The *modus* originated according to Honoré¹¹⁷ from the Roman law as

“a qualification added to a gift or testamentary disposition whereby the person benefited is required or bound to devote the property he receives or the value thereof in whole or in part to a specified purpose”.

In some instances the *modus* could be treated as a *fideicommissum* in favour of the beneficiary.¹¹⁸

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¹¹² 1998 1 SA 382 (A) 386E-387D. The court confirmed the majority ruling in *Crookes NO v Watson* 1956 1 SA 277 (A) that a trust *inter vivos* “is in effect a contract for the benefit of a third person.” The amendments to the trust deed in the *Hofer* case were made before the relevant beneficiaries accepted any benefits and, therefore, they did not have to approve such amendments. Kernick 50 argues that if the trust was accepted as a contract of donation *sub modo* the beneficiaries would have been adequately protected.

¹¹³ Kernick 51. See in 2.9 more on the fiduciary relationship.


¹¹⁶ Van der Merwe & Rowland 318.

¹¹⁷ 44.
Honoré suggests that the modus in South African law is effectively either a fideicommissum or a trust and then continues to summarize the relation between the three as follows:

“A modus in favour of a defined beneficiary can be construed as a fideicommissum unless the property is immovable and only a personal right is intended. A modus for a personal or impersonal object can be construed as a trust, provided that the intention of the founder was to entrust the administration of the property to an office-holder and not merely a private owner, and that the burden is confined to the property given or bequeathed. A modus for an impersonal object in which such an intention is not present must be treated as a simple common-law modus.”

The fiduciary is an owner of property with a duty to restore property to a specific beneficiary, the fideicommissary, at a specified moment. Since the decision in Braun v Blann and Botha NNO, it is clear that the fideicommissum and the trust are two distinct concepts in South African law.120 The trust is an administrative device, separating ownership and management from enjoyment, and the fideicommissum is a construction enabling the successive enjoyment of property by beneficiaries.121

2.7 THE SEPARATION OF ENJOYMENT AND CONTROL

One of the main advantages of the trust has always been the separation of management, ownership and enjoyment. As Honoré correctly explains, the separation of ownership from management and enjoyment can also be achieved by way of the usufruct. The trustee as such is not a prospective beneficiary, while in the case of the usufruct, the usufructuary has a current right to enjoyment and the owner of the bare dominium has a future right to enjoyment.

118 Honoré 44.
120 1984 2 SA 850 (A). At 859B-D the following is stated: “Admittedly, many of the functions which the fideicommissum, either by itself or in conjunction with other devices of the Roman law performed, could have been performed by the trust had the latter been known to the Romans, but the fact remains that historically and jurisprudentially the fideicommissum and the trust are separate and distinct legal institutions, each of them having its own set of legal rules. The fideicommissum has a long and intricate history which cannot be traced and analysed in judgment.” This decision was crucial in eliminating the confusion created by Estate Kemp v MacDonald’s Trustee 1915 AD 491, where the testamentary trust was construed as a type of fideicommissum. See also Estate Watkins-Pitchford v CIR 1955 2 SA 437 (A) 460B-D, and Greenberg v Estate Greenberg 1955 3 SA 361 (A) 368G.
121 Honoré 56-57. The role of the fideicommissum in estate planning will be discussed in 2.6.
122 Ibid 17. The application of the usufruct will be discussed in more detail in 2.6. Moffat et al 13 refers to the three facets of ownership, namely nominal ownership, benefit and control.
Although hugely affected by English, Scottish, Roman and Roman-Dutch law in many aspects, the trust in South Africa developed into a rather unique concept referred to as a “genuinely South African, not an English or Roman-Dutch, law of trusts.” It is clear that the *inter vivos* trust is established by way of a contract, but at the same time it would be an over-simplification to state that it is merely a contract and nothing else.

It has become trite law that the trustee is the owner of the trust assets in his official capacity and the beneficiary is, in the case of a discretionary trust, only the holder of a personal right against the trustee. In the *bewind* trust the beneficiary indeed becomes the owner and the trustee merely fulfils the role of an administrator. The *bewind* makes it clear that the trust in the South African context is a legal concept under which the ownership of the asset may vest in the trustee, who is also the administrator of the asset, or in the beneficiary, in which case it is a *bewind* trust. The intentional *bewind* trust, however, is today a rare phenomenon in the South African context and does not play any significant role in business and estate planning, because it does not provide the required protection and separation of discretionary trusts.

The important aspect of South African trust law, compared to Scottish law for instance, is that the essential feature is not ownership of the trust property, but control thereof. In *Creighton Trust v CIR* the court stated that as the donor had

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124 In Honoré 35 it is explained that a contract is a private matter between consensual parties, while the courts clearly have a “general protective supervisory jurisdiction over (the) contracting parties” to a trust, to such an extent that they may even replace one of the contracting parties (a trustee) with another. This factor of control by the courts makes the trust a public-law institution.

125 Van der Merwe & Du Plessis 187. Compare the discussion by Strydom 89. See Pace & Van der Westhuizen 18-19. See De Waal & Paisley in Zimmerman et al *Mixed Legal Systems* 835 comparing Scots law with South African law in this regard. In Scots law it is fundamental that the trustee is the owner of the trust property, while SA law makes provision for the *bewind*-trust structure.

126 Honoré 7. In Olivier *et al Trustreg* 111-112 the *bewind* trust is equalised with the trust in the wide sense as if it were exactly the same thing. It seems as if the only relevant difference for him between the trust in the wide and narrow sense is the question of ownership of the trust assets. See also Hyland & Smith 3–5.

127 It must be noted, however, that some drafters of business-trust deeds make use of so-called vesting trusts that may be, if worded incorrectly, result in *bewind* trusts instead of discretionary trusts as they claim it to be.

128 Compare Honoré 7.

129 *Creighton Trust v Commissioner for Inland Revenue* 1955 3 SA 498 (T) 502E-F.
for his own benefit “the control, order or disposition” of the trust property, the property must be regarded as deemed property in his personal estate.

It is generally accepted that the beneficiary in a discretionary trust has nothing more than a *spes* to a future benefit and Coetzee came to the conclusion that the concept of *spes* has no effective role to fulfil in an investigation of the rights of trust beneficiaries, because, in practice, it does not grant any protective rights to the beneficiary.\(^{130}\) He submits that there must be some rights conferred upon the discretionary beneficiary and that the primary source of such rights is the fiduciary relationship between the parties of the trust.\(^{131}\)

In *Land Bank v Parker*\(^ {132}\) Cameron JA stated that “(t)he essential notion of trust law, from which the further development of the trust must proceed, is that *enjoyment* and *control* should be *functionally separate.*” (Own emphasis) Many family and business trusts, however, have developed in such a manner that functional separation between control and enjoyment is entirely lacking. Cameron JA criticised, with reference to *Nieuwoudt v Vrystaat Mielies*,\(^ {133}\) the tendency to debase the core idea of the trust by not separating beneficial interest from control. The risk is always that a lack of separation between control and enjoyment may result in abuse, because there is no independent interest in ensuring that the trust is dealt with in a valid manner.\(^ {134}\)


\(^{131}\) Coetzee 382. Secondary sources he refers to in the footnote may be real rights in the case of the bewind trust *inter vivos*, after acceptance of the benefits, and rights of demand in cases of trusts *mortis causa* after *dies cedit*. Coetzee on 389 criticizes the South African court’s tendency to utilize contractual rights and not fiduciary rights in the enforcing of trust deeds. See *Land and Agricultural Development Bank of South Africa v Parker and Others 2005 2 SA 77* (SCA) 86G for reference to the fiduciary responsibility of the trustee over property on behalf of and in the interests of a third party.

\(^{132}\) *Land and Agricultural Development Bank of South Africa v Parker and Others 2005 2 SA 77* (SCA) 86E, 87C and 88G. In this case the founding trustees were also the beneficiaries and Parker further also reserved some exclusive rights for himself. See also 86D-E, where it is stated that the “core idea of the trust is the separation of ownership (or control) from enjoyment.” See Sher "The Proper Administration of Trusts" 2006(2) *Juta’s Business Law* 65.

\(^{133}\) *Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk 2004 3 SA 486* (SCA). In this case the sole trustees were also the sole income beneficiaries of a farming trust. See also Meyerowitz et al “Estate and Tax Planning: *De Facto* Control of a Trust” 2006 *The Taxpayer* 85.

\(^{134}\) *Land and Agricultural Development Bank of South Africa v Parker and Others 2005 2 SA 77* (SCA) 88G. See also the discussions by Kloppers “Enkele Lesse vir die Trustees uit die Parker-beslissing” 2006 *Tydskrif vir Suid-Afrikaanse Reg* 414; and, Kernick “Declaration of Independence” 2007(1) *De Rebus* 27.
The term “beneficial interest” is not defined or even referred to in the TPCA. The Act does refer to “beneficiaries” and “for the benefit of (a) person” (s 1), as well as “contingent interests” (s 1); and, “any person having an interest in the trust property” (ss 3(b), 19 and 20). The term “beneficial interest” was used in *Adam v Jhavary* in the context of a right to ownership of an asset instead of a right of ownership of the asset, which reminds one of a contingent right. (Own emphasis) The term “beneficial interest” was thereafter regularly used by the courts and more recently by the Appeal Court in *Braun v Blann and Botha*.

Honoré’s submits that the “beneficial interest” concept is closely linked to the distinct segregation in the trust concept between the separate trust fund and the private assets of the trustee. The writers further convey that this term indicates that the beneficiaries’ right is a “protected right in *personam*” - which is “something more than a mere right in *personam*”.

It is submitted that the term “beneficial interest”, as defined in section 1 of the Companies Act 71 of 2008, is wider than the term used in trust law. In company law it includes, in relation to a company’s shares, “the right or entitlement” by way of “ownership, agreement, relationship or otherwise”, to “receive or participate in any distribution”, to “exercise or cause to be exercised” the rights attaching to the shares, or to “dispose” of the company’s securities. Section 56(2) strengthens this further and emphasises the vesting of a beneficial interest by way of certain relationships and/or agreements.

In *Thorpe v Trittenwein* the Supreme Court of Appeal confirmed Parker and emphasised that trustees must steer away from a “blurring of the separation between

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135 1926 AD 147 153-154, referred to by Honoré at 141.
136 1984 2 SA 850 (A) 859. Olivier et al Trustreg 4-6 submits that the concept of a “beneficial interest” is unnecessary when the beneficiary’s rights are evaluated in terms of the subjective rights and the vesting of rights doctrines. For the development of the term ‘beneficial interest’, see also *Estate Kemp v McDonald’s Trustee* 1915 AD 491 507 and *CIR v Estate Crewe* 1943 AD 656 678.
137 579.
138 S 140A of the Companies Act of 1973 contained a similar definition, which was restricted in its application to that section only. The contents of s 56(2) is very similar to that of s 140A(2). See Stein *The New Companies Act Unlocked* (2011) 200-201.
139 The terms “beneficial ownership” and “beneficial interest” used in s 75(4) of the Securities Services Act 36 of 2004 are not defined and the contents thereof are unclear.
140 2007 2 SA 172 (SCA) 178 J. See the discussion by Lötz & Nagel “Section 2(1) of the Alienation of Land Act, Trusts, Trustees and Agency” 2006 *Tydskrif vir Hedendaagse Romeins-Hollandse
ownership and enjoyment, a separation which is at the very core of the idea of a trust”. Although it was the seller, who was not prejudiced by the absence of the written authority of the other trustees, who wanted to escape the consequences of the sale, the court was adamant that parties cannot enjoy the advantages of a trust when it suits them and then cry foul when it does not. If the result of their actions is unfortunate, they have only themselves to blame.

The legislature basically confirmed the concept of a trustee as laid down by the courts as “persons entrusted (as owners or otherwise) with the control of property with which they are bound to deal for the benefit of others.” It is clear that control, rather than ownership, over the property placed in the hands of the trustees, is the test for trusteeship. In the case of a financial instrument ownership may have vested in the beneficiary from the start and the position of the trustee is merely one of management and control. The legislature also made it clear that the trust property does not form part of the personal estate of the trustee.

The inclusion of the trust as juristic person in the Companies Act 71 of 2008 and the aspect of control by related and inter-related persons has added an interesting new dimension to this topic. Subsections 2(2)(c) and (d) determine that, for the purpose of subsection (1), a person controls a trust when that person has the ability to control the majority of the votes of the trustees or to appoint the majority of the trustees, or to appoint or change the majority of the beneficiaries of the trust, or has the ability to influence the policy of the trust materially.

Section 2(2) deals with the aspect of “relation”, which includes marital relationships, affinity, consanguinity, and the concept of an individual related to a juristic person by way of control over that person, and even juristic persons being related to each other by way of control. It is clear that section 2 of the Companies Act affirms the importance of the control aspect as it was developed by the courts.

Reg 698. Two previous decisions, in matters of divorce and the redistribution of assets, are also relevant: Jordaan v Jordaan 2001 3 SA 288 (C), and, Badenhorst v Badenhorst 2006 2 SA 255 (SCA).

Estate Kemp v MacDonald's Trustee 1915 AD 491 499.

See Zinn NO v Westminster Bank NO 1936 AD 89 on 96. This makes provision for the bewind trust where ownership does not settle in the trustee and also for the trust in the wide sense.

See s 12 of the TPCA.
The aspect of “connected person” in relation to a trust, as defined in the Income Tax Act, includes any beneficiary, any connected person in relation to such beneficiary and any other person who is a connected person in relation to such trust. It further includes any trust of which such a natural person (including a relative) is a beneficiary. The revenue service has tried to extend the term “beneficiary” for the purposes of connected persons to any person named in a will, trust deed or letter of wishes, upon whom the trustees have the power to confer benefits from the trust. It is submitted that the inclusion of a person named in a letter of wishes is an extension of the concept of beneficiary beyond the powers of the Minister. Where the letter of wishes, however, limits the discretionary powers of the trustees and becomes enforceable, it may be the correct view.

2.8 PIERCING OF THE TRUST VEIL

The separation of ownership and control in trusts is closely linked to the piercing of the corporate veil doctrine in company law. The so-called “corporate veil” shall, as general rule, be lifted when the corporate personality is being misused to cover fraudulent or other improper conduct. In Milwaukee the court stated that the corporation shall be seen as a separate entity,

“but, when the notion of a legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association”.

The “piercing of the veil” principle is, therefore, a basis on which the culprits can be held personally liable for their wrongful actions, perpetrated in the name of the company.

Hyland and Smith refer to it as “piercing the veneer”, where a trust is a

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144 S 1 of Act 58 of 1962.
145 See SARS Practice Note No 7 of 06-08-1999.
146 See 3.2.18. The wrong application of the practice of testamentary dispositions by founders or other third parties in trust deeds may fall foul of this stipulation.
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“mere smokescreen which is being used to achieve other (ulterior) motives”.

To pierce the veil implicates that the legal existence of the juristic person is ignored

“only for the purposes for adjudicating the rights and liabilities of the parties to the particular dispute. For all other purposes the separate legal existence of the company continues to be recognised in law.”

In Cape Pacific it was stated that lifting the corporate veil means,

“disregarding the dichotomy between a company and the natural person behind it (or in control of its activities) and attributing liability to that person where he has misused or abused the principle of corporate personality”.

A piercing of the trust veil will take place when the ownership and the control of the assets of the trust vest in the same party to such an extent that the trust became the alter ego of that individual. Any attempt to differentiate between the two would become artificial and has the potential to prejudice creditors and other third parties.

One of the first instances where the principle of piercing the corporate veil was applied in South African law was in Orkin Bros Ltd v Bell, where the directors of a company were held personally liable to a seller who sold goods to a company at the instance of its directors. They knew the company to be in insolvent circumstances and the sole purpose of the transaction was to diminish the personal liability of the directors under a contract of suretyship. This was held to constitute a fraud on the seller and he obtained judgment against the directors personally.

Although the law is far from settled with regard to the exact circumstances in which it would be permissible to pierce the corporate veil, various tests to determine some circumstances under which it is justifiable to pierce the veil of corporate identity have developed during the last three decades in South Africa. Each case will involve a

149 Hyland & Smith 10. See their discussion at 11-14 on Jordaan v Jordaan 2001 3 SA 288 (C) and Badenhorst v Badenhorst 2006 2 SA 255 (SCA).

150 Davis et al (eds) 21.

151 Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd 1995 4 SA 790 (A) 802F-I.

152 1921 TPD 92.

153 The court referred to this case in Lategan & Another NNO v Boyes 1980 4 SA 191 (T) 2011. They are of the opinion that this principle was not applied in In re Yeridje Tobacco E Co Ltd (1916) 2 Ch 426 and R v Gillett 1929 AD 364 as the directors were held responsible in terms of statute and not because the veil was pierced.

154 Smalberger JA in Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd 1995 4 SA 790 (A) 802H.
process of inquiring into the specific facts while bearing in mind “the fundamental 
document that the law regards the substance rather that the form of things”.155

Le Roux J in Lategan v Boyes156 states that “our Courts would brush aside the veil of 
corporate identity time and again where fraudulent use is made of the fiction of legal 
personality.”

In Botha v Van Niekerk157 Flemming J came to the conclusion, after a comprehensive 
analysis of the legal position, that personal liability would only become justifiable 
when it is clear that the third party suffered an unconscionable injustice because of 
the unjust actions of the liable party.

Smalberger JA submits in Cape Pacific that the preservation of the corporate identity 
must be balanced against policy considerations which arise in favour of piercing the 
corporate veil, and will, therefore, “look at substance rather than form in order to 
arrive at the true facts”.158 These policy considerations may include fraud, 
dishonesty, improper conduct, an improper purpose or where the company was used 
as a facade. He warns against a rigid test and supports a flexible approach which 
allows the facts of each case to determine “whether the piercing of the corporate veil 
is called for”.159

In Hülse-Reutter v Gödde160 it was held by the court that “the separate legal 
personality of a company is to be recognised and upheld except in the most unusual 
circumstances.” The court acknowledges that the exact circumstances in which it 
must be disregarded are far from settled, but will depend on an analysis of “the facts 
of each case, considerations of policy and judicial judgment.”

155 Cape Pacific 791A. An aspect that has not been decided by the courts yet is the implication of 
the so-called “dog collar trust”, where the founder, who is also a trustee and a beneficiary, 
retains the power to remove and appoint trustees. It is submitted that such a clause infringes 
the separation between control and enjoyment and may indirectly allow the founder to dispose 
of the trust property within the meaning of s 3(3)(d) of the Income Tax Act.
156 Lategan & Another NNO v Boyes 1980 4 SA 191 (T) 202H.
157 Botha v Van Niekerk 1983 3 SA 513 (W) 525E-F.
158 803I-J.
159 805F.
160 Hülse-Reutter v Gödde 2001 4 SA 1336 (SCA) [20].
In the recent matter of *Airport Cold Storage (Pty) Ltd v Ebrahim*\(^\text{161}\) the court reiterated that directors and members must enjoy extensive protection against personal liability, but that such protection can never be absolute. In exceptional circumstances the corporate veil may, therefore, be pierced, lifted or pulled aside.

Van der Linde and Lombard\(^\text{162}\) refer to *equitable considerations* to be taken into account when the necessity of piercing the corporate veil is considered. In the *City of Glasgow* case it was argued that the court, after taking into account all relevant circumstances, would pierce the veil only "where the interests of justice or fairness or right dealing so demand." \(^\text{163}\)

In *Amlin (SA) Pty Ltd v Van Kooij*\(^\text{164}\) fraud, agency, evasion, abuse of the corporate form, and the creation of a mere facade to conceal the true state of affairs or as a means or device to conceal wrongdoing or to avoid obligations, were all submitted as justifiable motivations for piercing the veil. Dlodlo J in the *Amlin* case investigated the application of the piercing principle in a number of foreign jurisdictions and refers to the following tests that have been applied:\(^\text{165}\)

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\(^{161}\) 2008 2 SA 303 (C). Compare *Die Dros (Pty) Ltd and Another v Telefon Beverages CC and Others* 2003 4 SA 207 (C), where the court held that fraud, dishonesty or other improper conduct may justify the piercing of the veil. See *Haygro Catering BK v Van der Merwe* 1996 4 SA 1063 (C), where the court applied the doctrine after the members failed to display the name of the business on the premises as well as on the close corporation documentation.

\(^{162}\) In "Identity of Interest between Trustees and Beneficiaries in so far as Object of Trust is Concerned" 2007 De Jure 429 437 and their reference to the submissions of Benade THRHR 213, and Davids "The lingering question: Some Perspectives on the Lifting of the Corporate Veil" 1994 Tydskrif vir Suid-Afrikaanse Reg 155 in favour of an equitable doctrine. Contra *Botha v Van Niekerk* 1983 3 SA 513 (W) 523.

\(^{163}\) *City of Glasgow District Council v Hamlet Textiles Ltd; Atlas Marine Co SA v Avalon Maritime Ltd* [1991] 4 All ER 769 (CA), quoted by Dlodlo J in *Amlin (SA) Pty Ltd v Van Kooij* 2008 2 SA (C) 558 566.

\(^{164}\) 2008 2 SA (C) 558 568 in reference to *Adams v Cape Industries plc* [1990] Ch 433 ([1991] 1 All ER 929. See also *LeBergo Fashions CC v Lee and Another* 1998 2 SA 608 (C), where a restraint of trade was contravened to the advantage of a close corporation by the corporation’s sole member. In *The Shipping Corporation of India Ltd v Evdomon Corporation* 1994 1 SA 550 (A) 566, the Appeal court confirmed that some element of fraud or other improper conduct is normally necessary to move a court to allow a piercing of the veil. In *Van der Merwe NO v Hydraferg Hydraulics CC; Van der Merwe NO v Bosman* 2010 5 SA 555 (WCC) [41], the court stated that if it was legally possible on the facts of the matter to have disregarded the veneer of the trust form, it might have been done in one of two ways: "(b)y holding the trustees personally liable to performance, or by directing the trust to perform as if the obligation had been properly incurred by the trustees acting in the capacity that they purported to".

\(^{165}\) *See Amlin (SA) Pty Ltd v Van Kooij* 2008 2 SA (C) 558 564-567.
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(a) when the one company operates as a puppet of the other (Canada);\(^{166}\)
(b) fraudulent or improper use (Canada);\(^{167}\)
(c) a mere tool or conduit of another corporation (Canada);\(^{168}\)
(d) to achieve equity (USA);\(^{169}\)
(e) a mere facade concealing the true facts (UK).\(^{170}\)

The legislature recently created some certainty by way of section 20 of the Companies Act 71 of 2008, as amended by the Companies Amendment Act 3 of 2011, both of which became effective on 1 May 2011.

Section 20(6) grants recourse to the shareholders against anyone who “intentionally, fraudulently or due to gross negligence causes the company to do anything inconsistent” with the Act or certain limitations, restrictions or qualifications.

Section 20(9) codified the doctrine of piercing the corporate veil and reads as follows:

“If, on application by an interested person or in any proceedings in which a company is involved, a court finds that the incorporation of the company, any use of the company, or any act by or on behalf of the company constitutes an unconscionable abuse of the juristic personality of the company as a separate entity, the court may –

(a) declare that the company is to be deemed not to be a juristic person in respect of any right, obligation or liability of the company or of a shareholder of the company or, in the case of a non-profit company, a member of the company, or of another person specified in the declaration; and

(b) make any further order the court considers appropriate to give effect to a declaration contemplated in paragraph (a).”

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\(^{166}\) See Toronto (City) v Famous Players Canadian Corp (1936) 2 DLR 129 and Aluminium Co of Canada v Toronto (City) (1944) 3 DLR 609, where the parent company effectively controlled the policies and operations of its subsidiaries.

\(^{167}\) See Lockharts Ltd v Excalibur Holdings Ltd et al (1987) 47 RPR 8, where the court also refers to the “puppet” scenario.

\(^{168}\) See O'Donnell v Weintraub 67 Cal Rptr 274 (CA, 1968) 277-8. The specific factors, which may be relevant, include an absence of corporate formalities; inadequate capitalisation; degree to which corporate and individual property have been separated; amount of financial interest of the individual in the corporation; degree of control individual has over the corporation; and whether the individual has used the corporation for personal purposes.

\(^{169}\) See Nassau County, Plaintiff v Richard Dattner Architect, PC 2007 WL 1529599 (NY Sup); 2007 NY Slip Op 51065 (U). Factors referred to include a failure to adhere to corporate formalities; inadequate capitalisation; use of corporate funds for personal purpose; overlap in ownership and directorship and common use of office space and equipment.

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The statutory remedy grants the courts the opportunity to discard the separate legal personality of the company on the basis that it was misused.171 Even shareholders may be held liable by any interested party. This may incentivise all stakeholders to uphold the integrity of the corporation and its actions in all proceedings and business transactions. It may be difficult to determine when a company was used for abusing practices or when abusing practices were conducted on behalf of the corporation.172

Some suggest that this codification may give shareholders the incentive to make provision in the memorandum of incorporation to protect themselves against certain actions by the directors of the company.173

The principle of unconscionability, referred to in section 20(9) above, is foreign to South African law, although it has been suggested by the South African Law Commission nearly thirty years ago as part of a solution to address unreasonable stipulations in contracts.174 It is generally accepted that this doctrine requires both a procedural and substantive element. Although the courts will have to determine the exact contents thereof, it is submitted that “an unconscionable abuse” will require *mala fides* on the part of the company representative, resulting in substantive unfairness to the other contracting party.175

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171 Other instances where a company’s separate legal personality may be ignored are in terms of s 165 (derivative actions), 161(1)(b) and 218(2) (civil actions). See Stein 374-375.

172 See Schoeman “Piercing the Corporate Veil under the New Companies Act” 2012(6) De Rebus 26-28 28, submits that the legislature followed the same conservative approach that the courts have followed before, and that the term “unconscionable” highlights this approach.

173 See “Access to Justice: Human Rights Abuses Involving Corporations – South Africa”, a project of the International Commission of Jurists, Geneva, Switzerland, 2010, 8-10 www.icj.org (accessed 12-02-2011), where it is proposed that the memorandum includes a clause stipulating that one of the purposes of the company is to uphold the Bill of Rights entrenched in the Constitution. As such a stipulation will make actions contrary thereto ultra vires, shareholders can act against directors not abiding thereto.


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The application of the piercing of the veil doctrine on trusts has not received the same amount of attention as in corporations. In the United States it was acknowledged that in case of a so-called “dummy” trust, where an individual uses the trust assets in a purely personal capacity, it would justify the use of the piercing theory.\(^{176}\) It was submitted that in a trust context the piercing doctrine becomes justifiable when someone exercised such control over the trust, that it became a “mere instrumentality or alter ego of that individual”, and the person used that control to commit a wrongful action, which caused injury to a third party.\(^{177}\)

In *Creighton Trust v CIR* \(^{178}\) it was held that the donor remained in full control of the trust property and had for his own benefit, “the control, order or disposition of the property”. The court, therefore, looked past the trust and determined that the trust property must be deemed to be property passing on the death of the donor.

In *Jordaan v Jordaan*,\(^ {179}\) Traverso J found, on the respondent’s own evidence, that the trusts became his *alter ego* and was indeed viewed like that by the respondent himself. The court looked through the trust entity and ruled that the trust assets had to be taken into account for the redistribution order.

In *Badenhorst* the appellant alleged that the trust was in effect the *alter ego* of the respondent. Although Combrinck AJA did not make a direct finding in this regard, he did find that the respondent was in “full control of the trust” and “he paid scant regard to the difference between trust assets and his own assets”.\(^ {180}\) It is made clear that control over the assets of the trust must be a *de facto* control, irrespective of the *de iure* position.

In *Knoop NO v Birkenstock Properties (Pty) Ltd*,\(^ {181}\) the applicants alleged that the insolvent was using a trust as a front for her own benefit even though her estate had been sequestrated. They had to prove that the insolvent had misused or abused the

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178 1955 3 SA 498 (T) 502E.

179 2001 3 SA 288 (C) 301B-C.

180 *Badenhorst v Badenhorst* 2006 2 SA 255 (SCA) 261H.

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principle of corporate personality and that the trust property was in fact the property of the respondent. Where a corporate entity was properly established but has been misused to perpetrate fraud, or a dishonest or improper purpose, the separate personality may be disregarded in the relation to the specific transaction, while giving full effect to it in other respects.182

Nxusani AJ held in Knoop that “it matters not whether the corporate entity is a Trust or a company. Provided that it can be established on a balance of probabilities that the particular transactions complained of were the tainted fruits of fraud or other improper conduct, a court would, in appropriate circumstances, disregard the separate legal personality in order to reveal the perpetrator as the “true villain of the piece”.183

In the very recent matter of Rees v Harris184 the court tested for piercing of the trust veneer and decided that there were no facts placed before the court which could justify the inference that the assets of the trust belonged to the trustee in his personal capacity, or that he had been in de facto control of the trust to the exclusion of his co-trustee. Nor were adequate facts put forward to indicate that the trustee treated the trust as his alter ego.

It is submitted that the piercing of the veil principle has been successfully extended to South African trust law and that it is justifiable to apply the doctrine of piercing of the trust veil or veneer on the same basis as the piercing of the corporate veil.185

184 2012 1 SA 583 (GSJ).
185 In First Rand Limited v Britz [2011] ZAGPPHC 119 case no 54742/09 (20-07-2011) (unreported) the court applied the principles of the corporate “piercing the veil” doctrine directly to trusts. They also applied s 65 of the Close Corporation Act 69 of 1984 to the trust. Although there are many aspects of the judgment that can be criticised and even the end-result can be seriously challenged, does the judgment give an indication of how our courts may in future bring the trust and the corporation closer to each other. Compare Stafford A Legal-Comparative Study of the Interpretation and Application of the Doctrines of the Sham and the Alter-ego in the Context of South African Trust Law: The Dangers of Translocating Company Law Principles into Trust Law LLM dissertation Rhodes University (2010) 125-133 for a somewhat different approach to this issue.
2.9 THE FIDUCIARY RELATIONSHIP

The word “fiduciary” means “trust like” or “appertaining to trust” and has developed as an integral part of many common-law systems. The very nature of a fiduciary relationship is one of trust and good faith. Glover submitted that

“(f)iduciary relationships in commerce were once thought to be an improbable thing. The heart of commerce was conceived as certainty and despatch – which left little room for conscientious obligations and the balancing of rival equities”.

This is, however, not true. In 1928 New York’s Chief Justice Benjamin Cardozo stated, in reference to the fiduciary duty, that, “(n)ot honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behaviour. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.”

Bogle pleads for a “fiduciary society” based on the claim that “fiduciary duty is the highest duty known to the law”. This may sound very noble, but does not assist in the theoretical base thereof. Idensohn submits that the term “fiduciary”

“remains an ill-defined and misleading term; a vague elusive ‘concept in search of principle’”.

The writer advocates clearer fiduciary principles, and distinguishes between four possible theories for the fiduciary relationship, namely: the reliance theory, when one person places trust in another; the contractual or voluntary assumption theory, when the trusted person agrees to act in the interests of the trusting person; the vulnerability or unequal relationship theory, where one person has some power over the other; and, the property theory, where one person has control over property that is beneficially owned by another.

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186 See Watt 337.
188 “Fiduciary Principle” 1.
190 Idensohn 143. Last-mentioned will include the trust position where the beneficiary has only a contingent right (spes).
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Watt\textsuperscript{191} submits that the fiduciary duty “is the defining duty of trusteeship”, with the two principle obligations being the trustee’s duty not to allow his interests to conflict with that of the trust, and not to make an unauthorised profit from his position of trust or from the trust property.

Idensohn\textsuperscript{192} identifies the following aspects which were confirmed as fiduciary principles in the application of the reliance theory in the \textit{Volvo v Yssel} case:

(a) it is not a prerequisite for a mutual understanding between the parties that the one will relinquish his own interests and act on behalf of the other;

(b) the beneficiary must have “relax(ed) the care and vigilance it would and should have ordinarily exercised in dealing with a stranger”;

(c) such relaxation or reliance by the beneficiary must have been justified in the circumstances.

The Companies Act 71 of 2008 contains a partial codification of the fiduciary duty of directors. It incorporates the common law, but does not spell it out in any detail.\textsuperscript{193} The director is required to act in good faith, with reasonable care and skill, and in the best interests of the company.\textsuperscript{194}

\begin{itemize}
\item \textsuperscript{191} Watt 337, 343-364.
\item \textsuperscript{192} 148. The writer refers to the characteristics of fiduciary relationships identified in \textit{Phillips v Fieldstone Africa (Pty) Ltd} 2004 3 SA 465 (SCA), namely: scope for the exercise of some discretion or power; that power or discretion can be used unilaterally so as to affect the beneficiary’s legal or practical interests; and, a peculiar vulnerability to the exercise of that discretion or power.
\item \textsuperscript{193} S 77(2)(a). See Havenga “Regulating Directors’ Duties and South African Company Law Reform” 2005(6) \textit{Obiter} 609. Compare the decision in \textit{Bester NO v Wright; Bester NO v Mouton; Bester NO v Van Greunen} [2011] 2 All SA 75 (WCC), where the court stressed the fact that the director’s actions did not benefit the company in any way. The only benefit was to the directors themselves, at the peril of the company. It was held as being an inappropriate use of funds, in breach of their fiduciary duties towards the company. See Stein 251.
\item \textsuperscript{194} S 76(3). In “Access to Justice: Human Rights Abuses Involving Corporations – South Africa”, a project of the International Commission of Jurists, Geneva, Switzerland, 2010, 8-10 \url{www.icj.org} (accessed 12-02-2011), it is argued that the reference to “proper purpose” may include the horizontal constitutional duty of Companies, which would include a prohibition against the use of “directorial powers contrary to the Bill of Rights”. S 7 does indeed stipulate, amongst others, the purpose of the Act as being the promotion of compliance with the Bill of Rights and the development of the economy. Even the “best interests of the company” may be interpreted in future as more than the interests of the shareholders only. The compilers submit that it would have been better if the Act explicitly spelt out the fiduciary duties. For a contrary debate see Esser and Du Plessis “The Stakeholder Debate and Directors’ Fiduciary Duties” 2007 \textit{SA Mercantile Law Journal} 346. The third report of the King Committee on Governance also
\end{itemize}
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The separation of management and enjoyment is closely linked to the fiduciary nature of the role of trusteeship. A person in a fiduciary position “is not allowed to put himself in a position where his interest and duty conflict”. Should he find himself in that position, “he is obliged by his trust to prefer the interest of his beneficiary”. Fiduciary duties were traditionally framed in the two-fold convenient expression of “the profit rule” and “the conflict rule”, but it became trite law that the positive side of the fiduciary duty contains more than that. The so-called “positive duty of loyalty” has been expressed in the notion of good faith.

Martin submits that liability for the trustee will arise if one of the following factors is present:

(a) the fiduciary has used trust property;

(b) the profit has been made by use of or by reason of the fiduciary position or of an opportunity or knowledge resulting from it, even though no trust property was used;

(c) there was a conflict (or a significant possibility of a conflict) of interest and duty, even if no trust property was used, and the opportunity did not arise from the fiduciary relationship.

Olivier supports the following remark by Chief Justice Cardoza that

“(m)any forms of conduct permissible in a work-a-day world for those acting at arm’s length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone but the punctilio of an honour the most sensitive is then the standard of behaviour. As to this, there has developed a tradition that is unbending and invertebrate.”

emphasised the convergence of the interests of shareholders with those of other stakeholders – like employees, trade unions, etc. See Stein 251.

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195 Lord Herschell in Bray v Ford [1896] AC HL as quoted by Pettit 442; Martin 618.
196 See Swain v Law Society [1981] 3 All ER 797. Stephenson & Wiggins 69 refers to it as the “duty to loyalty”, which is referred to by the Scots as “the most fundamental duty” of trustees.
197 Moffat et al 553 & 556 refers to the “no conflict of interest” rule and the “no secret profits” rule.
199 Martin 630. Some nexus between the fiduciary position and the profit made is required.
200 In Meinhard v Salmon (1928) 164 NE 545, 546 as quoted in Olivier et al Trustreg 1-9. See also Moffat 544. Kloppers “Enkele lesse vir Trustees” 421 states that the fiduciary liabilities of the trustee require from last-mentioned to act with greater care than when dealing with his own estate.
Chapter Two: History and Development of the Trust

Watt submits that the fiduciary duty in English law is not concerned with fairness between the trustee and the beneficiary, but is a matter of public policy "in order to set an example and to encourage good behaviour in all who hold positions of trust."

The nature of the fiduciary relationship between the trustees and the beneficiary is one where the trustees may only act in the interest of the beneficiary at all times, in concurrence with the powers and duties conferred upon him by way of the trust deed. The two poles of the relationship are, therefore, the fiduciary rights of the beneficiary on the one hand and the fiduciary obligation of the trustee on the other – both derived from the trust deed. This obligation is expressed in South African law as the requirement that a trustee should consistently act like a diligent et bonus paterfamilias.

In Gross v Pentz it was acknowledged that even the beneficiary with only contingent rights, has "vested interests in the proper administration of the trust". In Doyle v Board of Executors this position is confirmed when it was generally stated that trustees have fiduciary duties towards beneficiaries. In Land Bank v Parker

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201 Watt 337.
202 In Hofer v Kevitt 1996 2 SA 402 (C) 408B it was submitted that the trustee does not automatically have a fiduciary duty towards a potential beneficiary. See Coetzee 357-358 in reference to Olivier Aspekte van die Reg insake Trust en Trustee met besondere verwysing na die Amerikaanse reg LLD thesis University of Pretoria (1982) 46. Coetzee 388, 391 and 411 indicates the close connection between fiduciary responsibility and the bona fides, both interlinking with the boni mores. See also Land and Agricultural Development Bank of South Africa v Parker and Others 2005 2 SA 77 (SCA) 86F-G, where it is stated that "the English law trust, and the trust-like institutions of the Roman and Roman-Dutch law, were designed essentially to protect the weak and to safeguard the interests of those who are absent or dead. This guiding principle provided the foundation for this court's major decisions over the past century in which the trust form has been adapted to South African law: that the trustee is appointed and accepts office to exercise fiduciary responsibility over property on behalf of and in the interests of another". Compare also Coetzee "Die Regte van Trustbegunstigdes: 'n Nuwe Wind wat Waai?" 2007(5) De Rebus 1-9.
203 Olivier et al Trustreg 1-9 state that the trustee must comply with his duties "eerbaar en sonder die motief van selfbevoordeeling en ooreenkomstig die vereistes van goeie trou". (Own emphasis.)
204 Gross v Pentz 1996 4 SA 617 (A) 628I.
205 1999 2 SA 805 (C) 813A. Coetzee submits in Trustbegunstigdes se Regte 397 that if there were any uncertainty about the fiduciary rights of beneficiaries (especially after Hofer v Kevitt 1998 1 SA 382 (SCA)), it was removed by both the Doyle v Board of Executors and Land Bank v Parker decisions. See Land and Agricultural Development Bank of South Africa v Parker 2005 2 SA 77 (SCA) 86F.
207 Land and Agricultural Development Bank of South Africa v Parker 2005 2 SA 77 (SCA) 86F. In Roman law the fiduciary position was expressed as bonus et diligens paterfamilias. See Pettit
Cameron JA says that “the trust-like institutions of the Roman and Roman-Dutch law were designed essentially to protect the weak and to safeguard the interests of those who are absent or dead”.

From the facts in the National Provident Fund\textsuperscript{208} case it is clear that the fiduciary duty reaches much further than the extent of the profit and the conflict rule. The applicant was a fund registered in terms of section 4 of the Pension Funds Act and the respondent a trade union. The aforementioned adopted a resolution that sought to impose obligations on the trustees appointed by the union to manage benefit funds established by the union. The resolution stated that the employee trustees are accountable to the union and its members, that they must take mandates from the union and that, if they so failed, must be disciplined in terms of the union’s constitution.

The court confirmed that the trustees owe a fiduciary duty to the fund and to its members. The fund’s primary object is the payment of benefits to its beneficiaries. The court, however, held that by following the union’s policy, the union-appointed trustees had acted in breach of their fiduciary duties to do their best for the beneficiaries. The trustees’ primary duty is not its representation of the union, and they do not represent the party which appointed them. They may, therefore, not place the views and interests of the party that appointed them above the interests of the fund or its members.\textsuperscript{209}

Van der Linde and Lombard,\textsuperscript{210} without any reference to the aspect of the fiduciary relationship, confirm this when they submit that if a person who is administering property is bound by the instructions of a third party, that the trustee is acting as an agent and not as a trustee.

The question of control over the trustees, whether it is by the founder, the beneficiaries, co-trustees, or by a third party, may become fundamental in

\textsuperscript{208} PPWAWU National Provident Fund v Chemical, Energy, Paper, Printing, Wood and Allied Workers’ Union (CEPPWAWU) 2008 2 SA (W) 351.

\textsuperscript{209} PPWAWU National Provident Fund v Chemical, Energy, Paper, Printing, Wood and Allied Workers’ Union (CEPPWAWU) 2008 2 SA 351 (W) 358E-361A.

\textsuperscript{210} “Nel v Metequity Ltd 2007 3 SA 34 (SCA): Identity of Interest between Trustees and Beneficiaries in so far as Object of Trust is concerned: Effect on validity” 2007 De Jure 434.
determining whether a trust really exists. The question of independence must be evaluated both in terms of *de facto* and *de iure* control. In *Badenhorst* the court emphasised that it was necessary to prove in the case at hand that the trustees were actually in *de facto* control. It is not only about form, but also about substance. When a *bona fide* trust is not in existence the legal consequence of the transaction may be a partnership or an agency and may result in the trustee being held personally liable in terms of the contract or for breach of its fiduciary duty.

A trustee cannot operate in a “sleeping” position as one may find with partnerships and even in the case of private companies where one of the parties is by agreement not involved in the daily decisions of the corporation. Trustees must act collectively and in the *Parker* case the court stated that the rationale behind this is the fact that the trustees have joint ownership of the assets of the trust, and “(s)ince co-owners must act jointly, trustees must also act jointly.” Where a trustee acts without the authority of his co-trustees, he cannot represent and bind the trust.

It is submitted, however, that the principle for trustees to act jointly is not so much linked to the joint ownership aspect as it is to the fiduciary nature of the trustees’ function. When someone is burdened with a fiduciary duty he cannot escape his responsibility by leaving it to his co-trustees to act in the interest of the beneficiaries towards whom he has a duty. The exception is where the trust deed specifically provides for the limitation of the fiduciary duty.

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211 *Badenhorst v Badenhorst* 2006 2 SA 255 (SCA).

212 It is trite law that a partnership can currently not be formed without the contracting parties having the clear intention of establishing a partnership. See *Pezzutto v Dreyer* 1992 3 SA 379 (A) 389. Contra Snyman-Van Deventer & Henning “*Is die Essensialia van die Vennootskap Ondergeskik aan die Bedoeling van die Partye? ’n Oorsig oor die SA Reg.*” 2007(1) *Journal for Juridical Science* 115, criticising this requirement, stating: “Die bedoeling van die partye kan slegs dui op die bedoeling om aan die essensialia te voldoen en nie om ’n vennootskap op te rig al dan nie.” See further *Ponelat v Schrepfer* 2012 1 SA 206 (SCA) where the court summarised the essentials of a universal partnership as follows: (a) each of the parties brings something into the partnership; (b) the business is carried on for the joint benefit of the parties; (c) the object is to make a profit; and, (d) the contract is legitimate. See also *McDonald v Young* 2012 3 SA 1 (SCA) in this regard.

213 Kloppers “Enkele Lesse vir Trustees” 418.

214 It is questionable whether any director can still act in a sleeping position after the introduction of the 2008 Companies Act. It is submitted that the position of non-executive directors may be under serious threat.

215 *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) 85B. See also *Coetzee v Peet Smit Trust* 2003 5 SA 674 (T) 678H; *Nieuwoudt NNO v Vrystaat Mielies (Edms) Bpk* 2004 3 SA 486 (SCA) 493E.

216 See *O’Shea NO v Van Zyl and Others NNO* 2012 1 SA 90 (SCA).
The different duties and obligations of the trustee, both common law and statutory, are all indicative of a position of trust. Pace and Van der Westhuizen\textsuperscript{217} discuss these under the following headings:

(a) always act in good faith;\textsuperscript{218}

(b) give security, similar to other fiduciary positions like tutors, curators and executors;\textsuperscript{219}

(c) observe the trust deed. The trustee in a certain way acts as the agent of the beneficiary and has to comply with the contents of the deed in a fiduciary capacity irrespective of whether the deed is actually a contract or not. If not, it will constitute a breach of trust;\textsuperscript{220}

(d) taking possession of the trust property on behalf of the beneficiary for whose benefit the property is held. The trustee cannot have control of the trust property without being in a fiduciary position;

(e) preserve the trust property and make it productive. The trustee must manage the property at all times as if he was managing his own property. The duty to

\textsuperscript{217} 50-59. “Good faith” is an integral element of a fiduciary relationship. The position of trustee is one of fiduciary. See Honoré 323: “Trustees, moreover, unlike a voluntary association, share a common fiduciary obligation to the fulfilment of the trust objects ....” See also the requirement of “utmost good faith” in s 2(a) of the Financial Institutions (Protection of Funds) Act 28 of 2001.

\textsuperscript{218} There are a number of decisions about trustees not acting jointly or according to the stipulations of the trust deed – see \textit{Land and Agricultural Development Bank of South Africa v Parker} 2005 2 SA 77 (SCA); \textit{Coetzee v Peet Smith Trust} 2003 5 SA 674 (T); \textit{Nieuwoudt v Vrystaat Mielies (Edms) Bpk} 2004 3 SA 486 (SCA); \textit{Man Truck & Bus (SA) Ltd v Victor} 2001 2 SA 562 (NC); \textit{Vrystaat Mielies (Edms) Bpk v Nieuwoudt} 2003 2 SA 262 (O); \textit{Thorpe v Trittenwein} 2007 2 SA 172 (SCA). The TPCA does not use the words “good faith”, but refers in s 9 to “care, diligence and skill”. It confirms the common-law rule in \textit{Sackville-West v Nourse} 1925 AD 516 534 that a trustee is obliged “to observe due care and diligence”.

\textsuperscript{219} Although it is a common-law principle it was also legislated by way of s 6 of the TPCA and can even be enforced by the Master of the High Court in spite of a trust deed that does not require security.

\textsuperscript{220} See the discussion by Pace & Van der Westhuizen 53. In \textit{Standard Bank v Koekemoer} 2004 6 SA 498 (SCA) 504A the court referred to some potential action by trustees which may be “\textit{ultra vires} the trust deed or constitute a breach of trust prejudicial to the beneficiaries.” See also \textit{Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk} 2004 3 SA 486 SCA 494I for reference to the applicability of the law of agency on trusts. See also Pettit \textit{Equity} 520, where it is submitted as a basic right of a beneficiary to have the trust duly administered in accordance with the provisions of the trust deed as well as the general law applicable to the trust.
not only preserve the property but also earn a reasonable return is inherent of the duty of being entrusted with the assets of someone else; 221

(f) keep the trust property separate, register it correctly and open a bank account. Although the trustee often becomes the owner of the trust property, he must prevent it from blending with his own assets. The trust property must be identifiable as such and this clearly indicates a position of trust; 222

(g) impartiality. The very nature of this aspect is one of trust. The trustee must be impartial in all situations and may not allow his own interests to compete with those of the beneficiaries and may not even be partial between the beneficiaries except where it is consonant with the deed;

(h) account to the beneficiaries; 223

(i) act with care, diligence and skill in the affairs of the trust in terms of section 9 of the Act. This is a clear confirmation of the common-law fiduciary duty of the trustee; 224

(j) account to the Master of the High Court in terms of section 16 of the Act.

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221 See in this regard Administrators, Estate Richards v Nichol and Another 1999 1 SA 551 (SCA) 558I, where Scott JA made the following remark: “Generally speaking, however, a trustee will as far as is practicable seek to spread the investments of the trust over various forms of undertaking in order to obtain a balance of stability and growth in the capital value of the trust and the income it produces.” The court does not support the decision by the court a quo that the trustees are restricted to invest not more than 50% of the value of the trust estate in shares or unit trusts, because “(t)here is nothing in the evidence to support the imposition of such a limit”. (559E)

222 See Badenhorst v Badenhorst 2006 2 SA 255 (SCA); Jordaan v Jordaan 2001 3 SA 288 (C); Tijmstra v Blunt-Mackenzie 2002 1 SA 459 (T). S 11 of the TPCA is applicable.

223 S 19 of the TPCA renders any person having an interest in the trust property the right to petition the court for an order directing the trustee to comply with certain requests or to perform certain duties.

224 In Sackville-West v Nourse 1925 AD 516 533 the court stated that a trustee had to use greater care in handling trust property than he might in dealing with his own property. The court went much further, however, and stated that no business risks should be taken by trustees. This limited approach was later qualified in Administrators, Estate Richards v Nichol 1999 1 SA 551 (SCA) 558I, where the Supreme Court of Appeal made it clear that the test for prudent decisions, made with due care and diligence, is a question which must be decided on the facts of each particular case. It is stated at 557I as follows: “An investment considered prudent in earlier times may rightfully be regarded as quite imprudent in the context of modern conditions. The ongoing and rapid decline in the value of money brought about by inflation, which has become a feature of our economy in the course of the past few decades, may well result in a sharp decline in the value of a monetary security”. 
The legislature basically confirmed the concept of a trustee as laid down by the courts as “persons entrusted (as owners or otherwise) with the control of property with which they are bound to deal for the benefit of others.”

Section 9 of the TPCA reads as follows:

“Care, diligence and skill required of trustee

(1) A trustee shall in the performance of his duties and the exercise of his powers act with care, diligence and skill which can reasonably be expected of a person who manages the affairs of another.

(2) Any provision contained in a trust instrument shall be void in so far as it would have the effect of exempting a trustee or indemnifying him against liability for breach of trust where he fails to show the degree of care, diligence and skill as required by subsection (1).”

It is submitted that the terms *care, diligence and skill* collectively express the meaning of the term *fiduciary*. “Care” means concern, serious attention, consideration, and protection. “Diligence” speaks of proper care and effort, while “skill” refers to proficiency, expertness, and ability. These three terms are also used in the Companies Act to describe the duty of directors when exercising the powers and performing the functions of a director. When performing with care, diligence and skill, all actions must be taken in good faith, with a proper purpose and in the best interest of the company. It further states that directors will be held liable “in accordance with the principles of the common law relating to breach of a fiduciary duty, for any loss, damages or costs sustained by the company as a consequence of any breach by the director” of these requirements.

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225 *Estate Kemp v MacDonald’s Trustee* 1915 AD 491 on 499. In English law the common-law standard of conduct required of a trustee was that of the “ordinary prudent man of business” (*Speight v Gaunt* (1883) 9 App.Cas.1), until the Trustee Act 2000 provided that a trustee must exercise such *care and skill as is reasonable*. There are different scales of reasonableness for laymen and professionals.

226 *Webster’s Reference Concise English Dictionary* (2005) Geddes & Grosset at 48, 92 and 309. Honoré 263 states that the trustee must “observe exacta diligentia (scrupulous care)”. Stephenson & Wiggins 71 submits that the trustee is under duty to the beneficiary to exercise such care and skill “as a man of ordinary prudence would exercise in dealing with his own property”, and if the trustee is more skilful than the ordinary person, he must exercise such skill as he has.

227 See s 76(3) read with s 77(2)(a) of the Companies Act 71 of 2008.
In terms of English law the paid trustee is charged with a higher standard of care, diligence, knowledge and skill than the unpaid trustee. Moffat states that the term “fiduciary” is abstract, with its core meaning to be “under a duty of loyalty to some other person or body”.

The principle of managing the affairs of another is of a fiduciary nature. Kloppers states that the fiduciary liabilities of the trustee require the aforementioned to act with greater care than when dealing with his own estate.

Oakley distinguishes between the fiduciary duty of the trustee and the fiduciary relationship between the trustee and the beneficiary. If a relationship is fiduciary, the characteristics of a trust are taken to be at the heart of the entire relationship. The fiduciary relationship is, therefore, far more encompassing than a mere fiduciary duty - as a duty amongst many. The fiduciary duty is mostly associated with standards of good faith, disclosure, proper exercise of discretionary powers, care and diligence.

It is submitted that it is necessary to move from the “profit-rule” and “conflict-rule” approach, and even beyond a “positive duty of good faith” approach to where a fiduciary relationship exists and the whole relationship is based on the principle of fides between the parties.

Coetzee proposes that the rights of all trust beneficiaries primarily derive from the fiduciary relationship between the parties to the trust, although it is not the only source. He further submits that the fiduciary relationship, with the ex lege rights and liabilities flowing from it, has probably developed from the English equity right which is in essence a set of rules of fairness, with specific rights and liabilities exercised in a specific manner. This construction is not very different from the Roman law

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229 Moffat Trusts Law 545.

230 In general see Balden & Rautenbach “Die Sorgsaamheidsplig van Trustees in die uitvoer van hulle Beleggingsbevoegdhede: Kan ons by die Engelse Trustreg leer?” 2005(1) Tydskrif vir Regswetenskap 91-117.

231 Oakley 158-160.

232 On 382, with reference to some secondary sources such as the source of the trust itself, like the trust deed. See also Olivier LLD thesis 116-117.
principle of *bona fides* and is found in most jurisdictions in some form or another.\(^{233}\) The South African courts traditionally accepted that the rights of the beneficiary resulted from either the law of succession or the law of contract (*ex contractu*) and thus not directly from the fiduciary relationship (*ex lege*), but, according to Coetzee, this tendency is apparently changing.\(^{234}\)

Coetzee\(^{235}\) summarizes the fiduciary position as follows:

(a) when a fiduciary relationship exists, that relationship continues independently and is directed by its own unique rules as far as the nature and content of the rights and liabilities related to the relationship are concerned;

(b) the fiduciary relationship is also of some importance in disciplines such as agency law, partnership law, law of contracts and company law;

(c) South African law acknowledges the principle of fiduciary rights and liabilities resulting from a trust relationship;

(d) possible *ex contractu* rights in favour of a beneficiary may never be used to exclude the fiduciary rights of the beneficiary, but must be applied additionally to it.

Coetzee\(^{236}\) submits that all trust beneficiaries have legally enforceable rights against trustees, based on the fiduciary relationship which results *ex lege* from the trust relationship as primary its source.

Ultimately it remains imperative to distinguish between the very wide usage of the words “trust” and “trustee”, which refer to a fiduciary relationship which was not necessarily created by a trust document, but which came into existence merely by binding someone to administer property, separate from his own, for the benefit of a

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\(^{233}\) Coetzee 388 refers to the position in a number of jurisdictions where the additional rights of beneficiaries are called “tracing rights” (England), or “real subrogation” (Scotland), and others where it is regulated by statute (Sri Lanka, Louisiana and Quebec).

\(^{234}\) See the difference in approach in *Hofer v Kevitt* 1998 1 SA 382 (SCA) compared to *Gross v Pentz* 1996 4 SA 617 (A). See also *Doyle v Board of Executors* 1999 2 SA 805 (C) 813A and *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) for the newer and fresher approach to the aspect of the fiduciary nature of the trust.

\(^{235}\) 397-398.

\(^{236}\) 413. Compare Faris “Fiduciary Duties and Responsibilities when dealing with Trust Assets” 2011(4) *De Rebus* 16.
third party. This would include someone acting as a tutor, curator, agent, guardian, director or executor, burdened with a fiduciary duty.

It is submitted that the legislated content of the fiduciary duty for companies, namely care, diligence, skill, good faith, proper purpose and best interest, can also be applied when the fiduciary duty of the trustee is evaluated. Such an approach will go a long way in aligning the trust and the corporation - especially where the trust fulfils the role of business entity.

2.10 THE LEGAL PERSONALITY OF THE TRUST

Common law dictates that a trust has no distinct legal personality. The practical application of the trust in modern society has, however, compelled the legislature to grant the trust juristic personality for certain purposes. The trust is regarded as a mere collection of assets and liabilities with the assets of the discretionary trust belonging to the trustees. It is accepted, however, and prescribed by section 12 of the TPCA, that the trust property is separate from the trustees’ personal estate, which actually implies, at least for insolvency purposes, that the trust has a distinct estate, which actually constitutes a “legal entity”, although not a “person”.

Honoré’s differentiates between the terms “person”, “taxable entity”, “juristic entity or person”, and “legal entity”.

In *Magnum Financial Holdings* it was confirmed that a trust can be a debtor for all practical purposes, although it is still not a “person”. The trust has moved dangerously close to legal personality when the deeds office used to register fixed property in the name of trusts, replacing this practice by registering it in the name of “the trustees for the time being”. In practice, litigation is also sometimes conducted in the name of a trust and investments are made by trusts in their own names.

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237 See Stein 240-253 for more on the duties of directors.
238 See *CIR v Friedman* 1991 2 SA 340 (W), and *CIR v Friedman NO* 1993 1 SA 353 (A).
241 11, 39, 40. “Legal personality” is a reference to a characteristic of a non-human entity regarded by law to have the status of a person.
242 *Magnum Financial Holdings v Summerly NO* 1984 1 SA 160 (W). In *Ex parte Milton NO* 1959 3 SA 347 (SR) 350 it was submitted that a trust possesses a “quasi-personality”.
The latest attempts by the legislator to endow the trust with juristic personality was in the form of the National Credit Act 34 of 2005, the Consumer Protection Act 68 of 2008 and the Companies Act 71 of 2008, where it was included in the definition of a “juristic person” and consequently also a “person” for purposes of these Acts. The question asked by De Waal many years ago, namely whether the trust is not in the process of becoming a legal person, has now more relevance than ever and cannot be ignored any longer. Many of the criticisms lodged against the business trust will be addressed if the trust is for all purposes acknowledged as a legal person.

A legal person is endowed with rights and liabilities under law, similar to a natural person. It is often regarded as a legal fiction, but Corbett CJ stated in *The Shipping Corporation of India Ltd v Evdomon Corporation* that the “conception of a company as a separate entity distinct from its shareholders is no merely artificial and technical thing. It is a matter of substance . . .”

Sections 30(1) and 31 of the Companies Act 61 of 1973 touched on the legal personality of certain entities and it was interpreted by some as being of specific relevance to the business trust.

**Section 30(1)** reads as follows:

“No company, association, syndicate or partnership consisting of more than 20 persons shall be permitted or formed in the Republic for the purpose of carrying on any business that has for its object the acquisition of gain by the company, association, syndicate or partnership, or by the individual members thereof, unless it is registered as a company under this act, or is formed in pursuance of some other law or was before 31 May 1962 formed in pursuance of Letters Patent or Royal Charter.”

Olivier JA submitted in the *Save* case that the underlying purpose of this prohibition is to protect business people from dealing with unidentified “large fluctuating bodies”. The section forbids the formation of a company, association,
syndicate or partnership with more than 20 persons, unless it is registered as a company or formed in pursuance of another law. No penalty is prescribed but the result was that it would be unlawful.\textsuperscript{247}

This implied that a business trust or partnership with more than 20 individuals as members was an unlawful association, except if it could be argued that it was formed \textit{in pursuance of another law}. It may be submitted that the reference to “\textit{some other law}” is much wider than an Act of parliament and that a business trust is indeed an entity which is formed in pursuance of the common law. The Afrikaans text, however, which is the text signed by the State President, reads “\textit{kragtens hierdie Wet of opgerig word ingevolge ‘n ander wet}”. If interpreted according to its normal meaning, the conclusion will most probably be that this text does indeed refer to an Act (a statute) and not to the law in general.

Section 30(1) was the source of the accepted rule that a partnership can never have more than 20 partners. If correctly interpreted, it meant that a business trust with more than 20 beneficiaries would not be a lawful trust and would consequently not have been given any protection.

\textbf{Section 31} reads as follows:

\begin{quote}
\textit{“No association of persons formed after 31 December 1939 \textbf{for the purpose of carrying on any business} that has \textbf{for its object the acquisition of gain} by the association or by the individual members thereof, shall be a \textbf{body corporate}, unless it is \textbf{registered as a company} under this Act or is formed \textbf{in pursuance of some other law} or was before 31 May 1962 formed in pursuance of Letters Patent or Royal Charter.”}
\end{quote}

This section declares that no association \textit{shall be} a body corporate (read “juristic person”) unless it is registered as a company or is formed in pursuance of another law. No penalty is prescribed but the result is that the entity formed would, therefore, not be a legal (juristic) person. It is trite law that the business trust in South Africa does not have legal personality (thus no legal person),\textsuperscript{248} although it “constitutes a legal entity” for certain purposes and in \textit{Magnum Financial Holdings} it was decided...

\begin{footnotes}

\textsuperscript{248} In Commissioner for Inland Revenue v MacNeillie’s Estate 1961 3 SA 833 (A) it was ruled that a trust is neither a \textit{persona} nor an entity (840F-G).
\end{footnotes}
that “in certain respects a trust does possess legal personality”, but it is still not a “body corporate”.  

Nienaber JA summarized sections 30(1) and 31 in the *Mitchell's Plain* case as follows:

(1) if membership exceeds 20, it must be registered as a company if it is formed for the critical purpose; failing which it will have no *locus standi in judicio*; if fewer than 20, it is not illegal if it is formed for the critical purpose and is to operate as, say, a partnership;

(2) if it is formed for the critical purpose it must be registered as a company in order to enjoy corporate personality; if it is not formed for the critical purpose it may yet enjoy corporate personality if it possesses the characteristics of a *universitas* (i.e. operating as an unincorporated voluntary association).

The Companies Act 61 of 1973 was repealed by section 224 of the Companies Act 71 of 2008.

**Section 8(3)** of the 2008 Companies Act, which replaced sections 30(1) and 31, reads as follows:

“No *association* of persons formed after 31 December 1939 for the purposes of carrying on any business that has for its object the acquisition of gain by the association or its individual members is or may be a *company or other form of body corporate* unless it –

(a) is registered as a company under this Act;

(b) is formed pursuant to another law; or

(c) was formed pursuant to Letters Patent or Royal Charter before 31 May 1962.”

This section declares that no association is or may be a company or other form of body corporate (read juristic person) unless it is registered as a company or is formed pursuant to another law. No penalty is prescribed but the result is that the entity formed would, therefore, not be a legal person. The business trust is in terms

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250 1996 (4) SA 159 (A) 166B-D.
of this Act, however, included in the definition of “juristic person” (section 1) and would, therefore, not be affected by this section.

It may seem that all partnerships with the purpose of carrying on any business that has as its object the acquisition of gain, is prohibited from being a body corporate, but as a partnership it is in any event not a body corporate (read juristic person), and is apparently of no consequence. In as far as it has been interpreted in the past that a partnership with more than 20 partners will *per se* be unlawful, it must be accepted that it will now be a lawful entity.

It is submitted that the term “body corporate” has the same meaning as “corporate body”, which implies that it is a corporation in the widest sense. It is thus a body with legal personality and can as an entity “acquire rights and duties separate from its members”. As the Companies Act 2008 defines a trust as a juristic person, all business trusts are automatically also “body corporates” for the purposes of that Act.

It is, therefore, submitted that the only result of a contravention of section 8(3) (for non-trusts) would be the lack of corporate personality. If it possesses the characteristics of a *universitas*, such as a voluntary association, it will even enjoy corporate personality. It is submitted that section 8(3) has no bearing on the business trust and the business trust is, for the purposes of the Companies Act 71 of 2008, a juristic person and will, therefore, automatically enjoy corporate personality and qualify as a body corporate.

It is clear that the legislator finds it necessary to endow the trust with legal personality for certain purposes. The reason for this may be two-fold: it cannot allow the

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251 For the purposes of the National Credit Act 34 of 2005 a partnership is included in the definition of “juristic person”.


253 Davis *et al* (eds) 18. Contra Magnum Financial Holdings (Pty) Ltd (in liquidation) v Summerly 1984 1 SA 160 (W) 163H, where it was ruled that, although a trust does possess legal personality, it is “insufficient to constitute it a body corporate within the meaning of this term as used in sections of the Acts referred to” (the Insolvency Act 24 of 1936 and the Companies Act 61 of 1973).

254 The Consumer Protection Act 68 of 2008 states that the concept of “juristic person” includes “a body corporate; a partnership or association; or a trust as defined in the Trust Property Act”.

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potential uncertainty regarding the effect of particular legislation on trusts, nor can it allow trust parties to be able to hide behind the lack of legal personality. The question is whether the legislator should amend the common-law position of trusts and grant the trust legal personality under all circumstances. The trust may, alternatively, develop legal personality by way of a natural legal evolutionary process.255

2.11 THE REQUIREMENTS FOR A VALID TRUST

It has been stated that it is “more useful to describe than to define a trust, and then to distinguish it from related but distinguishable concepts.”256 There are a number of different opinions on the essential elements of a valid trust.257

A common feature of the English trust jurisprudence is the so-called “three certainties”. Lord Eldon258 stated in 1823 already that for a trust to be valid, “the words must be imperative”, “the subject must be certain”, and “the object must be as certain as the subject”. This statement was confirmed by Lord Langdale in the famous “three certainties judgment” in Knight v Knight259 - certainty of words, certainty of subject, and certainty of object.

Honoré260 is of the opinion that there are three requirements for a valid trust, namely:

(a) the serious intention to create a trust;

(b) the indication of the trust property; and

(c) the object of the trust.

In Honoré261 the essentials of the trust are summarised as follows:

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255 These options are referred to in more detail in Chapter 10.
256 Martin 47.
257 See the extensive discussion by Strydom 27-33. Compare Zimmerman et al Mixed Legal Systems 829–834 for a comparison between the requirements for a trust in South African law with that of Scotland.
258 In Wright v Aykyns (1823) Turn & R 143 at 157, as quoted by Pettit Equity and the Law of Trusts (2006) 44.
259 (1840) 3 Beav 148. See the detailed discussion on the English position by Pettit Equity 44-57.
260 79. For the difference between the object of the trust and the purpose of the trust see Peterson and Another NNO v Claassen and Others 2006 5 SA 191 (CPD) 197C-E (16) and (17). Compare also Hyland & Smith 20-21.
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(a) the founder must intend to create a trust;
(b) this intention must be expressed in a mode appropriate to create an obligation;
(c) the property subject matter must be defined with reasonable certainty;
(d) the trust object must be defined with reasonable certainty, and
(e) the trust object must be lawful.

Honoré summarizes the main features of the trust as follows:

(a) the founder must either have handed over control of the trust property, or must have bound himself or some other person to hand it over, or must be bound to do so (e.g. by statute);
(b) the handing over normally takes the form of a transfer of ownership (or the ownership was transferred to the beneficiary but the control was vested in the trustee);
(c) the founder and the trustee may also be beneficiaries;
(d) the trustee is subject to a fiduciary obligation;
(e) a trustee must have a degree of independence;
(f) trusteeship is an office.

These features are, however, not necessarily also the essentialia of the trust. It is submitted that Strydom’s opinion, after evaluating the different views of writers,

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117. These requirements are similar to those laid down by the court in Administrators, Estate Richards v Nichol and Another 1996 4 SA 253 (C) 258D-F.
6.
262 The founder must have the legal and mental capacity to create a valid trust. See Martin 77-79.
263 The “bewind” trust is by some seen as a trust in the strict sense because the administrator holds an office and is subject to the same degree of public control as one who owns the trust property. See Honoré 9. Martin 82 states that the disposition of an equitable interest in English law must be in writing. In South Africa ownership of immovable property can only be transferred by way of registration. See Strydom 33, where he submits that this intention must be properly communicated also. In this summary of essential elements the discussion by Strydom on 27-33 will be used as source. He refers to a number of works by the different writers. See in this regard the following sources referred to by him: Honoré The South African Law of Trusts (1992) 96; Klopper 601; Corbett The Law of Succession (1980) 409; Olivier Trustreg en Praktyk (1989) 37; and, Theron Die Besigheidstrust LLM dissertation Randse Afrikaanse University (1990) 32.
some supported by case law, is a valuable contribution and summarizes the minimum requirements for a valid trust in the South African context.

It is submitted that the following can be regarded as the essential elements of the trust:

(a) the founder must have an intention to create a trust;\textsuperscript{266}

(b) the office for someone charged with a legal duty (obligation) must exist\textsuperscript{267} (i.e. trustee);

(c) the trust property must be identifiable with reasonable certainty (subject);\textsuperscript{268}

(d) the trust must have a lawful object.\textsuperscript{269} (The object will automatically include a beneficiary, even if it is impersonal).

\textsuperscript{266} There seems to be unanimity amongst academics regarding the element of intention, as quoted by Strydom 27. Honoré 67. Confirmed in Administrators, Estate Richards v Nichol 1996 4 SA 253 (C) 258E-G. Honoré 128-136 explains that, contrary to English and Sri Lankan law, the South African trust cannot be created unintentionally. Both the constructive and the resulting trust were not received in South Africa. See also Honoré 118 a.f., where it is stated that the intention to create a trust \textit{inter vivos} must be shared by the founder and the trustee. This intention may even be inferred without the explicit use of the word “trust”. In this regard they refer to the facts in Coetzee NO v Universiteit Stellenbosch 1959 2 SA 172 (C). See also Pace & Van der Westhuizen 33, where they draw a distinction between the intention to create a trust in the narrow or wide sense.

\textsuperscript{267} For the trust \textit{mortis causa} the obligation will be unilateral and for the \textit{inter vivos} trust bilateral. Strydom is of the opinion that it must clearly be a trustee, but Honoré states that it may even be the founder or another party who must have the obligation to transfer the property to the trustee. See also Pace & Van der Westhuizen 34 regarding this element.

\textsuperscript{268} The trust property may consist of any asset or group of assets. See the definition of “trust property” in the Trust Property Control Act 57 of 1988. Honoré 146 states, with reference to Conze v Masterbond Participation Bond Managers 1996 3 SA 786 (C), that, if no property is located in the trustee only a trust in the wide sense can result. See also the support for this element in Deedat v The Master 1995 2 SA 377 (A). Strydom supports Coetzee, Olivier and Theron regarding the necessity of a beneficiary as essential element. In the Fifth Edition (2002) of Honoré is the element of the \textit{beneficiary} being adequately defined replaced with the \textit{object} being sufficiently certain. There is also a differentiation between the elements at creation of the trust and those necessary for it functioning properly. Olivier regards this differentiation as artificial. The element of an identifiable beneficiary is absent where the trust is formed for an impersonal object and for that reason it is submitted that it cannot be regarded as an essential element.

\textsuperscript{269} This object may be to benefit one or more parties or it may be impersonal. In Peterson and Another NNO v Claassen 2006 5 SA 191 (CPD) 197B the court states that “(w)hilst it is correct that one of the essentials for the creation of a valid trust is that the trust object must be lawful, it does not follow, however, in my view, that a trust is void if it is created with a fraudulent, illegal or immoral purpose. There is, in our view, a material difference between the object of a trust and the purpose thereof.” The result is that when a trust is created for an unlawful purpose it does not automatically render it void. (See 198G-H of the Peterson case). According to Pace & Van der Westhuizen 35 if “the person or class for whose benefit the trust is intended is not named or determinable, the trust fails for want of a certain object”.

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We support Olivier et al\textsuperscript{270} in their submission that the source of origin should not be included amongst the essentials of the trust. As long as the source is included, the essentials of the trust *mortis causa* and the *inter vivos* trust will potentially differ. When the source is removed as an essential element, however, the differences disappear.\textsuperscript{271}

The process of creating the trust, registering the trust, transferring the assets and taking control of the assets are, therefore, excluded, according to Olivier’s reasoning, from the essentials. From the moment that the trust exists and is ready to be administered, there are no more differences between the testamentary and living trusts, and then the *essentialia* are as follows:

(a) clearly defined property;

(b) specified (or specifiable) beneficiaries, or a clearly defined impersonal object; and

(c) a trustee who has accepted his appointment in terms of the Trust Property Control Act.

It is submitted that the last element should not be limited to trustees who are appointed by the Master in terms of the Act, but that it is indeed only necessary for an individual to accept the fiduciary position in relation to the object or the beneficiary for a valid trust to exist.

It is further submitted, however, that to exclude the intention to create a trust (or at the very least to have a founder, donor or settler) as an essential element does not hold up. The trust cannot accidentally come into being. Each and every trust, irrespective of whether it comes into existence by way of an agreement between parties or a will, and whether it is regulated by the TPCA or the CISCA, needs the presence of a founder (or testator) (i.e. someone with the intention that it must be

\textsuperscript{270} Olivier et al *Trustreg* 2-13 refers to the remark by Mennell on the American position, namely: “The elements of a trust are the transfer, the *res*, the settlor, the trustee and the beneficiary. A “key sentence” approach is possible: The transfer of the *res* by the settlor to the trustee for the beneficiary’s benefit creates a trust” and makes it clear that the transfer of the property is not necessary in the South African context.

\textsuperscript{271} Olivier et al *Trustreg* 2-14-2-19.
formed), some property, asset or subject, an object or beneficiary on whose behalf it is created, and lastly, the office of trustee (or legally obligated individual or entity).

The office of trustee remains an essential element for the trust to function as a trust. When a trust is without a trustee for any period of time, the trust will not disappear, but it will at the same time also not operate as a trust as there is no one to give effect to its very object. The question is, therefore, not whether there is an individual in office, but whether the office does exist.\(^{272}\)

Theron\(^{273}\) submits that if the trustees are not allowed to, or do not, act independently, no trust actually exists. The result of such a situation is that the trustees may be regarded as mere agents of the beneficiaries, as in agency the principal may control the action of his agent.\(^{274}\) She takes this assumption from American jurisprudence and supports it with some South African input. Honoré’s\(^{275}\) apparently supports this submission and states that “it seems incompatible with the independence of a trustee that the founder should be free unilaterally to revoke the trust or that the trustee should be bound during the course of administering the trust to obey instructions given by the founder . . .”

It is submitted that, where the founder or one of the trustees can control trustee decisions by way of a veto right or a “hire-and-fire” clause (i.e. the so-called dog-collar trust), the result will be similar to those envisaged by Theron and Cameron. The result will thus be that the property of the trust does not necessarily vest in the trustees or in the beneficiaries, but in the person who controls the trust.

The trust will, therefore, fail on two levels. In the first instance, if there is effectively no property, there is also no trust, as the subject of the trust is an essential element. If that was the position from the start in terms of the trust deed, the founder never had the intention to create a trust, but merely to appoint people who can co-manage the assets with him or act as his agents.

\(^{272}\) It is submitted that Olivier et al Trustreg 2-16 disregard the trustee as an essential element when they state that if there is not a trustee, another can just be appointed, because their focus is on the individual and not on the office. See Olivier’s discussion on 2-20 - 2-21 on Nel and Others v Metequity Ltd 2006 SCA 140 (RSA); 2007 3 SA 34 (SCA); 2007 2 All SA 602 (SCA), and Peterson and Another NNO v Claassen 2006 5 SA 191 (C).

\(^{273}\) “Die Besigheidstrust” 285. The writer also refers to the control test advocated by Bromberg.

\(^{274}\) See Goodricke & Son v Registrar of Deeds, Natal 1974 1 SA 404 (N).

\(^{275}\) 91. They submit that the result may be either a partnership or an agency instead of a trust.
It is submitted that a trust deed executed for the purposes of a collective investment scheme must also comply with the essential requirements of a trust. This aspect will be dealt with in more detail in Chapter 7.

2.12 THE TRUST DEED

The intention to create a trust must be couched in some form or another, namely by way of a will, written contract, transfer, statute, treaty, judicial order or orally – as long as it creates a legal obligation regarding a subject and is to the benefit of an object, even if it is impersonal.

A living trust is created by way of an agreement between parties because the form is of a contractual nature and specifically in the form of a *stipulatio alteri*.276 The trust deed itself must comply with the following minimum requirements:277

(a) the founder of the trust must have the *intention* to create a trust;

(b) the founder must create a *binding obligation* and someone must accept it;

(c) the trust assets and trust beneficiaries (or the *object*) must be readily ascertainable.

From the above it is clear that the agreement between the parties to a trust does not have to be in writing. The TPCA, however, only has bearing on a trust of which the arrangement between the parties “is by virtue of a trust instrument”. A “trust instrument” is described in section 1 as “a written agreement or a testamentary writing or a court order”.

A trust which is not executed in writing may comply with all the requirements for a valid trust, but will not be subject to the TPCA, except if reduced to writing. From the deed it had to be clear that the founder intended creating a trust by committing himself to an identifiable obligation, which was accepted by the trustees.

Section 2 of the TPCA states that

276 See Olivier et al Trustreg 9-3.
“(i)f a document represents the reduction to writing of an oral agreement by which a trust was created or varied, such document shall for purposes of this Act be deemed to be a trust instrument.”

This clause is important because a “trust instrument” is limited in terms of section 1 to a **written** document. Any oral trust will, therefore, not be a trust for the purposes of the TPCA until it is reduced to writing.

The CISCA does not explicitly require a written trust document, but does imply that. In the definition of a collective investment scheme, reference is made to the “deed”, which is defined as an agreement between a manager and a trustee or custodian (section 1). Although a written document is not specified, section 97 requires the deed to set out the requirements for the administration of the portfolio. It is therefore clear that only a written document will qualify.278

Over and above these minimum requirements there are numerous other factors to take into consideration when a trust deed is prepared.

### 2.12.1 CONTENTS OF THE DEED

In South Africa a trust deed, and specifically a discretionary business trust deed, is usually drafted in the form of a contract.279 The donor would conclude a written agreement with the trustees to the following effect:

> “The parties agree to establish and register a trust deed, to accept and receive a donation from the donor, and to utilize such for the benefit of the beneficiaries. The trustees are prepared to accept office as trustees and are willing to administer the trust on the terms and conditions recorded in the deed of trust.”

The legal effect is that the trustee assumes formal ownership of the assets of the discretionary trust and of the duty to utilize these assets to the benefit of the beneficiaries, as prescribed by the terms of the deed.280

The identity of the beneficiaries and the trust property, as well as the object of the trust, must be clear and unequivocal. A discretionary trust deed should state clearly

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278 “Deed” is defined in *Webster’s Reference Library Concise English Dictionary* (2005) 84 Geddes & Grosset as “a legal document recording a transaction”.

279 The definition of “trust” in the TPCA also confirms the establishment of *inter vivos* trusts by way of agreement. Hyland & Smith 7 refer to the trust deed as the “constitutive charter” of the trust.

280 See *Crookes NO and Another v Watson and Others* 1956 1 SA 277 (A).
that the trustees have an unencumbered discretion as to how, when and to whom of the beneficiaries to distribute the income and the capital of the trust estate.

The deed should further cover the following aspects: the vesting date, the need for security, meetings and decision-making processes to be followed by the trustees, powers regarding the application and distribution of income and capital, the payment of tax, amendments to and the termination of the trust, and the compensation of the trustees. The founder has the opportunity to give the trustees guidance regarding administrative and management issues. The trustees will only have the power to act in terms of the trust deed and the TPCA.281

Like in any other contract it is ideal to cover important management and discretionary aspects, over and above the essentials, such as the duties and powers of the trustees, the vesting of rights, security, meetings and decision-making processes, tax, application of income and capital, termination of the trust, record-keeping requirements, liabilities, amendments to the deed, limitations, compensation, testamentary dispositions, etc.282

A deed in terms of the CISCA is in the form of an agreement between a manager and a trustee or custodian and sets out the requirements for the administration of the portfolio, which consists of a group of assets in which members of the public are invited to invest.

It is submitted that although trust deeds in terms of the CISCA have to comply with the essential requirements of trusts, the Registrar of Collective Investment Schemes does not necessarily compel the parties to comply. Many approved deeds do not include the minimum essentials. Some deeds lack any reference to the object or the obligations of the trustees. Without any obligations, the intention is usually also difficult to determine.283

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281 In the recent decision of Abraham Krok Trust v Commissioner for SARS [2010] ZASCA 153 29-11-2010 case no 58/2010, the Supreme Court of Appeal had to examine a trust deed and the stipulations regulating the distribution of income and capital in some detail to determine the taxability of the distributions made.


283 See Chapter 7 for a more detailed discussion on the trust deed for collective investment schemes.
2.12.2 CONTROL OF TRUST ASSETS

It has become an essential part of a lawful trust that a separation between enjoyment of the trust assets and the control of these assets is necessary. The trustees must be empowered and allowed in practice to administer the assets under control for the benefit of the beneficiaries, within their discretion.

The individuals controlling the trust “must be substantially different from and be independent of those that benefit from the trust.”

It is, therefore, important that a trust deed does not allow the donor or one of the trustees (or the founder) so much control over the trust assets and the management of the trust, that it can be argued that the trust became a “sham”.

The donor must divest himself effectively of the trust property. In *Badenhorst v Badenhorst* the court found the following factors to be adequate to decide that they will ignore the existence of the trust for the purposes of a redistribution order, namely:

- the husband had the right to replace a trustee unilaterally;
- the husband ran the trust in practice without consultation with his co-trustee;
- the husband acted as if there were no difference between his own assets and those of the trust.

The court stated that it was not only about form, but also about substance – how the trust had to be run *de facto* – that had to be taken into account to determine whether there is a satisfactory level of separation between enjoyment and control.

In the *Parker* case it was confirmed by the Supreme Court of Appeal that enjoyment and control should be functionally separate. If the separation was not

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284 Geach & Yeats 40.
286 2006 2 SA 255 (SCA).
287 Taken from discussion by Joffe “Sham Trusts” 25-26.
288 See *Jordaan v Jordaan* 2001 3 SA 288 (C), where the court determined that the manner in which the person administered the trusts was relevant in determining whether the trusts became his *alter ego* or not.
adequate the court would pierce the protection given by it and creditors would be able to attach assets of the trust as if they belonged to the individual who misused the trust.

Geach and Yeats\(^{290}\) listed some indicators of unacceptable control by the founder or beneficiary, namely where the founder or beneficiary:

(a) retains lifetime power to dismiss and/or appoints trustees (the so-called dog-collar trust); or

(b) retains power to vary the provisions of the trust deed; or

(c) retains the power to veto important decisions.

They further illuminated the risk the founder or beneficiary might run in falling into the trap of section 3(3)(d) of the Estate Duty Act 45 of 1955 (read with sections 3(4)(b) and 3(5)(b)), in that a deceased person’s estate included property that he was competent to dispose of for his own benefit immediately prior to his death.\(^{291}\)

The substance-over-form principle lately being applied by our courts in this regard will always entail a factual enquiry. Even where apparent independent trustees have been appointed, but become the puppets of the founder or beneficiary, a court may determine that the trust must be ignored for certain purposes as there was no real \textit{de facto} separation between control and enjoyment.\(^{292}\)

Van der Linde and Lombard\(^{293}\) submit that a lack of separation between control and enjoyment can have at least three different consequences:

(a) the trust can be regarded as invalid, because there is \textit{de jure} no real separation of control and enjoyment; or

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\(^{290}\) 40-42.

\(^{291}\) See Geach & Yeats 54.

\(^{292}\) Compare also \textit{Nel v Metequity Ltd} 2007 3 SA 34 (SCA), where the court decided that an identity of interest between trustees and beneficiaries in so far as the object of the trust is concerned, does not invalidate the trust automatically.

\(^{293}\) “\textit{Nel v Metequity: Identity of Interest}” 438. Olivier “Traps and Pitfalls” 2001 \textit{South African Law Journal} 229 adds another possibility and that is that the application of substance-over-form principle may lead to the conclusion that a partnership was formed instead of a trust, which may lead to personal liability by trustees.

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(b) the trustees can be held personally liable for breach of trust, because there is
*de jure* separation and, therefore, a valid trust, but not *de facto* separation
between control and enjoyment; or

c) the trustees can be held to the provisions of the trust document, because the
circumstances under (b) exist.

Van der Linde and Lombard\(^{294}\) argue that the current basis on which our courts
decide whether or not adequate separation of control and enjoyment is present in a
particular case, has in practice become one of equitable considerations and that no
identifiable test, based on clear guidelines, has been developed yet.

It is submitted that a number of factors still inhibit legal advisors and accounting
professionals in South Africa from ensuring that proper separation between control
and enjoyment is brought about in trust deeds, namely:

(a) a general lack of knowledge and/or understanding by legal and accounting
practitioners preparing trust deeds;

(b) a lack of specialisation in trusts by legal and accounting practitioners;

(c) an unhealthy fear by individuals to lose control over their assets;

(d) the concept of fiduciary duties not being well-developed in the minds of the
general public and practitioners;

(e) the *ad hoc* development of the concept by our courts, without clear,
unambiguous direction;

(f) the lack of a well-developed and well-regulated trust and fiduciary model;

(g) the lack of independent, professional trust and fiduciary services specialising
in the formation of trusts and the management thereof.

2.12.3 SUBJECT MATTER OF THE TRUST

The TPCA defines “trust property” as:
"movable or immovable property, and includes contingent interests in property, which in accordance with the provisions of a trust instrument are to be administered or disposed of by the trustee."

One of the essential provisions of the trust deed must be “a definite or identifiable subject-matter”, or must at least be capable of ascertainment by admissible means of interpretation. Any admissible evidence, including extraneous facts, may be used to prove the identity of the trust property. The trust property must, therefore, be defined with sufficient certainty. The assets may be of a movable, immovable, corporeal or incorporeal nature.

In the case of a business trust the subject matter may often be immovable property or other business assets. The founder will sometimes not contribute a large amount of cash to the assets of a business trust as cash injections, but will often rather contribute capital in the form of loans. A loan will not qualify as subject-matter of the trust as it remains the property of the lender. Any cash or investments held by the trust must be in a bank or investment account identifiable as trust assets.

The Financial Institutions (Protection of Funds) Act 28 of 2001 regulates the investment, safe custody and administration of trust property by financial institutions. It imposes specific duties on all persons dealing with trust property controlled by financial institutions. When dealing with trust property, utmost good faith must be observed and the necessary care and diligence must be exercised. No improper advantages may be gained by trustees and financial interests must be declared. Trust property may further not be invested in conflict with the terms of the trust instrument. A contravention of these requirements does constitute a punishable offence.

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295 Deedat v The Master 1995 2 SA 377 (A) 383E-F. In that case the court determined that the financial statements were adequate evidence of the existence of a trust fund which satisfied the element of a subject matter. See Honoré 148.

296 See s 10 of the TPCA. Depending on the structure of the loan it may amount to a “credit facility” or a “credit transaction” as defined in s 1 of the National Credit Act 34 of 2005, in which case the trustees must ensure that they do comply with the stipulations of that Act.

297 The TPCA still refers to the Financial Institutions (Investment of Funds) Act, which was repealed by the Financial Institutions (Protection of Funds) Act. Aforementioned makes use of the definition of “financial institution” as defined in the Financial Services Board Act 97 of 1990 (as amended). The said definition currently includes, amongst others, collective investment schemes, independent intermediaries, authorised financial services providers and any other party who deals with trust property as a regular feature of its business, without being authorised to deal so in terms of legislation, other than the Companies Act, the Close Corporations Act or the TPCA.
Any immovable or movable property that can be registered, like motor vehicles, must be registered as trust property. Section 11 of the TPCA requires trust property held by the trustee to be reflected in the bookkeeping of the trustee as such. It should, therefore, also be indicated as such in the bookkeeping records of the trust itself.

It is proposed that a trust asset register be kept, giving all relevant details of trust property. It is further submitted that the nature of trust assets as capital or stock-in-trade must be clearly indicated for accounting and tax purposes.\(^{298}\)

The initial asset (donation) does not have to be substantial and may be nominal as the case often is. It is imperative, however, that an initial donation takes place. No trust, as defined in the TPCA, can be formed without an asset, which is the subject matter of the agreement between the founder and the trustee.\(^{299}\) The only asset of the trust may be nominal for any length of time and it will have no negative effect on the validity of the trust.

It is also customary that the situation of the greater portion of the trust property (subject) determines the jurisdiction of the Master of the High Court when \emph{inter vivos} trusts are registered and letters of authority issued. Section 3(1)(a) of the TPCA apparently deals only with the jurisdiction of testamentary trusts.

### 2.12.4 OBJECT OF THE TRUST

In \emph{Peterson v Claassen}\(^{300}\) the court emphasised that, while the object of a trust is required to be lawful for the validity of the trust, a “fraudulent, illegal or immoral purpose” will not render a trust invalid. Object cannot be equated with purpose and a finding of invalidity on the basis of an unlawful purpose would often lead to unfair results.

The object should be declared in the trust deed and if not, it is submitted that no trust comes into being. While the object of a trust is openly proclaimed and objectively

\(^{298}\) Geach & Yeats 190.

\(^{299}\) Honoré 146, with reference to \emph{Conze v Masterbond Participation Bond Managers} 1996 3 SA 786 (C), submit that a trust in the wide sense may result in a trust without any property.

\(^{300}\) \emph{Peterson and Another NNO v Claassen} 2006 5 SA 191 (CPD).
ascertainable by way of the deed, an unlawful purpose will usually be “jealously guarded by those who harbour such purpose.” 301

The primary object of every trust should be the benefit of the beneficiaries. Any other object will always be secondary to this main objective. The founder may elaborate on that object by specifying the purposes for which the assets may be applied, as long as it is to the benefit of the beneficiaries.

In a business trust, specific rules of distribution of profits and/or capital may be spelled out to protect the individual parties. All powers of trustees and purposes of the trust must be consonant with the object to benefit the beneficiaries.

The purpose of a trust will often not be openly addressed by the founder in the trust deed, and in a family trust with an estate planning purpose the word “estate planning” will most probably not even be mentioned. Where a trust is, however, created for an unlawful purpose, but with a lawful object, agreements concluded may be void or voidable if such agreements themselves are proved to be unlawful.302

The court submits that invalidity of a trust based on an unlawful purpose may result in “far-reaching and commercially impracticable consequences” for parties who unknowingly contracted with such a trust.303

In trusts formed in terms of the CISCA, the object has been described as the establishment of

   “one or more separate portfolios in which investors can obtain participatory interest in diversified assets of local or foreign origin”,

and then elsewhere in the deed it is stipulated that the manager undertakes

   “to invest and secure the interests of investors in a portfolio”.304

301 Peterson and Another NNO v Claassen 2006 5 SA 191 (CPD) paras [14]-[17], in reference to Administrators, Estate Richards v Nichol 1996 4 SA 253 (C) 258E-G.
302 Peterson v Claassen para [22]. Ordinary contractual principles must be applied to determine the validity or not of the contractual agreements that result from an unlawful purpose.
303 Peterson v Claassen para [39].
304 Reference to EFT Standard Deed and Cisca Model Deed on Property dated 14-03-2003 (writer has same on record). See Annexure A.
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It is clear that even here the object should not be to establish portfolios, but to secure the interests of investors. The draftsmen do not necessarily understand the essential nature of the trust object.

2.13 THE PARTIES INVOLVED IN THE TRUST

The founder (who is usually also the first donor), the beneficiary and the trustee are the essential parties to a trust. In case of a business trust the founder will usually play a very active role and would most probably also be one of the trustees.

The trustees as a whole would fulfil roles similar to that of directors of a private company or members of a close corporation. It is imperative for the trustees to accept the initial donation as that action of acceptance completes the circle of a trust to be formed. The trustees must also be authorized by the Master of the High Court before they may act in their capacity as trustees. Their actions shall be void if they act without the necessary authorization.

In the case of a business trust formed in terms of the CISCA, the Registrar of Collective Investment Schemes will approve the scheme and in that sense approve the role of the trustees to act as such.

The beneficiaries are not consensual parties as their involvement is initially passive. They usually do not co-sign the agreement and their consent to be nominated as beneficiaries of the trust is not necessary. Most trust deeds do grant them the opportunity to resign as beneficiary. The gratuitous beneficiary does not necessarily know that he is a beneficiary but does still have the discretion to accept or refuse a distribution from the trustees.

The beneficiary in a collective investment scheme trust is an active party, not at the formation of the trust, but when he decides to participate in the scheme by purchasing units.

305 Olivier et al Trustreg 9-5.
306 See Simplex (Pty) Ltd v Van der Merwe and Other NNO 1996 1 SA 111 (W); Van der Merwe v Van der Merwe 2000 3 SA 519 (C). Contra Kropman and Others NNO v Nysschen 1999 2 SA 567 (T). This principle was recently confirmed by Supreme Court of Appeal in Lupacchini NO v Minister of Safety and Security 2011 2 All SA 138 (SCA).
2.13.1 THE FOUNDER

The terms founder, donor, planner, lender, sponsor and settlor are mostly used interchangeably by the drafters of trust deeds, referring to the same roles. Some of the terms are sometimes used in combination with one or the other, indicating a different role from that of the founder or settlor, like a planner and a settlor. For the purposes of this work, however, the term “founder” is consistently used to refer to one or more individuals or legal entities who act as initiators of the trust, and who determine the details of the specific trust as well as the contents of the deed.

A practice, often based on certain misconceptions about the law of trusts, developed amongst some drafters to differentiate specifically between the founder and the planner. It was believed that the founder must be an independent party from the planner. This led to some founders in name having no real intention to create a trust for the benefit of the beneficiaries, but merely acting in that position, instructed by the person who had formed the intention.\(^\text{307}\)

It is submitted that a trust will not fail purely for the reason that the party indicated as the founder never intended to form a trust — as long as a third party did form such intention. It is further submitted that the contractual principle for simulated contracts, namely the Roman maxim \textit{plus valet quod agitur quam simulate concipitur}, is applicable.\(^\text{308}\) In \textit{Maize Board v Jackson} it was confirmed that parties to a contract “may not . . . conceal the true nature of their transaction”.\(^\text{309}\)

In practice another family member or even the lawyer drafting the deed is sometimes purported to be the founder, while it is common cause between the parties that the donation will be made by the real founder — who is the one with the intention to create a trust to the benefit of the beneficiaries. It is an established principle of the

\(^{307}\) See Olivier et al \textit{Trustreg} 9-4–9-5 and the reference to \textit{Crookes NO v Watson} 1956 1 SA 277 (A). Contra Geach & Yeats 52-59.

\(^{308}\) Expressing the principle that greater value is attached to what is done than to what appears to be done. See Van Jaarsveld (ed) \textit{Suid-Afrikaanse Handelsreg} (1988) 25.

\(^{309}\) 2005 6 SA 592 (SCA) 596B. See also \textit{Automotive Tooling Systems (Pty) Ltd v Wilkens} 2007 2 SA 271 (SCA). In the landmark decision of \textit{Zandberg v Van Zyl} 1910 AD 302 309 it was stated that the parties may not “call it by a name, or give it a shape, intended not to express but to disguise its true nature”
law of contract that only a provision that was “intended to have contractual effect” will be applied to have “business efficacy.”

It is, therefore, submitted that such a purported founder may be ignored by our courts as founder and the true person with the intention to establish the trust will be acknowledged as founder. This may have serious consequences for trusts as the founder is often endowed with special powers in terms of the trust deed and it may be established that the powers were not exercised by the real founder and the actions have no legal effect or business efficacy.

It is submitted that in the local business trust context the founder is the only party necessary to establish a trust. The founder must have the necessary legal capacity to enter into the said contract and must comply with his promise — that is to transfer the donation to the trustees. The intention of the founder to donate certain assets must be clear and such intention shall create an obligation on his part.

The founder may also be a beneficiary and even a trustee — as long as he is not the sole beneficiary, as no trust will then come into existence.

The main purpose of the founder is the establishment of the trust. Thereafter his role will be limited to rights or liabilities stipulated in the deed. The past trend to grant the founder a number of special powers in terms of the *inter vivos* trust deed, which sometimes effectively allowed him to control the trustees by way of veto rights and/or “hire and fire” clauses (so-called “dog-collar” clauses), has largely disappeared because of the emphasis lately placed on the requirement that control over the trust and the enjoyment of the assets of the trust must be clearly separated.

**2.13.2 THE BENEFICIARY**

The focus of the trust concept should be on the beneficiary or beneficiaries, because he/she or they are ultimately the reason for a trust being formed. In light of the

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310 Absa Bank v Swanepoel NO 2004 6 SA 178 (SCA) 181E-F.

311 Although most trust deeds make use of the term “donor”, the term “settlor” is not often found in South African trusts and although some practitioners do prefer it, it is regarded by writer as a foreign concept. It is submitted that it was adopted by local drafters from examples of foreign trusts deeds, especially those of English origin. A “settlor” is often used with a “planner”, where first-mentioned is an independent party who makes the first donation to the trust, with the planner fulfilling the role of the traditional founder.

312 See Pretorius v Commissioner for Inland Revenue 1986 1 SA 238 (A); Crookes NO v Watson 1956 1 SA 277 (A).
discussions on usufruct and fideicommissum it is imperative to determine exactly what is the nature and position of the beneficiary(s) for all intents and purposes. In Ras NO v Van der Meulen\(^{313}\) it was implicated by the Supreme Court of Appeal, though not directly decided, that once a beneficiary has accepted a benefit, she cannot unilaterally be removed by the trustees. In the recent Potgieter\(^{314}\) case this position was confirmed when the court did not allow the amendment of the beneficiaries without the permission of beneficiaries whose guardian had accepted an interest on their behalf.

One can accept that the decision of an estate owner to employ a trust as an estate planning instrument, relates not only to considerations of providing assets to the trust beneficiaries, but also to protection of such assets. Protection of assets will not only include direct protection against potential creditors, but also against legislative consequences brought about by income tax, capital gains tax, estate duty and insolvency legislation.

Strydom\(^{315}\) investigated the interests of a trust beneficiary from two angles, the law of succession and contract perspective on the one hand, and the legislative perspective on the other. He states that the nature of the rights of the beneficiary as seen from the law of succession and law of contract can be described in terms of real rights, personal rights and intellectual property rights, and are indeed “subjective rights”.

The nature of vested rights and contingent interests can be collectively referred to as “vested rights”, with the clear understanding that a vested right requires that “a determinable person must be unconditionally entitled to an asset.”\(^{316}\)

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314 Potgieter v Potgieter. See also Coetzee 2007(5) De Rebus 1-9.
315 Strydom 143. See his references to Olivier et al Trustreg en Praktyk (1989) 93; Van der Merwe & Rowland 344 n 76, as well as Abrie et al Boedels: Beplanning en Bereddering 84 n 10 for support of the idea that the beneficiary’s as well as the trustees’ rights must be understood on the basis of the subjective rights doctrine. Olivier (1989) 93 is of the opinion that, in light of the subjective rights doctrine, it became unnecessary to refer to the rights of the beneficiary, and, therefore, differs from the court in using the term “beneficial interest” of the beneficiary in CIR v Merensky Estate 1959 2 SA 600 (A).
316 Cowen “Vested and Contingent Rights” 1949 (66) South African Law Journal 404 stated that “vested” and “contingent” rights “bear different meanings according to their context in both popular and legal parlance.”
Chapter Two: History and Development of the Trust

The challenge with the subjective rights doctrine, however, is that a specific legal object cannot have more than one legal subject. The question is, therefore, whether both the trustee and the beneficiary can be legal subjects of the same legal object at the same time.\textsuperscript{317} It does not seem to be the position and for the purposes of this study it will be accepted that the rights of a beneficiary are subjective in nature. The trustee and the beneficiary shall not be the legal subjects of the same legal object at the same time. The crucial question would, therefore, always be whether vesting of the object in the beneficiary has taken place or not.

It is clear from Strydom’s analysis that estate duty and income tax law only become applicable when the beneficiary has a vested right, of which the value is determinable. In regard to insolvency law, a contingent interest, over and above a vested right, is also included for sequestration purposes.

Honoré’s\textsuperscript{318} discusses three meanings of a vested right in the trust context, namely:

(a) ownership;

(b) an unconditional right; and

(c) the right to receive by way of distribution.

Ownership of a right refers to the most complete real right someone can have in relation to a legal object and vesting does not necessarily refer to ownership. The

\textsuperscript{317} Corbett \textit{et al} 427 make the following statement: “The fact that under the trust the trustee acquires bare \textit{dominium} of the corpus of the trust and is regarded as being in the position of a fiduciary does not debar an immediate vesting of the corpus, ie a \textit{morte testatoris}, in the capital beneficiary. Since the trustee enjoys no beneficial interest in the corpus and consequently, in contrast to the position under a conditional \textit{fideicommissum}, no condition of survivorship arises by reason of the vesting of dominium in him (the trustee) as fiduciary.” Strydom 145 explains that Corbett associates the trust here with the \textit{fideicommissum purum} and last mentioned concept does not form part of our law. See \textit{Estate Kemp v McDonald’s Trustee} 1915 AD 491 and \textit{Braun v Blann and Botha} 1984 2 SA 850 (A) in this regard.

\textsuperscript{318} 555-557. He qualifies all three situations as follows: in the case of ownership it does not necessarily include enjoyment; in the unconditionality requirement ownership is not necessary as it may be a personal right only; the right to capital distribution may be postponed although it has vested already. The case of \textit{Jewish Colonial Trust Ltd v Estate Nathan} 1940 AD 163 became the authority for many writers on the topics of contingent rights and vested rights, especially in the law of succession. Strydom “Aansprake van trustbegunstigde” 158 refers to \textit{Austin on Jurisprudence} 886, where it is stated that a vested right must comply with two requirements: (a) a determinate person presently existing, in whom the right is vested; and, (b) the title, mode or acquisition, or investive fact, must be presently consummate or complete.
vesting of an interest in an object may not coincide with the right of enjoyment of that object.319

Van der Merwe320 submits that a resolutive conditional right, opposed to a suspensive conditional right, although still subject to a condition, is already a vested right, as it is subject only to the “continued existence of the right.” Although the condition has not been fulfilled, the title to the right is complete. Honoré’s,321 with reference to Goliath v Estate Goliath,322 draws a distinction between a vested and contingent (conditional) right by stating that a right can be acquired by the beneficiary, while the enjoyment of it has been postponed. Such a right will be transmissible to the successors of the beneficiary on death or insolvency.

The third instance, namely where the right vests only with distribution or when the trustees take the decision to distribute, is the most common understanding of the term “vesting” in the discretionary trust. The most important discretion of the trustee in a discretionary trust is the power to decide when and to whom vesting (in the sense of distribution) shall take place.

It is clear that the specific wording of the trust instrument, as well as the actions by the parties, will determine whether the beneficiary has a vested interest or merely a contingent interest in the assets of the trust.323 Where the estate owner, therefore, tries to over-regulate the role of the trustee, he may create a vested right with extremely adverse protection results. If the trustee has a discretion only as to the mode of trust income application, the beneficiary has vested a right to the income, but if the trustee has a further discretion as to whether income or capital must be distributed, the beneficiary has only a contingent right.

A contingent right, however, “is a mere expectation (spes)”.324 The cession of a contingent right will be relevant only for insolvency purposes if such action adversely

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320 Van der Merwe “Vested Rights” 323.

321 556.

322 1937 CPD 312 317.

323 Compare Ras NO v Van der Meulen 2011 4 SA 17 (SCA).

324 See Honoré 557-558. In some Fairburn Capital trust deeds (with Guernsey as jurisdiction) references are made to vested, contingent and expectant rights. It is not clear what the
affected the insolvent estate. More often than not such a cession would not have had that effect.

Many commonly referred to “vesting business trusts” that are disguised as discretionary trusts, may leave the beneficiary without any protection against his creditors and result in forming part of his estate at death or at insolvency. Van der Merwe, with reference to case law, submits that the term “accrual” in income tax has become equated with “vesting”, and that a person is entitled to a right the moment it is vested in him.325

As vesting is the cornerstone of the taxation of trust beneficiaries, and taxation is often a vital issue in the utilisation of a trust as business vehicle, it remains a pertinent question.326 Van der Merwe327 offers the following explanation of a vested right:

(a) it indicates that its beneficiary is the holder of a complete real or personal right;

(b) a complete right is one that has all the parts necessary to allow for its full operation and for all consequences flowing from it;

(c) a right will not be complete when it is subject to a suspensive condition;

(d) ownership of the benefit and the transmissibility and immediate enjoyment of the right are not requirements for its vesting.

2.13.3 THE TRUSTEE

In terms of section 6(1) of the TPCA, “(a)ny person whose appointment as trustee in terms of a trust instrument, section 7 or a court order comes into force after the

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325 Van der Merwe “Vested Rights” 325. He further states, with reference to Lategan v Commissioner for Inland Revenue 1926 CPD 203 209, that the words “entitled”, “acquired”, “vested”, and “accrued” are “seemingly” used as synonyms. See also CIR v People’s Stores (Walvis Bay) (Pty) Ltd 1990 2 SA 353 (A). Some authors differ from this interpretation and Van der Merwe submits that it may be because they do not differentiate between vesting in the law of contract and vesting in the law of succession.


327 “Vested Rights” 329.
commencement of this Act, shall act in that capacity only if authorised thereto in writing by the Master”. 328

Although the section refers to the “appointment” in terms of which the trustees are “authorised”, the section really deals with the authorisation of trustees and not their appointment. Trustees are appointed in terms of the trust deed or a will, but authorised to act in terms of the TPCA. 329

This issue of authorisation has been the subject of debate in a number of cases, but it seems clear that all acts committed by a trustee before the letters of authority were issued by the Master of the High Court, would be void and cannot be ratified or validated at a later stage. 330 Simplex (Pty) Ltd v Van der Merwe made it clear that non-compliance with section 6(1) invalidates all acts concluded by the unauthorised trustee and that this section is not only for the benefit of the beneficiaries, but in public interest to protect outsiders. 331 This judgment was not followed in Kropman, where the purpose of section 6(1) was accepted as being solely to protect the beneficiaries. 332 The Watt decision apparently supported Simplex, but limited the invalidity to acts involving the acquisition of rights and the incurring of liabilities on behalf of the trust. 333


329 In this regard see Watt v Sea Plant Products Bpk 1998 4 All SA 109 (C), and discussion by De Waal “Authorisation of Trustees” 478. Geach & Yeats 60.

330 See Simplex (Pty) Ltd v Van der Merwe 1996 1 SA 111 (W) 112J-114J, and Van der Merwe v Van der Merwe 2000 2 SA 519 (C). Contra Kropman NO v Nysschen 1999 2 SA 567 (T) 576F where it was held that a court had a discretion to validate acts of a trustee that are performed without the requisite authority retrospectively. Compare Watt v Sea Plant 112h-j. This matter was recently raised in Moosa NO v Akoo 2008 1 All SA 585 (N), where the court at [14] confirmed the legal position as decided in the Simplex and Van der Merwe cases and decided that the actions of the individuals who have not been appointed by the Master could not be ratified.


332 576F.

333 112H-114D.
In *Minister of Safety and Security v Lupacchini*, Van der Merwe J states that “(i)t is clear that the Act distinguishes between the appointment of a trustee and his/her authorisation in terms of section 6(1). It is trite that a trustee is appointed in terms of the trust instrument and in exceptional cases by the Master or Court as provided for in the Act.”

The uncertainty that existed after *Watt v Sea Plant Products* and *Kropman v Nysschen* has been given the final death blow in the recent Supreme Court of Appeal judgment, *Lupacchini NO v Minister of Safety and Security*, where Nugent JA stated that “(i)f we were to find that acts performed in conflict with the section are valid it seems to me that we would be giving legal sanction to the very situation that the legislature wished to prevent.”

For many years the Master did not even issue letters of authority to testamentary trustees and they in practice received both their appointment and authorisation from the will of the deceased. In recent years, however, it became custom to issue letters. In the case of trusts in the wide sense that are not registered with the Master and not controlled by the TPCA, both the appointment and authorisation take place as a result of the deed.

The existence of a trust is not dependent upon the presence of one or more trustees. In the absence of any trustees, or when the prescribed minimum number of trustees is not in office, the Master is required in terms of section 7 to appoint (and authorise) the necessary trustees. Trustees that are authorised in terms of the TPCA must comply with the provisions of the said legislation. They must further administer the assets in accordance with the terms and conditions of the trust deed.

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334 ZAFSH 82 case no A217/2008 decided on 03-09-2009.


336 The issue of an insurable interest by Trustees over trust property is closely linked to the obligation to care for the trust assets. The trustees’ ownership is referred to as “bare ownership” (legal or fiduciary) as opposed to “beneficial ownership” by Van Niekerk “The insurable interest of a Trustee in Trust Property” 2007(1) *Juta’s Business Law* 31. See the discussion on *Barnard v Malan Meyer Steenkamp CC* case no 4342/2003, decided on 20-05-2005 TPD.
Trustees acting in terms of a trust deed lodged with the Registrar of Collective Investment Schemes are appointed by the manager of the Scheme as trustee only after it was registered as a trustee by the Registrar. These trustees, which include the trustees on unit trusts and some pension scheme trusts, but exclude special-purpose vehicles, etcetera, have to comply, over and above the specific legislation applicable to it, with the terms of its founding deed as well as general common-law principles relating to fiduciaries. In these trusts a management company usually fulfils the management role and not the trustee. The function of the trustee in a unit trust or other collective investment scheme arrangement is to hold title to the property for the investors (beneficiaries) and to safeguard their interests against mismanagement.

2.13.4 THE MASTER OF THE HIGH COURT

The powers and duties of the Master of the High Court are prescribed by the TPCA. The Master authorises the trustee, may require security from the trustee, may call him to account, may institute an investigation into his administration and disposal of trust property, may appoint additional trustees and may remove a trustee from office under certain circumstances.

The Master can consequently be regarded as the protector of the beneficiary against an unscrupulous trustee.

The Master is not a party to the trust but does play an integral part in that the trust is registered by the Master and the trustees authorised. Although a trust that is regulated by the TPCA becomes a valid trust when the agreement is signed by the parties, the trust is ineffective and only a trust in name as the trustees have no legal power to act until duly authorised by the Master. The first duty of the trustee, before he may take control of the trust property, is to lodge the trust instrument with the Master, as well as all subsequent amendments thereof.

337 CISCA, s 68(1) and (2) read with 69(3). Not all security instruments (“securities”) as defined in s 1 of the Securities Services Act 36 of 2004 (SSA) packaged in the form of trusts are registered with the Registrar of Collective Investment Schemes. Many do not qualify as collective investment schemes and should, therefore, be registered with the Master of the High Court.

2.13.5 THE REGISTRAR OF COLLECTIVE INVESTMENT SCHEMES

The executive officer of the Financial Services Board is also the registrar of collective investment schemes.  

In terms of the CISCA a collective investment scheme, as well as any association of collective investment schemes, any manager of a collective investment scheme, and any trustee or custodian for a collective investment scheme must be registered with and authorised by the registrar.

The registrar has extensive powers in terms of Part II of the Act regarding the investigation of parties registered with or authorised by him, which may lead to the cancellation or suspension of registration, the imposition of fines or audits, and the declaration of certain practices as irregular or undesirable.

Where a pension fund is in the form of a trust, it must be registered with the Registrar of Pension Funds, as regulated by the Pension Funds Act.

2.14 CONCLUSION

In this Chapter the historical context of the South African trust concept has been discussed, as well as some of the most intricate aspects, such as its nature, the separation of enjoyment and control, veil-piercing and the fiduciary relationship. Many of these may prove to be of value when the application of the trust as business entity is evaluated.

It is submitted that the trust has developed in South Africa from an obscure and uncertain start, to a strong, albeit sometimes unvalued, legal entity. South Africa has developed a proud heritage of trust law and this will become even more apparent in the next Chapter when the current practical application of the trust will be investigated in some detail.

Although the trust is still not recognised as a juristic person for all purposes, it is submitted that the proverbial dam wall, still upheld by the purists, is close to collapsing. As with all legal entities, both advantages and disadvantages are present. The trust as legal entity will in this context be compared with some other

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339 CISCA, s 1 and 7, read with Financial Services Board Act 97 of 1990, s 1 and 13.
legal entities, such as the company and the close corporation. It may be only the legislature that can elevate the South African trust to that of legal persona and so allow it to fulfil its full potential as business vehicle.

In the next Chapter the practical application of the discretionary inter vivos trust will be evaluated.
3.1 INTRODUCTION

In the previous Chapter the history and development of the trust, as well as some of its most important characteristics, have been discussed. This Chapter will give a broad overview of the different applications of the trust concept and will contextualize it in the broader legal environment.

The application of the trust stretches from personal to employment to commerce — and beyond. Traditionally the standard contract regulates much of the social-legal and extra-legal inter-relationships in most countries and within that context the trust phenomenon often fulfill a major role in some jurisdictions.\(^1\)

The advantages and disadvantages of using the discretionary trust, compared to some other juristic figures, such as fiduciary and limited rights structures, as well as business vehicles, like the company and close corporation, will be evaluated. Specific manifestations of the trust will be referred to and lastly the application of the offshore trust be will be touched on briefly.

3.2 THE ADVANTAGES OF THE DISCRETIONARY TRUST\(^2\)

3.2.1 LIMITED LIABILITY

The discretionary trust may be dormant for any length of time or used for activities of a business nature without the necessity to show actively transactions as required for a company or close corporation.

The risks that a business can fail or face some major liability or experience an unforeseen calamity, are some of the important aspects for business people to consider. The legal vehicle in which the business operates -- whether a company,

\(^1\) Watt 52 who further indicates that this application is often extended to the relationship between state and citizen.

\(^2\) See in general Geach & Yeats Chapter 13, and Honiball & Olivier 309-325.
close corporation, trust or partnership -- must be suitable for the type of risks the business may encounter.

The general rule is that neither the shareholders nor the directors of a private company are liable for the obligations and liabilities of the entity. Directors of companies may, however, be liable in a variety of instances, such as when they acted in bad faith or acted without the necessary authority. Many of these prohibited actions can be linked to a breach of the director’s fiduciary duties. 3

Members of close corporations can also be held liable in cases of abuse of the juristic personality of the corporation, the failure to use the name of the corporation correctly and can be held jointly liable for the debts of the corporation under certain circumstances. The fiduciary duty of the members is spelt out and the professed skill of the member is used as yardstick. 4

Partners are in general jointly and severally liable for the debts of the partnership.

In the case of a trust the liabilities are only payable from the assets of the trust. The trustees are also only liable for trust debts in their capacities as representatives of the trust and then only to the extent of the trust assets. Beneficiaries of discretionary trusts cannot be held liable for trust debts, since the trustee is the owner of the trust assets. 5 The trust concept thus grants the trustees a high level of protection against the claims of the trust’s creditors. It limits the liability of the parties to the trust to a larger extent than that of a partnership and compares well with that of the corporation. The TPCA requires a trustee to perform his duties and exercise his powers with care, diligence and skill. Any provision in the trust instrument exempting a trustee from or indemnifying him against liability for breach of trust, shall be void. 6

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3  S 76 of the Companies Act 71 of 2008 codifies the common-law rules and requires good faith, care, skill and diligence from the director. The breach of fiduciary duties does not necessarily relate to the guilt required to cause liability (dolus or culpa). See Du Plessis v Phelps 1995 4 SA 165 (C).
4  See ss 63, 65 and 42, 43 and 50 of the Close Corporations Act 69 of 1984 in this regard.
5  Havenga et al 339. See also Theron “Die Besigheidstrust” 274.
6  Subs 9(2) of the TPCA.
In English law trustees can validly restrict their liability for loss or damage due to negligence, as long as it was not caused by their own fraud or dishonesty. The wide exoneration clauses currently permitted under English law may, however, be under threat after some recent minority judgments and the question whether such clauses are repugnant to public policy.

3.2.2 STATUTORY REQUIREMENTS

The largely common-law development of the trust concept in South Africa created an instrument with the minimum of statutory requirements to adhere to. This is a major advantage for an entrepreneur whose focus is on the business and not the governance aspects of the business vehicle. The registration of the trust is simple, but not inexpensive, compared to close corporations and companies. The annual management can be less expensive than other corporate forms, as no annual returns or minimum accounting or auditing requirements have to be adhered to.

Many trustees will fulfil their position without any compensation and the minimum requirements for the post of trustee are prescribed. There is no statutory limitation on financial support to beneficiaries or third parties to purchase a beneficial interest in a trust. There are no statutory prescriptions regarding the application of trust capital. The trustees have a discretionary power to distribute the income and gains of the trust and do not have to comply with prescriptive legislation in this regard.

Trust instruments are amended in terms of the deed itself, but the TPCA does require the amendments to be lodged with the Master. The Master would usually not allow the trustees to amend the trust deed without the permission of the founder, except where the trust instrument clearly determines otherwise. Where any of the

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8 Armitage v Nurse [1997] EWSA Civ 1279 is regarded as the settled law on exoneration clauses in English trust law. This principle was recently challenged in Walbrook Trustee (Jersey) Ltd v Fattal & Ors [2008] EWSA Civ 427 and Spread Trustee Company Ltd v Sarah Ann Hutcheson & Others [2011] UKPC 13.
9 See Theron LLM dissertation 275.
10 In terms of the Companies Act 71 of 2008 has close corporations reached a numerous clausus and no new ones can be registered in future, which may result in the trust as business vehicle becoming an attractive alternative.
11 See s 4 of the TPCA.
beneficiaries has acquired vested rights in any of the trust assets the Master would also require their permission to amend the trust instrument.\textsuperscript{12}

The TPCA is short and clear compared to the Companies Act and to a lesser extent the Close Corporations Act.\textsuperscript{13} The simplicity of the statutory requirements makes the trust a user friendly vehicle for the small to medium business operator. The fact that no new close corporations may be formed since 1 May 2011 may make trusts as business entities more attractive in future.

3.2.3 LEGAL AND NATURAL PERSONS

A major business-related advantage of the discretionary \textit{inter vivos} trust is the capacity it creates to connect natural persons and legal entities to one another. As a trust can be a member of a close corporation as well as a shareholder of a private company, a high number of natural persons, including minors and other individuals with limited legal capacity, can have a financial interest, albeit indirect, in a commercial trust entity.\textsuperscript{14}

Natural persons that are prohibited from acting as directors or trustees, like non-rehabilitated insolvents or those burdened with a criminal record, can utilize the trust concept to protect their business interests and they can take part actively in the business without being appointed to a fiduciary position.

The owner of a business can ensure the perpetuity of the business for the sake of future generations by protecting the shares or members’ interest in a trust. Any insolvency or other unfortunate event will not destroy the value created.

It further creates an opportunity for two or more business persons to partner in a business initiative while they isolate their respective shareholdings without having to place these in their own names.

\textsuperscript{12} See De Waal “Die Wysiging van ‘n Inter Vivos Trust” 1998 \textit{Tydskrif vir die Suid-Afrikaanse Reg} 326; Kernick “Some Thoughts on the Variation of an Inter Vivos Trust Deed” 2008(5) \textit{De Rebus} 44.

\textsuperscript{13} Since the introduction of the Companies Act 71 of 2008 on 1 May 2011, and the amendments to the Close Corporations Act, no new close corporations may be formed. All existing close corporations will, however, continue indefinitely.

\textsuperscript{14} The members of a close corporation are limited to 10 (subs 2(1), which does limit the utility of the trust in conjunction with the close corporation. The members (shareholders) of a private company are limited to 50 (subs 20(1))).
3.2.4 PERPETUAL EXISTENCE

The perpetual existence of the trust makes it the ideal entity for certain estate planning exercises and business transactions. This quality ensures that a family business or a business wherein more than one family is involved can perpetuate without major changes, even after the original planners are retired or deceased.  

The trust is also the ideal alternative for the fideicommissum as there is no limitation as to the duration of the trust, as is the position with the fideicommissum. It can easily replace a usufruct as the death of an income beneficiary has no effect on the continuance of the trust to the benefit of the capital beneficiaries.

Besides the prevention of the direct negative tax consequences of the fideicommissum and the usufruct, the timelessness of the trust has the further benefit that the planner does not have to wait for his death before the exercise commences but can purchase the relevant asset from the start in the name of the trust.

The trust is not dissolved at death of a trustee or a beneficiary – which is the position of the partnership. It is usually not even necessary to transfer the beneficial interest if one of the trustees or beneficiaries is deceased. A new trustee can just be appointed and the dead beneficiary may either be substituted with another or the balance of beneficiaries will continue without any substitution for the deceased.

The perpetuity of the trust is especially of great value when dealing with fixed property as transfer duties, transfer costs and executor fees are prevented as well as other taxes like capital gains tax and estate duties.

3.2.5 TERMINATION

The flexibility in determining the moment of termination of the trust makes it attractive as planning instrument. Most trust deeds stipulate that the trust will be terminated either when the trustees so decide or when all the assets of the trust have been distributed (which is subject to the discretion of the trustee). The perpetuity of the

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16 See Immovable Property (Removal or Modification of Restrictions) Act 94 of 1965, ss 6 and 7.
17 For the negative tax implications in case of a partnership, see Whiteaway’s Estate v Commissioner for Inland Revenue 1938 TPD 482.
trust therefore mostly rests upon the discretion of the trustees. As they operate from a fiduciary position and have a duty to benefit the beneficiaries at all times, the decision to terminate also has to comply with that duty.

Termination of the trust can therefore be timed to take place exactly at the stage when it is in the best interests of the beneficiaries and not a moment earlier or later. Trusts can be sequestrated in terms of the Insolvency Act 24 of 1936, since they fall within the definition of a debtor as defined in section 2. A trust can, however, still not be wound up in terms of the Companies Act 71 of 2008, although it does fall within the definition of a juristic person for the purposes of that Act.\(^\text{18}\)

### 3.2.6 ACCOUNT AND AUDIT

The flexibility and discretion regarding the bookkeeping and accounting of a trust ensures that it can be administered in a cost-effective way. Before 2011 the accounts did not have to be done by a qualified accountant (as was the case with a close corporation) and no annual financial audit was necessary (as in the case of a company). The 2008 Companies Act, however, requires that the financial statements of juristic persons (not trusts) must either be compiled, audited, or independently reviewed annually, depending on their public interest score.\(^\text{19}\)

Most trust deeds granted the trustees the discretion to make use of a qualified accountant or auditor. Many trusts have only one or two major assets, like a holiday home for instance, and no serious accounting exercise is necessary to ensure proper financial management. In these cases a trust was traditionally more cost-effective than a close corporation, but with the same advantages of multiple ownership and perpetuity. The new auditing and independent review requirements equalized the playing field in this respect.

The Master always required a new trust to be formed to nominate an accounting officer, who was usually one of the trustees. The accounting officer does not need specific minimum qualifications and may either fulfil the bookkeeping role himself or may outsource it. The trustees may also appoint an outside person as accounting

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\(^{18}\) See *Melville v Busane* 2012 1 SA 233 (ECP).

\(^{19}\) Reg. 26(2) sets out the method of calculating the public interest score, which factors include number of employees, third-party liability, turnover, and extent of parties with beneficial interest in the entity. See also s 30(2).
officer, especially if the trust is used as a vehicle of trade. In future the business trust will be required to appoint an accountant who is qualified to do either a financial audit or an independent review.

3.2.7 TAX PLANNING

When an inter vivos trust is created and operated with care and the appropriate advice, a trust can be administered so as to mitigate taxes such as estate duty, capital gains tax, donations tax, transfer duty and even income tax. The assets owned by the trust will not be subject to estate duty, capital gains tax and executor’s fees on the death of the founder.20

The income of a trust and any capital gains made are taxed in the hands of the trustees at higher rates than those for individuals. However, when the income or gains are distributed, they are taxed in the hands of the beneficiaries at their individual tax rates. One of the advantages of this is that the income or gain can be split amongst a number of beneficiaries who will each be assessed at his personal tax rate – each making use of his rebate.21

Trusts should never be regarded as tax-planning instruments in the first place as the tax dispensation is too fluid and uncertain, although the tax consequences should always be considered on an ongoing basis.22

A donation of property that is disposed of under and in pursuance of a trust (section 56(1) (l)) is not subject to donations tax. This exclusion is only applicable where the trustees dispose of property in terms of the trust deed. If property is disposed of gratuitously to someone who is not a beneficiary of that trust, such disposition would

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20 The correct implementation of a trust in estate planning may lead to a very favourable application of the s 4(q) deduction provided by the Estate Duty Act. See Abraham Krok Trust v SARS [2010] ZASCA 153 case no 58/2010 for a recent decision in this regard. Compare also SARS Practice Note No 35 para 5, where it is stated that “in the case of a discretionary trust no vesting is regarded as having taken place where the surviving spouse’s right to income from the trust can be defeated or diminished by the exercise of the trustees’ discretion”. Compare Commissioner of SARS v Klosser’s Estate 63 SATC 93. See also Meyerowitz et al (eds.) “Secondary Tax on Companies – Loan to Discretionary Trust – Whether Deemed Dividend” 2007(12) The Taxpayer 227.


22 See Le Grange “CGT and Loan Accounts” 2003(2) Insurance and Tax 16.
not be “under and in pursuance of the trust” and would be taxable. An objective test must be used to determine whether the person the disposal was made to, is a beneficiary of the trust or not. 23

3.2.8 REDUCTION OF PERSONAL ESTATE

The *inter vivos* trust creates an annual donation opportunity as section 56(2)(b) of the Income Tax Act provides an exemption from donations tax for

> “so much of the sum of the values of all property disposed of under donations by a donor who is a natural person as does not during any year of assessment exceed R100 000”.

Donation is defined in section 55 as “any gratuitous disposal of property including any gratuitous waiver or renunciation of a right.” Any financial year in which the individual taxpayer does not make use of this opportunity to reduce his personal estate, will be lost forever as the exempted amount cannot be carried over to the next financial year.24

The main motivations for reducing an individual personal estate would be the protection it grants against creditors and the minimizing of estate duty, capital gains tax and executor fees at death. The impact at death is very important to most estate planners as it often puts a serious cash flow burden on the deceased estate. When an estate planner annually donates the exempted amount or less to a trust of which he is a beneficiary, he effectively reduces his personal estate and consequently the cost implications at death.25

When a couple are beneficiaries of a trust, both of them may decide to donate the maximum annual exempted amount to the said trust, which will reduce effectively their combined estates by R200 000. As all inter-spousal donations of cash are exempted, one spouse may donate an amount to the other spouse, who in turn donates it to the trust. Such donations between spouses may not take place on condition that the donee must donate it again to the trust, as that may be interpreted

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24 See Ger B “Time for Estate Duty to Go?” 2012(5) *De Rebus* 59-60 for the double taxation problem caused by estate duty and donations tax.
as an aggregate donation of R200 000 from the first spouse, which will cause donations tax on the R100 000 from the second spouse.  

3.2.9 ASSET PROTECTION

An *inter vivos* trust which is set up and administered properly can assist a family to protect assets from potential creditors and their own unwise business decisions.  

The manner in which assets are transferred is important to ensure that transfers of property are not made in such a way as to prejudice creditors. Loan accounts will remain assets in the estate of the founder or other donor. As the value of the asset increases and the value of the loan account decreases over time, however, the benefit of the asset-protection initiative also increases.

These assets are also excluded from the deceased estate of the donor and ultimately protected from the creditors of the beneficiaries of the donor. If shares in a business are held in trust instead of by the individual, the death of the individual has no consequence for the business and the value of the shares is not an asset in the deceased estate. The continual transfer of assets from spouse to spouse and generation to generation gradually erodes the value of the estates and ultimately impoverishes the family.

In some instances certain assets must even be sold to enable the executor to pay the necessary taxes and costs – a result that may have been prevented with proper planning and the utilisation of a trust. Where shares in companies or membership in a close corporation is held by a trust, the trustees can continue with all commercial aspects of the business. Where it was held by the deceased in his personal capacity, however, normal commercial decision-making processes are usually suspended by the executor, which can lead to customer shrinkage and a dramatic drop in the value of the business and its assets.

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27 This practice by placing certain assets out of reach of creditors may be associated with the concept of judgment proofing. The aforementioned, however, has developed as a fraudulent practice detrimental to the creditor. See discussion by Schwarcz “Judgment Proofing: A Rejoinder” 1999 *Stanford Law Review* 77-86.
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3.2.10 SELECTION OF TRUSTEES

The fact that the founder of a trust has the advantage of electing the trustees of the trust he creates, is a comforting thought. In many discretionary trusts he may even determine the trustees to succeed him after his death. Some trust deeds provide for the beneficiaries to be involved in the nomination of future trustees. In business trusts the ideal provision is for each beneficiary to be represented by at least one trustee of its choice. In *Stander v Schwulst* the beneficiaries sought for the removal of the trustees and made a number of allegations about the alleged mismanagement by the trustees – some actions directly in conflict to the trust deed.  

3.2.11 CAPPING GROWTH OF ESTATE

The worldwide assets of South African residents are subject to a 20% estate duty charge on death as well as CGT of 10% on asset value increase since 2001. When appreciating assets are placed in a trust when first acquired, by way of a loan, the value is capped in the hands of the lender, which can be decreased at a rate of R100 000 per annum by way of donations by the lender to the trust.  

It is imperative in transactions where assets are sold to a trust against a loan account with the purpose of establishing the future growth in value in the trust and not in the personal estate, that the assets will be transferred at the proper market-related value of the assets. In *ITC 1745* the court decided that the shareholders who transferred their shares to a trust, had to pay donations tax on the difference between the value of the company and the lower value at which they affected the transfer. This will apply equally to capital gains where such a change of ownership takes place.  

3.2.12 FLEXIBILITY

A discretionary trust is very flexible and can often be administered so as to take into account changes over time in family and financial circumstances. Even legislative

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28 *Stander v Schwulst* 2008 1 SA 81 (C). See discussion by Du Toit “Choose your Trustee with Care” 2007(2) *Juta's Business Law* 91-93 for discussion on what can be the expected from trustees.

29 Duncan “A post-amnesty potpourri” 2005(9) *De Rebus* 45-46.

30 65 South African Tax Court 181.

31 Strauss “Donations Tax – Estate Planning Gone Awry” 2003(9) *De Rebus* 44.
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changes, like the tax dispensation, can often be accommodated. The flexibility factor positions the trustees to manage the assets in the best interest of the beneficiaries at the particular time. It enables the trustees to utilise the trust effectively through uncertain times, such as divorce, insolvency, increase in family size or fortune, and even drastic amendments to tax legislation.

Trustees can protect future generations of beneficiaries who may not be in the position to take wise decisions or to protect the assets accumulated by previous generations.

3.2.13 NUMBER OF BENEFICIARIES

Until 1 May 2011 the partnership was limited to 20 persons. In terms of section 2(1) of the Close Corporations Act 69 of 1984 a close corporation may not have more than 10 members. This limitation frustrates parties who want to hold shares in close corporations by way of trust. In practice the Registrar of Companies interprets the membership requirement as if every beneficiary of a trust qualifies as a member and if the trust has another trust as beneficiary, the beneficiaries of the second trust are also included to determine the number of members.

The 10-person requirement therefore compels business people to utilise either a company or a trust instead of a close corporation when need be to accommodate more than 10 potential parties with an interest in the venture. The private company is limited to 50 shareholders, while there is no limitation as to the number of beneficiaries or trustees a trust may have.

In private property development and other syndication initiatives parties will often make use of the trust because of the unlimited number of investors that may become involved.32

3.2.14 SEPARATION OF ENJOYMENT AND CONTROL

A proper separation between the beneficial enjoyment of a trust and the control thereof are necessary to ensure that the trust does not become the alter ego or

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32 Many of these ventures may fall foul of the CISCA if they are not formed in terms of that Act. See also 4.3.10 for the effect of the public property syndication scheme regulations.
extension of the founder. Especially where the founder is both a trustee with special powers and a beneficiary of the trust, the trust may lack the necessary element of separation.

This factor also makes it possible for natural persons that would otherwise be prohibited from taking part in the normal commercial environment (e.g. an insolvent) to be involved and to protect their position, while the rest of the business world is also protected against their potential future indiscretions.

The requirement of separation is a positive aspect of the trust as it guarantees the separation of trust assets from those of the individual and the resultant protections that brings.

3.2.15 PRIVACY

The fact that it is often very hard to identify the individuals involved in a business or property belonging to a trust, is a frustration for many, but not for those who treasure the anonymity. Many business people want, for a number of reasons, their identity to be confidential. Many business deals are of a sensitive nature and may include information and ideas that need protection against unscrupulous individuals or companies.

The Master will only reveal the identity of trustees and the contents of a trust deed (including the identity of the beneficiaries) if he is satisfied that the enquirer has a protectable interest in the trust.

3.2.16 ESTATE PLANNING

Discretionary inter vivos trusts provide for the creation of flexible succession arrangements. Assets owned by the trust will not be subject to cumbersome, lengthy and costly legal procedures after death, as is the case with the administration of assets in the personal estates of the respective parties to the trust. The assets locked-up in the trust will also not attract executor fees, which, at a maximum of 3.5% (plus value-added tax, where applicable) may be substantial in cases of wealthy clients.

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33 See 2.7 for a more detailed discussion on this aspect.
34 Honoré 17. The decision and obiter remarks in Land and Agricultural Bank of SA v Parker 2005 2 SA 77 (SCA) became a water-shed case in this regard. See also 2.7 of this thesis.
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Trust assets are accessible at all times, whilst assets in the personal estates of the parties are frozen during the estate administration process. Even a simple trust bank account, to which both the husband and wife, as trustees, have access, can alleviate a lot of hardship to be endured by the survivor if his partner suddenly passes away and joint accounts are frozen by financial institutions.

The trust is an ideal general estate planning tool, and issues such as perpetual existence, tax planning, flexibility, reduction of personal estate, and asset protection are all relevant aspects during the estate-planning process.35

3.2.17 FAMILY ASSET MANAGEMENT

A discretionary inter vivos trust can provide a centralised asset management structure and controlled distributions for beneficiaries who are not in a position to manage assets responsibly themselves. This may be due to minority, disability, prodigality or insolvency.

A trust can provide for joint-ownership of indivisible assets like holiday homes, businesses and farms. Where an estate owner is subsequently mentally incapacitated through sickness or disability, a trust prevents the need for the appointment of a curator bonis to manage the founder’s affairs.

Certain farming and other business activities with more than one family member being involved can often best be served in a trust format. Surviving spouses can be protected as far as income benefits are concerned while the children can continue actively with the business or farm operation.

Trusts often operate as “one owner, many users” entities. While management and accounting is centralized, saving on costs, the beneficiaries can all enjoy the benefits of “ownership” on an equitable basis, without being taxed with the duties related thereto.

3.2.18 LETTERS OF WISHES

Letters of wishes are usually associated with testamentary trusts as non-binding indications by the founder of the manner in which he wishes the trustees to exercise

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35 See Geach & Yeats 216. See further Mhlonge “Is there Life in the Inter Vivos Trust as Estate Planning Tool after the advent of CGT?” 2001(4) Insurance & Tax 3-9.
their discretion. It is, however, also used by founders in relation to discretionary *inter vivos* business trusts. These wishes should not be binding on trustees and should not interfere or limit their unfettered discretion. Testamentary disposition clauses should be regarded and worded like letter-of-wishes provisions, and should never allow interference with the discretionary powers of the trustees. Letters of wishes were thus never regulated documents as they merely expressed the wish of an individual without any legal effect. That has changed when the Revenue Service extended the term “beneficiary” for the purposes of connected persons to any person named in a will, trust deed or letter of wishes, upon whom the trustees have the power to confer benefits from the trust.36

It is submitted that the inclusion of a person named in a letter of wishes is an extension of the concept of beneficiary beyond the powers of the Minister. Where the letter of wishes, however, limits the discretionary powers of the trustees and becomes enforceable, it may be the correct view.37

### 3.3 THE DISADVANTAGES OF DISCRETIONARY TRUSTS

#### 3.3.1 NO LEGAL PERSONALITY

Although the trust is still not accepted as a legal person in South African law,38 it often is treated as a person for certain purposes,39 or is dealt with as if it does have a legal personality.40 Section 1 of the Companies Act 71 of 2008 includes the trust in the definition of a “juristic person”.41

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36 See SARS Practice Note No 7 of 06-08-1999. Compare s 1 of the Income Tax Act 58 of 1962 for the definition of “connected person”.

37 See 3.2.18.

38 Except where a specific trust receives legal personality by way of statute, like the Kakamas Trust Act 107 of 1976.


40 See discussion on this aspect in Matthews *Verwydering van die Rookskerm en die Turquand-reel in die Suid-Afrikaanse Trustreg* LLM dissertation North-West University (2007) 7-11. See also *Magnum Financial Holdings v Summerly NO* 1984 1 SA 160 (W), where the trust was acknowledged as a “debtor”.

41 Compare 2.10, where this aspect is discussed in more detail.
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The lack of legal personality for all purposes may be a deterrent for business people in using the trust or in dealing with business ventures structured in trust form, because of the perception of risk that it brings with it.

Although it has been argued convincingly that the granting of full legal personality to trusts may be the next step in the natural evolution of the concept, the current legal position does not allow for that. The lack of juristic personality makes the trust less attractive and business people tentative to it. One of the direct results is the exclusion of a safe-net like the application of the *Turquand* rule. It is submitted that the conferment of legal personality on the trust would make it more attractive as a business vehicle.42

3.3.2 REGULATION

The limited regulation by the TPCA and the lack of administrative control by the Master of the High Court have been criticised widely. Issues such as accessibility by creditors to trust documents, surety for costs,43 lack of disclosure, lack of personal liability of trustees and the freedom regarding the application of trust assets, are all issues under scrutiny.44

3.3.3 UNCERTAINTY

There are a number of issues about trusts that have not been adequately addressed by either legislation or the courts. Business people want certainty about the entity they operate from as well as the entity they are dealing with.

One example of such uncertainty is whether the *Turquand* rule is applicable to the trust or not.45 Another was the applicability of section 30 of the Companies Act 61 of

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42 See Delport P “Companies Act 71 of 2008 and the *Turquand* Rule” 2011 *Tydskrif vir Hedendaagse Romeinse Hollandse Reg* 132-138. He refers to the three company law doctrines, namely the doctrine of disclosure, the doctrine of constructive notice and the *Turquand* rule.
43 See *Crest Enterprises (Pty) Ltd v Barnett and Schlosberg NNO* 1986 4 SA 19 (C).
45 See *Man Truck & Bus SA Ltd v Victor* 2001 2 SA 562 (NC) 569, as well as *Vrystaat Mielies (Edms) Bpk v Nieuwoudt en ‘n Ander NNO* 2003 2 SA 262 (O) 268, and *Land & Agricultural Bank of SA v Parker* 2005 2 SA 77 (SCA) 85B-D, 86B, 90G. Contra *Parker NO v Land and Agricultural Bank* 2003 1 All SA 258 (T). Both Claassen “Aanwending van die Turquand-reël in die Trustreg” 2004(1) *De Rebus* 24-26, and Geach & Yeats 138 support the extention of the rule to trusts.
1973, which was repealed on 1 May 2011. A third is the question whether trustees could be held jointly and severally liable for the wrongful actions of their co-trustees.

### 3.3.4 LACK OF CONTROL OVER CO-TRUSTEES

The exact position of a trustee in relation to his co-trustees’ actions is not clear, but Geach and Yeats are of the opinion that trustees could be jointly and severally liable for one another’s wrongful acts. Even if that is not the correct position, trustees have to accept that they must fulfil a watchdog role at all times. Trustees may report wrongful actions of co-trustees to the Master who in turn may give the trustee certain instructions and may even remove the said trustee.

In the recent matter of *Steyn v Blockpave* Rampai J was confronted with the question whether the trust was properly before the court. As a trust functions through its trustees, it is required that all trustees act “together for and on behalf of the trust.” The court decides that even if the two trustees did take a decision at a trustee meeting, the third trustee had to be consulted. Although a trustee’s physical presence is not necessarily required at all meetings, “her participation and input in the making of all the decisions was essential. The trust required the full and complete participation of all its trustees in order to function legally.” The court decided that the two trustees who launched the proceedings without the proper participation of the third trustee had to carry the costs out of their own personal pockets.

The term “special resolution” in section 1 of the Companies Act 71 of 2008 in relation to trusts, is described as a decision by the owner or owners of the trust, or by another authorised person, “that requires the highest level of support in order to be adopted, in terms of the relevant law under which that juristic person was incorporated”. It seems as if special resolutions may be taken either by beneficiaries, in the case of

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46 Theron “Artikel 30 van die Maatskappywet” 673. In light of subs 8(3) of Companies Act 71 of 2008 this became a theoretical question only.
47 In general see Havenga et al 339.
48 Geach & Yeats 212. See their reference to Gross v Pentz 1996 4 SA 617 (T).
49 Subs 20(2)(e). The Master may also approach the court to remove the trustee in terms of subs 20(1).
50 *Steyn and Others NNO v Blockpave (Pty) Ltd* 2011 3 SA 528 (FB) para [8].
51 Para [18].
52 Para [41].
Chapter Three: Application of the Trust

the bewind trust, or by trustees in the case of both the bewind and the discretionary trusts. No reference is made to the majority of trustees or a unilateral decision by all the trustees. It is submitted that this special resolution concept does not add anything to the law regarding trusts.

3.3.5 LOSS OF EFFECTIVE CONTROL

It is imperative for the founder of an *inter vivos* trust to lose legal ownership (not necessarily beneficial advantages) and control of assets transferred to a trust. The trustees own, administer and control the trust assets. The founder’s security is locked up in the fiduciary duty of the trustees and their duty to adhere to and apply the terms of the trust deed. This includes the duty to distribute income and capital according to the prescribed terms of the deed and at all times to act in the best interests of the beneficiaries.

3.3.6 HIGHER TAX RATES

Retained income as well as capital gains by trusts are taxed at higher rates than those applicable to individuals. Capital gains are taxed at an effective rate of 20%, without any abatements, and all retained income is taxed at 40%. The accurate application of the anti-avoidance provisions and income-splitting opportunities can actually facilitate overall tax savings rather than additional taxes.

Trusts were also paying 10% on transfer duty until this was changed as from 23 February 2011 when trusts and companies were levelled with individuals on a sliding scale with the first R600 000 exempted from transfer duties.

One of the requirements for qualification as a Small Business Corporation (SBC) is that the shareholders of the company must be natural persons, which disqualifies trusts. 53 This requirement is often an inhibiting factor for business owners when they are considering protecting their company shares in a family or business trust.

Sole proprietors are currently not required by the South African Revenue Services to declare value-added tax at invoice stage, but only when payment is received. This is

53 The other major requirements are as follows: the annual gross income, excluding capital gains, must be less than R14m; the shareholders must not hold shares in any other private company or membership in any other close corporation; and, the investment income, plus income from the rendering of personal services, must not be more than 20% of the total income of the company. See subs 12E(4) of the Income Tax 58 of 1962.
very helpful as far as the cash flow of the business is concerned and a factor that causes business owners to steer away from operating in a corporation and place the shareholding in a trust.

3.3.7 COSTS

Some of the major disadvantages of trusts are the upfront costs, such as the drafting and registration of the trust, the costs of transferring assets to the trust and the costs of proper administration (e.g. accountants and independent trustees).\textsuperscript{54}

3.3.8 LOAN ACCOUNTS

In \textit{ITC 179}\textsuperscript{55} the tax court dealt with the scenario where a creditor bequeaths a loan of the trust to the trust. It was decided that the trust had, in terms of section 12(5) of the Eighth Schedule of the Income Tax Act, a deemed capital gain equal to the amount bequeathed. This resulted in the trust having to pay 20\% capital gains tax on the loan account due by the trust to the testatrix.

It is submitted, however, that the effect of this ruling can be prevented by determining in the will that all debts due shall be discharged for full consideration and thereafter the residue of the estate will be bequeathed to the trust.\textsuperscript{56} This will have the same effect if the trust has the necessary liquidity, which would often have to be secured by way of life insurance on the life of the testator.

Alternatively the testator may bequeath an amount equal to the outstanding loan account to the trust without referring in the will to the loan. The practical implication of this method is that the will must be amended, or at least a codicil added, every time the loan account changes. In \textit{XXX Trust v The Commissioner of SARS},\textsuperscript{57} Lacock J did decide in favour of the deceased estate where the testatrix left the residue, which included the loan account, to the trust. On the facts, however, it was determined that the creditor (testatrix) never had the intention to discharge a debt for

\textsuperscript{54} Transfer duties have been levelled with that of individuals since 1 March 2011.

\textsuperscript{55} \textit{ABC Trust v Commissioner, SARS 67 SATC 256}. See discussion by Ger "Capital Gains Tax – When death to a creditor brings tax to a debtor" 2005(12) \textit{De Rebus} 43-44.


\textsuperscript{57} Case no IT12399 Tax Court, Kimberley, Northern Cape Division, decided on 01-12-2008.
no consideration. One of the decisive factors, however, was the fact that the trust was at all times financially able to repay the loan had it been demanded.

The normal course of trust business is for the founder or a donor to lend the trust the capital needed to either purchase the assets from the donor or from a third party, with the intention that the growth in value must occur in the trust and not in the donor’s personal estate. These loans are traditionally interest-free and the intention is often that it will not be repaid, but will be bequeathed to the trust at the donor’s death.

In *Commissioner, SARS v Brummeria Renaissance (Pty) Ltd*\(^{58}\) the Supreme Court of Appeal decided that, in the specific circumstances, the interest-free loan account constituted gross income and was therefore taxable. In light of the rather unique facts of the case before the court, it is still uncertain exactly how SARS is going to apply the judgment, as an across the board application may result in unfairness in many instances.\(^ {59}\)

Interest-free loans are not unique to trust structures but are also found in most private business entities where the business person has to find ways of funding his business from personal resources.

A practice has developed whereby individuals make use of the annual exemption from donations tax (section 56(2)(b)) to reduce the loan account he holds against the trust. Paragraph 12(5)(b), read with paragraph 12(5)(a) of the Eighth Schedule of the Income Tax Act, however, causes the waiver of a debt to result in a deemed capital gain for the debtor whose indebtedness has been so reduced.

In the case of a trust, the resulting capital gains tax would be more than donations tax. It is therefore imperative that any donation to a trust which owes the donor money, must take place without requiring from the donee to use the donation to reduce the loan account.\(^ {60}\)

Where a debt owed by a person to a creditor has been reduced or discharged by that creditor, for no consideration, or for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged, except where

\(^{58}\) [2007] SCA 99 (RSA).

\(^{59}\) See also the discussion of Ger “Interest-free Loans and Tax” 2007(12) *De Rebus* 48-49.

\(^{60}\) See Stein “The CGT R30 000 Trap” 23-24.
the reduction or discharge constituted a capital gain, the party’s whole debt has been so reduced or discharged.

3.3.9 RISK OF CHANGING BENEFICIARIES

In a recent decision in the Johannesburg Tax Court, involving the T-Trust, it was ruled that, where all the trustees and beneficiaries of a trust were substituted, a new trust was in effect created. The trust owned a property when the trustees and beneficiaries resigned and new trustees and beneficiaries were appointed. The court decided that transfer duty was payable because a “transaction” as defined in the Transfer Duty Act of 1949 took place, and, because all beneficiaries were replaced the object and purpose of the trust was in reality changed and a new trust therefore effectively created. This case related to a pre-2002 matter, and the Revenue Laws Amendment Act of 2002 specifically provides that transfer duty is payable where the beneficiaries are changed. This case will undoubtedly have an effect on capital gains tax.  

This matter was again pertinent in *Potgieter v Potgieter*, where the court decided that the parties had no authority to amend the trust deed, and to change the beneficiaries of the trust, without the consent of the beneficiaries who already accepted the donation. Their attempt to do so was not breach of contract as they simply “had no power to do what they purported to do”. Their agreement was without any force and effect and thus invalid.  

In the matter of *Hofer v Kevitt NO* no provision was made in the trust deed for the amendment of its terms nor was there any reservation of a unilateral right of revocation for the donor. The trust deed was amended on three occasions on the instructions of the donor – with the approval of the trustees and that of the beneficiaries in the last two institutions. The court decided, in support of *Crookes v Watson*, that it must be determined whether the parties were entitled to amend the deed and whether “the result of such an amendment will be to prejudice the rights of other beneficiaries”.

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63 1997 4 All SA 620 (A) para [12].
64 1956 1 SA 277 (A) 306A-C.
3.3.10 LOSS OF SMALL BUSINESS STATUS

Only close corporations, private companies, co-operatives and societies can qualify as small business corporations and enjoy the significant tax benefits thereof. The entire shareholding or member’s interest must be held by natural persons at all times during the tax year. A trust can therefore neither be a small business corporation nor can it be the shareholder or member of a small business corporation.65

3.4 TRUSTS AND OTHER LEGAL CONCEPTS

Strydom classifies the trust on the basis of the discretion (or not) of the trustee, the source of the trust, the purpose of the trust, and the vesting of rights on the trust property in either the trustee or the beneficiary.66 These different aspects and the way they manifest in trust deeds often determine the different names and categorisation trusts receive from academics, practitioners and the public. One trust can therefore at the same time be described as a discretionary trust, a property trust, a business trust and an inter vivos trust. Each of these only describes one aspect of the same construction.

In this thesis the main focus will be on the purpose of the trust. The purpose of a specific trust will be determined by five factors: the intention the founder had when he instructed the trust being drafted; the contents of the trust instrument; the name of the trust; legislation pertaining to the trust; and the actual application of the trust. The purpose of a specific trust may change during its lifetime, either by way of amendments to the trust instrument, or by way of changes to the practical application of the trust.67

3.4.1 TRUST MORTIS CAUSA

The trust mortis causa is used by the testator who wants to benefit someone, but who either does not want to give the beneficiary the immediate ownership and control of the assets, or wants to give the ownership, but without the control. Where the

65 A trust can be used as a personal service provider, but last-mentioned cannot in any form qualify as a small business corporation.
66 Strydom 1-3.
67 In general see Olivier et al Trustreg en Praktyk (2009) 5-1 a.f; Geach & Yeats a.f; Honoré 91. The purpose must always be differentiated from the object of the trust. The primary object must always be the benefit of the beneficiaries.
ownership does not immediately pass to the beneficiary, the trustee becomes the owner of the asset, but only on behalf of the beneficiary, and the beneficiary is the *cestui que trust*.

The trust *mortis causa* or testamentary trust is established by way of the last will and testament of the founder (testator) and is often drafted without a clear understanding by the testator of what the implications of the trust are.

There is not yet clarity on the exact legal principles applicable to testamentary trusts and this concept is in the process of being developed largely by case law. A testamentary trust must in the first place comply with the requirements for the formation of a valid will. If the last will and testament is not valid, the testamentary trust referred to in the will shall also not be valid.

In light of the common-law principle that trustees may not trade with the assets of a trust, the lack of a clear and specific power in the will to trustees to do so, will make it unlawful for a trustee to do business with trust assets. Many testamentary trusts are created by a single sentence in a will, without stipulating any powers and duties of trustees. In such a case the common-law powers and duties of trustees would be applicable, as well as the stipulations of the Trust Property Control Act.

Many wills create testamentary trusts that are bewind trusts, without that necessarily being the intention or without the testator understanding the consequences thereof. A bewind trust is a trust that is constructed in such a manner that the ownership of the assets of the trust vests in the beneficiaries, and not in the trustees, although the trustees still manage and control the trust. Some of these trusts may operate as business trusts if it either holds business assets or an active trading business is operated by the trustees.

The construction of the wording in the will is therefore crucial. In the case of a bewind trust the asset vests in the estate of the beneficiary and is therefore at risk as far as creditors of the minor (or other beneficiary) are concerned. The asset will become detachable at the very moment majority age is reached. If it is not a bewind

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68 See *Braun v Blann and Botha NNO* 1984 2 SA 850 (A) in this regard.
69 See Wills Act 7 of 1953. Geach & Yeats 18.
trust, the moment of accruing to the beneficiary, and him becoming owner thereof, may be postponed, depending on the wording of the will.71

The application of the testamentary trust as a business trust is possible but not very common and not advisable – for the same reasons why its application as an estate planning vehicle is limited. A business trust should ideally include detailed stipulations regarding the powers and duties of the trustees and a will is for most parts not the ideal instrument to achieve that.

### 3.4.2 INTER VIVOS TRUST

An *inter vivos* or living trust for the purposes of this research will be a reference, except if clearly stated otherwise, to a discretionary trust. The concept of a discretionary trust implies that the assets of the trust vest in the trustees and they have discretion as to how these assets will be distributed amongst the beneficiaries. The beneficiaries cannot claim any interest at all, unless the trustees exercise their discretion in their favour.72

In some jurisdictions a further differentiation is drawn between the so-called “exhaustive” and “non-exhaustive” discretionary trust, where the first-mentioned refers to a more limited discretion, where the trustee is compelled to distribute the total income, but still has discretion as far as the specific division between beneficiaries is concerned.73 The beneficiary therefore only has “a right to be considered as a potential beneficiary, a right to have his interest protected by a court of equity and a right to take and enjoy whatever part of the income the trustees choose to give him”.74

The legal principles applicable to a living trust are mainly to be found in the law of contract.75 In an evaluation of the living trust, also as a business vehicle, contract

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71 See discussion in Olivier et al *Trustreg* (2009) 8-15 in this regard. See also explanation of the so-called “gift-over” stipulation where a beneficiary becomes, for instance, insolvent. See *Badenhorst v Bekker* 1994 2 SA 155 (N) regarding stipulations protecting assets from insolvent estates. See also *Vorster v Steyn* 1981 2 SA 831 (O). For *nudum praeceptum* in wills see *Vorster v Steyn* 1981 3 All SA 177(O) 177-178; 1981 2 SA 831 (O).

72 See Coetzee 232 for a detailed discussion on the rights of the beneficiaries in a discretionary trust.

73 Coetzee 233.

74 Pettit 74.

75 *Crookes NO v Watson* 1956 (1) SA 277 (A).
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law and certain aspects thereof, will often be used. The *inter vivos* discretionary family and business trust respectively will be evaluated, although it is not submitted that it is a numerous clauses.

In estate planning the testator has a number of options available to bestow certain rights on the property that are the subject of succession by more than one person -- either simultaneously or successively. A variety of trusts as well as the *usufruct*, *fideicommissum*, *usus*, *habitatio*, *modus* and substitution will be mentioned, with the emphasis on family, business and testamentary trusts as strong options.

Van der Westhuizen\(^76\) defines estate planning as follows:

\[“(T)he process through which the juridical, financial, economical, social, psychological and other needs of a person (the estate owner) with regard to his estate and in relation to himself, his family and beneficiaries during his lifetime and in contemplation of death is determined and planned, which involves the deciding in advance by the estate owner of what to do with his assets and liabilities, how to do it, when to do it, and who to do it.”\]

During the estate planning process the two major sets of tools used, integrally and interchangeably, are the legal and the financial tools. The estate planning professional needs to assist the estate owner in identifying his needs and wants, to translate those needs and wants practically into a legal and financial framework, and lastly, to apply them into the legal and financial reality of the specific jurisdiction.

3.4.3 DISCRETIONARY FAMILY TRUST

One of the major causes for not planning the future of one’s estate is the lack of knowledge about the legal and financial vehicles available to assist in such a process. It is submitted that the trust is one of the most important legal vehicles available to estate owners in achieving their estate planning goals.

Geach and Yeats\(^77\) state that the family trust “is designed to secure the interests and protect the property of a group of family members.” Traditionally the family trust is founded by a family member on behalf of him or herself, as well as a number of family and future family members. It often forms an integral part of the estate planning of the individual, with the added advantages of protection against future

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\(^77\) 13.
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creditors and marital powers, as well as a vehicle for succession of generations to come.

The living trust plays a crucial role as holders of shares in private companies and memberships in close corporations, as well as share and asset holders in general, especially of business assets and fixed property. The main purposes of trusts in these structures are often asset protection and the successful management of succession and generational planning.

Although there is a standard stipulation in many family trust deeds that the trustees may carry on a business, it does not necessarily change the nature of the trust to a business trust. The trust deed itself will often not indicate its real nature, but the position of the trust in the total estate planning of the founder, combined with the practical execution thereof.

Although not the sole purpose, practice indicates that one of the main purposes and applications of the family trust is its role as part of the estate planning structure. It is not necessarily always the ideal tool, and Lötter submits that any of the following problems relating to an *inter vivos* trust can actually render it ineffective as an estate planning tool, namely: the absence of the essential trust elements; mismanagement; the lack of an independent trustee; the non-compliance by trustees of their duties; or a lack of understanding by the trustees of the legal workings of a trust. 78

It is submitted that incorrect wording which brings about premature vesting of the trust assets, or structuring, such as a “donation” brought in as a loan instead of a permanent transfer of property, can be added to the list of potential problems.

The living trust as an estate planning tool has the potential of keeping assets, and the future growth in value of the assets, away from the personal estate of both the planner and the beneficiaries, and thus away from future creditors. It is an effective way to protect oneself and the generation to come against unwise decisions, without losing the enjoyment and advantages of the asset.

The greatest advantage of the trust as an estate planning tool is locked-up in this attribute of separation between ownership and control.

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The living trust is often the ideal vehicle to replace other estate planning structures such as the **usufruct**, the **fideicommissum**, **usus**, **habitatio**, **modus** and the testamentary trust.

There are, however, also challenges in the application of the trust as an estate planning vehicle. De Waal exposes the practical application of the transfer of trust property when a trustee dies, as the aforementioned is theoretically the owner of the asset. In practice the asset is, however, not treated as if it had been owned by the trustee.\(^{79}\)

### 3.4.4 THE USUFRUCT

The **usufruct** became a popular mechanism for transferring assets, especially fixed property, to a heir, but at the same time creating a right on the use or fruit of the said property in favour of another person, the usufructuary, who can be regarded as a legate and not an heir.\(^{80}\)

There is a distinction between a **fiduciary** interest, which represents a vested right in the corpus of the **fideicommissary** property, and a **usufructuary** interest.\(^{81}\) As the usufructuary is entitled to both the use and enjoyment of the property, as well as the fruits thereof, he may even let the asset to a third party.\(^{82}\)

A variety of practical and tax-related problems, relating to the usufruct, have, however, developed over a period of time. A favourite application is where the testator determines in his will that his farm will be inherited by his son, who will continue with the farming operations, with a **usufructuary** right in favour of his wife, to ensure that she will have a roof over her head and will benefit from the profits of the farm as an income. At the death of his mother, the son, however, will be liable for estate duty on the value of the usufruct which is added to his bare dominium. In practice the son may not have the taxable amount available or may not be in a position to raise the funds. This may result in his subsequently selling the farm or

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80 See Van der Merwe & Rowland 271.
81 See *Estate Watkins-Pitchford v Commissioner for Inland Revenue* 1955 2 SA 437 (A) 447G-H.
82 See *Barrie NO v Ferris* 1987 2 SA 709 (K) 713I.
other assets to facilitate the taxes payable – which was never the intention of the testator.\(^{83}\)

The testator may bequest a unit in a sectional title scheme to his daughter, subject to a lifelong usufruct to his girlfriend, who has no income and after two years of non-payment of any levies, disappeared.\(^{84}\) In terms of the Sectional Titles Act 95 of 1986, the owner of the unit is liable for all levies. Section 1(a) defines the “owner” as “...the person registered as owner or holder thereof... ” It can be argued that a usufructuary who holds the property and enjoys the fruits thereof for the rest of her life, is a “holder” for these purposes.\(^{85}\)

Alternatively the owner of the bare dominium, the daughter, may be forced by the body corporate to pay the levies although she had no enjoyment of the property and as long as the usufructuary resides there, she cannot rent it out to defray the levies. If she refuses or is unable to pay the levies, she may ultimately lose the property and even the usufructuary may end up on the street. This could never have been the intention of the testator.

The testator may bequest a property to his children with a usufruct to his wife. A few years after his death she decides to emigrate. If she just relinquishes her right to the usufruct, it will result in donations tax, and if she leaves the usufruct in place and emigrates, it is a deemed disposal, because she ceases to be a South African taxpayer, and she will be liable for capital gains tax. The bare dominium holders will then also not be able to sell the property until she dies.\(^{86}\) It could never have been the intention of the testator to leave his wife with this type of problem.

Although the usufruct was once a very popular concept in estate planning,\(^{87}\) it has, however, in many instances become a millstone around the neck, because of certain

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\(^{83}\) The value of the right is determined by capitalizing at 12% the annual value or yield of the interest over the expectation of life (or the period of the right) of the person entitled to such interest.

\(^{84}\) Based on a factual situation as discussed by Maluleke J in “The Liability of a Usufructuary for payment of arrear Levies in a Sectional Title Scheme” 2007(4) De Rebus 42.

\(^{85}\) See Ex Parte Standard Bank Ltd: In re Estate Rodger 1963 3 SA 683 (SR).

\(^{86}\) Based on a factual situation as discussed by Jones “Usufructs – a good idea that can backfire” Moneywebtax, Estates and Trusts www.moneywebtax.co.za (accessed 21-05-2009).

tax and practical implications. It is fair to submit that similar purposes can often be achieved by way of the trust.

In terms of section 66 of the Deeds Registries Act\(^\text{88}\) the duration of a usufruct is limited to the lifetime of the person in whose favour it was created. In practice, however, a contingent usufructuary right may be registered, which means that the right is dependent on a future event, like a remarriage or emigration.

A usufruct may be created in favour of more than one person at the same time, but more than one usufruct cannot exist concurrently over the same property.\(^\text{89}\) Although a second usufruct can therefore not be registered over property, a contingent usufruct may indeed be registered. The aforementioned may be claimed from the bare dominium owner only once the first usufruct has lapsed and will then be ceded to the holder thereof.\(^\text{90}\) It is submitted that the document creating the contingent usufruct should determine that it is subject to the holder thereof only claiming it after the lapse of the existing usufruct.\(^\text{91}\) West argues convincingly that “from a deeds registry point of view, a contingent usufruct is regarded as a real right.”\(^\text{92}\)

The challenges relating to the usufruct, faced by the estate planner, include estate duty and transfer-duty realities,\(^\text{93}\) the limitations created by the Subdivision of Agricultural Land Act 70 of 1970, capital gains tax and the limitations regarding the use of property with a usufruct as security for a bond to be registered.

The family trust as an alternative can be structured to provide for a number of beneficiaries and even to separate income and capital beneficiaries. If the testator would therefore bequest an asset to a discretionary trust with one party as the capital beneficiary and another party as the income beneficiary, a similar result can be achieved as with the usufruct. When the income beneficiary dies, the result will be that the capital beneficiary will remain as the only beneficiary, both income and

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88 Act 47 of 1937.
89 West “The Registrability of Contingent Usufructs and Related Matters” 2003(10) De Rebus 60.
90 See Registrars Conference Resolution 47 of 1987.
91 West 60.
92 Ibid.
93 See s 2 of the Transfer Duty Act 40 of 1949.
capital. As no vesting of capital has taken place no transfer of ownership is realised and no tax or other considerations are relevant.

3.4.5 THE FIDEICOMMISSUM

Another structure available to the estate planner is that of the fideicommissum, which is a legal structure in terms of which the testator leaves assets to a specific individual, on the condition that on that individual’s death, the property is to go to another nominated person. It therefore confers successive interests in the same asset on two persons. The ownership of the fideicommissary only begins when the ownership of the fiduciary ends. 94

While the office of trusteeship is “subject to continuing judicial and institutional scrutiny”, the fideicommissum structure is not subjected to the creation of an office. 95

While the trust is an administrative device separating management and enjoyment, the fideicommissum enables beneficiaries to enjoy property successively, with no focus on the administrative element. The fideicommissum, therefore, does not grant the parties any protection against third parties or their own poor management.

The fideicommissum is always for a specific period of time, namely until the death of the fiduciary in the unconditional fideicommissum, or, in the case of the protective fideicommissum, until a specified date or age, while a trust can be formed for an unlimited period of time.

As the purpose of the trust is to create a monitored administrative structure, it is clear that the fideicommissum will most of the time not be an acceptable replacement for the trust concept. The trust on the other hand may often be able to replace the necessity for a fideicommissum effectively.

Traditionally the fideicommissum was used where the testator wanted to ensure that the asset falls in the hands of the next generation. The fiduciary is therefore prevented from selling the asset. The trust is an ideal vehicle for succession, but is

94 Geach & Yeats 33–34. See the distinction between fiduciary interest and usufructuary interest in Estate Watkins-Pitchford v Commissioner for Inland Revenue 1955 2 SA 437 (A) 447G-H. At 449H the court submitted that “the heir or legatee to whom the power of appointment is given is the fiduciary and the persons selected from those named by the testator are the fideicommissaries.”

95 Honore 43.
not limited to that purpose. One of the advantages of the trust structure over the
*fideicommissum* is that the asset can be left for an unknown number of future
generations, while a *fideicommissum* over immovable property is limited by statute to
a duration of two substitutions, whereafter it lapses and the last fideicommissary
retains ownership without encumbrance.\(^\text{96}\)

### 3.4.6 THE USUS AND HABITATIO

The *usus* and *habitatio* are two legal concepts in many ways analogous to the
usufruct, but not the same. One difference is that the usufructuary can let a property
he only has a usufruct over, but a *usus* or a *habitatio* cannot. The reason for this is
the nature of the usufruct which entails a right to both the use and enjoyment of the
property, as well as the fruits thereof.\(^\text{97}\)

*Habitatio* refers to a right to live in or on a specific property and is often used by a
spouse in favour of a second partner regarding fixed property that the children from
the first marriage will inherit. The testator wants to protect the right of the spouse to
live on the property, or part of the property, until the spouse’s death or remarriage.
The beneficiary of a *habitatio* only has the right to live there and cannot transfer or
cede that right or apply the right in a fruitful manner such as a letting out of the
property.\(^\text{98}\)

The *usus* is a similar benefit with regards to non-fixed assets. The benefit is limited
to the utilisation or application of the asset without the right to transfer, cede or rent
that benefit to a third party.

It is generally accepted that a *usus* or *habitatio* is included in the meaning of
“property” for the purposes of the Estate Duty Act and would therefore attract tax in a
similar manner as a usufruct with the same potential detrimental consequences.\(^\text{99}\)

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\(^{96}\) Immovable Property (Removal or Modification or Restrictions) Act 94 of 1965, ss 6 and 7.

\(^{97}\) See *Barrie NO v Ferris* 1987 2 SA 709 (K) 713I. The real right must be registered against the
deed of the property in order to be enforceable against third parties.

\(^{98}\) See Scott “Effect of the Destruction of a Dwelling on the Personal Servitude of *Habitatio*” 2011
*Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 155-159 for general discussion on the right of
habitatio.

\(^{99}\) Act 45 of 1955 subs 3(2). The value is determined by capitalizing at 12% the annual value or
yield of the interest over the expectation of life (or the period of the right) of the person entitled
to such interest. See Van der Merwe “Extinction of personal servitude of *habitatio* – *Kidson v
Jimspeed Enterprises CC*” 2010 *Tydskrif vir Hedendaagse Romeins-Hollandse Reg* 657.
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The *usus* and *habitatio* can be substituted by a trust by granting a beneficiary limited contingent or vested rights. If these rights are contingent they are protected from creditors of the beneficiary until vesting takes place. The rights may be granted *inter vivos* or by way of a testamentary trust – which may have two different tax outcomes.

In the recent *Kidson v Jimspeed*\(^{100}\) matter the question was whether a *habitatio* lapses if it is unused but not abandoned by the holder of the right. The property has been transferred to a new owner without his being aware of the *habitatio*. The building accommodating the *habitatio* has also been destroyed. The court decided that the intention was never to abandon the right and it also did not prescribe – neither was it cancelled in the deeds registry. The mere non-use of the dwelling did not automatically lead to a lapsing of the right. The fact that the current owners were not aware of the right of *habitatio* does not affect the personal servitude. The Kidsons could not compel the owner of the land to re-erect the dwelling. The real right vests in the land and no positive duty is transferred to the next owner except the duty to allow passively the holders of the right to enjoy their right.\(^{101}\)

3.4.7 THE MODUS

The *modus* places an obligation to perform on the beneficiary – whether *ex contractu* or *ex testamento*. At the death of the testator the beneficiary becomes the legal owner of the property and receives with his ownership the liability to perform in terms of the *modus*. It is therefore a pure and unconditional bequest, with a string attached to it – a contractual obligation to do something. The beneficiary of the *modus* acquires a personal right against the person who is burdened with the *modus* and he can claim specific performance.\(^{102}\)

\(^{100}\) *Kidson v Jimspeed Enterprises* CC 2009 5 SA 246 (GNP). The court, with reference to *Galant v Mahonga* 1922 EDC 69, confirms that a personal servitude differs from a real servitude in that it is attached to the person and not to a *dominant tenement*. In *Janse Van Rensburg v Koekemoer* 2011 1 SA 118 (GSJ) [7] it was confirmed that a *habitatio* afforded without payment (donation of future entitlement) must be in writing to have force and effect. See also Scott 2011 THRHR 155-159, for a discussion of this case.

\(^{101}\) In *National Stadium South Africa v Firstrand Bank Limited* case no 670/10 (01-12-2010) SCA para [31], Harms DP stated that “(r)eal rights have as their object a thing (*res*). Personal rights have as their object performance by another, and the duty to perform may arise from a contract."

\(^{102}\) *Van der Merwe & Rowland* 281-285. *Van der Merwe et al* 297 states that “(i)n so far as a modus is a qualification of the right to performance, . . . . and not a debt, . . . . one can argue that a contractant should not be entitled to claim specific performance of a modus, which requires the other contractant to act positively.”
In Honoré\textsuperscript{103} it is submitted that the \textit{modus} can sometimes be construed as a \textit{fideicommissum} and under certain circumstances even as a trust.

The \textit{modus} cannot be addressed by way of a trust as the two beneficial interests are not seated in the same property.

### 3.4.8 SUBSTITUTION

Substitution takes place when someone, nominated by the testator, takes the place of the heir or legate who cannot or does not wish to adiate the bequest. Substitution prevents intestate succession or a legate from becoming part of the residue.\textsuperscript{104}

Substitution can be achieved by way of a trust with different classes of beneficiaries.

### 3.4.9 DISCRETIONARY TESTAMENTARY TRUST

The family trust can be utilised to replace the testamentary trust. The testator then refers to the family trust in his last will and testament. The main advantage of using the existing family trust instead of a testamentary trust is the fact that the administrative rules are usually much more detailed.

The testator has the opportunity to set everything in place while still alive. The trust and the will can become two complementary documents. The testator ensures the appointment of trustees he has faith in and he manages the trust with them for a period of time. As co-trustee he is involved in the administration of the trust and decisions about investments, etcetera. The testator's co-trustees will experience first-hand the thinking of the testator and will be able to exercise their powers along the same line after the testator's death. The trust may include a testamentary disposition clause, which allows the testator to indicate his future wishes, as long as it does not interfere with or annihilate the discretionary nature of the trust as that may cause vesting to take place before the appointed time.\textsuperscript{105}

\textsuperscript{103} 50.

\textsuperscript{104} Van der Merwe & Rowland 286 differentiate between the direct and \textit{fideicommissum} substitution. Any reference in this study is to direct substitution.

\textsuperscript{105} Olivier \textit{et al} Trustreg 9-13. See Honoré 593 a.f. for some specific rules regarding the vesting of capital assets to a second or subsequent beneficiary. Such a testamentary clause should be constructed with the same effect as a letter of wishes and nothing more.
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The vesting of an asset in a beneficiary indicates the moment at which that person becomes the owner thereof or at least acquires the right of ownership where it must first be registered in his name. Before an asset has vested in the beneficiary he merely has a contingent right to the property and it does not form part of his estate on death or insolvency.\(^{106}\)

If a will stipulates that the property is inherited by a testamentary trust, formed for the benefit of a number of beneficiaries and it is left to the discretion of the trustees if, when and how the different beneficiaries will receive their respective benefits, a discretionary testamentary trust is formed. Such a construction does not delegate the testamentary power of the testator to the trustee, as the trust is nominated as the heir. The discretion is therefore limited to the nomination of the specific beneficiary to receive a benefit – similar to the situation where an \textit{inter vivos} trust is nominated as beneficiary by a testator.

\subsection*{3.4.10 PUBLIC-BENEFIT TRUST}

Honiball and Olivier\(^ {107}\) define the charitable trust as “a trust with a gratuitous, charitable or philanthropic object or purpose”.

It is submitted, however, that the \textit{object} of a charitable trust would always be the benefit of the beneficiaries, who are the community at large or a specific section of the community, while the \textit{purpose} would be to support or fund children, sport, animals, etcetera. In this sense “community” may even include the animal or plant kingdoms or an organisation representing them, in which case the ultimate, indirect beneficiaries would actually be the human race.

A trust that wants to qualify for tax relief on the basis that it is non-profitable or charitable, has to register as a public-benefit institution (PBO).\(^ {108}\) The institution must meet the requirements in section 10(1)(cN), read with section 30, of the Income Tax Act.

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\(^{106}\) Honoré 556-557. Coetzee 306 makes it clear that even if there are still outstanding requirements to be adhered to but it is \textit{certain} that these \textit{will be} adhered to, vesting has already taken place.

\(^{107}\) 431. See also Labuschagne “Having your Church as a Beneficiary of your Trust: An Ingenious Scheme or a Tax Dodge?” 2008(12) \textit{Taxtalk} 18-19.

\(^{108}\) A PBO does not have to register as a non-profit organisation (NPO) in terms of the Non-profit Organisation Act 71 of 1997.
Section 30 specifies that a trust (inter vivos or mortis causa), based on a trust deed as founding document, established in South Africa and registered with the Master of the High Court, can qualify as an institution for public-benefit activities. Such a trust may be of a discretionary or vesting nature and may even be a bewind.

Part 1 of the Ninth Schedule of the Income Tax Act unfortunately requires that the sole and principal object\textsuperscript{109} of the PBO trust must be the carrying on of one or more public-benefit activities, namely welfare and humanitarian; health care; land and housing; education and development; religion, belief and philosophy; cultural; conservation, environment and animal welfare; research and computer rights; and, sport. It further makes provision for PBO trusts whose principal object is to provide funds or resources for other PBOs and also includes a general section for those that do not fit into one of the specific categories.\textsuperscript{110}

A PBO trust may take part in trading activities (profitable activities), which are an integral part of, and directly related to, the sole and principal object of the trust. These are substantially directed at recovering costs, and do not result in unfair competition to taxable entities.\textsuperscript{111}

PBO trusts may invest surplus funds, with the trustees acting with the necessary prudence, integrity and reasonableness.\textsuperscript{112}

### 3.4.11 NON-PROFIT TRUST

A non-profit organisation means:

> “a trust, company or other association of persons –
> (a) established for a public purpose; and
> (b) the income and property of which are not distributable to its members or office-bearers except as reasonable compensation for services rendered.”\textsuperscript{113}

\textsuperscript{109} In trust terms these categories are a reference to purpose and not object.

\textsuperscript{110} Only donations to a PBO trust which conducts activities specified in Part II of the Ninth Schedule are deductible by the donor under s 18A.


\textsuperscript{113} Non-profit Organisation Act 71 of 1997, s 1.
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The object of the Non-profit Organisations Act 71 of 1997 is to encourage and support non-profit organisations in their contribution to meeting the diverse needs of the people in the country.

In the case of a trust the trustees will be the office-bearers of the organisation and the trust deed must, in terms of section 12(2)(d), make provision for the trust “to be a body corporate and have an identity and existence distinct from its members or office-bearers.”

This Act therefore bestows upon a trust registered in terms of this legislation legal personality. The identity of these trusts is distinct from the trustees.

The motivation for an organisation to register is two-fold: firstly, the protection, credibility and direction given by the act, regulations and the directorate; and secondly, the potential benefits and allowances by way of government grants.114

3.5 SPECIFIC MANIFESTATIONS OF TRUSTS

Trusts sometimes manifest in particular ways, which cause practitioners to grant certain names to these specific trusts to differentiate them from the ordinary acceptable way in which trusts usually operate. Some of these examples of trusts are actually not trusts in the legal sense of the word, as they do not comply with the essentialia of the trust.

3.5.1 BLIND TRUST

The so-called “blind trust” is sometimes also referred to as the “limping” or “black-hole” trust, in which it is not possible to ascertain the purpose of the trust or beneficiaries from the trust deed. Roper and Ware115 explain that the founder of the blind trust is often a “dummy”, with charitable institutions as “dummy beneficiaries”. The intention is to benefit third parties who will be nominated by the trustees.

Geach and Yeats describe the blind trust as a secretive trust because the identity of the beneficiaries is usually concealed. They submit that this type of trust may constitute a contravention of legislation aimed at preventing money laundering or

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114 See s 11 of Act 71 of 1997.
other criminal behaviour. Where the real purpose and identity of the beneficiaries cannot be established from the contents of the trust deed, these trusts may fall foul of anti-avoidance provisions.

The blind trust has mainly been used to erect a wall between an owner of assets and the management and administration of the assets to limit any potential conflict of interest. It is sometimes used by individuals with private equity holdings when they go into public office to ensure that their objectivity is not compromised in any way. During the term of the trust the trustees have full discretion over the assets and the beneficiaries have no knowledge of the holdings of the trust.

In the United Kingdom the 1998 Neill Committee found the use of blind trusts by political parties to be “inconsistent with the principles of openness and accountability” and recommended that such trusts be “prohibited as a mechanism for funding political parties,” this subsequently being incorporated into legislation in 2000.

The American Heritage Dictionary defines the blind trust as “intended to avoid conflict of interest; the trustee assumes full powers for managing the assets; the public officer loses the right to information on the assets during the term of the trust”.

These trusts have not received any official acknowledgement in South African law and it is submitted that it is unnecessary to create a special type of trust for these purposes. Any discretionary trust registered in terms of the TPCA can be used for these purposes if the beneficiary, who wants to remain uncompromised, is not a trustee.

There is always the risk with blind and sham trusts that they may be acceptable in an offshore jurisdiction, but not in the non-resident jurisdiction or resident jurisdiction, which may leave the founder in a precarious position. In many cases the letter of

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116 Geach & Yeats 31.
117 See Honiball & Olivier 431. Compare Roper & Ware 40-41 for the potential grounds of offshore and onshore attack on the blind trust. On 57 they describe money laundering as “the process by which criminals place illegally gained money into legitimate financial institutions so that such money gains the appearance of legitimate funds”. It is usually the proceeds of crimes, like drug trafficking, theft, fraud, smuggling or tax evasion.
wishes might be an indication to authorities of the real intention of the founder, and, although the letter should not be enforceable, it can be of value to the tax authorities.  

3.5.2 SHAM TRUST

In English law the sham trust has been described in the well-known Snook\textsuperscript{122} case as:

“acts done or documents executed by the parties to the ‘sham’ which are intended by them to give to third parties or to the court the appearance of creating between the parties the legal rights and obligations different from the actual rights and obligations (if any) which the parties intended to create”.

In a sham trust the appearance of the transaction is not a true reflection of the intention and the actual substance thereof.

Olivier\textsuperscript{123} is of the opinion that “sham” trusts do not exist, as a trust is either valid or invalid. This implies, therefore, that a sham trust is indeed no trust. It therefore seems as if a sham trust is actually an invalid trust and the property does not vest in the trustees in their office of trustees but in one or more individuals – often trustees in their personal capacity.\textsuperscript{124}

As the sham-trust concept touches on the issue of penetration of the corporate veil, it is submitted that the above submission may be an over-simplification of the matter. In the unreported \textit{Knoop NO v Birkenstock Properties (Pty) Ltd}, Nxusani AJ made the following statement:

"The corporate veil may be pierced where there is proof of fraud or dishonesty or other improper conduct in the establishment or the use of the company or the conduct of its affairs and in this regard it may be convenient to consider whether the transactions complained of were part of a ‘device’, ‘stratagem’, ‘cloak’ or ‘sham’."\textsuperscript{125}

\textsuperscript{121} See Roper & Ware \textit{Offshore Insight} (2001) 66. See 53-54 for discussion on letters of wishes.


\textsuperscript{123} Olivier \textit{et al Trustreg} 2-20(1)-(2).

\textsuperscript{124} Mitkute & Tanega 49 supports this view. See also Joffe "Sham Trusts" 2007(1) \textit{De Rebus} 25-26.

\textsuperscript{125} ZAFSHC case no 7095/2008 (04-06-2009) para [11]. The court further submitted at [17] that “it matters not whether the corporate entity is a Trust or a company.”
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The main test in determining whether a trust is a sham or not, is with the parties to the trust. The intention of the parties should usually indicate the true nature of the transaction. Stafford\(^{126}\) submits that an investigation should further determine the legal character of the agreement as well as all the circumstances and incidences of the specific transaction. In this investigation oral evidence may be necessary and the ultimate verdict may rest on a balance of probabilities.

In *Badenhorst*\(^{127}\) Combrinck AJA refers to the trial judge’s test whether the trust in question was a sham or not, which is apparently equalised by him with the test for a separate legal entity and the *alter ego* notion.\(^{128}\) Our courts are not always successful in clearly differentiating between the two concepts.

### 3.5.3 BEWIND TRUST

The bewind trust may be in the form of either a testamentary or an *inter vivos* trust. In the case of the bewind trust the beneficiaries, and not the trustees, are the owners of the property (capital and/or income) of the trust assets, while the trustees are in control of the property. It must be clear, however, from the trust deed that this was the intention of the founder.\(^{129}\)

If this was indeed the intention, the founder or testator may then not go further and deprive the beneficiary of his rights to deal with the property in the trust, as that will constitute a *nudum praeceptum* (a nude prohibition).\(^{130}\) The moment the beneficiary becomes the owner of the trust property he may deal with it irrespective of any limitations stipulated by the founder or testator. The trustees are merely nominated as administrators on his behalf.

In light of the *nudum praeceptum* principle, the bewind trust has very limited practical application and value in the South African context.


\(^{128}\) See 3.5.6 for more on the alter ego trust.

\(^{129}\) See Du Toit TSAR 2011(3) 540-546. See the interpretation of *Schaumberg v Stark* 1956 4 SA 462 (A). See further Olivier *et al* *Trustreg en Praktyk* (2009) 5-11.

\(^{130}\) This principle is subject to the common-law principle that the right of disposal of minors may be limited by their guardians.
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The result of the bewind trust, where the trust assets vest in the beneficiaries, is similar to that of the *fideicommissum purum*. Both Corbett and Van der Merwe and Rowland are consequently of the opinion that the *fideicommissum purum* has lost its relevance in South African law and fallen in disuse.\(^{131}\)

Subsection (b) of the definition of “trust” in section 1 of the TPA refers to an “arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee”.

It is generally accepted that this is a reference to a bewind trust.

### 3.5.4 VESTING TRUST

The general meaning of the term discretionary trust is a reference to the absolute discretion\(^{132}\) of the trustee regarding the appointment of beneficiaries or the distribution of capital or income to beneficiaries.

Olivier *et al* divide the rights of the beneficiaries of the trust between “vested rights” and “contingent rights” (also called “conditional rights”). The vested right has been referred to as an “immediate right”, a “complete right” or a “present and certain right”, while the contingent right refers to an interest or expectation (*spes*), the realisation of which cannot be certain.\(^{133}\)

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131 See Corbett *et al* 337; Van der Merwe & Rowland 309. Strydom 146 submits that the practical consequences of the bewind trust and the *fideicommissum purum* are similar. The bewind works with the beneficiary as the only party with rights and the *purum* with the rights of both the trustee and the beneficiary.

132 Strydom 106 refers to *CIR v Sive’s Estate* 1955 1 SA 249 (A) 262D, where the court submits that the discretionary power can be expressed by either a general power of discretion or by subjecting the discretion to an objective standard like that of a reasonable person. In *Sive’s* the testator bequeathed the residue of his estate to his children in equal shares, but gave the trustees the discretion to decide, about half of each share and all income, how it must be divided amongst the heirs. If the discretionary power is, however, limited by some subjective instruction from the founder, one can argue that the discretion is substantially limited and that the trust lost its discretionary nature. In *Braun v Blann and Botha NNO* 1984 2 SA 850 (A) 866H-867A, Joubert JA states: “To recognize the validity of conferring our common-law powers of appointment on trustees to select income and/or capital beneficiaries from a designated group of persons would be a salutary development of our law of trusts and would not be in conflict with the principles of our law.”

133 Olivier *et al* Trustreg 4-7-4-11. Van der Merwe 2000 SA Mercantile Law Journal 322 explains that, for contractual purposes, a conditional right “is an existing though unenforceable right which cannot be executed.” *McAlpine v McAlpine NO* 1997 1 SA 736 (A). For the concept of contingency see the decision in *Ackermans v CSARS* case no 441/09 (01-10-2010) (SCA), about contingent rights.
It is submitted that the distinction between a discretionary trust and a vesting trust is somewhat clouded in our law and has led to some confusion amongst practitioners. Strydom\textsuperscript{134} confirms this when he states that

\begin{quote}
\textquote{the inaccurate, loose way in which the terms “conditional claims” (“aansprake”) and “vested rights” have been used, caused a number of different meanings to be associated with these terms}. (Own translation.)
\end{quote}

According to Strydom the non-discretionary or vesting trust is where the beneficiaries as well as their respective benefits are determined by the trust deed (or will) in such a manner that the property vests in the beneficiaries at the very moment when it settles in the trust.

The trustee may still be empowered with certain discretions – as long as it does not postpone the vesting of the trust benefits.\textsuperscript{135} A trust is therefore only discretionary in nature if the beneficiary does not receive vested rights to capital or income the moment such capital or income settles in the trust.

To qualify as a vesting trust, three elements required in the trust deed or the will have evolved:

(a) the identity of the beneficiaries must be certain; and

(b) the percentage of the total or the specific property to vest in each beneficiary must be certain; and

(c) the moment of vesting of the property in the trust must coincide with the moment of vesting in the beneficiary.

Van der Merwe,\textsuperscript{136} in reference to Watermeyer JA in \textit{Jewish Colonial Trust},\textsuperscript{137} distinguishes two uses of the word “vest”, namely an indication of ownership (including enjoyment) of a right, and secondly, an unconditional right. The ownership of a right does not necessarily include the ownership of the asset linked to the right.

\begin{flushright}
\textsuperscript{134} Strydom 159. The main development of these terms took place in the law of succession. Some writers, referred to by Strydom 160 argue that a “conditional right” cannot exist. A “right” either exists or it does not. Strydom 161-162 submits that when a \textit{spes} is worthy of protection it should be regarded as a “right”.

\textsuperscript{135} Strydom 108-109. Olivier \textit{et al.} Trustreg 5-10–5-11.

\textsuperscript{136} 2000 SA Merc LJ 320-323. On 323 he refers to the “complete and unconditional” right concept of Cowen and the “fixed and certain” description of Corbett \textit{et al.}

\textsuperscript{137} \textit{Jewish Colonial Trust Ltd v Estate Nathan} 1940 AD 163.
\end{flushright}
Chapter Three: Application of the Trust

The vesting of an interest does not necessarily coincide with the enjoyment of the interest. In this sense the right may sometimes still be conditional, especially in a contractual sense.

Van der Merwe's conclusion is that vesting merely implies the “absence of a suspensive condition” and that transmissibility and ownership (including enjoyment of the right) are not requirements of vesting.¹³⁸

Honoré distinguishes between three applications of the term “vesting of rights”:

(a) full ownership;
(b) where it is a mere personal right, but immediate and not contingent; and
(c) where it is certain to be distributed to the beneficiary at a later stage.¹³⁹

Honoré further submitted that, if the trustee has the discretion whether to pay income or distribute capital to the beneficiary, or how much to pay, the aforementioned has a mere contingent right.¹⁴⁰

It is submitted that all three applications mentioned by Honoré will have the effect of a vesting of rights in the individual beneficiary and will accordingly result in the taxation of the property in the hands of the beneficiary as well as the availability of the asset to the creditors of the beneficiary.

Writer supports Honoré in as far as they require in a vesting trust no discretionary powers to settle in the trustee, although I suspect that I do not mean the same thing. It has become customary with many drafters of trust deeds to create so-called vesting business trusts, with two or more beneficiaries with allocated beneficial holdings in the trust. These beneficiaries are often referred to as shareholders.

The trust document will stipulate that the trustees are empowered to apply the net income to such an extent and in such proportions and to distribute any part of the capital or property to such an extent, proportionally, as they may from time to time in their absolute discretion deem fit. The deed may or may not make it clear that when

¹³⁹ 556-557.
¹⁴⁰ 557-558.
a distribution of income of capital takes place it has to be according to the percentages held by the respective beneficiaries.

The rational for these practices is the protection of the different parties to the trust and to ensure that the trustees have to distribute according to the specified beneficial interest. The trustee’s discretion is therefore only limited as far as the precise allocation of the distributed income or capital is concerned.

Writer submits that these trusts are not vesting trusts and the fact that they are referred to as such by many practitioners, is based on a wrong understanding of the term “vesting”. The utilisation of the term “vesting” in this context is very dangerous and may cause hazardous results as far as creditors and tax implications are concerned.

### 3.5.5 THE SLEEPING TRUST

A founder may decide to form a trust to be used at a later stage or even after his death. A testamentary trust is often very limited in terms of the details of the trust deed and a sleeping trust may thus fulfil an important role – especially where the intention is that the trust must continue for a substantial period and even for generational transfers. In light of transfer duties and costs the founder may decide not to have the assets transferred to the trust until after his death.

Dormant trusts may also be referred to as “sleeping trusts”. Trustees firstly have a duty to determine whether to exercise their discretion and secondly to exercise their discretion lawfully under the terms of the trust. In a dormant trust the trustees may fail to make any distributions for a substantial period of time – sometimes even based upon the wishes of the founder. In *Re Locker’s Settlement*¹⁴¹ the court held that it can compel the trustees to exercise their discretion, but it cannot compel them in which manner to do so.

A sleeping trust will remain a valid trust and can theoretically remain so in perpetuity, except where the existence of the trust is limited in terms of a time period – either in terms of the trust deed or by law.

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3.5.6 THE ALTER EGO TRUST

The “alter ego trust” is a trust in which one or more of the parties to the trust practically control it for his own benefit. The principle is that there must be at least a level of separation between control and enjoyment of assets.\(^{142}\) If a trust has become the alter ego of an individual the trustees will manage and distribute the assets either to the direction of that individual or in his best interest and not that of the beneficiaries in general.\(^{143}\) The risk of a family trust becoming the alter ego of the founder is obviously more severe than with any other trust, as the nature of the family trust is to keep the assets available for the enjoyment of an enclosed group, the family.

The founder must, therefore, be very aware of his renouncing of the assets when they are donated or sold to the trust. It is important that the trust deed as well as the selection of trustees indicates that the founder and the beneficiaries lose effective control of the assets.\(^{144}\) This is a factual question, as a court will not only look at the contents of the trust deed, but also at the manner in which the parties have managed and controlled the assets of the trust in practice.\(^{145}\)

The alter ego trust thus either exists where assets settled on a trust, but the trustees act as puppets under instruction of a third party, or the trust property is treated by the trustees as if it were personally owned by an individual and not by the trustees on behalf of the beneficiaries. The trustees must be in more than *de iure* control – there must be *de facto* control by them.\(^{146}\)

Effectively retained control by the founder may implicate that the trust and the apparent creation of a separate estate, may be in the form of a sham or it may have created an alter ego for the founder.\(^{147}\) Roper and Ware\(^{148}\) refer to the principle

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\(^{142}\) See *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) in general.

\(^{143}\) Hayton *Modern International Developments in Trust Law* 45-46. The critical distinction is “between a trustee holding to the order of the settler and a trustee holding to the order of the settler only if the settler orders”.

\(^{144}\) See Hayton 147.


\(^{146}\) See *Brunette v Brunette* 2009 5 SA 81 (SECLD) paras [3]-[5] in this regard.

\(^{147}\) Mitkute & Tanega 49. See also *Rahman v Chase Bank (CI) Trust Co Ltd* [1991] JLR 103, where the settlor retained the power to appoint the trust capital and to veto the main
“to give and to retain is not possible”), which was applied in the well-known Rahman judgment, dealing with this matter of undue control by the founder. Where undue control was a factor of the trust from initiation, the trust may have been a sham, which means that no real trust has been formed and an alter ego is not even relevant.

3.6 THE TRUST VERSUS THE CORPORATION

The individual who wants to embark on a business venture in South Africa may do so as a sole proprietor, in a partnership with one or more others, or in a trust, a company, or a close corporation. The last two are so-called corporative structures, each having a legal personality separate from its members, and is regulated by statute.

Factors which may affect the appropriateness of a specific business entity are the number of persons involved in the venture, the extent of their individual involvement, the capital requirements, management and control issues, risk issues, tax consequences and specific legislative or legal requirements.

3.6.1 THE COMPANY

Since 1 May 2011 all companies in South Africa are regulated by the Companies Act 71 of 2008. The types of companies that can be formed are state-owned companies, private companies, public companies, personal liability companies, and non-profit companies.

There is no limitation on the number of shareholders in a private company and its memorandum of incorporation must prohibit it from offering any of its securities to the

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149 The Income Tax Act 58 of 1962 recognises different aspects of business entities for tax purposes, such as “small business corporations”, “employment companies” and “personal service companies”. Since the introduction of the 2008 Companies Act no new close corporations can be registered, although existing ones may continue to operate for an indefinite period of time.

150 See Airport Cold Storage (Pty) Ltd v Ebrahim 2008 2 SA 303 (C) for more on the aspect of juristic personality.

151 Some professions may require that their members may only practice in the form of a personal liability company. See Davis et al (eds.) 17-18.
public, as well as restricting the transferability of its securities. All distributions, including share buy-backs, dividends and redemptions, are subjected to a liquidity and solvency test, and specific minimum shareholder protections are afforded.\textsuperscript{152}

The legislator attempted to replace the close corporation with a small company regime. The shareholding burden of private companies (compared to the membership element of close corporations) was alleviated by allowing directors more powers; simplifying the altering of share structures; and, the creation of more flexibility regarding the governance of shares.\textsuperscript{153}

The Act reflects a clear trend towards personal liability of the directors and requires a high standard of conduct from them.\textsuperscript{154} All companies must produce annual financial statements, of which some must be audited and others independently reviewed by a qualified person.\textsuperscript{155} The required auditing or review process is determined by the public-interest score which in turn is determined by the number of employees, the amount of third-party liabilities against the company, the annual turnover of the company and the number of individuals, trusts or legal entities with a beneficial interest in the entity.

A specific business-rescue regime is provided by the Act, as well as detailed rules regarding the winding-up of solvent companies and the process of deregistration.\textsuperscript{156} The 2008 Companies Act favours administrative mechanisms, instead of criminal enforcement, in the protection of the rules of company law, which approach may make companies more attractive to smaller businesses in future.\textsuperscript{157} Until the introduction of the 2008 Act, all companies, irrespective of its annual turnover or

\textsuperscript{152} S 4 deals with the solvency and liquidity test, as well as the shareholder protection requirements.

\textsuperscript{153} See Stein 10-12.

\textsuperscript{154} See s 69 and 75-78 in this regard. See Chapter 3 of the Act for the enhanced transparency and accountability principles.

\textsuperscript{155} See s 30 of the Act. The public-interest score must be calculated annually and may determine whether an audit is required or only an independent review for the particular financial year.

\textsuperscript{156} Chapter 6 deals with the business-rescue process. See Part G of Chapter 2 for the winding-up of solvent companies. Insolvent companies are still winded-up in terms of Chapter 14 of the Companies Act of 1973, in anticipation of the new Bankruptcy Act (subject to the 2008 Act in case of any conflicting stipulations).

\textsuperscript{157} The Company Tribunal, Take-Over Regulation Panel, the Companies Intellectual Property Commission and the Financial Reporting Standards Council are the major administrative role players.
number of shareholders, had to be subjected to an annual audit, which was a cost
deterrent for the smaller enterprise.

The trust and the company have two totally different objectives, but there are also
synergies between them that cannot be ignored. It is possible to operate a business
or trade within a trust structure just as in a company. This aspect will be discussed in
detail in Chapter 4. It is submitted that the two legal figures should not be seen as
opposition to each other, but as complementary. Trusts are not ideally positioned
and regulated for certain business activities and may be used for purposes of
arbitrage. The many positive applications of the trust in the business arena will be,
however, elaborated upon in the next Chapter.

3.6.2 THE CLOSE CORPORATION

Close corporations were introduced as a new form of business enterprise by the
Close Corporations Act 69 of 1984. The purpose was the incorporation of smaller
businesses with ten or fewer members. Companies were prevented from becoming
members of close corporations, and the legislation was simple and less cumbersome
than that of for companies. Close corporations are clothed with legal personality,
separate from its members, and enjoy perpetual succession, although they have the
capacity and powers of a natural person.

All close corporations were excluded from annual audits, although financial
statements had to be prepared by a registered accountant, until the amendments
introduced by the 2008 Companies Act. The requirements regarding auditing or
review have, since 1 May 2011, also been linked to the number of employees, the
annual turnover, third-party liabilities and the number of individuals or trusts with a
beneficial interest in the entity.

Close corporations exclude some of the more complicated company law principles,
like the *ultra vires* doctrine, capital maintenance requirements, unanimous consent
and the doctrine of constructive notice. Other corporative law principles, like the

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158 Trusts do qualify as members of close corporations, subject to the ten-member requirement.
Each beneficiary is regarded as a separate member.

159 See subss 2(2) and 2(4) of Act 69 of 1984.

160 See Davis *et al* (eds.) 6 and the reference to *J & K Timbers (Pty) Ltd v G L & S Furniture
Enterprises CC* 2005 3 SA 223 (N), about s 54 of Act 69 of 1984.
Chapter Three: Application of the Trust

lifting of the corporative veil, limited personal liability, and the limitation of certain loans, are applicable to close corporations.\textsuperscript{161}

As no new close corporations may be registered after 1 May 2011, it is not an option for new business ventures in future. This may popularize trusts for certain smaller business activities – particularly where only one person is involved in the business activity. The fact of the matter is that companies are more onerous and complicated than close corporations, which may entice business operators to look for an alternative, such as the trust.

3.7 THE OFFSHORE TRUST

Offshore trusts became internationally very popular as investment vehicles and for the wealthy to distribute their risk amongst a number of legal and financial jurisdictions. The inconsistency of financial markets, the differences amongst tax regimes, the fluctuations in currencies and scarce resources, and national and regional political instability, have all contributed to the need for diversification.\textsuperscript{162}

The elements and contents of an offshore trust remain the same as that of a local discretionary trust where the trustees are vested with ownership of the assets of the trust. Many trusts in other jurisdictions make use of a protector, who acts as bridge between the founder and the trustees.\textsuperscript{163} The precise powers and duties of the protector can often be determined by the founder at settlement.

It is common practice for founders of offshore trusts to issue a letter of wishes\textsuperscript{164} to the trustees, indicating their desires and preferences regarding the administration and distribution of the assets, without limiting the discretion of the trustees. The contents of the letter usually indicate the preferences of the founder, which are

\textsuperscript{161} See ss 23, 52, 64 and 65 of the Act. See Haygro Catering BK v Van der Merwe 1996 4 SA 1063 (C) and Airport Cold Storage (Pty) Ltd v Ebrahim 2008 2 SA 303 (C) for the circumstances wherein the court may apply s 65 and the lifting of the corporate veil. In Haygro the members failed to display the name of the business on the premises as well as on the close corporation documentation. This was found to constitute a “gross abuse” by the members.

\textsuperscript{162} Roper & Ware Pitfalls 9 submit that approximately a quarter of the world’s money is in offshore trusts.

\textsuperscript{163} See Roper & Ware Pitfalls 15-16. The parties are the settler or grantor (or founder), the trustees, the beneficiaries and the protector. See in the South African context Clegg “Offshore Trusts – Section 25B (2A): The Conduit Principle and the Participation Exemption” 2007(10) The Taxpayer 189.

\textsuperscript{164} It is also sometimes referred to as “a letter of intent”.

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similar to the choices he would have exercised, had he retained the control of the trust. The founder knows that the trustees would honour these wishes under normal circumstances. The market for offshore trusts has been stimulated by a number of competing jurisdictions initiating trust legislation that attracts non-resident trust founders.

A popular perception exists amongst economic theorists that regulatory competition should result in more efficient legislation. Charles Tiebout’s model of regulatory competition does add up for corporations looking for arbitrage opportunities by way of different regulatory regimes, but does not work for a variety of other reasons. Barkin does conclude that most tax havens aim at particular regulatory niches rather than to try to compete for business across the board. He furthers submits that offshore regulatory standards are increasing over a period of time. The aspect of regulatory arbitrage will be discussed in 5.9 and the practical application of regulatory models in more detail in Chapter 9.

Mitkute and Tanega define an offshore trust, for their purposes, as “a trust governed by and benefiting from special offshore laws and policies, including trust, bankruptcy and conflict-of-law rules, enacted specifically to meet the needs of non-resident settlers”. These laws and policies are geared to address specific aspects, like protection against creditors, control, perpetuity, confidentiality, and a special tax regime. Creditors and trustees from traditional jurisdictions may find it difficult to challenge most offshore trusts because of aforementioned jurisdictions’ debtor-

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165 Roper & Ware Insights 53.
166 This theory was developed by Charles Tiebout in evaluating public and municipal service models. See Tiebout “A Pure Theory of Local Expenditures” 1956 Journal of Political Economy 416 http://www.jstor.org/pss/1826343 (accessed 20-08-2011). This aspect is discussed in detail in Chapter 9.
167 See Barlin Racing all over the place: A Tiebout Model of International Regulatory Competition 2010 APSA Annual Meeting Paper http://papers.ssrn.com/sol3/papers.cfm?abstractid=1643010 (accessed 20-08-2011) on for a modified Tiebout regulatory model. Compare Mitkute & Tanega 46-61, 51-52, where they refer to issues such as imperfect information, lack of mobility and cross-border externalities, as limitations to the so-called “naive Tiebout model”. Regulatory models, including the Tiebout model, will be discussed in Chapter 8 in more detail. See Chapter 9 for detailed discussion on regulatory models.
168 20.
169 47. See Roper & Ware Insight 35-36 for the elements of the offshore trust deed.
friendly legislation, which include protective trusts, reserved powers to the founder, fraudulent conveyances and conflict-of-law provisions.\textsuperscript{170}

In terms of the Organisation for Economic Cooperation and Development (OECD) a tax haven is a jurisdiction that actively develops tax policies aimed primarily “at diverting finances and other geographically mobile capital from high-tax to low-tax countries”. It is estimated that as much as 60 percent of the money in the world is offshore – a large portion of it in trusts.\textsuperscript{171}

Ginsberg states that the purpose of an offshore trust is not to evade tax, but to reduce income, capital gains and inheritance taxes. The essence of any trust is to break the chain of legal ownership between the founder and his own wealth.\textsuperscript{172} The foreign trust just takes this scenario further by also removing the second estate from the legal and financial jurisdiction to which the founder is connected. The motivation may be tax, personal or professional risk, or the political or economic uncertainty in the home jurisdiction.

3.8 CONCLUDING REMARKS

The advantages and disadvantages of the trust have been compared, where after its relationship with some other legal figures has been investigated.

It is submitted that the trust has positioned itself as one of the major figures in the South African legal environment and is only second to the corporation. It cannot be denied, however, that the trust became much more than a mere tool for estate planners and to protect minors and financially incompetents.

It will be submitted in the next Chapter that the trust is fulfilling an important role in the commercial domain. The specific position of the trust as a business vehicle will thus be investigated and evaluated. This will be done in the context of some of its practical applications, the relevant legislative setting, and the specific financial environment within which it operates.

\textsuperscript{170} Mitkute & Tanega 49-50.

\textsuperscript{171} Even governments keep large amounts of money offshore. Moyo 20 refers to Asymmetric Threats Contingency Alliance statistics, which claim that India has an estimated US$ 1.5 trillion, Russia US$ 470 billion, United Kingdom US$ 390 billion and China US$ 96 billion in Swiss bank accounts.

\textsuperscript{172} Ginsberg International Tax Havens (1997) 43.
As indicated in the previous Chapter, the fact that the trust is still not acknowledged as a legal *persona* may be a factor preventing the trust from fulfilling its potential as business vehicle.
4.1 INTRODUCTION

In the previous Chapter the trust in general has been evaluated, as one can only appreciate the value of the trust in the business context if an appreciation of the nature, strengths and versatility of the trust concept has first been developed.¹ The definition of “trust” in the TPCA² has been used as the point of departure and will not be repeated here. In this Chapter the trust in its role as a business entity will be discussed in some detail. It may be debatable whether the trust can be described as an “entity” in any of its manifestations, because its legal personality has not been confirmed in all respects as yet. For the lack of a better general term, however, I shall refer to the trust as an entity in the sense that, at least in the business environment, it is often treated in practice as a juristic entity.

The Income Tax Act³ defines a trust as:

“any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person”.

A universal definition of the trust can be found in the Hague Convention, namely, “the legal relationships created – inter vivos or on death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.”⁴

¹ Hayton (ed) Modern International Developments in Trust Law 145. Hayton puts it very eloquently when he submits that the trust concept “straddles the law of property and the law of personal obligations and allows circumvention of the English privity of contract doctrine that prevents third parties from enforcing a contract for their benefit made by others.”
² Act 57 of 1988 s 2.
³ Act 58 of 1962 s 1.
⁴ The Hague Convention on The Law Applicable to Trusts and on their Recognition (1985) article 2. In English law the trust is defined in the context of the equity principle. See Martin 47.
In the South African context Honoré defines the trust as

“a legal institution in which a person, the trustee, subject to public supervision, holds or administers property separately from his or her own, for the benefit of another person or persons or for the furtherance of a charitable or other purpose.”

Langbein states that the business trust is centre to the battle between “gratuitous transfer and bargained-for exchange”; “between gift and deal”.

Sitkoff’s observation of the situation in the United States is that “the business trust is something of an orphan in the domestic legal academy”. He continues in saying that business-law scholars assume that it falls “within the purview of the trust scholars”, and the aforementioned “have cast it aside as the province of the business law scholars”. The question can be asked whether the situation is indeed any different in South Africa.

Hansmann and Mattei submit that the trust internationally provides a level of flexibility in business structures that are not even available in jurisdictions with liberal corporative alternatives. This has contributed to the convergence of trust and corporate law in some countries. In many offshore jurisdictions the need for a trust concept in the business sphere has motivated jurisdictions to introduce the trust in their respective countries. Italy and Luxembourg ratified the Hague Convention on the Law Applicable to Trusts and on their Recognition in 1992, China promulgated the Trust Law for investment and commercial utilisation in 2001, and Israel is actively amending its taxation of trusts. Part of the customising of trusts for commercial purposes is the lengthening of the time for which a trust may exist. Many jurisdictions have abolished any limitation, others are enforcing perpetual existence, and some introduced extraordinarily long time spans, like 1 000 years.

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5 1.
6 In Hayton 190.
7 “Trust as “Uncorporation”: a research agenda” 34. See also Langbein “The Secret Life of the Trust: The Trust as an Instrument of Commerce” 165; and, Scharcz “Commercial Trusts as Business Organizations: Unraveling the Mystery” 559.
8 434.
4.2 DISCRETIONARY BUSINESS TRUST

In an etymological sense, the term “business” refers to the “state of being busy either as an individual or society as a whole, doing commercially viable and profitable work.” In Honoré the business trust is defined as

“a trust the main object of which is to carry on a business enterprise with a view to making a profit and distributing it among the beneficiaries.”

The business trust is therefore in the first place a trust and as the “principles of fiduciary law, loyalty and prudence, do not depend upon the transferor’s motive, whether making a gift or a deal”, the business trust effectively straddles the two forms.

In this definition the business trust is limited to a vehicle of enterprise and operates as an organisation somewhere between the partnership and the company or close corporation. The authors mention a number of examples of the business trust, namely to trade in, as an investment vehicle, to realise an estate in, to protect the interests of debenture holders, to manage pension funds, to create employee share purchases, to manage incentive schemes, as collective investment vehicle, as protection against government interference, and for the management of national parks and public places. The fact that a trust is not a corporation, although it often looks and even functions like a corporation, is one of those anomalies that make the business trust such an enigmatic legal concept.

Pace and Van der Westhuizen state that the term “business trust” is only an indication of the purpose for which the trust was created. They consequently describe the business trust as “any trust which is primarily used for carrying on a business for profit.” To determine whether a specific trust is indeed conducting a

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11 91.
12 Hayton 190.
13 Honoré 15-16. See also Olivier et al Trustreg 8-23 and further for the application of trusts in the business environment.
14 Hayton 151. Compare also Hayton Law Relating to Trusts and Trustees (1995) 28-37 for a discussion of the attractive commercial qualities of the trust and its different roles, like as a commercial security device and as a commercial device to segregate assets.
15 Wills and Trusts (2007) 7. See also Klopper 343, where he summarizes the two main elements of the business trust as firstly (usually) in the form of an inter vivos trust and secondly with the purpose to operate a profitable business for a group of related or unrelated individuals.
business for profit, they suggest that a number of factors are to be considered, including the objectives of the trust, the intention of the founder, the intentions of the trustees, the contents of the trust deed and the nature of the assets in trust, to name but a few.

They then state that the current value of asking the question whether a trust is a business trust or not, “has more to do with the so-called classification of trusts between private and public trusts and has no specific meaning, even for tax purposes.”\(^{16}\) This distinction is supported by Theron who equals the public business trust to a unit trust and compares it to the American business trust, while she describes the private business trust as a phenomenon of “the trust in the ordinary sense of the word”.\(^{17}\) (Own translation.)

It is submitted that Theron is not correct in as far as she alleges that the American business trust requires the issuance of share certificates and is therefore not comparable with the South African private business trust.\(^{18}\) The oldest common-law form of the business trust, the so-called Massachusetts trust, did apparently make use of shares, but the modern statutory business trusts, like the Delaware business trust, make use of trust certificates for a residual interest in the trust. These certificates merely confirm the holder’s undivided interest in the trust asset.\(^{19}\) This is not much different from the usual annexure to many local private business trust deeds, stipulating the beneficiaries with their respective percentages next to their names. Although not very common, some South African drafters of business trusts also make use of share certificates – even where just one family is involved.

Theron submits that if a trust has a number of trustees they can be regarded as an association and will be limited by the requirements of section 30 of the Companies

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\(^{16}\) Pace & Van der Westhuizen 8. Schwarcz 2003(2) The Business Lawyer 563-564 states that commercial trusts can be categorized in two ways: by the type of trust, or by the business use to which the trust has been placed. He submits that both are relevant as there is sometimes “an imprecise correlation between labels and functions”.

\(^{17}\) Theron 1990 SALJ 675. She uses the trusts under consideration in Goodricke & Son (Pty) Ltd v Registrar of Deeds, Natal 1974 1 SA 404 (N); Pretorius v Commissioner for Inland Revenue 1984 2 SA 619 (T); and, Commissioner of Inland Revenue v Pretorius 1986 1 SA 238 (A) as examples of the private business trusts.


\(^{19}\) Schwarcz “Commercial Trusts” 563-564.
Chapter Four: Business Trust

Act 61 of 1973, which is applicable when the entity was formed “for the purpose of carrying on any business that has for its object the acquisition of gain”\(^\text{20}\). 

She unfortunately does not refer to the proviso “unless it is registered as a company . . . or is formed in pursuance of some other law . . .” It is submitted that all trusts are either formed in terms of the common law or are registered in terms of the TPCA or the CISCA (or its predecessor) and is therefore formed in pursuance of a law. If correct, section 30 was therefore not applicable to trusts.\(^\text{21}\) It may be submitted that the reference to “some other law” is much wider than an Act of parliament and that a business trust is indeed an entity which is formed in pursuance of the common law. The Afrikaans text, however, which is the text signed by the State President, reads “kragtens hierdie Wet of opgerig word ingevolge ‘n ander wet”. If interpreted according to its normal meaning, the conclusion will most probably be that this text does indeed refer to a statute and not to the law in general.

Section 30 was replaced by section 8(3) of the Companies Act 7 of 2008, which reads as follows:

“No association of persons formed after 31 December 1939 for the purposes of carrying on any business that has for its object the acquisition of gain by the association or its individual members is or may be a company or other form of body corporate unless it –

(a) is registered as a company under this Act;

(b) is formed pursuant to another law; or

(c) was formed pursuant to Letters Patent or Royal Charter before 31 May 1962.”\(^\text{22}\)

It is submitted that Theron is correct in her argument that a trust is an association of persons, which leads to the consequential submission that any business trust which

\(^\text{20}\) See Theron 1990 SALJ 679 for discussion on the applicability of s 30 on business trusts. Compare Klopper 1988 De Jure 340. This Act was repealed by the 2008 Companies Act and s 30 has been replaced by s 8(3) in the new Act.

\(^\text{21}\) Although a trust is not technically created in pursuance of the Trust Property Control Act, the activities of the trust cannot effectively commence before the trustees have not been appointed in terms of the Act. The trust will therefore not be null and void but will be useless. The legislator most probably did not have trusts in mind when s 30 was included, but unlegislated entities, such as associations and partnerships. Theron supports this submission in 1991 TSAR 285.

\(^\text{22}\) The two major differences between the old s 30 and the new s 8(3) is (a) the removal of the requirement of twenty persons, and (b) the replacement of “company, association, syndicate or partnership” with “association” only.
Chapter Four: Business Trust

is not formed in pursuance of a particular piece of legislation, is prohibited to act as a body corporate.\(^{23}\)

Our highest court\(^{24}\) at the time has accepted the interpretation of the purpose of this prohibition by James LJ in the English case of *Smith v Anderson*, where he submits it to be the prevention of “mischief arising from trading undertakings being carried out by large fluctuating bodies so that persons dealing with them do not know with whom they are contracting”.\(^{25}\)

Nienaber JA summarized sections 30(1) and 31 in the *Mitchell’s Plain*\(^{26}\) case as follows:

1. if membership exceeds 20, it must be registered as a company if it is formed for the critical purpose; failing which it will have no *locus standi in judicio*; if fewer than 20, it is not illegal if it is formed for the critical purpose and is to operate as, say, a partnership;

2. if it is formed for the critical purpose it must be registered as a company in order to enjoy corporate personality; if it is not formed for the critical purpose it may yet enjoy corporate personality if it possesses the characteristics of a *universitas* (i.e. operating as an unincorporated voluntary association).

It is therefore submitted that the only result of a contravention of section 8(3) would be the lack of corporate personality. If it possesses the characteristics of a *universitas*, such as a voluntary association, it will even enjoy corporate personality.

It is submitted that section 8(3) has no bearing on the business trust, as the aforementioned is, for the purposes of the Companies Act 71 of 2008, a juristic person and will therefore automatically enjoy corporate personality.

\(^{23}\) See Theron *TSAR* 679–680 on the question of whether a business trust can be regarded as an enterprise formed with the object of acquiring a gain. “Business” was defined in *Smith v Anderson* (1880) 15 Ch D 247 as “anything which occupies the time and attention and labour of a man for the purpose of profit”. It is submitted that the term “body corporate” has a wide meaning here, referring to a legal entity comprising of a collection of individuals with rights and duties distinct from their personal rights and duties as individuals.

\(^{24}\) *Mitchell’s Plain Town Centre Merchant’s Association v McLeod* 1996 4 SA 159 (A) 169I. and *Director: Mineral Development, Gauteng Region v Save the Vaal Environment* 1999 2 SA 709 (SCA) 716 [8].

\(^{25}\) (1880) 15 Ch D 247 (CA) 273. Referred to by the Appeal Court in the *Mitchell’s Plain* case at 716.

\(^{26}\) 1996 4 SA 159 (A) 166B-D.
Business trusts are sometimes also referred to as “trading trusts”. Geach and Yeats\textsuperscript{27} also differentiate between a public and a private trading trust, with the first being where members of the public are invited to become income beneficiaries, as in the case of a unit trust, with the private trading trust as an entrepreneurial vehicle for the carrying on of a business.

Pace and Van der Westhuizen\textsuperscript{28} further state that the public trust invites the general public to become income beneficiaries in return for a contribution to the trust fund. A trust registered with the Registrar of Collective Investment Schemes\textsuperscript{29} will therefore, in terms of their definition, qualify as a business trust. A collective investment scheme\textsuperscript{30} refers to a scheme “in pursuance of which members of the public are invited or permitted”, and “members of the public”, “excludes persons confined to a restricted circle of individuals with a common interest”, which makes it clear that not every trust in which a number of individuals on invitation are involved, is necessarily a public business trust.\textsuperscript{31}

In South Africa the business trust concept did not develop as a special form of trust or as a special form of business the way it did in the United States. The business trust in the US made its debut in Massachusetts in 1827, where the business trust is even today often referred to as the “Massachusetts trust”. These trusts were the result of limiting legislation regarding property development and were originally associated with property arrangements only. A practice developed to vest a business or real estate in a group of trustees, who manage it for the benefit of the beneficial owners, with the ownership of the beneficiaries represented by negotiable or transferable shares. These trust estates operated as business companies but were not statutorily regulated in the same way.\textsuperscript{32}

\textsuperscript{27} 23.
\textsuperscript{28} 8.
\textsuperscript{29} In terms of s 1 of the CISCA.
\textsuperscript{30} As defined in s 1 of Act 45 of 2002. Compare with the definition of related and inter-related persons in s 2 of the Companies Act 7 of 2008, where the control of the majority of votes in a trust or control over the appointment of trustees is put on an equal footing with the family relationship between natural persons.
\textsuperscript{31} Compare s 96 of the Companies Act 7 of 2008, which sets out offers that are not regarded as offers to the public.
In 1988 the Delaware Business Trust Act in the United States codified the common-law business trust with the purpose of modernising the common law with respect to the use of trusts in commercial transactions. The statutory business trust’s major advantage is its continued flexibility as the trust agreement establishes the rights and obligations of the trustees and the beneficial owners, and not the legislation, as with corporations. It therefore acts as the ideal compromise between the company and the common-law trust.

In *Nieuwoudt v Vrystaat Mielies*, which deals with, amongst other things, the applicability of the *Turquand* rule to trusts, the court emphasises some of the practical frustrations of the trust as a business trust in the South African context, especially the fact that no central trust register, as with companies, exists. An interesting remark is that the specific trust was formed “probably for estate planning purposes or to escape the constraints imposed by corporate law . . . while everything else remains the same”.

Theron submits that the applicability of the trust as a business vehicle is based on the flexibility of the trust, the transferability of assets, the separation of formal ownership, and the lack of statutory directives. She describes the business trust as “a trust of which the exclusive or main purpose is that the trustees trade with the trust assets with the aim at making a profit.”

Hayton submits that the following elements of the trust concept make the use of it attractive to the commercial world: beneficiaries’ proprietary interests in a segregated trust fund, for the protection it provides; the protection that the strict fiduciary duties and standards afforded by the office of the trustee provides to the beneficiaries; the flexibility of the terms of the trust instrument; the lack of legal personality which enables the trust to be created and managed in a less formal and more inexpensive way.
way; and, the availability of judicial assistance in protecting trustees and
beneficiaries.

For the purposes of this thesis the business trust will be regarded as a vehicle of
estate and business planning, with the beneficiary of the trust being either individuals
or one or more other family or business trusts. The purpose of the trust, more so
than the object, fulfils a crucial role in this investigation.

This type of trust raises two distinct problems, which will be evaluated in Chapter 10:

(a) whether the business trust is a better form of business organization than the
    partnership and/or the corporation; and

(b) whether existing trust law is adequate to govern business trusts.39

4.3 APPLICATION OF THE BUSINESS TRUST

The business trust has been defined as “an unincorporated business organization
created by a legal document, a declaration of trust, and used in place of a
corporation or partnership for the transaction of various kinds of business with limited
liability”.40 The term “business trust” has different meanings to different people. The
most common business trust is where a venture is conducted in a trust as if it were a
corporation. Many farmers make use of the trust to conduct their farming operations,
irrespective of whether the farm property itself is registered in that trust or in another
entity’s name (or even in the farmer’s own name).

Business trusts are also used in conjunction with others, often as a type of
partnership where a service business, from where retail business or joint property
business is managed. It is also popular amongst professionals to hold the fixed
property from where a legal, medical or other practice is carried on. Hayton41 refers
to the following not so obvious applications of the business trust, namely:

(a) for the structuring of buy-and-sell agreements between business partners;

39 Schwarcz 2003 The Business Lawyer 559. See further 10.2.
41 Law Relating to Trusts and Trustees 36.
(b) for the reduction of taxes relating to intellectual property royalties by assigning it to a trust in a low tax jurisdiction;

(c) for the structuring of family businesses where non-participating family members can retain an interest in the business by way of a trust without being actively involved in the business itself.

In a number of court decisions during the last decade it was decided that the living trust and certain of the protections it grants, must be tested in terms of substance and not only form. The question is not only what the trust deed seems to reflect *de iure*, but also how the trust is run *de facto*.42

In the *Parker* case43 the Supreme Court of Appeal decided in this regard that *enjoyment* and *control* should be *functionally separate*44 and laid down some practical indicators of this independence. The strong reaction of the court, albeit *obiter*, led to direct instructions by the Master of the High Court regarding the appointment of independent trustees.

It is submitted that the *Parker* case is the result of the healthy development of the trust concept in South Africa. Some may argue that the legislator should have intervened sooner in this regard. I submit, however, that the necessity for an independent trustee on each and every trust was a developmental issue rather to be addressed in terms of *stare decisis* when the time was ripe. Both an under- and over-regulated trust legal environment may be to the detriment of its future development.45

Most of the recently reported cases requiring an independent trustee dealt with the so-called family trust and not the business trust and were in consequence of divorce matters.46 This has led many practitioners to believe that the requirement is only

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42 See *Badenhorst v Badenhorst* 2006 2 SA 255 (SCA) 261A where the Appellate Division of the Supreme Court decided to ignore the existence of the living trust for the purposes of a redistribution order.

43 *Land & Agricultural Bank of SA v Parker* 2005 2 SA 77 (SCA) 87C.

44 See also discussion by Kernick 2007(1) *De Rebus* 27-29.

45 The desirability or not of addressing trust issues by way of legislation is addressed in Chapter 10.

46 Although one can argue that the “Jacky Parker Trust” which was the source of dispute in the *Parker* case, carried in it many elements of a business trust. In *Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk* 2004 3 SA 486 (SCA) on 490A and 493D the court referred to the
relevant to family trusts. The fact that a classical business trust may have a number of different beneficiaries who regard themselves as “shareholders” of the trust, does not exonerate the trust from the need for a functional separation between enjoyment and control. If everyone that enjoys also controls, the principle remains the same as in the case of a family trust.

In *Parker* the court stated that “it is separation that serves to secure diligence on the part of the trustee, since a lapse may be visited with action by beneficiaries whose interests conduce to demanding better. The same separation tends to ensure independence of judgment on the part of the trustee – an indispensable requisite of office – as well as careful scrutiny of transactions designed to bind the trust, and compliance with formalities (whether relating to authority or internal procedures), since an independent trustee can have no interest in concluding transactions that may prove invalid.” On 87G Cameron JA went further and stated as follows: “As long as the functions of trusteeship remain *essentially distinct* from the beneficial interests, there can be no objection to business trusts, since the mechanisms of the trust form will conduce to their proper governance, which will in turn provide protection for outsiders dealing with them” (own emphasis).

It is submitted that at least one independent trustee is necessary on the board of a business trust to bring about the required *essential distinction*. An independent trustee alone is obviously not necessarily adequate to ensure the distinction. The two roles must also be kept functionally separate. It does remain a factual question therefore in each case whether the enjoyment and control were indeed kept separate or not. An independent trustee, who also acted independently and has applied his mind independently to trust matters, however, will go a long way, in the path to separation. Therefore, in the *Parker* case Cameron JA makes it clear that the trust as a legal vehicle for business is not problematic, as long as there is a *functional separation* between the enjoyment and control, and the trusteeship remains *essentially distinct* from the beneficial interests it represents.

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trust in question as a “family business trust” and a “business trust” respectively. See the *Jordaan* and *Badenhorst* matters.

47 *Land & Agricultural Bank of SA v Parker* 2005 2 SA 77 (SCA) 87C.

48 87G.
Subsequent to some prudent decisions over the last decade, which steered our trust law in a positive direction, our jurisprudence is unfortunately also challenged with decisions that may have the opposite effect. In a recent decision by the Tax Court, it was ruled that, where all the trustees and beneficiaries of a trust were substituted, a new trust was in effect created. If this ruling is followed by the Supreme Court of Appeal it may have a devastating effect on business trusts which are often sold to third parties as part of a business transaction. It is submitted that the core idea of the trust must be developed in the minds of jurists to be brought in line with the practical reality of modern society. In many instances it was already allowed to do exactly that. The crucial role that trusts fulfil in this and many other well-developed legal and financial systems is adequate motivation not to allow archaic thinking to stand in the way.

In light of the peculiar position of the commercial trust in the American context of the Massachusetts and Delaware forms of business trust, it has been referred to as an “uncorporation”. Although the American legal thinking may more often than not offend the Roman-Dutch scholar, it is submitted that it may sometimes contribute to the South African development.

4.3.1 TRADING TRUST

The public trading trust has been described as “a trust arrangement where several beneficiaries contribute capital to a fund in return for transferable certificates”. This type of arrangement is regulated by the CISCA and will be discussed elsewhere.

The private trading trust is an ordinary trust with the object of utilising the trust assets to conduct a profitable business. Although the trustees of most family and general estate planning trusts (including many testamentary trusts) have the power to conduct business for a profit with the trust assets, it is not their main objective.

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50 Sitkoff 2005 University of Illinois LR 31.

51 See 4.6.11.

52 Honiball and Olivier 304.
For the purpose of this thesis I shall define a trading trust as a business vehicle, used to own and manage business activities of some or another form, with either individuals or other trusts as beneficiaries. The trading trust therefore fulfils the same role as a partnership, close corporation or company.

The common-law principle is that a trust may not carry on business with the trust assets, because in principle a trustee may not expose trust assets to any form of risk. This limitation can be overcome by an expressed power in the trust deed to do business or trade.

Geach and Yeats\(^{53}\) state as an advantage of the trading trust, the fact that “it holds out the possibility of a limited liability form of trading without the complexities or expense inherent in trading through a company or close corporation.”

Although a trust is not a legal person, it is dealt with as one in terms of tax and insolvency legislation. A trust can be a debtor and/or creditor, can be sequestrated and can possess an estate and incur liabilities.\(^{54}\) It is therefore clear that there is no limitation on the use of a trust for trading purposes.

In a trading trust, just as is the case in any trust, the trustees will be liable only to creditors if the trustees bound themselves or if they acted negligently, outside their powers or with *mala fides*.

Geach and Yeats\(^{55}\) state that a private trading trust may be regarded as a partnership if certain elements are not included in the trust deed. They refer to the four-fold essentials of partnerships, with reference to *Joubert v Tarry and Co*\(^{56}\) as follows:\(^{57}\)

(a) each partner brings something into the partnership or commits to bringing something into it;

(b) the business must be carried on for the joint benefit of the parties;

\(^{53}\) 295.

\(^{54}\) *Magnum Financial Holdings (Pty) Ltd (in liquidation) v Summerly and Another NNO* 1984 1 SA 160 (W).

\(^{55}\) 23.

\(^{56}\) 1915 TPD 277.

\(^{57}\) Geach & Yeats 280-281.
(c) the object must be to make profit; and

(d) the contract between the parties should be legitimate.

Honiball and Olivier refer to a few specific uses of private trading trusts, such as voting trusts (voting rights of a number of shares in different companies placed in the trust), agricultural land trusts (to hold the land for generations and without subdividing), investment trusts (including property-holding trusts), and general trading trusts where retail- or service-related business activities are conducted in a trust (also often used for farming activities).

Many trading trusts are drafted as so-called vesting trusts, where the trust deed, or an addendum to the deed, indicates that each party has the right to a certain percentage of income and/or capital. If there are no independent trustees appointed to the trust, it may comply with all the elements of a partnership. A partnership makes the parties thereof more vulnerable against creditors and is automatically terminated at the death of one of the partners. It is therefore important to separate control and enjoyment and to ensure that the ownership of the assets settles in the trust itself and not in the beneficiaries.  

In *Nieuwoudt v Vrystaat Mielies* only one of two trustees signed a contract on behalf of the trust for the sale of mielies. The appellants (which included the other trustee) alleged that the contract was null and void because of the one trustee’s failure to sign. The respondent contended that the contract was valid because of a clause in the trust deed stipulating that the trustees may authorise some trustee(s) to sign on behalf of the trust. The respondent also raised the *Turquand* rule as binding the trust to the contract. The court decided that what the clause relied on was not relevant to the facts, neither was the *Turquand* rule. The court consequently ruled that the trust deed provided that, if there were two trustees, they have to act jointly. The trust was therefore not bound by the contract.

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58 Geach & Yeats 24, with reference to *Land & Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA), is of the opinion that not only a trustee, but the majority of trustees, should be independent to ensure that such trusts are not being regarded as partnerships.

59 *Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk* 2004 3 SA 486 (SCA).

60 *Nieuwoudt v Vrystaat Mielies* 494[21].
This use of the trust comes closest to the traditional corporation. The reasons for the use of the trust in this sense are manifold, of which the lower level of accountancy compliance and consequent costs, the simplicity of establishing it and managing it and the potential of income-splitting, may be some of the main driving forces.

The trust is far more flexible than the company, as ownership can be changed by way of mere cessions and no share transfers are necessary. In the case of a family or a family trust as initial beneficiaries, no transfer has to take place at the death of the originator.

Although the establishing and registration of the business trust is fairly expensive in comparison to the company, this once-off cost compares favourably when the company’s ongoing costs are taken into consideration.

Cameron JA\textsuperscript{61} recently stated that “(t)he great virtue of the trust form is its flexibility, and the great advantage of trusts their relative lack of formality in creation and operation: the trust is an all-purpose institution, more flexible and wide-ranging than any of the others.”

Company legislation is cumbersome and complex,\textsuperscript{62} while trusts are driven by the common law, with the TPCA as the only piece of legislation focusing on the regulation of trusts in general. The aforementioned only touch on the basic aspects of registration, appointment and sureties.

The fact that the general public does not have access to the details of trust deeds and the parties involved by way of a central database, such as the Companies and Intellectual Properties Commission (CIPC) in the case of close corporations and companies, is often regarded as a negative factor to be taken into consideration by business people.

Dual ownership and the possibility of yet unidentified ownership are often regarded as an advantage by individuals in business.

\textsuperscript{61} Land & Agricultural Development Bank of South Africa v Parker 2005 2 SA 77 (SCA) 87 [23].

\textsuperscript{62} Companies Act 71 of 2008.
4.3.2 PRIVATE INVESTMENT TRUST

Trusts are often used for specific non-trading activities, such as property transactions, to hold shares in private and public companies, or as a pure investment vehicle. It is a popular vehicle for development or transactional purposes where a number of individuals, families, trusts or companies are involved. It is also ideal as a vehicle for the generational transfer of assets or one or more businesses.

The ownership of land may only be conveyed from one person to another by means of a deed of transfer, executed or attested to by the Registrar of Deeds, and other real rights in land may only be conveyed by means of a deed of cession. The term “person” includes a trust for the purpose of the registration of immovable trust property. Land may also be transferred in the form of shares or undivided shares. 63

Real estate developers often place land, potentially earmarked for development purposes, in a trust for an interim period while rezoning and sub-division applications, ecological impact reports and developmental authorizations are underway. These authorizations may take a number of years to be finalized and in the meantime no active trading is taking place in the legal entity. A trust is often more ideal than a company for these transactions, especially where the land will ultimately be sold off in piecemeal fashion. It is common to find, after such a development has been finalized, that small pieces of dormant land remain behind in the original legal entity (i.e. a trust). In case of a company the owners are obliged to keep the legal entity as an active trading vehicle. They must continue to lodge and pay annual returns, have the company financials audited annually and comply with the extensive company legislation. In the case of a trust as a holding vehicle of land, it can remain dormant for any length of time without any taxing legalities, sanctions or costs.

Agricultural land is ideally held in trust as it is custom for farms to be transferred from one generation to the other. The rapid growth in the value of agricultural land has made this practice extremely viable as, once in a trust, further transfers can be prevented for any length of time. The trend by farmers to pass a usufruct or habitatio on one or more farms to their spouses is also often replaced by a beneficial right to income from the trust the farm belongs to.

63 Deeds Registries Act 47 of 1937 (as amended).
The above practice is also beneficial in the case of family holiday homes, time share, share block and fractional title units, or any other property the founder purchases for the future benefit of his descendants in general. If a trust is not utilised such property may have to be registered in the names of a number of persons who legally will become unintentional partners and by the second or third generation it may be extremely taxing and unpractical. Every time one of the co-owners die a fresh registration is necessary.

By placing such assets in a family or business trust he further protects it from the indiscretions of future generations as well as unnecessary costs regarding transfers and taxes.

The recent Supreme Court of Appeal decision in *Thorpe v Trittenwein*, however, again highlighted an unsatisfactory aspect of trusts as property vehicles. Although technically correct it seems as if the court missed the opportunity to rectify the legal position as far as the authorisation requirements for trustees in property transactions are concerned. The court confirmed that the trustee signing a deed of sale must have written authority from the other trustees. This places trusts in a more stringent position than partners and company representatives and may inhibit the utilisation of trusts in property transactions. Trustees are not acting as agents of their co-trustees and it was, therefore, possible for the court to extend the leniency applied to partnerships where the authority of the partner does not have to be in writing, but may be expressed or implied. However, this limitation can be addressed in practice by way of the trust deed.

The main advantages of holding private company shares and close corporation members’ interest in a trust is the protection of the individual’s personal estate from the results of company failures, creditors and estate duty and capital gains tax at death. The founder effectively creates distance between his personal estate and that of the company and although he still acts as director and manages the company (and most likely also acts as trustee) he is not the owner of the company. His position is

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64 2007 2 SA 172 (SCA).
65 See Lötz & Nagel 2006 *THRHR* 698.
66 This requirement is part of the application of s 2(1) of the Alienation of Land Act 68 of 1981, determining that no alienation of land shall be of any force or effect unless it is contained in a deed and signed by the parties thereto or by their agents acting on their written authority.
likened to that of a director in a public company in that his fiduciary position is legally separated from his ownership. At his death the directorship of the company will change but the shares do not form part of his estate and no capital gains event takes place. In the case of a close corporation the member’s interest must be transferred if it is held by the deceased in his own name, but when in a trust, only the individual nominated to represent the member (which is the trust) has to be changed, without any effect on the operation of the corporation.

Public company shares are mainly held in a trust as an investment vehicle to protect the asset from the creditors of the founder and to ensure that all future growth in the value of the asset takes place outside his personal estate. At death public company shares are transferred to the beneficiaries of the deceased at the current value thereof, but when held in trust the death of the founder has no effect on the shareholding. It is excluded from the deceased’s estate and no capital gains event takes place.

4.3.3 COLLECTIVE INVESTMENT SCHEME TRUST

In this paragraph the business trust in the form of a collective investment scheme will be touched upon, but it will be discussed in more detail in Chapter 7.67

Collective investment schemes mostly manifest in the form of unit trusts, although not all collective investments schemes are necessarily unit trusts. A financial instrument is an instrument having monetary value or recording a monetary transaction; or, an easily tradable package of capital.68 The financial instrument trust is a trust registered with the Registrar of Collective Investments Schemes.

Theron69 refers to the dual test in section 37 of the previous legislation, the Unit Trust Control Act 54 of 1981, in terms of which no person may develop a non-unit trust scheme to which the public is invited to participate and the investors share proportionately.70 The CISCA (parts IV to VIII) differentiates between certain categories of collective investment schemes, namely those in securities, in property,

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67 See 7.2.1 and 7.7.1 for more on the role of trusts in collective investments schemes.
69 The Unit Trusts Control Act 54 of 1981 and the Participation Bonds Act 55 of 1981 were wholly repealed by s 117 of the CISCA.
70 See Theron TSAR 287-288. See also www.asisa.co.za/index.php/collective-investment-
and in participation bonds. It further makes provision for declared schemes and foreign schemes.

A collective investment scheme can be described as “a trust based scheme that comprises a pool of assets that is managed by a collective investment scheme manager”. All collective investment schemes (including a manager, trustee, custodian or nominee company) are “financial institutions” in terms of section 1 of the Financial Services Board Act 97 of 1990.

Each participant in participation bonds has a proportional stake (participatory interest or unit) in the specific collective investment scheme in participation bonds. The trust is the financial instrument used to manage and administer the investment on behalf of the investors. This scheme enables individuals to invest in a cost-effective way on the stock exchange and in the money markets.

In Chapter 7 the different role players in a collective investment scheme, namely the portfolio manager, the scheme manager, the trustee (or custodian), and the mortgagor, will be discussed in some detail.

In *Fedbond v Investec Employee Benefits* the court confirmed that a participant can only claim repayment of its investment in a collective investment scheme from the mortgagor and not from the manager. The relationship, however, is tripartite in nature. Although the manager is not a debtor to the participant, the agreement between them provides obligations for both the manager and the participant.

Trusts often fulfil a central role as one of the legal entities in the structuring of financial instruments – either as a collective investment vehicle or as a special-purpose vehicle. Many investment and risk funds held on behalf of third parties, such as unit trust funds, structured finance vehicles, retirement funds and medical aid funds, are held in a trust form. In this context the trust has become a major tool in the business and financial world and billions of rands are invested through structures

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72 See 7.2.

73 *Fedbond Participation Mortgage Bond Managers (Pty) Ltd v Investec Employee Benefits Ltd* 2010 4 All SA 467 (SCA) [23] and [24]. Confirming *Syfrets Participation Bond Managers Ltd v Commissioner, South African Revenue Services* 2001 2 SA 359 (SCA). In a minority judgment Harms DP held that there is indeed a debtor-creditor relationship between the manager and the participant para [41].
involving trusts in one form or another, either as a mere holder of units or as a special-purpose vehicle or entity.

Honoré\(^\text{74}\) summarizes the different phenomena in the trust arena as follows:

“In the ordinary trust the trustee administers the property while the beneficiary enjoys it. The business trust exploits this form in that the beneficiaries often provide the capital for the business which is carried on by the trustee and in return receives a share of the profits. In the unit trust (read the collective investment scheme) the business administration is carried on by a third person, the manager or (the) management company.”

The TPCA does not, in terms of section 113 of the CISCA, apply in respect of a collective investment scheme. Any trust that is therefore formed in terms of the aforementioned Act, will not be administered in terms of the TPCA.\(^\text{75}\)

In Chapter 7 the role of trusts in collective investment schemes will be dealt with in more detail.

4.3.4 NON-COLLECTIVE INVESTMENT SCHEME TRUST

It is accepted that the words “trust” or “trustee” are sometimes used in a context where they do not refer to a trust in the real sense of the word. In Conze v Masterbond, where the investor’s loan to a company was secured by a debenture mortgage bond in favour of the trustee for the debenture holders, the court held that the trustee was only “an agent in a fiduciary capacity” of the debenture holders. Although there was a contract (trust instrument) between the company and the trustee, the court was of the opinion that, since the trust property did not pass to the trustee, his conduct was not subject to the TPCA.\(^\text{76}\) In this matter the mortgage bond was passed in favour of the trustee in terms of sections 117(3) and 118(3) of the Companies Act 61 of 1973, while the debenture holders held all rights under the bond.\(^\text{77}\)

\(^{74}\) 619.

\(^{75}\) The CISCA and the TPCA do unfortunately not clearly indicate their exclusive roles. The ideal situation would have been legislation that clearly states the different types of trusts and their administration.


\(^{77}\) See the discussion on the strict (narrow) and wide manifestations of the trust concept in Chapter 2.
It is submitted that the TPCA should have been applicable to the matter, as the debenture holders were the owners of the rights under the mortgage bond, and it was therefore a trust as defined in sub-clause (b) of the definition of “trust” in the TPCA (called a “bewind-trust” by the court at 794F).\(^78\)

Since the commencement of the CISCA on 3 March 2003 all schemes “in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio” qualify as collective investment schemes (subject to certain qualifications). A scheme similar to the Masterbond scheme would consequently now be regulated by the CISCA.

It is envisaged that a number of selected individuals may decide collectively to invest, without inviting or permitting the members of the public to invest, and that such investment schemes shall be excluded from the CISCA. It is submitted that, if a trust is used as a legal vehicle, it will be regulated by the TPCA. Whether such a trust is a discretionary trust or a bewind trust will be determined by the contents of the trust deed.

In *Commissioner for SARS v NWK*\(^79\) the proposed finance structure included a trust which would have received certain rights by way of cession, in return for carrying the “administrative burden” of the transaction. The court found that the whole transaction was structured with the purpose to “deliberately disguise the true nature of the loan” and that “(t)he loan was a simulated transaction, designed to create a tax benefit for NWK.”\(^80\) Although the trust was never actually incorporated in the scheme, the original intention was to use a trust with an administrative role only. The purpose of the trust would have been to complicate the financial structure further and to ultimately mislead SARS.

### 4.3.5 PENSION FUND TRUST

Martin submits that in view of the special nature of the pension fund trust as far as the size of the funds, their quasi-public nature, the opportunities for misappropriation

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\(^78\) See Van der Merwe 2000 *SA Mercantile LJ* 319-320, where he states that “(t)he first use (of vest) refers to the ownership of a right and not to the ownership of the benefit or asset as such” and “(t)he vesting of a right does not mean that a right to ownership in the thing is obtained.”

\(^79\) *Commissioner for South African Revenue Service v NWK Ltd* 2011 2 *SA* 67 (SCA).

\(^80\) Paras [87] and [89].
by the employer, the non-volunteer status of the employees, and the public interests in these trusts, it was necessary for the legislator in England to legislate many provisions administering these trusts.\(^{81}\)

The Pensions Regulator has a variety of powers aimed at the protection of the members and has supervisory powers over the trustees, including the power of appointment, removal and suspension. Other important aspects of English pension fund trusts that are regulated by statutory provisions, include the constitution of the trustee body, the requirements for appointment as and disqualification of trustees, decision-making by trustees, the appointment of advisors to the trustees, rules of investment, the funding of pension schemes, entitlement to surplus funds and the winding-up of the trusts.

There has always been some controversy about the balance between statutory pension regulations and reliance on trust-law principles. Some national and international legal developments, such as the equal treatment of men and women in the awarding of pension benefits,\(^{82}\) and the sharing of pension entitlements at divorce have affected the contents and working of pension fund trusts in recent years.

Pension funds in South Africa are regulated by way of the Pension Funds Act 24 of 1956 (as amended),\(^{83}\) and are also “financial institutions” in terms of section 1 of the Financial Services Board Act 97 of 1990.

A pension fund organisation in South Africa may be in the form of “an association of persons” or in the form of a “business carried on under a scheme or arrangement”. The three categories of organisations are (a) an association of persons for its

\(^{81}\) Martin 483. He states that the main objective of the Pensions Acts of 1995 and 2004 in the UK was to protect the beneficiaries from the effects of maladministration, fraud and insolvency. The office of Pensions Regulator was created by the Pensions Act 2004. There is an independent body, the Occupational Pensions Board, which has some limited supervisory powers. Moffat et al 483 submit that most pension schemes in the UK are established and administered under trusts law.

\(^{82}\) In Barber v Guardian Royal Exchange Assurance Group [1991] 1 Q.B. 344, and Coloroll Pension Trustees Ltd v Russell [1995] 1 C.R. 179, both decisions of the European Court of Justice, it was held that the trustees should do everything in their power to ensure compliance with the “equal pay” principle - also as far as pensions are concerned.

members, (b) a business for a class of persons, and, (c) an association of persons or a business on behalf of beneficiaries of one or more pension funds.

If it is in the form of a trust it must be registered with the Registrar of Pension Funds. Only pension funds in the form of trusts to which the state contributes, shall become juristic persons in terms of section 4B (read with 4A). A category (a) fund shall become a body corporate (section 5(1) (a)), and a category (b) fund, even if it is an unincorporated entity, shall be treated as if it were a body corporate (section 5(1) (b)).

It is submitted therefore that a trust being utilised as a pension fund organisation becomes a juristic person for all purposes of the Act upon registration in terms of the Pension Funds Act.

4.3.6 EMPLOYEE AND/OR EMPOWERMENT TRUST

The trust is one of the most affordable, simplistic and effective mechanisms to use for share allocation to employees (including previously disadvantaged employees) in private and public companies. It has in recent years been utilised by many companies for broad-based black empowerment programmes.

South African companies are required by current legislation to implement specific minimum empowerment programmes and for many of the smaller private entities this has become a burden with respect to both finances and management as they do not have the capacity to adhere to these requirements. The objectives of Broad-Based Black Economic Empowerment are to empower more black people to own and manage enterprises, to achieve substantial change in the racial composition of ownership, to promote access to finance for black economic empowerment, to enable access to economic activities, to promote the human resource development of black people, to ensure black-owned enterprises benefit from preferential government procurement policies, and to assist the development of operational and financial capacity of black economic empowerment enterprises. 84

The strongest resistance against sharing with employees in shareholding is often found in the uncertainties regarding the ideal candidates, as smaller companies do

84 See Investor Handbook 2009, Department of Trade and Industry, for more details on the B-BBEE framework.
not have the financial and infrastructural means to headhunt the best suitable empowerment partners in managerial positions. They ultimately have to resort to the distortion of empowerment of general employees, with the risk of high turnover of personnel, limited educational and training backgrounds, tendencies towards a culture of labour disputes, etcetera, and such transactions may often be extremely risky for the business owner or entrepreneur.

The future utility of companies as direct empowerment vehicles must still be determined within the context of the new company legislation. It is submitted that non-profit companies may indeed be utilised under the Black Economic Empowerment (BEE) codes. In the case of private companies it will consider the effect, if any, that some new corporative principles, like the public interest score, fiduciary capacity, and beneficial interest, may have on empowerment transactions in the future. One of the advantages that the new Companies Act may have is the removal of the limitation of a maximum of fifty shareholders.\footnote{See ss 3, 117 and 122 of the Companies Act 71 of 2008 (as amended) and ss 26, 28 and 82 of the Company Regulations 2011.} Empowerment shareholders’ rights, privileges, restrictions and prohibitions may have to be included in the Memorandum of Incorporation. The constructive notice principle was included in some past empowerment transactions. As the doctrine has been abolished in terms of the 2008 Act, third parties are not deemed to know of restrictions on companies’ powers. Even the concepts of economic and voting rights under the empowerment score-card may have been impacted by the new Act.\footnote{Shares do not have a par value any longer.} The question may even be asked whether companies used for empowerment fronting may be guilty of unconscionable abuse of the juristic personality.\footnote{See subss 20(9) and 163(4) of Act 71 of 2008.}

The use of a trust to hold the empowerment shares has the major advantage that no vesting into the hands of individuals has to take place, as in the case of direct shares in a company, for the employee to actually receive benefits and to share in profits or dividends. Instead of granting a percentage ownership to a few qualifying individuals, with the coupled risk, the shareholding can be spread, by way of a trust, amongst the employees in general, with one or more representative trustees as directors.
One of the major advantages in using the trust as a holder of shares is the fact that it can be dormant and does not have to trade actively in any way. Empowerment transactions may often be lengthy processes, as finances are not always readily available and huge numbers of individuals or groups must sometimes be consulted during the process. If a merger is involved, competition tribunal approval is also necessary. The structure can therefore be finalised beforehand, by way of a trust, and the parties can subsequently negotiate the details and apply for the necessary approvals or financial assistance.

The management of the trust is simple and largely regulated by the contents of the deed. This brings about the added advantage that the parties can manage the internal intricacies in detail in the trust deed, without having to adhere to cumbersome legislation in the process. Section 95(c) of the Companies Act of 2008 makes specific provision for trusts to be utilised in the establishment of employee share schemes, either by means of the issue of shares in the company, or the granting of options for such shares. As no enforceable rights are created in a discretionary trust, the planners do not run the risk of being targeted by shareholders if the transaction does not materialize the way they have expected.

Trusts are also commonly integrated in public company structures, as it is often the ideal vehicle for broad-based empowerment. An example of this is Dipula Property Investment Trust, a property-letting business, which was jointly controlled by Redefine Income Fund Limited, with major stakeholders in the form of national companies such as Stanlib Property Fund, Standard Bank, Old Mutual and Investec Property funds, and Dijalo Property Services (Pty) Ltd, an empowerment company.

Outward Investments (Pty) Ltd, a property-owning and property-letting enterprise, was a wholly owned subsidiary of Redefine, and wanted to create, with Dijalo, a black majority-owned property fund. Dipula Property Investment Trust, a special-purpose vehicle, acquired various properties owned by Outward, with Dijalo Property Services (Pty) Ltd and Redefine Income Fund Limited as the only equity holders in Dipula Property Fund (Pty) Ltd, which was a 100% discretionary beneficiary of Dipula Property Investment Trust.

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88 See s 97 for the standards for qualifying employee share schemes.
89 See Dipula Property Investment Trust (Acquiring Firm) and Outward Investments (Pty) Ltd (Target Firm) 18-12-2006 case no 78/LM/Sep06 (Competition Tribunal).
Redefine and Dijalo thus used a discretionary trust with no equity, to form a new legal structure in which the majority shareholding is held by a black-owned company. There may have been a number of motivations for using the trust as legal entity in this transaction, but one of the apparent reasons was to prevent a contravention of competition laws.

Another major recent transaction of this nature involving trusts was the structuring of the 26% broad-based black economic empowerment stake in the phosphate and phosphoric acid producer, Foskor. Besides the 15% ownership by 12 black business consortia, another 11% was allocated to broad-based special interest groups.

Two special-purpose vehicles in the form of a trust for communities in the vicinity of Foskor’s operations and another trust which controls an employee share ownership scheme for Foskor’s 2,000 employees, have been introduced. The transaction will ultimately have in excess of a million beneficiaries.

It is submitted that the trust remains the ideal vehicle for this type of transaction where a large number of individuals must benefit from without involving all of them in the management and administration of the endeavour — which would be an administrative nightmare. It is important that these trusts are “blind” in the sense that the beneficial interest is not linked to the individual as such but to his status as an employee of the company or as a resident of a specific area.

A trust structure further creates the opportunity to empower a number of individuals by way of rotating trustees acting as representing directors. The collective bargaining power of a trust holding a substantial number of shares compared to hundreds or even thousands of individual minority shareholders, cannot be underestimated.

It is submitted that no other legal vehicle can be as effective as a well-structured trust in the empowering of a large number of employees.

4.3.7 FRIENDLY SOCIETY TRUST

A friendly society is defined in terms of section 1 of the Friendly Societies Act 25 of 1956:
“(a) any association of persons established for any of the objects specified in section 2; or

(b) any business carried on under a scheme or arrangement instituted for any of those objects,

and includes any central society referred to in section 39, whether or not it is liable to provide any benefits mentioned in section 2, and any central society, association or business as aforesaid which is or may become liable for any such benefits, whether or not it continues to admit or to collect contributions from members.”

Section 2 refers to a variety of objects, such as relief to certain vulnerable categories of people, certain annuities, endowments or insurances, and other businesses declared by the Minister. The principle of friendly societies is the collective contribution to the association or business in return for the benefits — excluding pension funds and certain collective saving schemes.90

A central society has control over at least two affiliated societies. A society becomes a body corporate with legal personality in terms of the Act. All friendly societies are also “financial institutions” in terms of section of the Financial Services Board Act 97 of 1990.

It is submitted that trusts may be used as friendly societies and may be ideal vehicles under certain circumstances for these societies to operate in. If a trust is used, it will be registered with the Registrar of Friendly Societies and the trust will not, in terms of section 49, be subject to the TPCA.

4.3.8 SECURITY TRUST

In terms of section 43 of the Companies Act 2008 a trust instrument can be used as a secured or unsecured security document for a debt instrument, other than company shares.

A trust can also be appointed as a trustee for the holders of company debt instruments, provided that the trust remains independent and does not have any interest or relationship that might conflict with its duties as a trustee, and must be approved by the holders of at least 75% of the value of the debt instruments, present at the approval meeting.

90 See also Wille et al Principles of Financial Law (2007) 74-76.
It is submitted that a trust deed drafted for these purposes does not necessarily qualify as a trust in terms of the Trust Property Control Act, as ownership is not always transferred, but it is a trust instrument as defined in section 1 thereof. All trust instruments must be lodged with the Master before a trustee may assume control of the trust property. Trust property includes all property, including contingent interests in property. It is submitted that securities, as defined in the Securities Services Act, are property. The trustees must therefore also be authorised by the Master in writing as prescribed by section 6 of the TPCA.

4.3.9 COMMUNITY TRUST

The utilisation of the trust for community projects or the registration of agricultural land on behalf of communities is becoming a common practice. The trust is often the ideal legal vehicle to house the common goals of a large number of individuals, families or communities. In the restitution process, involving agricultural and other land, the trust is a simple and cost-effective way of vesting the property for the benefit of the beneficiaries.

As the trustees of a trust carrying on farming operations may become members of an agricultural, special farmer’s or trading co-operative, as prescribed by the Co-operatives Act 91 of 1981, it is an uncomplicated vehicle for a group of subsistence farmers to share in the advantages of co-operatives.

4.3.10 PUBLIC PROPERTY SYNDICATION SCHEME TRUST

A public property syndication scheme is defined as “the assembly of a group of investors invited, by word of mouth or through the use of electronic and media print, radio, television, telephone, newspaper and magazine advertising, brochures and direct mail, to participate in such schemes by investing in entities, which could be companies, close corporations, trusts, partnerships or individuals, whose primary asset or assets are commercial, retail, industrial or residential properties, and, where investors share in the profits and losses in these properties, and enjoy the benefits of net rental growth therefrom through proportionate share of income”.91

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91 See s 15(1) of Regulation No. R293, issued in terms of s 120(1) of the Consumer Protection Act 68 of 2008, and published in GG No. 34180 of 01/04/2011.
A public property syndication scheme trust will thus include any property syndication scheme which is structured in the form of a trust. The purpose regulating this type of scheme is the protection of the consumer against unscrupulous investment initiatives. Where the public is not invited to investment in the property syndication, the particular scheme will be excluded from the application of these regulations. Any investment syndication in the form of a trust will make use of a trust instrument specifically designed to accommodate a number of individuals, trusts or legal entities as participants.

4.4 LEGISLATION

All legislation regulating business entities, as well as those regulating financial institutions and instruments and related functions, may be of importance in an investigation of the business trust. In every instance the question would be whether the trust concept can be used for any of these entities or vehicles regulated by the specific legislation. In this Chapter the impact of some legislation on the business trust will be considered and in Chapter 7 the role of these and other legislation will be evaluated from the perspective of the trust as financial instrument.

4.4.1 COLLECTIVE INVESTMENT SCHEMES CONTROL ACT (CISCA)

The CISCA does not deal with business entities in general. Its purpose is to regulate and control the establishment and administration of collective investment schemes. Aforementioned are very important instruments in the financial environment and therefore in the business realm. A collective investment scheme may be packaged in the form of different entities, of which the trust is one. A collective investment scheme itself may be formed and operated in a trust and a trust may also fulfil the role of trustee or custodian in a scheme. Most arrangements in which several beneficiaries contribute capital to a fund in return for transferable certificates, may be in the form of a trust,92 and is regulated by the CISCA.

The agreement between the scheme manager and the trustee or custodian is referred to as a “deed” and in a trust deed form will fulfil that role. Trusts became known in the financial world in the form of unit trusts, which all qualify as collective

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92 See Honiball & Olivier 304. The one further requirement is that members of the public are invited or permitted to invest in the scheme. If it is a closed scheme amongst people that know one another it does not qualify as a CIS.
investment instruments. The term “business” refers to a state of being involved in a commercially viable action, with a motive to be profitable to someone. In this wide sense all collective investment schemes qualify as business trusts. The CISCA does not affect any other type of business trust besides the CIS. Thousands of business trusts in the form of collective investment schemes have been registered and operated in South Africa over the past forty years.

It is submitted that the CISCA has unwittingly contributed to the development of the trust as business entity. *Conze v Masterbond* and the *Syfrets Participation Bond* cases were both decided before the CISCA came into operation. In *Conze* the Masterbond trustees pooled money from the investors, earmarked for a debenture, into one account. The court, in evaluating a debenture trust deed, had to draw a distinction between the trust in the narrow and that in the wide sense. After determining that ownership of the property did not vest in the trustees, the court decided that the Trust Property Control Act did not apply to the debenture trusts. In the *Syfrets* case the nature of participation bond schemes was evaluated, to determine whether a disposal of the participations has taken place. The court submitted that a true sale requires both an identifiable *merx* and a *pretium*, and, as both were absent, the trustees held the money only on behalf of the participants and not as owners.

In *Fedbond v Investec* first-mentioned argued that the deed between the parties, regulating the participation bond scheme, did not contain all the terms agreed upon by the parties. The court refused extrinsic evidence offered by Fedbond, to extend the written agreement by way of inconsistent and contradictory terms. The court further submitted that the relationship created by way of the investment in such a scheme is tripartite in nature. The investors are creditors of the mortgagor, while the manager must honour the withdrawal notice. In this regard the manager is therefore also in a debtor-creditor relationship towards the participant.

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93 *Conze v Masterbond Participation Trust Managers* 1996 3 SA 786 (C) and *Syfrets Participation Bond Managers Ltd v Commissioner*, SARS 2001 2 359 (SCA).

94 794E-G and 795F-G.


96 *Fedbond Participation Mortgage Bond Managers (Pty) Ltd v Investec Employee Benefits Ltd* 2010 4 All SA 467 (SCA) paras [23] and [41].
In the *NWK* matter the trust vehicle was intended as cessionary of the rights of the originator of the scheme. This part of the scheme, however, never materialised and the rights were instead ceded to the bank, who was in fact the owner of the originator. It was clear that, if a trust was indeed utilised in this scheme, as was intended, it would have formed an integral part of the simulated transaction by the parties.97

Over and above its application in unit trusts, trusts are also regularly used as special-purpose institutions in securitisation transactions and this aspect will be discussed in more detail in Chapter 7.98

### 4.4.2 PENSION FUNDS ACT 24 OF 195699

The purpose of this Act is to provide for the registration, incorporation, regulation and dissolution of pension funds. A pension fund organisation refers to either an association of persons or a business carried on under a scheme, and may be operated in the form of a trust. The objectives of a pension fund organisation must always be to provide annuities or lump sum payments for its members or former members.100 Any retirement fund must apply to the Registrar of Pension Funds for registration under the Act and may be in the form of a retirement annuity fund, a provident fund, a preservation fund or a pension fund.

Retirement funds in South Africa are strictly regulated for the protection of the investors in the respective funds. Regulation 28 sets out the maximum exposures that these funds may have to different asset classes.101 The linked investment services providers offer a wide range of different unit trust funds on each platform to enable investors to comply with the asset class requirements. The asset allocation is determined by the unit trust investment manager, while the investor focuses on his personal objectives and risk profile. Investors will typically select amongst equities, bonds, property or cash. The new regulations compel investors to re-balance their selection of underlying funds whenever a transaction is done.

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97 [Commissioner for SARS v NWK Ltd 2011 2 SA 67 (SCA)].
98 See 7.3.
100 See the definition of “pension fund organisation” in s 1 of the Act.
101 Since April 2011 investors must comply with the asset class limits at an individual level and not only at a fund level.
Retirement funds can be structured as either defined benefit or defined contribution funds.\textsuperscript{102} Many retirement funds are in the form of trusts, with the trustees managing the fund on behalf of the members.\textsuperscript{103} When a trust is registered as a pension fund organisation, it becomes a body corporate with separate legal personality.\textsuperscript{104}

4.4.3 BANKS ACT 94 of 1990

The purpose of this Act is to provide for the regulation and supervision of public companies taking deposits from the public. Only a public company may be registered as a bank.\textsuperscript{105} The Basel I Accord was revised by way of the Basel II Capital Accord, which was implemented in its entirety by the South African Reserve Bank. This implementation required amendments to the Banks Act 94 of 1990, which amendments were affected by way of the Banks Amendment Act 20 of 2007.\textsuperscript{106} The primary purposes of the Accords were to develop a framework that would strengthen the safety, soundness and stability of the international banking system.\textsuperscript{107}

In terms of section 37(7)(c)(ii), read with section 1(1), a trust, controlled and administered by a juristic person or governing body, may become an associate in a group of persons predominantly engaged in financial activities, and at least one of which is a bank, to form a banking group.

The Banks Act, as well as the Mutual Banks Act 124 of 1993, will be dealt with in more detail in Chapter 7, in the context of the application of the trust as an entity in the financial environment.

\textsuperscript{102} See Van Zyl et al\textsuperscript{174-179} for discussion on differences between the two types of funds.
\textsuperscript{103} See the definition of “pension fund organisation” in s 1 of the Pension Funds Act 24 of 1956.
\textsuperscript{104} Ss 4B(1) and 5.
\textsuperscript{105} See s 1 of the Banks Act for the definition of “the business of a bank”.
\textsuperscript{106} These amendments came into effect on 1-01-2008 and the Regulations were published in GG No 30629, GN R3, dated 1-01-2008. Basel III was first published in September 2010 and endorsed by the G20 leaders at the Seoul Summit in November 2010. The full implementation into national legislation and regulations will take place between 2013 and 2019.
4.4.4 COMPANIES ACT 71 OF 2008

The purpose of this Act is to regulate and control the law relating to companies. Business trusts are often used in conjunction with companies as part of a business structure. All trusts are juristic persons for the purposes of this Act. Although this Act does not deal with trusts per se, it does have some bearing on the trust concept. The most common feature is the vesting of company shares in trusts.

In terms of section 3 a company will qualify as a subsidiary of a trust when the trustees of that trust are directly or indirectly able to exercise a majority of the general voting rights associated with the shares of that company, or to elect or appoint the majority of the directors. A private company or close corporation of which the shares or membership interest respectively, is held by a trust, will therefore be regarded as a subsidiary of that trust, as the trustees of the trust will exercise control over the company and will elect the directors.108

Section 40(5)(b)(ii) makes provision for certain shares to be held in trust for a third party, subject to specific performance by aforementioned. Subsections (6) and (7) stipulate specific rules regarding such shares and the manner and conditions under which it may be transferred to the subscribing party as and when it has become negotiable or upon fulfilment of all the prescribed obligations. Section 95(c) makes specific provision for trusts to be utilised in the establishment of employee share schemes, either by means of the issue of shares in the company, or the granting of options for such shares.109

The Companies Act will be dealt with in Chapter 7 in the context of finance instruments.

4.4.5 CLOSE CORPORATIONS ACT 69 OF 1984

The purpose of this Act is the regulation and control of close corporations. The effect of this Act on business trusts is limited. The most relevant section is 29(1A), read with the definition of “member” in section 1.110 As a trustee of an inter vivos trust may

108 See also the meaning of “holding company” in relation to a subsidiary, in s 1.
109 See s 97 for the standards for qualifying employee share schemes.
110 This subsection was inserted by Act 25 of 2005 and commenced on 11-01-2006.
be a member of a close corporation, it is possible to utilise a trust as part of a business structure with a close corporation as the trading entity.

Before 2006 such a structure was not possible and parties had to make use of private companies to achieve the same result. The comprehensive compliance requirements and high auditing fees associated with companies, however, discouraged business people to make use of such structures. This situation has left many business people with limited protection against creditors of their private estates, as well as against estate duty and capital gains taxes at death.

Since 2006 thousands of business people have consequently vested their membership interest in close corporations in the trustees of business trusts. This practice has popularised close corporations again and made them more competitive with companies.

Although the Act has been amended by the Companies Act 71 of 2008, existing close corporations will continue. No new corporations could be formed after 1 May 2011 and existing corporations could be converted to companies in terms of Schedule 2 of Act 71 of 2008. It is submitted that Act 69 of 1984 will continue to be of importance to many business trusts in future as thousands of corporations’ members’ interest will remain in the hands of trustees.

4.4.6 TRUST PROPERTY CONTROL ACT (TPCA)

The primary purpose of this Act is to regulate the control of trust property. It defines the scope of the Act and the specific instruments that are regulated by the Act. All trusts subject to the jurisdiction of the Master of the High Court are also subject to this Act. Some important aspects of the Act are the authorisation and appointment of trustees, the statutory requirements of care, diligence and skill to be exercised by trustees, the registration of trust property, the variation of trusts deeds, the custody of trust documents and the removal, remuneration and resignation of trustees.

All trust deeds not regulated by other legislation must be lodged with the Master in terms of section 4 of this Act. All trustees whose appointment is in terms of a trust instrument, section 7 of this Act, or a court order must be authorised in writing by the Master to act as such.
4.4.7 SECURITIES SERVICES ACT 36 OF 2004 (SSA)

The Securities Services Act of 2004 makes provision for trusts to be used as associates to self-regulatory organisations and further includes a trust in the definition of juristic persons. The trust is also included in the definition of person for the purposes of market abuse. A trust may further be used as derivative instrument, issuer of securities and money markets, as financial institution, as financial instrument, and as foreign collective investment scheme.

The Financial Markets Bill of 2011 confirms this position. Trusts have, therefore, a role to fulfil in terms of the financial markets and may be employed in a variety of roles.

4.5 THE TRUST AS BUSINESS ORGANISATION

In 1720 the Bubble Act was introduced in England, with the intention of curbing the manic speculative run in securities. The statute prohibited investors from “presuming to act as a corporate body”. In response to this prohibition the investors created unincorporated “deed of settlement companies”, with a trust as part of the structure.

Mutual covenants were concluded between the shareholders of the company and the trustees. A deed of settlement was drawn up and determined the stipulations of the covenants, which had to be adhered to by the trustees. The stockholders were only liable to the extent of their own shares in the capital. The trust concept made it possible for investors to form joint stock companies with limited liabilities. Irrespective of the advent of inexpensive and readily obtainable corporations (offering limited liability) in the mid-eighteen hundreds, trusts retained a significant role in collective investment and collective retirement schemes.

Some jurists have shown such a disdain for the trust as a commercial entity, that they actually exclude them from any discourse. Langbein, however, states that this denial is “at odds with the reality of American trust practice”, as “most of the wealth

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111 Subss 57(1)(a) and (b).
112 S 72.
113 S 1.
114 See ss 1, 63-68 and 81.
115 Moffat et al 481-482.
that is held in trust in the United States is placed there incident to business deals, and not in connection with gratuitous transfers.”

Theron summarised the main objections against the business trust as follows:

(a) the limited liability of the trustees;
(b) the perpetuity of the trust;
(c) the trust deed largely determines the rules for the specific trust;
(d) the possible favourable tax position of the trust;
(e) the lack of adequate protection of the public;
(e) the fact that the trust enjoys corporative advantages without corporate controls.

Honoré defines a business trust as “a trust the main object of which is to carry on a business enterprise with a view to making a profit and distributing it among the beneficiaries.” In the South African context it therefore plays a similar role in business as a sole proprietor, partnership, private company or close corporation.

The main legal differences between a business trust and an incorporated entity, mentioned by Honoré are:

(a) the trust does not have legal persona;
(b) the trust often has more continuity by way of its trustees than companies;
(c) the trust has less stringent statutory regulations to comply with;
(d) the trustee has limited liability, similar to a director or member;
(e) the trust does not have to maintain its capital for protection of creditors, like companies;

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118 Theron 1991 SALJ 279. See also Jooste 66-72.
119 Honoré 53.
120 Ibid.
(f) the trust does not have to comply with requirements such as the acquisition of a member’s interest in a close corporation;

(g) the trust is not limited as far as trustees or beneficiaries are concerned, as is the case with the close corporation and private company;

(h) the trust does not need to compile annual financial statements;

(i) the trust’s annual financial accounts do not have to be audited like the company’s;\(^{121}\)

(j) the trust does not have to appoint a registered accountant;

(k) the trustees do not need prescribed minimum qualifications;

(l) the trustees do not have to comply with statutory restrictions of decision-taking;

(m) the trustees do not have to comply with statutory restrictions to amend the trust deed;

(n) the trust does not have to reserve a name with the Registrar of Companies;

(o) the trust does not have to deal with a national regulator like the Companies and intellectual Property Commission, when changes are affected, but deal with the local Master’s office.

The Close Corporations Act determines that, subject to section 29(1A) or (2)(b) and (c), only natural persons may be members of a corporation. Subsection (1A), however, determines that a natural or juristic person or trustee of a trust *inter vivos* may be a member of a corporation, subject to certain provisions. This subsection was introduced in 2005 and hugely increased the utility of the *inter vivos* trust as an integral part of business structures.\(^{122}\)

The allocation of juristic personality to the trust by the Companies Act 71 of 2008 enforces the applicability thereof in the business sphere.

\(^{121}\) This requirement was amended by Act 71 of 2008. Some companies only have to be reviewed and not audited in future.

\(^{122}\) Subs 29(2)(b) further makes provision for trustees of testamentary trusts.
A trust for business purposes is useful and flexible and is often used as an estate planning or investment vehicle or to facilitate share incentive schemes. When members of the public are invited to invest money in a trust in exchange for membership, other statutory measures, such as the CISCA, become applicable. In addition to the normal features of all trusts, the object of the business trust must be to take part in the business milieu with the specific purpose of making a profit.

It is sometimes alleged that the business trust can be distinguished from an ordinary trust, as the aforementioned object is to protect and preserve the trust assets. It is submitted, however, that even this element of distinction has been largely eroded in the recent past. Most trusts are nowadays created as generic vehicles, with both the element of protection and preservation on the one side, and the object of profit on the other side. The nature of estate and business planning has often become so involved and entangled, that the founder uses the business and family trust interchangeably in the planning process.

The inherent gratuitous nature of trusts does not affect the applicability thereof in the business environment. The fact that a trust is formed by way of a gratuitous act does not in any way limit the actions of the trustees. A fiduciary duty towards the beneficiaries does not automatically prohibit the trustees from conducting a business with the assets of the trust. Although the nature of business includes the taking of risks it is submitted that no risk-taking will often not be in the best interest of the beneficiaries, as inflation may subsequently erode the value of the trust property.

It is submitted that a trust deed has to comply with the following minimum essentials to be valid as a business trust:

(a) the founder must have the intention to create a trust;

(b) one or more trustees must be appointed;

(c) the trust property must be identifiable;

(d) the trust must have as its object the benefit of one or more beneficiaries;

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123 Collier-Reed & Lehman (eds) 263.
124 Havenga et al 338.
125 Ibid.
(e) the trust deed must authorise the trustees to utilise the trust property for a commercial activity.\textsuperscript{126}

\subsection{CAPITA SELECTA ON THE BUSINESS TRUST}

\subsubsection{THE CONDUIT PRINCIPLE IN BUSINESS TRUSTS}

I submit that the business trust is the ideal vehicle to hold the shares in private companies and the membership in close corporations. It was with relief that small businesses accepted the introduction of section 29(1A) to the Close Corporations Act,\textsuperscript{127} which resulted in thousands of private companies having been converted into close corporations. The main impact of this amendment was the opportunity given to trustees of trusts \textit{inter vivos} to become members of close corporations under certain circumstances.

Section 29(1A) of the Close Corporations Act 69 of 1984 reads as follows:

\begin{quote}
“A natural or juristic person in the capacity of a trustee of a trust \textit{inter vivos}, may be a member of a corporation, provided that:

(a) no juristic person shall directly or indirectly be a beneficiary of that trust;

(b) the member concerned shall, as between himself and the corporation, personally have all the obligations and rights of a member;

(c) the corporation shall not be obliged to observe or have any obligation in respect of any provision of or affecting the trust or any agreement between the trust and the member concerned of the corporation; and

(d) if at any time the number of natural persons at that time entitled to receive any benefit from the trust shall, when added to the number of members of the corporation at that time, exceed 10, the provision of, and exemption under, this subsection shall cease to apply and shall not again become applicable, notwithstanding any diminution in the number of members or beneficiaries.”
\end{quote}

Subsection (a) ensures that a juristic person cannot by default indirectly become a member of a close corporation. In terms of subsection (b) a trustee, who is a member, representing a trust, has all the rights and obligations of a member in his personal capacity. It is submitted that subsection (d) only refers to individuals who are at a specific moment in time \textit{entitled to receive any benefit}. This should not include all beneficiaries of a discretionary trust but only those who have an

\textsuperscript{126} The term “commercial” expresses an intention to make a profit.

\textsuperscript{127} Act 69 of 1984. This subsection was amended by s 2 of the Close Corporations Amendment Act 25 of 2005 and commenced in January 2006.
entitlement regarding benefits. It is submitted that this section has been misinterpreted by the office of the previous office of the Registrar of Companies and Close Corporations (Cipro). 128 They included all beneficiaries with only contingent rights (income and capital) in determining the number of natural persons entitled to receive benefits for the purposes of subsection (d). In practice a discretionary family trust with two parents, four children and five grandchildren as beneficiaries will not comply with the exclusion of subsection (d), although distributions are only made to the parents.

Where a business trust has a family trust as its only beneficiary, Cipro also takes the beneficiaries of the family trust in account to determine the number of natural persons entitled to benefits, while subsection (d) clearly refers only to the trust that is a member of the close corporation. The practical application by Cipro of subsection (d) has caused many attempts to convert small private companies into close corporations to fail and has, it is suggested, in many cases frustrated the apparent purpose the legislator had with this amendment. It is submitted that Cipro should have regarded each trust as one member and left the enforcement aspect to the accounting officers of the close corporation to ensure that distributions were not made in any single financial year to more than 10 natural persons.

All shares in private companies or membership interests in close corporations, held by an individual in his own name, will form part of that individual’s insolvent or deceased estate. An individual investing in private companies or close corporations owning major property portfolios, for instance may find himself in an extremely vulnerable position as far as estate duty and capital gains tax at death are concerned. A trust is the only way in which such an investor can protect the shares or interest from future creditors and major tax liability effectively, while retaining both the potential benefit and some level of control over the asset.

Section 29(1A) has opened the door to the effective utilisation of business trusts by smaller business people. Where assets are held in a company or close corporation with a discretionary family or business trust inter vivos as shareholders or members,

128 Cipro has been replaced in May 2011 by the Companies and Intellectual Property Commission (CIPC), which has been established by s 185 of the Companies Act 2008.
the close corporation is not disturbed or affected by the death of the founder and the business in the company or corporation can continue as usual.

One of the main disadvantages of the close corporation, in comparison to the private company, is the fact that the member does not have protection in his personal capacity to the same extent as the shareholder of a company.

In terms of section 43 of the Close Corporations Act a member is liable to the corporation for a loss “caused by his or her failure in the carrying on of the business of the corporation to act with the degree of care and skill that may reasonably be expected from a person of his or her knowledge and experience.” A member shall also be liable to the corporation if a breach of his fiduciary duty in terms of section 42 has caused a loss to the corporation or an economic benefit to the said member. In terms of section 54 all members are agents of the corporation when dealing with third parties.

The separation of shareholder and director in a company gives more protection to the shareholder than the member of a close corporation. The shareholder cannot act on behalf of the company towards third parties. That role is fulfilled by the director. A director does not have to represent any specific share.

In the light of the requirement for an annual audit of companies, which have become more stringent and costly since the introduction of new international auditing requirements, the private company became a less attractive vehicle for smaller businesses. The advantage of holding shares of private companies in a trust sometimes, however, outweighed the disadvantages of the extra costs.

The trust became the ideal vehicle to use for private company shareholding and close corporation membership.

4.6.2 THE TAX DISPENSATION OF TRUSTS

Trusts that are used for trading or other business initiatives are not regulated separately and are treated as ordinary trusts for tax purposes. A trust is defined in section 1 of the Income Tax Act 58 of 1962 as:

“any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person”.
Chapter Four: Business Trust

The result of the inclusion (in section 1) of a trust as a “person” for income tax purposes is that normal income tax principles apply to trusts as taxable entities.

The term “beneficiary” in relation to a trust is defined as a person who has “a vested or contingent interest” in all or a portion of the receipts or accruals or the assets of that trust.

Although a trust itself is taxable there are two instances in which the trust income is taxable in the hands of someone other than the trust. The first is where it is distributed to beneficiaries and the second when there is a causal link between a donation or disposal to a trust and the receipt or accrual of income arising there from. The result is that trust income may be regarded as (a) the income of the beneficiary (section 25B), (b) the income of the trust itself, or as (c) the income of the donor (section 7).

Income received by a beneficiary from a trust retains its nature – the so-called conduit principle – subject to specific exceptions, like in the case of an annuity.

The rate of tax on income for a business trust is 40%, without qualifying for any rebate or interest exemption. A resident trust is taxed on its undistributed capital gains at a rate of 20% on 50% of the gain, which is double that which applies to individuals. This is subject to paragraphs 80(1) and 80(2) and certain tax-back or attribution provisions (Eighth Schedule). Paragraph 80(1) effectively creates a statutory conduit rule for capital gains. All trust losses are, however, trapped in the trust and cannot be distributed to beneficiaries. Paragraph 80(2) deals with the vesting of a capital gain by a resident trust in a resident beneficiary.

One of the implications of paragraphs 80(1) and 80(2) regarding capital gains tax is that a gain will be taxed in the hands of the first beneficiary it is distributed to. The conduit principle is therefore limited by statute as far as capital gains are concerned. As many family-oriented business trusts have traditionally been structured with the family trust as the only beneficiary of the business trust and the individuals as

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129 See Commissioner for Inland Revenue v Widan 1955 1 SA 266 (A).
130 See Honiball & Olivier 66, and Honoré 445.
132 See Honiball & Olivier 67-72 for discussion on the tax residence of trusts.
beneficiaries of the family trust, this limitation will result in the capital gains of the business trust being taxed in the hands of the family trust at double the rate of the individuals. This seems to be an attempt by the legislator to discourage the placement of capital items in trusts. The only way to prevent this negative tax implication is by way of including the beneficiaries of the family trust as beneficiaries of the business trust.\(^{133}\)

As the contingent interest of a beneficiary in a discretionary trust is treated as having a base cost of nil in terms of paragraph 81, it is, from a capital gains perspective, advantageous for beneficiaries to have the asset vested in them before the gain is made. This is apparently a deliberate attempt by the legislator to encourage trustees to vest capital items, and not only the gains, in the beneficiaries. It may also discourage parties to make use of discretionary trusts for property and similar transactions with major capital gains potential.

Transfer duty, regulated by the Transfer Duty Act 40 of 1949, is calculated as a percentage of the purchase price of property being transferred to a new owner. The transfer duty applicable to trusts and companies was 8% of the value of the property, while those applicable to individuals were calculated on a sliding scale, starting at zero and ending at 8%. Since 23 February 2011 the difference in transfer duty rates between juristic persons (including trusts) and individuals has been abolished.\(^{134}\)

### 4.6.3 THE BUSINESS TRUST AS B-BBEE VEHICLE\(^{135}\)

The trust became a very popular vehicle for Broad-Based Black Economic Empowerment transactions,\(^{136}\) as many of these transactions include a number of individuals and sometimes even groups or whole communities of people. Modi,\(^{137}\) with reference to the codes of practice issued in terms of the Broad-Based Black Economic Empowerment Act 53 of 2003, argues that it is unclear which qualification

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\(^{133}\) Honiball & Olivier 142 warn that the possibility of a capital gains tax event or a contravention of the general anti-tax-avoidance stipulations must be considered when the trust deed is amended accordingly. See also 143-150 on the so-called tax-back provisions in the Eighth Schedule.

\(^{134}\) As proposed by the Minister of Finance. See Tax Guide 2011/2012, J. Geldenhuys Chartered Accountants.

\(^{135}\) B-BBEE is an acronym for Broad-Based Black Economic Empowerment.

\(^{136}\) Hereinafter referred to as B-BBEE.

\(^{137}\) Modi "Applying BEE Codes to Trusts is a Conundrum" 2008(5) De Rebus 60.
criteria apply to business trusts compared to the criteria for family trusts, charitable trusts, broad-based group schemes and public benefit organisations. 138

One of the anomalies lies in the requirement that black participants in a trust must hold rights of ownership in the entity to qualify in terms of the Act. The fact that beneficiaries in a discretionary trust technically do not hold rights of ownership, was clearly overlooked, as well as the fact that the beneficiaries may be non-governmental or public benefit organisations and it may be impossible to prove that 85% of the value of benefits shall accrue to individuals within the prescribed definition.

The above is another example of the often-found misconceptions about the nature and workings of the trust and the consequent application thereof in the business environment. It is submitted, however, that the trust is the ideal vehicle to use when the purpose is to benefit a large number of individuals who may not all be identifiable at inception. In many B-BBEE schemes the individual beneficiaries may be changing from time to time and can only be defined in a rather wide manner — which makes the trust the only practical entity within which to keep the interests of these individuals. 139

4.6.4 THE APPLICATION OF THE TURQUAND RULE

For the trust to be utilised in the business environment it is important to grant protections to all parties similar to that of other business instruments, like companies and close corporations. Our courts do not reveal uniformity yet on the question whether the Turquand rule is applicable to trusts. 140

The application of the Turquand rule has been extended beyond company law and was applied in cases of labour unions, statutory boards and local government

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138 Specific sector charters, targeting defined industries, are also developed. Specific components for a B-BBEE scorecard have been identified with allocated weightings, namely ownership, management control, employment equity, skills development, preferential procurement, enterprise development, and socio-economic development.

139 See in general the Broad-Based Black Economic Empowerment Act 23 of 2003 and the Broad-Based Black Economic Empowerment Amendment Bill of 2011, published as Notice 893 in GG No 34845, dated 9-12-2011, promoting compliance with current B-BBEE legislation and the strengthening of the evaluation and monitoring of such compliance.

140 The Turquand rule was first established in the United Kingdom by the court in *Royal British Bank v Turquand* (1856) 5 E&B 248 (119 ER 474).
structures.\textsuperscript{141} In \textit{Wolpert v Uitzigt Properties}\textsuperscript{142} it was decided that the \textit{Turquand} rule “only applies when a third person deals with a registered company or some similar registered body or corporation.” This rule has recently been codified in South Africa by way of section 20(7) of the 2008 Companies Act.

In terms of the \textit{Turquand} rule a third party, who negotiates in good faith with an entity, may accept that the individual representing such entity has the necessary authority to bind the organization.\textsuperscript{143}

In \textit{Man Truck v Victor}\textsuperscript{144} the court accepted the possible application of the \textit{Turquand} rule to hold a trust responsible for the unauthorised actions of a trustee. The court did take into consideration the wide powers of authority granted to the specific trustee by the trust deed. The court effectively compared the trustee to the director of a company and the duties of a trustee to those of a director.\textsuperscript{145}

This decision was rejected in Honoré,\textsuperscript{146} who argues that the trustees must always act jointly, and that third parties dealing with a trust should “assume that contractual powers have to be exercised by all trustees acting together,” unless the trust deed has a different stipulation.\textsuperscript{147}

The decision in the \textit{Man Truck} case was followed in principle in \textit{Vrystaat Mielies v Nieuwoudt}.\textsuperscript{148} In this matter the trust deed determined that the trustees could delegate the power to sign a contract to one of the trustees, after the decision to sign was taken by all the trustees collectively. Where a contract is then signed by a single trustee, without the necessary delegation of power, the court enforced the contract by applying the \textit{Turquand} rule. The extension of the rule to trusts is justified, according to the court in the present case, because of the underlying good faith necessary

\begin{itemize}
  \item \textsuperscript{141} \textit{Mine Workers’ Union v Prinsloo} 1948 3 SA 831 (A); \textit{National and Overseas Distributors Corporation v Potato Board (Pty) Ltd v Potato Board} 1958 2 SA 473 (A); \textit{Potchefstroom Stadsraad v Kotze} 1960 3 SA 616 (A).
  \item \textsuperscript{142} \textit{Wolpert v Uitzigt Properties (Pty) Ltd} 1961 2 SA 257 (W) 264. See Claassen 2004 \textit{De Rebus} 24, and Du Toit “Die aanwending van die \textit{Turquand}-reël in die Suid-Afrikaanse trustreg” 2004 \textit{Tydskrif vir Suid-Afrikaanse Reg} 149.
  \item \textsuperscript{143} See Sharrock \textit{Business Transactions Law} (2010) 154.
  \item \textsuperscript{144} \textit{Man Truck & Bus (SA) Ltd v Victor} 2001 2 SA 562 (NC) 569.
  \item \textsuperscript{145} 570 E-F.
  \item \textsuperscript{146} Honoré 324.
  \item \textsuperscript{147} 325.
  \item \textsuperscript{148} \textit{Vrystaat Mielies (Pty) Ltd v Nieuwoudt} 2003 2 SA 262 (O).
\end{itemize}
between parties to contracts and the huge number of trusts involved in the commercial sphere.  

Where the trust deed in the *Man Truck* matter made provision for the appointment of a managing trustee, this was not the case in the *Vrystaat Mielies* case and one can therefore ask whether the two matters were really comparable. In *Parker v Land and Agricultural Bank* the court remarked *obiter* that the *Turquand* rule could not be applied to trusts.

The current legal situation regarding the application or not of the *Turquand* rule to trusts is therefore uncertain. When the Supreme Court of Appeal had the opportunity to finally address this issue, in *Nieuwoudt v Vrystaat Mielies*, it refrained from doing so, although it held in *Land Bank v Parker*, that the *Turquand* rule “may well in suitable cases have a useful role to play in securing the position of outsiders who deal in good faith with trusts”. The business trust is, even although it is not a legal person, an ideal candidate for the *Turquand* rule.

Claassen argues that the ambit of the *Turquand* rule must be extended to trusts to grant contracting third parties the necessary protection, while Geach suggests that “in practice outsiders dealing with trustees should assume that contractual powers have to be exercised by all trustees acting together.”

Claassen, however, submits that the principles used to regulate the application of the *Turquand* rule when applied to companies, are adequate to limit the liability of trusts. In this regard he mentions the following exclusions of the application of *Turquand*:

(a) where the third party was aware of non-compliance with internal requirements;

(b) where materially suspicious circumstances existed which should have been investigated by the third party;

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149  268A-D.
150  *Parker NO v Land & Agricultural Bank* 2003 1 All SA 258 (T).
151  *Nieuwoudt and Another NNO v Vrystaat Mielies (Edms)* Bpk 2004 3 SA 486 (SCA). See also Jooste 66-72.
152  *Land & Agricultural Bank of SA v Parker* 2005 2 SA 77 (SCA) 85B-D, 86B, 90G.
153  Claassen 26.
154  Geach & Yeats 138.
(c) where such action or authority is clearly in conflict with the contents of the trust deed; and

(d) where the alleged authority of the trustee is not identifiable with the function or office of the said trustee.  

The remark in *Thorpe v Trittenheim* that trustees could indeed authorise one another to act on each other’s behalf, rebutted the opinion that trustees had to always act jointly.

In *Mostert v Old Mutual* a pension fund was regarded as a legal persona because the Pension Fund Act determined that the fund held its assets and rights and duties seperately from its members. The court found that it had the essentialia of a universitas at common law, which gave it legal personality. At the same time the common-law trust concept was referred to as a non-legal persona.

Although the TPCA stipulates that the trust does not have a legal personality, for the purposes of the Estate Act 66 of 1965, the Insolvency Act 24 of 1936 and the Income Tax Act 58 of 1962, the trust is often dealt with as if it does have a legal personality. Section 1 of the Companies Act 71 of 2008 also includes the trust in the definition of a juristic person, for the purposes of that Act.

Matthews refers to the *TWK* case, where it was decided that company principles could be applied to a co-operative, because of their similar characteristics, and then argues that this principle should be applied in a similar fashion to the question of whether the Turquand rule can be applied in trust law. Matthews, supported by Claassen, argues convincingly that the Turquand rule should, in the interest of contracting third parties, be applied to trusts. The two main

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155 Claassen 25, with reference to Oosthuizen “Aanpassing van die Verteenwoordigingsreg in Maatskappyverband” 1979 TSAR 1, and *Tuckers Land & Development v Perpellief* 1978 2 SA 11 (T).

156 *Thorpe and Others v Trittenheim* 2007 2 SA 172 (SCA) 176I.


160 See discussion on this aspect in Matthews 7-11.

161 *TWK Agriculture Ltd v NCT Forestry Co-operative Ltd* 2006 6 SA 20 (N).

162 Matthews 32-33.

163 *Ibid* 34.
purposes it will serve are the protection of third parties and legal certainty. Some commentators are of the opinion that the doctrine has already effectively been extended by the courts to trusts.

It is submitted that they are correct and that it is in the interest of all role-players in the business environment that the *Turquand* rule be applied to trusts in a similar way as to companies. It is very difficult for a third party to determine the contents of a trust deed and even more so to find reliable records of all minutes of trustees.

The application of the *Turquand* rule on trusts will indeed place a heavy burden on co-trustees, but this will have the following important consequences:

(a) it will force trustees to be more actively involved in the management of the trust and will discourage the utilisation of “dummy” trustees;

(b) it will motivate trustees, and beneficiaries who are also trustees, to ensure that reliable trustees are appointed; and

(c) it will create more confidence in third parties in dealing with trusts in the business environment.

The *Turquand* rule can in any event not be applicable where the third party is aware of the fact that the prescribed internal formalities have not been complied with. In the *Man Truck* case the appellants had the trust deed in their possession and they should therefore have known that the trust did not have the prescribed minimum number of trustees in office at the time of entering into the agreement. Binn-Ward J in the recent local division matter of *Van der Merwe v Hydraberg Hydraulics CC* stated that, as it may be difficult for parties to be aware of the contents of a particular trust deed, which, by implication, puts the “deemed awareness” presumption of the *Man Truck* case in question. The result was that no definite decision was made

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164 Claassen 25.
165 Matthews 41.
166 Davis *et al* (ed) 42.
167 Referring to individuals who accept appointments as trustees, but with no real intention of applying their minds independently to decisions by the board of trustees. In practice they become rubber stamps of the founder or other trustees.
168 Kloppers 2006 TSAR 422.
169 *Van der Merwe NO v Hydraberg Hydraulics CC; Van der Merwe NO v Bosman* 2010 5 SA 555 (WCC) [27].
about the applicability of the rule in the case of trusts. It is, however, submitted that it may be just as difficult and time-consuming in South Africa to request the correct details of a company’s record from the Companies and Intellectual Property Commission than it is for a trust deed and letters of authority from a Master’s office. In both instances it should be expected from the prudent business person not to enter into transactions with juristic structures without requesting the necessary documentation from the counterparty.

The principle of the common-law *Turquand* rule, as far as companies are concerned, has been codified by section 20(7) of the Companies Act 71 of 2008. It may, however, be argued that there are substantial differences between the common-law doctrine of *Turquand* and the contents of this section, especially in the light of section 19(4), which effectively abolished the doctrine of constructive notice.

The practical effects of section 20(7) on the application of the *Turquand* rule on companies are as follows:

(a) third parties are excluded from invoking the doctrine where they “reasonably ought to have known” of the non-compliance by the company;

(b) the doctrine operates to protect outsiders only, as it excludes directors, prescribed officers and shareholders;

(c) relevant common-law principles relating to the presumed validity of company actions in the exercise of its powers, will operate concurrently with the codified rule (section 20(8)).

The Supreme Court of Appeal recently had to decide whether the *Turquand* rule may be applied where a company has failed to comply with section 228 of the Companies Act of 1973, which requires that a company’s directors may not dispose of the whole or greater part of the assets of a company, except by way of a special resolution by

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170 See Sharrock 154. See also s 54 of the Close Corporations Act 69 of 1984 in terms of which all members of a CC are also agents. All acts of members bind the corporation, unless the particular member did not have the necessary authority and the third party was aware of the fact. See J&K Timbers (Pty) Ltd v/a Tegs Timbers v GL&S Furniture Enterprises CC 2005 3 SA 223 (N); Klaas v Summers 2008 4 SA 187 (C).

its members. The court ruled that section 228 could not be circumvented by way of the Turquand rule.\footnote{See Stand 242 Hendrik Forgieter Road Ruimsig (Pty) Ltd v Göbel NO 2011 5 SA 1 (SCA); [2011] 3 All SA 549 (SCA). S 228 has been succeeded by s 112, read with s 115, of the Companies Act 71 of 2008. See the discussion by Narshi “Section 228 and the Turquand Rule” 2011(9) De Rebus 41.}

It is submitted that there is no logical reason for not extending the Turquand doctrine to the trust. It has been extended to a variety of other non-corporative entities, like trade unions, statutory bodies, and municipalities.\footnote{See Mine Workers’ Union v Prinsloo 1948 3 SA 831 (A); National and Overseas Distributors Corporation (Pty) Ltd v Potato Board 1958 2 SA 473 (A)); and, Potchefstroom se Stadsraad v Kotze 1960 3 SA 616 (A).} In the light of the Man Truck and Vrystaat Mielies cases, it is submitted, that it was already extended to the trust, even if only by implication.\footnote{The non-application of the doctrine by the highest court in Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk 2004 3 SA 486 (SCA) has admittedly somewhat inhibited the argument.} It should, however, now be brought in line with the application thereof in company law.

4.6.5 THE VESTING OF RIGHTS IN THE BUSINESS TRUST

The vesting of rights to trust assets in the beneficiaries are important in all aspects of trust law, but often more so in the case of the business trust. The vesting or not of the assets has a number of implications for creditors of both the trust and the beneficiary, one of which is the revenue services. The beneficiary of a discretionary trust does not have any enforceable right to the income or capital of the trust, but only a contingent right or spes, often referred to as a beneficial interest. A beneficiary with a vested right, however, can enforce his right against the trustees or any other third party.\footnote{See para 2.3 on bewind trust and para 3.5.4 on a vesting trust. Compare also 2.7 and 2.13.2 for more on the beneficial interest of a beneficiary.}

The incorrect use of the word “vest” can cause confusion as it can be deduced that the person with a vested right is the owner of the asset. The testamentary disposition of an asset does not automatically transfer the ownership of the asset to the heir – it does, however, grant the beneficiary a vested right to claim from the
executors the delivery of the legacy, but only after the liquidation and distribution account has been approved and confirmed.  

This may be subject to the principle that the minor receives full rights to the assets at the age of majority. If the will determines that the property must remain in the testamentary trust until an age later than the age of majority of the heir (i.e. 21 years) the beneficiary does acquire access to the bequest at the age of majority (which is 18). The stipulation that the property must remain in the trust until the beneficiary reaches the later age, is a *nudum praeceptum* and the beneficiary can claim the asset when the majority age is reached. The question is whether the rights of the beneficiary are automatically vested at reaching majority age or whether the beneficiary must first claim the asset from the control of the trustees to receive a vested right.

It is submitted that if the will states, “I bequeath my estate to John, provided that it must be placed in a testamentary trust until he reaches the age of 30 years”, John becomes the owner of the assets when the liquidation and distribution account has been approved. In the case that John is a minor, the assets will remain in the hands of the trustees until majority age is reached, at which moment the prohibition becomes a nude prohibition and Johns creditors have access to the assets.

If, however, the will states, “I bequeath my estate to the trustees of a testamentary trust of which John is the beneficiary, provided that the trustees of the trust may not distribute the assets to John before he reaches the age of 30”, the assets will be protected from John’s creditors until distribution has taken place.

In *Vorster v Steyn* the relevant stipulation in the will read as follows:

“I hereby bequeath my entire estate — movable and immovable — to my son, Peter William Vorster, the proviso being that, if at the time of my death the said Peter William Vorster happens to be an insolvent, the proceeds of my estate should go into trust until such time as the said Peter William Vorster is rehabilitated.”

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176 See *Commissioner for Inland Revenue v Estate Crewe* 1943 AD 656 667; *Greenberg and Others v Estate Greenberg* 1955 3 SA 361 (A).
177 See *Morley v Standard Bank Trustees Department* 1970 4 SA 299 (W), and *Re Estate Ansaldi* 1950 4 SA 417 (C).
178 *Vorster v Steyn* 1981 2 SA 831 (O).
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The court decided that the intention was to create a trust with the purpose of protecting the beneficiary against his creditors and was therefore a nude prohibition. Honoré\textsuperscript{179} submits that a restriction that is imposed with the intention to benefit the beneficiary who is already owner of the property, cannot bind the beneficiary.

Corbett\textit{ et al}\textsuperscript{180} made the following two remarks about the term “vesting”:

“In legal parlance the terms “vest”, “vested” or “vesting” bear different meanings depending upon the context in which they are used. When used in connection with rights of succession, they indicate what is fixed and certain as distinct from what is conditional or contingent.”

“The vesting of such an interest is not necessarily connected with the acquisition of ownership: the interest which vests may amount to a mere personal right. Moreover, even where it does relate to ownership, vesting alone does not bring about the immediate acquisition of ownership.”

In \textit{Jewish Colonial Trust}\textsuperscript{181} it is stated that

“(w)hen it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right – that he has all rights of ownership in such right including the right of enjoyment.”

The question of vesting or not must be determined with reference to the language used in the deed, which again must be properly interpreted in light of all the admissible surrounding circumstances.

The most obvious indication of vesting is the fact that the right of the beneficiary is unconditional, although it is submitted that it may sometimes also be subject to certain conditions. It may therefore sometimes manifest as a mere contingent right.\textsuperscript{182}

Honoré\textsuperscript{183} explains the word “vested” in three situations, namely:

(a) in the form of ownership;

(b) in the form of a personal right; and

\begin{itemize}
\item \textsuperscript{179} 155.
\item \textsuperscript{180} Corbett\textit{ et al} 133.
\item \textsuperscript{181} \textit{Jewish Colonial Trust v Estate Nathan} 1940 AD 163 175. The third form of vesting is common with testamentary trusts where the will allocates the asset to the heir, but subject the control or enjoyment by the heir to a future event.
\item \textsuperscript{182} See \textit{Jewish Colonial Trust v Estate Nathan} 1940 AD 163 175-176.
\item \textsuperscript{183} 556-557. They do not claim that these are the only possible meanings of the term.
\end{itemize}
(c) when the beneficiary’s right to the capital and the actual distribution of the capital to the beneficiary do not coincide.

The first meaning of vesting is obvious and mostly without any complications. Van der Merwe submits this application refers to the ownership of a right and not the ownership of the benefit or asset as such, and that it may be terminologically incorrect to use ownership in relation to a right.\textsuperscript{184} It is submitted, however, that when the term “ownership” is used to indicate the relationship between a person and a legal object, it usually implies the right to a physical object.\textsuperscript{185}

A vested right, however, also includes a right that is purely unconditional although ownership and/or the right of enjoyment has not yet passed. In the third place it may refer to a vesting of rights when the distribution of the capital to the beneficiary occurs, although his or her right in the capital has actually taken place in the past already. The second form may cause debate, and the third one is often just not thought of when drafting takes place.

Van der Merwe\textsuperscript{186} states that

\begin{quote}
\textit{(t)he vesting of a right does not mean that a right of ownership in the thing is obtained}.\end{quote}

Contingent rights to trust assets refer to a right that is subject to the discretion of the trustee. If the beneficiary is entitled to insist that the income is paid to him or her, subject only to the mode or exact time when, the beneficiary has an established right and the asset is his or hers for tax purposes and creditors of the beneficiary. If, however, the trustee has a discretion regarding the exact amount to pay the beneficiary or when he will be paid, if at all, only a contingent right was established and the asset will be taxed in the trust itself.\textsuperscript{187}

\begin{flushleft}
\textsuperscript{184} Van der Merwe 2000 \textit{SA Mercantile Law Journal} 319.
\textsuperscript{185} See 2009(2) \textit{Namibia Law Journal} 28 at \url{http://www.namibialawjournal.org/index} (accessed 20-01-2011). Exceptions are a usufructuary interest in a personal right, or a bond in respect of a usufructuary right, as provided for in terms of s 69 of the Deeds Registries Act 47 of 1937, referred to by Van der Merwe 320.
\textsuperscript{186} 320, with reference to the facts in \textit{Greenberg v Estate Greenberg} 1955 3 \textit{SA} 361 (A) 364.
\textsuperscript{187} Honoré 557-558. See also Strydom 160.
\end{flushleft}
4.6.6 TRUST PROPERTY

The term “trust property” has a much wider meaning and application than merely being property belonging to a trust or to the trustees or the beneficiaries of a trust, and can actually include all property administered as a result of a relationship of trust.

For the purposes of the TPCA, “trust property” is defined as follows:

“movable or immovable property, and includes contingent interests in property, which in accordance with the provisions of a trust instrument are to be administered or disposed of by the trustee.”

In terms of the Financial Services Board Act 97 of 1990 a financial institution includes any person who deals with trust property as a regular feature of his business without being registered, licensed, recognised, approved or authorised to deal so in terms of any Act, other than the Companies Act, the Close Corporations Act or the TPCA.188

The term “trust property” in the aforementioned Act refers to the Financial Institutions (Investment of Funds) Act 39 of 1984, which was repealed by the Financial Institutions (Protection of Funds) Act 28 of 2001.

For the purposes of the Financial Institutions (Protection of Funds) Act 28 of 2001 (and therefore the Financial Services Board Act 97 of 1990), “trust property” is defined as follows:

“any corporeal or incorporeal, movable or immovable asset invested, held, kept in safe custody, controlled, administered or alienated by any person, partnership, company or trust for, on behalf of, another person, partnership, company or trust”.

The TPCA concerns itself only with property administered or disposed of in terms of a trust instrument, whilst the other two Acts include all assets dealt with by one party on behalf of another, irrespective of whether it is in terms of a trust instrument or not.

For the purposes of this thesis, and specifically as far as trust property in a business context is concerned, property in the wider sense will be applicable.

In Chapter 3 the business trust in its role as a structured financial instrument will be investigated, irrespective of whether the assets are held in terms of a trust instrument or not.

188 See the definition of “financial institution” in subs 1(b)(ii).
4.6.7 JUDGMENT PROOFING

The question is whether the use of a trust structure as part of an estate or business planning exercise can be regarded as judgment proofing. Although the term has not been generally accepted in South African law, the concept of placing certain assets out of reach of creditors is common practice everywhere. “Judgment proofing” itself has developed a stigma as it is often associated with fraudulent behaviour.¹⁸⁹

It is submitted that the role of trusts as part of legal structures to separate certain assets and certain risks effectively from one another, is usually a legitimate and responsible business practice. The fact that such structures do exclude certain assets from creditors, should not be to their detriment, as the creditor must ascertain at contract stage which potential recourses are at his disposal. Schwarcz differentiates between arm’s length and non-arm’s length judgment proofing transactions and argues that first-mentioned is rather unlikely, while last-mentioned has been discouraged by legal systems for centuries by way of a number of restrictive measures.¹⁹⁰

Locke explains that the general manifestation of judgment proofing is when a business is split into an asset-owning company and an operating company. We submit that the mere utilisation of a legal entity, such as a company, for business purposes, is already a form of judgment proofing as the individual desire to protect his personal estate against his business creditors. If not, he could have traded as a sole proprietor.

Although the two entities practically function as one, the creditors of the one have no legal recourse to recover its judgments from the other entity. The operating company will therefore incur the risks, while the asset-holding company protects the business assets.¹⁹¹ The judgment proofing issue is closely linked to the aspects of conscionability and piercing of the corporate veil, which are both discussed

¹⁸⁹ See Schwarcz 1999 Stanford Law Review 77-86 for a discussion on asset securitisation as a judgment proofing tool. Schwarcz 77 refers to LoPucki who calls judgment proofing “the death of liability”.

¹⁹⁰ Lopucki “The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz” 1999 Stanford Law Review 55, 56 argues that securitisation has become a dangerous new judgment proofing technique. Compare also Mooney “Judgment Proofing, Bankruptcy Policy, and the Dark side of Tort Liability” 1999 Stanford Law Review 73. Locke LLD thesis Unisa 35 submits that securitisation is not often used as a judgment proofing method.

¹⁹¹ Locke 34-36.
elsewhere in this thesis.192 There will always be a tension between risk-taking and self-protection in the commercial world. It is submitted that adequate legal measures have been developed over time to address unjustifiable judgment proofing exercises by corporations.193

The trust remains an affordable and simple tool for the average business individual to separate his personal and business interests and even some mutual business interests. The trust is internationally accepted as an instrument to compartmentalise risk and as the very nature of business is one of risk-taking, it is imperative to allow individuals and companies to have access to legal methods of isolating different risks factors. If adequate risk isolators are not provided by legal and financial systems, it will inhibit economic growth. Schwarcz submits that “structural impediments to judgments proofing” can potentially “indiscriminately restrict the value creation that comes with business and financial innovation.”194 It is therefore submitted that the fact that the trust may be utilised for unscrupulous judgment proofing exercises, does not affect the overwhelming legal uses of the concept in commercial practice.

4.6.8 THE TRUST AND CONSCIONABILITY

The doctrine of unconscionability in contract law enables a court to decline to enforce a contract whose terms are seriously one-sided, overreaching, exploitative, or otherwise fundamentally unfair.195 Some unconscionable contracts are made freely and with full information by the prejudiced party.196 The general rule is that parties to a contract should honour their commitments. If this principle is not guarded jealously, the commercial arena may fall into disarray. To overcome the presumption that people usually contract in their own best interest, it must be proved that either the

192 See paras 4.6.8 and 2.8 respectively.
193 Marrow “Squeezing Subjectivity from the Doctrine of Unconscionability” 2005-06 Cleveland State Law Review 223 submits that the current legal system in the United States “has as a bedrock tradition the evolution of legislation for the control and regulation of the human inclination to take unfair advantage”.
194 Schwarcz 85.
195 Watt 76 submits that the term “unconscionability” “defines itself against a background of established laws of general application” and “describe(s) an oppressive abuse of legal rights and powers”.
196 It is sometimes argued that interference in a matter where the parties contracted while being fully aware of the objectionable terms, is paternalistic in nature.
negotiation process was tainted by duress or fraud or that the term sought to be
enforced is in violation of public policy.\textsuperscript{197}

The term “unconscionable” was introduced to South African law jargon in 1983. In
\textit{Botha v van Niekerk} it was decided that personal liability would only become
justifiable when it is clear that the third party suffered an \textit{unconscionable injustice}
because of the unjust actions of the liable party.\textsuperscript{198} In the \textit{Cape Pacific}
case, however, the court used the test of \textit{policy considerations}, such as fraud, dishonesty,
improper conduct, an improper purpose or where the company was used as a
facade, when a piercing of the corporate veil was considered.\textsuperscript{199}

The South African Law Commission recommended in a 1998 report that a court
should be able to interfere in a contract when it is of the opinion that the way the
contract came into being, or the form, execution or enforcement thereof, “is
unreasonable, unconscionable or oppressive”.\textsuperscript{200} The specific guidelines given in
determining such procedural or substantive unfairness,\textsuperscript{201} were listed as follows:

(a) the bargaining strength of the parties relative to each other;

(b) reasonable and commonly accepted standards of fair dealing;

(c) the extent of negotiations involved into;

(d) the reasonable practicality of renegotiation of certain terms;

(e) the context of the contract as a whole.

\textsuperscript{197} Marrow 195. See Wertheimer “Unconscionability and Contracts” in \textit{Philosophy of Law: Classic

\textsuperscript{198} See Botha v Van Niekerk 1983 3 SA 513 (W) 525E-F. See Che & Spier \textit{Strategic Judgment

\textsuperscript{199} \textit{Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd} 1995 4 SA 790 (A) 802F-805F. It is
a matter of “substance rather than of form in order to arrive at the true facts” (803I-J).

\textsuperscript{200} South African Law Commission Final Report on Project 47: Unreasonable Stipulations in
Duress in the Law of Contract and Unjustified Enrichment in South Africa” DPhil thesis Rhodes
University (2003) 373-376, submitting that “the terms “unconscionability” and “good faith” would
probably seem like two sides of the same coin”.

\textsuperscript{201} See Horton “Unconscionability in the Law of Trusts” 2008 \textit{Law Review} 18-19
\url{http://ssrn.com/abstarct=1280363} (accessed 06-08-2011) for a discussion on the differences
between procedural and substantive conscionability.
Berat argues in favour of the introduction of the concept of unconscionability to South African law in a new commercial code that will harmonise it with the existing doctrines of misrepresentation, duress, and undue influence. The legislator indeed took the first steps in this direction by including the doctrine first in the Consumer Protection Act in 2009 and then in the new Companies Act in 2011.

In first-mentioned Act the term “unconscionable” is defined as “having a character contemplated in section 40; or otherwise unethical or improper to a degree that would shock the conscience of a reasonable person”. Section 40 explains “unconscionable” behaviour, in the specific context, as the use of physical force, coercion, undue influence, pressure, duress, harassment, unfair tactics, or similar conduct. It further describes as unconscionable the taking of advantage of a consumer who is “substantially unable” to protect himself, because of physical or mental disability, illiteracy, ignorance, inability to understand the language of an agreement, or a similar factor.

Section 20 of the Companies Act deals with the validity of company actions and subsection (9) stipulates that if “a court finds that the incorporation of the company, any use of the company, or any act by or on behalf of the company, constitutes and unconscionable abuse of the juristic personality of the company as a separate entity”, the court may declare the corporate veil to have been pierced in respect of any right, obligation or liability of the company or of a shareholder of the company.

It is submitted that the test for unconscionability in the Companies Act would often differ substantially from the near crudeness of the behaviour referred to in the Consumer Protection Act. The purpose in both pieces of legislation is to protect the weaker party against the stronger party in the business relationship. In terms of the Companies Act it may often be a more subtle and sophisticated form of behaviour that would constitute unconscionability.

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203 See the Consumer Protection Act 68 of 2009 and the Companies Act 71 of 2008.
As many trusts are formed by way of contract, the question can be asked whether the doctrine of unconscionability is applicable to trusts. Horton submits that trust law does not recognise the principle largely because of the perception that it is unnecessary, as in many instances the founder or trustees can merely amend the trust deed. The fact is, however, that some trust clauses may substantially affect the rights of beneficiaries. He therefore submits that courts should be able to scrutinise procedurally suspicious clauses in trust deeds. Horton states that a founder’s right to dictate how the trust assets must be used in future (even decades after his death) have the potential “to cause negative externalities”.

Horton submits that the unconscionability rule, with its two-prong procedural and substantive test, is able to detect certain prejudicial clauses that are not covered effectively by other protective rules in trust law. The procedural element is ideal to identify terms that are not consonant with what an informed settler would have chosen, while the substantial aspect focuses on potentially grossly unfair results that a clause may cause.

It is submitted that Horton is correct in as far as he argues that many trust deeds are in the form of contracts where the contents are of little concern to the average founder. Many trust deeds in South Africa are drafted in the form of one-size-fits-all shelf documents, some of which are not even founded by the donor himself, but are received by way of a cession. The fact that the founder and trustees sign the trust deed does not necessarily proof that they have consensus on the contents thereof. It is submitted that it will be advantageous to incorporate a test like the conscionability test into trust law to broaden the power of courts to interfere with the contents of both mortis causa and inter vivos trusts on procedural and substantial grounds of unfairness.

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204 Horton 22.
205 Ibid 27. He acknowledges the role of certain rules in US law to counteract these results, like the “rule against perpetuities” and the “rules of property regimes or elective share statutes”, protecting spouses from complete disinheritance. He gives a list of potentially hazardous testamentary trust stipulations.
206 Ibid 32 and 43. In evaluating the causes of these undesirable clauses, Horton refers to so-called “mill trusts”, “self-help trusts” and the role of corporate trustees in the process of creating trust deeds that do not necessarily stipulate what the settler had in mind.
207 For an example of this type of behaviour see Potgieter v Potgieter NO [2011] ZASCA 181 case no 629/2010 (SCA).
Louw extends the unconscionability principle to the need for clear and simple language in documents. As a trust deed is often in the form of a contract the parties have to be aware of all their obligations and rights in terms thereof. An unconscionable agreement may be grounds for cancellation. Alternatively a court may redraft contractual terms that infringe on certain consumer rights.\textsuperscript{208}

The test of unconscionability has become a reality in the South African business milieu and trusts cannot be excluded therefrom. As trusts are often used as business vehicles and do qualify as juristic persons in terms of both the Consumer Protection Act as the Companies Act, they should give the same protection as any other business form.

### 4.6.9 THE BUSINESS TRUST AND THE \textit{LEX MERCATORIA}

The so-called new \textit{lex mercatoria} (the “Law Merchant”) is a system of general international contract law, often linked to cross-border arbitration options as protection and enforcement mechanism.\textsuperscript{209} In many cases the new \textit{lex mercatoria} replaces the traditional, public sources of law, such as national statutes and public international law.\textsuperscript{210} It is widely regarded as an autonomous legal system, which is a “constantly changing” body of law. International business itself is in practice creating it and enforcing it.\textsuperscript{211}

Various initiatives were launched to codify this legal system, of which the Unidroit Principles of International Commercial Contracts is the most comprehensive,\textsuperscript{212} and


\textsuperscript{209} See Snyman-Van Deventer “Die nuwe \textit{Lex Mercatoria}” 2011(2) \textit{Stellenbosch Law Review} 247-271. The writer differentiates the modern \textit{lex mercatoria} from that of medieval times.


the United Nations Convention on Contracts for the International Sale of Goods, 1980 (CISG) must also not be under-estimated. While the opponents of these general principles of contract law are questioning whether it will at all have the validity of law, the proponents argue that the functionality of these principles will ultimately allow the parties to international contracts to develop their own set of laws. This so-called “a-national contract law” can lower the costs of international transactions and prevent jurisdictional disputes. Parties generally prefer the dispute resolution mechanism to follow the law that governs the contract, which explains why more than 90% of transnational commercial contracts provide for alternative dispute resolution clauses.

The lex mercatoria is driven by international traders, their lawyers and the arbitrators involved in the administration of disputes. Although potential enforcement issues may remain a strong argument against the lex mercatoria, initiatives such as the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards goes a long way in addressing these. It has become a definite reality of the international business milieu and will be practised by business people, irrespective of whether it is acknowledged by national judicial systems or not.

The variety of legal solutions, coupled with the varying degrees of sophistication of these different solutions, is indeed problematic. Gopalen submits that even the international legal regime is not necessarily always “reflecting the needs of modern commerce”. Harmonisation is necessary and it will provide a neutral option for both sides of the business deal, while the national laws may be inappropriate for international transactions and may result in disparities. It will ultimately promote international trade and economic development while barriers are eliminated in the process.

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213 The existence of the International Chamber of Commerce (ICC) and the United Nations Commission on International Trade Law (UNICITRAL) are further examples of the need for harmonisation in the international commercial milieu.

214 The International Chamber of Commerce (ICC) actively encourage contractual parties not to choose domestic law of sale to govern their contracts.

215 Sweet 635.

216 By 2006 a total of 137 states have ratified the Convention. See Sweet 638. See Booysen International Transactions and the International Law Merchant (1995).

217 806-809.
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The opponents of harmonisation have a number of arguments against a transnational legal system, like the dangers of multicultural compromises between different legal orders; potential systemic faults in international drafting processes; misplaced idealism; the lack of uniform application by courts in different jurisdictions and the lack of accessibility of these judgments; the difficulty to express certain legal concepts in foreign languages, etcetera. Gopalen\textsuperscript{218} is of the opinion that none of these and other criticisms of the harmonisation process can outweigh the necessity for a genuine international legal regime. Such a regime should be based on commercial principles rather than nationalistic legal ideas, as business people “demand certainty and predictability more than nationally determined notions of justice or fairness”.

Gopalen\textsuperscript{219} does not support the notion that transnational commercial law is different from the new \textit{lex mercatoria} in that harmonisation is about the minimisation of the differences between the laws of the different jurisdictions, while the \textit{lex mercatoria} is about the existence or not of the system as a viable option. In this sense international conventions are part of transnational commercial law, but not part of the \textit{lex mercatoria}. I, however, submit that it is in essence the same thing.

In a well-researched article Snyman-Van Deventer indicates that the modern \textit{lex mercatoria} is much more inclusive than only the arbitration of international commercial disputes. Documents like the Unidroit Principles of International Commercial Contracts and the United Nations Convention on Contracts for the International Sale of Goods are the most comprehensive,\textsuperscript{220} and are contributing towards the proper codification of the underlying principles of the \textit{lex mercatoria}. The aforementioned has thus developed into a third sphere of law – additional to the

\textsuperscript{218}804-805.
\textsuperscript{219}811-812. See further 814-819 on the roles of international conventions and so-called soft law aspects.
\textsuperscript{220}This code was developed by the International Institute for the Unification of Private Law. The American Law Institute (ALI) developed the Restatement of the Law of Contracts and the Uniform Commercial Code (UCC), which it invited the different states in the US to enact as law. The ICC supports the UCC model and encourages the rest of the international business world to follow suit. See Bonell. Compare the Principles of European Contract Law by the Lando Commission. See Gopalan 847.
national and public international spheres — and has become a *de facto* international commercial legal system. \(^{221}\)

The sources of the *lex mercatoria* are cited as the legal principles common to trading countries, as well as the general customs of international commerce. The general characteristics include the following: non-national international public law; uniform rules applied in international commerce; the rules of international organisations; commercial customs; standard contracts; the disclosure of arbitration awards; and, general legal principles. \(^{222}\) This can be summarised as “a legal framework created by way of modern international commercial customs, principles, agreements, treaties and arbitration”. \(^{223}\) (Own translation)

The fact that many trusts are formed by way of contract, makes the *lex mercatoria* issue very applicable to transnational transactions where one or more trusts are involved. It becomes more common to find arbitration clauses in trust deeds and other contracts. In *Lufuno Mphaphuli Associates* the Constitutional Court acknowledged that arbitration has become an area of law “that is extremely important in the commercial world: recourse to arbitration proceedings to resolve disputes is extensive and is increasing.” \(^{224}\) It is submitted that, because of the role of the trust in the commercial environment of so many jurisdiction, the future development of the *lex mercatoria* will not leave the utilisation and development of the trust as legal entity in international law unaffected.

### 4.6.10 THE TRUST AND THE CIRCLE OF ASSENT DOCTRINE

Business trusts are usually formed by way of a contract between the founder and the trustees. As in all contracts the situation may occur where one of the parties is not aware of the contents of the agreement as the deed was prepared by a third party and the parties thereto signed it without reading it properly. The traditional legal position is that a person is bound by what he has signed. The recent *Potgieter*

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\(^{222}\) *Ibid* 267-268.

\(^{223}\) *Ibid* 270.

\(^{224}\) *Lufuno Mphaphuli Associates (Pty) Ltd v Andrews* 2009 4 SA 529 (CC). See also *Telcordia Technologies Inc v Telkom SA Ltd* 2007 3 SA 268 (SCA) for a decision on the application of an arbitration clause in a transnational agreement.
case\textsuperscript{225} is a classical case where one of the parties to a trust contract used ignorance of the contents of the deed as defence.

The doctrine of unconscionability, recently introduced to South African law by way of the Companies Act of 2008, can provide some form of relief under certain circumstances. Where a clause in a contract, however, does not qualify as being unconscionable, even though it may be unfair, the aggrieved has little or no recourse.

The Circle of Assent doctrine has been developed by the Tennessee court in the United States as a result of standard-form contracts. It is general knowledge that most local discretionary trusts can be regarded as standard-form contracts, as the legal and fiduciary fraternity often make use of a pro forma document and only change the parties to the deed. Lloyd submits that, as business lawyers have developed ways to sidestep the doctrine of unconscionability, the courts in that jurisdiction have counteracted with the development of the circle of assent doctrine.\textsuperscript{226}

The principle of this doctrine is that the parties are bound by the provisions in the contract

\begin{quote}
“over which they actually bargained and such other provisions that are not unreasonable in view of the circumstances surrounding the transaction”.\textsuperscript{227}
\end{quote}

The court summed up its reasoning as follows:

\begin{quote}
“We think it is simply a matter of ascertaining the agreement of the parties in light of modern notions of fair play: a matter of finding the elusive “circle of assent” which contains the agreement of the parties.”\textsuperscript{228}
\end{quote}

Lloyd differentiates this doctrine from unconscionability in the following way: the circle of assent determines what the parties have actually agreed to, while unconscionability determines whether a sensible man would have agreed to a specific term and whether an honest and fair man would have accepted such a term.

He submits that unconscionability became the “poor man’s” test, wherein unequal

\begin{itemize}
\item \textsuperscript{225} See Potgieter v Potgieter NO 2012 1 SA 637 (SCA).
\item \textsuperscript{226} Lloyd “The ‘Circle of Assent’ Doctrine: An Important Innovation in Contract Law” 2006(2) The Tennessee Journal of Business Law 238. The doctrine was first applied by the court in Parton v Mark Pirtle Oldsmobile-Cadillac-Isuzu Inc 730 S.W.2d 634 (Tenn. Ct. App. 1987).
\item \textsuperscript{227} Lloyd 238 as it was laid down in the Parton case. The court applied certain principles laid down in the Uniform Commercial Code.
\item \textsuperscript{228} Parton 638.
\end{itemize}
bargaining often plays a significant role, while the circle of assent searches for the genuine will of the parties by way of an inquiry into the circumstances in which the transaction was concluded.\textsuperscript{229} The two most basic considerations are the extent to which the parties should have been aware of the provision, and the extent to which the provision shifts a risk to one party he was not expecting.\textsuperscript{230}

Admittedly the applicability of the circle of assent doctrine has been limited to the protection of consumers from standard form agreements. It is possible that the concept may find tangent-points in the Consumer Protection Act 68 of 2008. Aforementioned requires that contracts are written in a clear and unambiguous manner, with consumers having been properly informed of their rights and duties. The courts have the right to interfere with specific stipulations in contracts where the Act is not complied with. This Act goes much wider than the doctrine of unconscionability, which has only recently been acknowledged in South African company law.\textsuperscript{231}

It is submitted, however, that it is worthy of investigating a broader applicability of the concept of the circle of assent in our law of contract. It has been applied for the following clauses: arbitration clauses, rolling clauses,\textsuperscript{232} unilateral amendments, and merger clauses.\textsuperscript{233} Lloyd submits that the circle of assent doctrine motivates businesses to have fairer contracts drafted and to warn the signatory of what he or she is getting into.\textsuperscript{234} It is submitted that founders and trustees are often not aware of the contents of the lengthy trust deeds they sign.\textsuperscript{235} They are also mostly unaware of the extensive common-law principles that they are bound to. The

\textsuperscript{229} Lloyd 244-245.
\textsuperscript{230} Lloyd 246.
\textsuperscript{231} The concept of unconscionability has first been introduced by way of sub s 52(1)(b) of the Consumer Act 68 of 2008.
\textsuperscript{232} Lloyd on 261 describes a “rolling clause as one where an item is ordered by a consumer and the contract stipulates that the consumer is bound by the terms of the agreement unless he returns the purchased item within a certain period of time.
\textsuperscript{233} The term “merger clause” refers to a clause that expressly stipulates that all the promises about the product are contained in the contract and nothing that is said by the salesperson, which is not also included in the contract, shall be enforceable against the seller. Parol evidence is often used in these matters.
\textsuperscript{234} 271.
\textsuperscript{235} In the recent matter of Potgieter v Potgieter NO [2011] ZASCA 181 para [20] case no 629/2010 (30-09-2011), the attorney who drafted the trust deed gave evidence to the effect that a certain clause in the deed was nothing more than “a vague and loose statement”, which was without any meaning and not intended to be part of the deed. He blamed it on the fact that he “slavishly copied” another document.
principles of contract law on the one hand and fairness on the other should be balanced in some way or another.

The direction that modern contract law is moving in, namely consumer protection from a human rights point of view should be broadened to include more parties. The complexity of many contracts, including trust deeds, should be taken into consideration when it is enforced. *Steyn and Others NNO v Blockpave (Pty) Ltd* \(^{236}\) is an example where trustees, in ignorance of the contents of the trust deed and the intricate workings of trust law, were of the opinion that they could act on behalf of the trust. One trustee has resigned and the remaining two trustees were of the opinion that they could represent the trust. The deed, however, required a minimum of three trustees at all times. Trustees may be held personally liable for their actions on behalf of a trust that is technically not in existence.

It is submitted that some tempering principles should be developed to protect trustees when their *bona fide* actions, in conflict with the contents of the trust instrument, may lead to personal liability. The circle of assent doctrine may offer some principles to consider in the development of a South African model.

### 4.6.11 THE EFFECT OF THE LUCKING CLAUSE

The so-called “lucking clause” has its origin in English law and refers to a court case in which a trust provision in a business trust was allowed, declaring that the trustees may leave the management of companies controlled to third parties and refrain from interference, except if actual wrongdoing takes place. In some cases it is even allowed to exclude the trustee’s duties of care and supervision, prohibiting the trustees to interfere. The purpose is apparently to allow certain parties, which may include the founder, to *de facto* control the assets of the trust, excluding the trust as shareholder. \(^{237}\)

It is trite law in South Africa that a clear separation of management, ownership and enjoyment is a central aspect of the trust concept. \(^{238}\) In Chapter 2 I indicated the close relationship between the separation principle and the fiduciary duty of a

\(^{236}\) 2011 3 SA 528 (FB).


\(^{238}\) See 2.7 for a detailed discussion on this aspect.
As it is the trustees’ core duty to act in the interest of the beneficiary at all times and under all circumstances, they cannot back down on this duty. This obligation is expressed in South African law as the requirement that a trustee should consistently act like a *diligent et bonus paterfamilias*. Van der Linde and Lombard, although without reference to the aspect of the fiduciary relationship, submit that, if a person who is administering property, is bound by the instructions of a third party, that trustee is acting as an agent and not as a trustee. If a trustee loses *de facto* control of its assets the question can indeed be asked whether a trust still exists. Where a *bona fide* trust is not in existence the legal consequence of the transaction may be a partnership or an agency and may result in the trustee being held personally liable in terms of the contract or for breach of its fiduciary duty.

A trustee cannot operate in a “sleeping” position as one may find with partnerships and even in the case of private companies where one of the parties by agreement is not involved in the daily decisions of the corporation. When someone is burdened with a fiduciary duty he simply cannot escape his responsibility by leaving it to third parties. Although a trust deed may specifically provide for the limitation of the fiduciary duty, it is submitted that it cannot be transferred to a third party without affecting the very nature of the trust.

In terms of the Companies Act of 2008 directors of companies have more powers than before, but the principle remains that control of the company, including the

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239 See 2.9.
240 See Olivier *et al* Trustreg 1-9. Contra Hofer *v Kevitt* 1996 2 SA 402 (C) 408B where it was submitted that the trustee does not automatically have a fiduciary duty towards a potential beneficiary.
241 “*Nel v Metequity Ltd* 2007 3 SA 34 (SCA): Identity of interest between trustees and beneficiaries in so far as object of trust is concerned: Effect on validity” 2007 *De Jure* 434.
242 See Badenhorst *v Badenhorst* 2006 2 SA 255 (SCA).
243 It is trite law that a partnership can currently not be formed without the contracting parties having the clear intention of establishing a partnership. See Pezzullo *v Dreyer* 1992 3 SA 379 (A) 389.
244 Kloppers 2006 TSAR 414 418.
245 It is questionable whether any director can still act in a sleeping position after the introduction of the 2008 Companies Act. It is submitted that the position of non-executive directors may be under serious threat.
246 See s 9 of the TPCA.
appointment of directors, stays with the shareholders. Aforementioned have the overriding right to limit the director’s powers by amending the Memorandum of Incorporation. In practice the trustees are shareholders of the private company endowed with the powers of control.

It is submitted that a total renunciation of the powers by the trustees, or an absolute limitation thereof by the trust instrument, shall be an infringement of the very nature of a trust. This is so for two reasons: such a provision may result in the founder remaining in de iure and de facto control of the trust assets, and the trustee’s duty of care, as laid down in the TPCA, will be removed. Duckworth suggests that the duty of care of the trustee is not necessarily removed. Even if so, the trustee is disempowered and cannot comply therewith effectively.

It is submitted that the lucking clause has no place in the South African trust and, even if it is included in the trust deed, cannot allow the trustee effectively to escape his responsibility and fiduciary duty towards the beneficiaries.

### 4.6.12 THE TRUST AS A CORPORATION

The fact that the trust closely resembles that of the corporation cannot be ignored. In many jurisdictions it is endowed with legal personality in practice although not necessarily in theory. The position of creditors and the limited liability of trustees and beneficiaries are not totally unlike the position of the manager (or director) and the shareholder in the company setting.

The South African courts have thus far refused to acknowledge the juristic personality of the trust, although the legislature has in many respects awarded it legal personality for the purposes of tax, insolvency, and ownership of fixed property. One of the anomalies is the treatment of the trust for insolvency

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248 911. He submits that the clause may either be regarded as invalid or the directors of the company may now have a fiduciary duty towards the beneficiaries of the trust.


250 See *Commissioner for Inland Revenue v Friedman NO* 1993 1 SA 353 (A).

251 See the Income Tax Act 129 of 1991, subs 2(1)(b) that extended the definition of “person” to include any “trust fund”, as well as the Income Tax Act 58 of 1962 (as amended). See further the Value-added Tax Act 89 of 1991, s 1, and the Transfer Duty Act 40 of 1949, s 1. The trust is, however, still not a taxable entity for estate duty purposes, as per *CIR v Macneillie’s Estate* 1961 3 SA 833 (A).
purposes. In *Magnum Financial Holdings* the court acknowledged that “in certain respects a trust does possess legal personality” and may therefore be sequestrated as if it were a person. A trust therefore does not possess legal or juristic personality outside of statute, except in the case of insolvency. De Waal has submitted two decades ago that the treatment of trusts in South Africa has moved us in the inevitable direction of legal personality.

It seems as if there is an active drive by the legislator to ensure that the trust’s *sui generis* position does not exclude it from the effects of new legislation. In terms of section 1 of the National Credit Act 34 of 2005 a “juristic person” includes “a partnership, association or other body of persons, corporate or unincorporated, or a trust if, (a) there are three or more individual trustees; or (b) the trustee is itself a juristic person, but does not include a stokvel”. Some trusts will therefore qualify as a juristic person, while others will not.

Section 1 of the Companies Act 71 of 2008 was the latest initiative by the legislature to award the trust legal personality, by including trusts in the definition of “juristic person”. As the term “person” in that Act includes a “juristic person” it means that all references in the Companies Act to either “person” or “juristic person” also include trusts. It is not clear what the intention of the legislature was and it is still uncertain what effect it will have on the development of the business trust in the direction of being accepted as a corporation. This trend to specifically include the trust as a juristic person was also followed in the recently promulgated Consumer Protection Act 68 of 2008.

In the Companies Act 71 of 2008 (as amended) “listed securities” refers to securities as defined in the Security Services Act, while “securities” is defined as “any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company”, and a “share” as “one of the units into which the propriety interest in a profit company is divided”. A “profit company” means

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252 *Magnum Financial Holdings (Pty) Ltd (in Liquidation) v Summerly* 1984 1 SA 160 (A) 163H. See the court’s reference to *Ex Parte Milton* 1959 3 SA 347 (SR) in this regard.

“a company incorporated for the purpose of financial gain for its shareholders.” As the term “company” includes all juristic persons incorporated in terms of the 2008 and the 1973 Companies Acts, as well as the Close Corporations Act of 1984, “securities” for the purposes of this Act clearly includes shares in both private and public companies, as well as membership holdings in close corporations.

As the term “company” includes all incorporated juristic persons, and trusts are juristic persons for the purposes of Act 71 of 2008, the question may be asked whether a legally formed trust is indeed incorporated in the sense of “being made a legal entity”. If so, the result will be that the term “securities” shall in future, for the purposes of company law, include a beneficial interest in a trust. It is submitted that the legislature should take the bold step to enact the legal personality of trusts. This should eradicate many of the negative and sometimes enigmatic perceptions about trusts and allow the trust concept to develop to its full potential – especially in the business environment.

It is submitted that the trust as corporate entity adds value to the repertoire of corporative law. It brings a flexibility that is not possible within traditional company legislation. In various aspects, such as the regular election of directors, special shareholder authorisation and other internal governance requirements, the trust is less restrictive and more manoeuvrable than the company.\(^{254}\)

4.7 THE OFFSHORE BUSINESS TRUST

In paragraph 3.7 some general aspects of the offshore trust have been touched on. In this section some aspects of the offshore business trust will be referred to, without any attempt to discuss it in detail, as it does not form a central part of this study.

It is a common phenomenon to walk down a major street in any of the capital cities of the world and enter a building that is registered in the name of an offshore company, the shares of which are held by a discretionary trust formed in another offshore jurisdiction, for the benefit of beneficiaries in a third country. The founder may reside

\(^{254}\) Hansmann & Mattei 453.
in a fourth location, having given the trustees guidance by way of a non-binding letter of wishes as to how they should exercise their discretions.\textsuperscript{255}

Foreign trusts have been a popular tax planning tool all over the world for many years. A variety of assets, immovable property, cash, ships, aircraft, shares, yields, family heirlooms, etc., can be transferred to an offshore trust. It is submitted by some that as much as two-thirds of all liquid capital in the world is to be found in offshore jurisdictions, and one-third of the world capital is deposited or administered through trusts. International financial centres are not only havens for financial service providers, individual investors and entrepreneurs from all over the world, but also by multinational companies, looking for safe places for assets, profits and savings. Asset protection trusts are the most common form of trusts offshore.\textsuperscript{256}

Even in unlikely civil-law jurisdictions, like China, has the phenomenal speed of wealth creation has driven private individuals to trust products. Aspects such as the continuation of family businesses, the preservation of business assets, and the need for professional and institutional partners — all against the “backdrop of greater regulatory and reporting requirements, demanding more transparency and disclosure of sources of funding and increasing the cost of compliance” — have largely contributed to the need for trusts.\textsuperscript{257}

The Organisation for Economic Co-operation and Development (OECD) defines a tax haven as “a jurisdiction that actively makes itself available for the avoidance of tax that would normally be payable in the high tax countries”. It is submitted that this definition is over-simplistic as tax is only one of the motivating factors individuals and corporates use for going offshore. “Offshore finance centres”, which is a more appropriate term, are divided into three tax classes by Ginsberg, namely countries where there are no relevant taxes, like the Cayman Islands, Bahamas and Bermuda; countries where taxes are levied only on internal taxable events and not on foreign sources, like Hong Kong, Cyprus and Malta; and, countries which grant special tax

\textsuperscript{255} See Watt 83 for a similar exposition.
\textsuperscript{256} \url{http://www.slogold.net/trusts.html} (accessed 17-09-2011).
\textsuperscript{257} Tan “Demand for Trusts Set to Take off in China” IFC Review \url{http://www.ifcreview.com/restricted.aspx?articleId=4795&areaid=24} (accessed 02-07-2012).
privileges to certain types of companies, such as the Channel Islands, Liechtenstein, Luxembourg, Isle of Man and Monaco.\textsuperscript{258}

He submits that other aspects, besides taxes and exchange controls, are addressed by so-called tax havens. Flexible corporate structures (also called “hybrids”), combining partnerships and corporate characteristics, and which often include unique trust and financial planning techniques, are motivational factors for utilising offshore finance centres. These jurisdictions are often the first ones to introduce innovative corporate, investment, trust, insurance, partnership and banking legislation.\textsuperscript{259} Roper and Ware\textsuperscript{260} refer to a number of aspects influencing the choice of jurisdiction, like political factors, offshore business factors, tax and corporate factors, as well as whether the trust law operates in a common-law or civil-law environment.

One of the most important aspects of offshore commercial activity is the \textit{de facto} jurisdiction where the management and control of the business take place. As most financial centres require local trust companies to act as trustees, with all management functions being executed by them, trusts remain very powerful offshore business vehicles. The founder can usually not fulfil any other position than that of protector and beneficiary, which legally exclude him from all management and control functions. By way of a non-enforceable letter of wishes he can, however, still direct the trustees in the exercising of their discretionary actions. The most likely application of the offshore trust is as the holder of the shares of one or more offshore companies.

In many offshore jurisdictions a variety of financial products, some of them utilising trusts, have developed. As a result of the regulatory environment in many jurisdictions an alternative global trading system in low or zero-tax offshore centres

\textsuperscript{258} Ginsberg \textit{International Tax Havens} (1997) 5. Roper & Ware \textit{Insight} 21-22 makes use of five types of International offshore Financial Centres, namely those having no income tax nor a range of exemptions (like Bahamas); those taxing local income only (like Hong Kong); a combination of the previous two (like Cyprus); those with special incentives, including international business company legislation (like Mauritius and Malta); and, those with special incentives for offshore and holding companies (like Switzerland).

\textsuperscript{259} Ginsberg 6.

\textsuperscript{260} \textit{Insights} 23-24.
has come into being. International banking, and offshore investment and mutual trusts, are continually increasing in importance. 261

In the Bahamas offshore trusts may be used to facilitate the setting up of collective investment schemes and a large number of international insurers are registered there. 262 Bermuda is one of the leading offshore mutual fund jurisdictions and its “purpose trust” offers a wide range of alternatives for commercial activities, not found in many other financial centres. 263

In British Virgin Islands mutual funds can be in the form of closed-end funds, open-end funds, master structures, umbrella funds or fund-of-funds. 264 The Cayman Islands are one of the choice destinations for capital markets and structured finance vehicles, which may be in the form of companies, trusts or partnerships. The special-purpose vehicles may undertake capital markets, Euro-paper issue, repackaging, transport financing and complex securitised transactions. These are also established offshore players in captive insurance. Mutual funds may utilise alternative structures, like exempt or limited life companies, limited partnerships or trusts, depending on the taxation and security regulations of the jurisdiction where the trust will invest or where its investors are domiciled. Unit trusts are popular because they are not subject to the capital and income constraints applicable to corporations. 265

The Jersey trust does not allow the founder to divorce himself entirely from ownership of the trust assets and can be registered by way of either the special form trust deed or a special contractual agreement. 266 Although Malta is a civil-law jurisdiction it also acknowledges the common-law trust, closely modelled on Jersey law. In Mauritius the offshore trust may be used for trading purposes, life assurance business, the management of cash deposits as well as for provident funds, pension funds, and employee service benefits or stock option plans. 267

261 Ginsberg 69-79.
262 Ibid 112-115.
263 Ibid 169, 176.
264 Ibid 208. These same options are also available in Ireland.
265 Ibid 244, 251, 256.
266 Ibid 427-428.
267 Ibid 511. See para 8.5 for more detail on the application of the trust concept in Malta and Mauritius.
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From the above it is clear that offshore trusts are largely utilised as commercial vehicles. In some offshore jurisdictions it is quite common to connect the trust to an offshore company by way of its shareholding. In this sense the trust fulfils a crucial role. Offshore companies will grant little protection if the shares were to be held by the individuals in their own estates in their countries of origin. In some jurisdictions, like South Africa, an offshore trust may not hold shares in a local entity, as a so-called “loop structure” is prohibited by the Exchange Control Regulations.

4.8 THE TRUST IN INTERNATIONAL FINANCE

Wood describes the trust in an international financial context as “a separate patrimony or segregated assets where the title to the asset is held by the trustee, but the assets are immune from the trustee’s private creditors.” He is also of the opinion that the concept of a trust is “an indispensable protection against risk”, and “(m)odern societies could not function safely without it.”

The advantages of trusts in the economic realm include the protection of beneficiaries against expropriation on the insolvency of the titleholder; the opportunity for experienced titleholders to act as active managers or as passive custodians; the protection against insolvency and systemic risks; the marketability of assets; and the flexibility trusts as financial vehicles have to offer.

For these and other reasons trusts are used in international finance for a variety of purposes, such as securities clearing systems; custodianship of investments; depository receipts (including currency conversions); market agencies (such as securities brokers); collective investment schemes; deposit protection funds; security interests held by trustees for syndicated lenders; for bondholder trustees; as vehicle

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268 The Bermuda purpose trust is especially geared for holding shares in active trading companies. See Regulation 10(1)(c) of the Exchange Control Regulations. Approval for a loop structure can only be granted by the Minister of Finance in exceptional circumstances, like the facilitation of a substantial BEE transaction or where it is established to be in the national interest. Alternatively the offshore company can acquire a South African listing, which will allow the SA resident shareholders to hold their shares on the SA share register (an inward listing). See Pratt v Firststrand Bank Ltd 2009 2 SA 119 (SCA) and Couve v Reddot International (Pty) Ltd 2004 6 SA 425 (W) for the application of s 10(1)(c). See A Review Framework for Cross-border direct investment in South Africa Discussion Document of National Treasury (February 2011) http://www.treasury.gov.za/documents/national%20budget/2011/A%20review%20framework%20for%20cross-border%20direct%20investment%20in%20South%20Africa.pdf (accessed 17-09-2011).


270 Ibid 304.
for sellers of unperfected sales for buyers; for nominee holders of shares; as investment trusts; for securitisation transactions; and for pension funds. 272

Wood 273 submits that, irrespective of whether the concept is called “trust”, “fiducie”, “bailment”, or “deposit”, the fundamental principle is the same, as long as one party holds the public title to the asset as apparent owner. His conclusion is that the trust, or some institution that can achieve the same results, is necessary in the modern economic society and in satisfying the needs in the international financial milieu.

4.9 CONCLUDING REMARKS

The purpose of this Chapter was to place the commercial trust in perspective, as it fulfils an important function in the business domain, both locally and internationally. The trust is used in a variety of roles in the business context. Not only is it a trading and estate planning vehicle, but it fulfils special roles as collective investment instrument, pension fund vehicle, empowerment entity and special-purpose instrument. All these roles are supported by specific legislative authority, as has been indicated. Specific aspects of the trust, some of them unique to the trust, such as the vesting of rights and the conduit principle, have been considered.

It became clear that the trust has established itself as a major force in the commercial world – both in South Africa and internationally. One of roles of the trust in the commercial environment is its role as a finance vehicle. The modern financial reality consists of much more than only money and credit, and has become a complex labyrinth of structures, instruments and schemes.

In the next two Chapters the general financial environment in South Africa will be dealt with and more specifically the concept of securitisation.

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273 302.
CHAPTER FIVE

THE FINANCIAL ENVIRONMENT IN SOUTH AFRICA

5.1 INTRODUCTION

In this Chapter the current financial milieu in South Africa will be discussed. Before getting to that, however, I shall briefly look at the historical background of money and the overall commercial need for financial instruments. The three classes of assets today known to man can be classified as immovables (land and real property), tangible moveables (physical goods), and intangible assets (debt claims, commercial receivables, investments, intellectual property, etc.), with financial assets as a sub-class of intangibles.¹

A few millenniums ago bartering was the common way of trading, until mankind, in its change from a hunter-gatherer to a consumer-trader, had to find other more user-friendly methods of trade.² Maritime trade between the Greeks and the Phoenicians became highly developed from 1000 BC and involved long-distance shipping of commodities. To stimulate growth, credit became a common practice at an early stage and the Code of Hammurabi restricted interest rates as early as 1800 BC.³

Common measures like gold was for practical reasons later on backed by paper notes, which were in turn later backed by cheques and other promises of payment. Certain instruments of payment received the status of legal tender and legislation was promulgated to determine that, when a debtor is under an obligation to repay money he has lent, he may pay it in any form that is accepted as legal tender.⁴ The

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¹ Wood 3. “Financial assets” in this sense will include currency and coins, bank deposits, commercial bank loans, and securities (bonds, shares, units).
⁴ By the beginning of the second century, coinage was available throughout the Roman Empire. See s 2 of the Currency and Exchanges Act 9 of 1933. “Legal tender” is currently largely regulated in terms of s 10 of the South African Reserve Bank Act 90 of 1989 and is defined in terms of s 17 as “a note or a coin of the Reserve Bank”. The National Payment System Act 78 of 1998 regulates the circulation of money and defines “money” as “a banknote or coin issued
Roman Empire, because of its ideology of control, reserved the principal financial powers in society for the state. It controlled the capital and therefore also the dispensing of money. By outlawing private companies it did not allow conglomerates to emerge, which may have contributed to the first “great crash” in 259 AD and the Empire’s ultimate collapse two hundred years later.⁵

Some submit that the Knights of the Holy Temple of Jerusalem (the Knights Templar) became the first full-fledged modern bankers by the twelfth century. This was followed by the development in Europe of commerce as a science and the availability of long-term credit facilities by the fourteenth century. In the next hundred years the powerful house of Medici sprung up in Italy and acted as international bankers, merchants, dealers, goldsmiths, ship owners, deposit-takers, and foreign exchange brokers. The Dutch set up the first organised markets for trading in financial instruments by 1602 and in 1609 the first multinational company was established, followed by the first stock exchange. In the same year the first central bank, namely the Bank of Amsterdam (Wisselbank) was established in the Netherlands. The rapid development in the commercial and banking milieu in the Netherlands can largely be contributed to the flourishing tulip trade of the early 1600s. Short selling, puts and calls, and futures transactions became rife in commodities like tulip bulbs, as well as in securities, like shares in the Dutch East India Company. In the next hundred years trading in bills of exchange and in other financial instruments were common practice in the United Kingdom, which culminated in 1720 in the catastrophic “Great South Sea Bubble”.⁶

Paper money was first introduced in South Africa in 1782 and eleven years later the first bank was established. The Lombard Bank belonged to the state and was entrusted with the issuing of government notes, until it was forced to close its doors after private banks evolved by 1837. Aforementioned was allowed to print its own

⁵ Smith & Walter ⁵.
⁶ Ibid ⁸-¹⁰.
paper money before the Reserve Bank became the sole issuer of banknotes in South Africa.\(^7\)

Although the central banks of national governments controlled the issuance of legal tender, registered banks in the form of public companies, under supervision of the relevant central bank, always fulfilled a central role in the management, administration, regulation and supervision of legal tender.\(^8\)

John Kutyn explains that money must be distinguished from currency.\(^9\) Money is a form of currency, while aforementioned is the item that is used as a means of exchange. In that sense a promissory note can be used as a form of currency, although it is not money. A real understanding of the term “money” in the modern financial reality has become rather complex. In New Zealand total bank deposits exceed total physical money by approximately fifty times. The banks could therefore meet not more than one per cent of their legal obligations towards depositors. He thus submits that the banking system as a whole depends on deposit holders not demanding the payment of their deposits.\(^10\)

The difference between tangible and intangible assets, is that the value of tangible assets depends on specific physical properties (like land or buildings), while intangible assets represent legal claims to some future benefit. One can therefore argue that a physical banknote is a tangible asset, but when it is deposited into a bank account it becomes intangible. According to the Banks Act 94 of 1990, “liquid assets” include Reserve bank notes, subsidiary coins, any credit balance in a clearing account, treasury bills, certain securities, and, certain Land Bank bills. Lawack-Davids\(^11\), in reference to Crawford\(^12\), identifies the following characteristics

\(^7\) Van Zyl et al 69. See Smith & Walter 11-15 for a discussion on the roots of the modern banking system.

\(^8\) See Lawack-Davids Aspects of Internet Payment Instruments LLD thesis University of South Africa (2000) 32-37 for a discussion on chattels issued by or on behalf of the state.

\(^9\) Melicher & Norton Introduction to Finance: Markets, Investments and Financial Management (2007) 15 submit that money “is anything generally accepted as a means of paying for goods or services and for paying off debts.” It must be easily divisible to be effective as an exchange medium, as well as inexpensive to store and reasonably stable in value over time.


of money: it is a medium of exchange; it can be used as final payment; it is freely
transferable by way of delivery; it attracts no collection or settlement; and a
transferee can take it free from the claims of previous holders. Where all five these
characteristics are present the chattel qualifies as “money”. It is submitted by the
writer that this understanding of money provides the necessary environment for new
forms of money to be accepted as such.

The financial landscape has changed dramatically during the last few centuries.
While the original purpose of private banks was to act as exchange agents only, they
quickly came to realise that the depositors do not require payment at exactly the
same time and they could therefore lend out money representing more gold (or any
other common measure) than they had in their vaults at that specific moment.

This practice became not only an interest spinner for banks, but was actually a
process of creating more money for commercial transactions. Banks therefore
became deposit-takers on the one hand and lenders of those same deposits on the
other, which made them financial intermediaries between savers and borrowers. 13
Smith 14 states that this process of financial intermediation by banks exposes them to
liquidity risk, credit risk and market risk.

Liquidity risk can be described as “the inability to meet commitments on time”, or “the
risk that a counterparty will not settle an obligation for full value when due”. Credit
risk (or exposure) refers to the same potential inability, but includes the further
possibility that payment after due date is also at risk. Market risk refers to “the risk of
unexpected movements”, such as in interest rates, which leads to “the risk of losses
in on- and off-balance sheet positions”. 15

summarises the role of banks as follows: the taking of deposits; the extension of loans; the
facilitation of transactions; the provision of payment, clearing and settlement services; the
provision of financial products, such as hedge funds, asset pools, etc.; and the reduction of the
costs and risks of investments, and that of producing and trading goods and services.
14 Smith 14. To this one can also add “operational risk”.
15 Smith 13-14. Glossary of Terms by Committee on Payment and Settlement Systems of the
These risks are largely addressed by the margin between the interest paid on deposits and that charged on loans to borrowers. When a borrower becomes unable to meet his obligations (credit risk) the lender will ultimately fall in default towards the depositors (liquidity risk). The universally accepted best practice is for financial institutions to manage their internal liquidity ratios with the utmost care. The international financial regulator had to intervene in recent times by prescribing minimum liquidity requirements to banks and other lending institutions.

The strong position of market-based economies and the globalisation of economic activities have required a less restrictive flow of capital between different destinations and had forced connecting jurisdictions to reorganise their internal and external financial systems. The respective systems must facilitate the availability and application of financial resources, such as effective payment systems, the flow of funds, the shifting of resources, the facilitation of different aspects of risk, and the coordination and application of economic information. Wood estimates that less than one per cent of the total value transferred in the major industrialised world today is in the form of actual coins and notes. Somewhere in this process national governments must position themselves and determine to what extent they will interfere.

As the demand for credit grew it became clear that banknotes and coins are not adequate as legal tender to satisfy the needs of a demanding and developing economy. See Kutyn “Banking and Systemic Risk” (22-10-2008) http://www.gold-eagle.com/editorials_08/kutyn_102208.html (accessed 22-07-2011) for the inherent risk caused by interest, to the financial system.

See reference to “front office” and “back office” segregation of duties and reporting lines in the organisational structures to ensure proper risk management, in Van Zyl et al (eds) 13

The Basel III capital and liquidity requirements are even more stringent than its predecessor. The new net ratio benchmark for funding will be 100% and will be implemented between January 2013 and January 2019.

Van Zyl et al (eds) 3. Efficiency in the financial environment is closely linked to the opportunities for competition and the availability of information.

Wood 478.

See Wiese “The Dawn of a New Era – Part Two” 2009(11) Cover 54- 55 for discussion on the introduction of the South African National Savings Fund. This is a compulsory retirement fund and may have a negative impact on existing occupational funds and result in reducing the current 9 000 funds to less than 1 000. Compare the criticism of the government-sponsored pension fund milieu in the USA by Moyo How the West was Lost (2011) 78-90 and the impact that had on the current financial crisis. The writer compares the government pension scheme with a Ponzi scheme.
commercial system, which became the ideal breeding ground for unrestrained speculation by some unscrupulous individuals and corporations.\textsuperscript{22}

The primary function of the financial system is to maximise the useful application of the available cash in the economy. To achieve this two competing mechanisms are used, namely financial intermediation and financial disintermediation. First-mentioned is a reference to the process of savings been taken in with the purpose of on-lending to borrowers, while last-mentioned refers to the process whereby the savers contract directly with the borrowers, without the intervention of an intermediary.\textsuperscript{23}

It became imperative to create other instruments of debt and payment to satisfy this hunger for credit. In some countries the national debt became a multiple of the gross domestic product.\textsuperscript{24} Securities became an integral part of the financial system and in recent years securitisation has become one of the most important financing methods internationally,\textsuperscript{25} as it represents an effective conversion of financial assets into marketable securities.\textsuperscript{26}

Structured finance is a collective term for some non-conventional financial arrangements, used to refinance and hedge certain profitable economic activities. It is mainly utilised when conventional finance is unavailable for the specific transaction, or too expensive — as it usually results in lower capital and agency costs. These products are remarkably flexible and are mostly seen in the form of either asset securitisation or credit derivative transactions.\textsuperscript{27}

\textsuperscript{22} Beattie \textit{False Economy} (2010) Chapter 10 explains the effect that globalisation, amongst other aspects, had on the development of the recent financial credit crisis. Edozien \textit{We are Caught in a Systemic Debt Trap} 05-09-2011 Cape Times, submits that the world needs a “new and completely different sort of financial system to solve the root of our economic problems.”

\textsuperscript{23} Smith 14.

\textsuperscript{24} In May 2011 the United States reported a national government debt of 14 trillion dollars, which is equal to 95% of the gross domestic product, while Japan’s stood at 228%. Moyo 37 writes about “the emergence of a society of leverage, one where citizen and country were mortgaged up to the hilt”.

\textsuperscript{25} Smith 110.

\textsuperscript{26} Partnoy “Financial Derivatives and the Costs of Regulatory Arbitrage” 1996-1997 \textit{Journal of Corporation Law} 227 states that financial intermediaries are constantly structuring new derivatives as response to changes in financial regulation.

Banks fulfil an important role in both the direct financing and the indirect financing arena and are major players in the structured financial arena. In the direct financing process the bank does not operate as financial intermediary, but as one of the issuers of certain financial instruments. In indirect financing the commercial bank fulfils its traditional role as facilitator between the borrower and lender, by way of the process of financial asset transformation.  

Sound financial systems are based on efficiency and stability. It must allow for the best investment opportunities in the particular environment to be accessible at the lowest possible cost, without the risk that the system may collapse. It must, therefore, be able to balance competitive business opportunities with good governance.  

Financial stability has been defined as “the smooth operation of the system of financial intermediation between households, firms, the government and financial institutions.” The major signs of a financially stable environment are an “effective regulatory infrastructure”, an “effective, well-developed financial market”, and “effective, sound financial institutions”.  

As financial systems are all about efficiency and stability, it is submitted that sound legal vehicles are a necessity for an effective regulatory infrastructure. Although the focus in this thesis is limited to an investigation into a specific concept as legal vehicle, its outcomes are closely linked to the effectiveness of the financial market and the soundness of the underlying institutions.

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28 See Van Zyl et al (eds) 6 for a somewhat different definition. They correctly state on 7 that the distinction between direct and indirect financing has become blurred, “as non-negotiable bank loans are increasingly being converted into negotiable instruments”.  

29 The Compendium of Standards of the Financial Stability Forum divides the key standards as follows: macroeconomic policy and data transparency, institutional and market infrastructure, and financial regulation and supervision.  

30 Van Zyl et al (eds) 47. See also the annual financial stability reports, confirming these sentiments at http://www.resbank.co.za/Publications/Reviews/Pages/Financial (accessed 20-03-2012).  

31 Van Zyl et al 3 describes “efficiency” as “the extent to which the system leads to the allocation of resources to the most valuable investment opportunities at the lowest possible cost”, and “stability” as “the ability of financial systems to withstand shocks”. See in general Moorcroft & Raath Banking Law and Practice (2009).
Chapter Five: Financial Environment

The fact that people and businesses operate across national borders, involuntarily pushes the local financial environment into the global context. The national legislature and tax administration must be acutely aware of international developments in the financial domain and the opportunities for individuals and businesses in the offshore markets. Residents are constantly looking for diversification, currency, and better return opportunities. In this process, aspects such as exchange controls, financial regulatory controls, tax implications and the potential legal structures, will influence the investors’ jurisdictional preferences.32

Some predict that the end to money as we know it is closer than we may think. The nature of money has changed from the historical commodity money, to symbolic money in the form of redeemable paper and then to credit money.33 The arrival of virtual money in the form of decentralised electronic cash, using peer-to-peer networking, digital signatures and cryptographic proof, without relying on trust, may have replaced the natural evolutionary process forever.34 Although BitCoin as a digital form of currency may seem futuristic, the many cashless and card-less initiatives by South African banks are merely a fight for survival to prevent their becoming obsolete, as governments, central banks and financial institutions may lose their grip on the money circle in near future.35

5.2 FINANCIAL INSTRUMENTS

The financial environment can be divided into the financial system, financial institutions or intermediaries, and the financial market and individuals. The role of financial institutions is to help the financial system operating effectively, while the markets act as the physical locations that facilitate the flow of the funds. The

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32 Roper & Ware Insight 5-10.
34 According to the Banking Association of South Africa the annual value of credit and debit card transactions are around R256bn, compared to the R84bn in cash transactions, and the astonishingly R714bn in electronic funds transfers.
35 Standard Bank introduced mimoney, linked to MXit Moolah; FNB introduced PayPal and e-Wallet; MTN has PayD; Vodacom and Nedbank introduced M-Pesa; and Absa is piloting NFC. See also www.bitcoin.co.za. See in general Moorcroft & Raath Banking Law.
investment aspect deals with the marketing of securities and the management of investment risk.\(^{36}\)

Financial instruments in a general sense can be described as instruments having a monetary value or recording a monetary transaction. They can be classified by the type of claim that the holder has against the issuer. If the claim is for a specific amount, it is a debt instrument, like a loan or bond. If it is an equity instrument, it obligates the issuer of the instrument to pay the holder thereof an amount based on the earnings after the debt instruments' holder has been paid, as in the case of shares.\(^{37}\)

In this process of development, financial instruments have been elevated to the position of currency as they have become an acceptable means of exchange. The majority of financial exchange transactions internationally are conducted by way of instruments other than money. Kutyn submits that one of the main factors causing a dysfunctional financial system is the application of financial instruments as currency.\(^{38}\)

Regulation of the financial sector is imperative, with banks being at the core of it. Banks run an inherently fragile business which can have a potentially major impact on the whole financial industry and ultimately the entire society. Pacces submits that the fragility of banks depends on the way they “intermediate financial resources between their providers and recipients”.\(^{39}\)

Financial instruments are developed within a specific market and function optimally within a proper regulatory environment – regulating the necessary financial institutions. South Africa has developed a well-regulated financial infrastructure, which accommodates world-class instruments. The regulatory environment is


\(^{37}\) The International Monetary Fund (Chapter 5) includes a variety of instruments, such as equity securities, debt instruments, financial derivatives, gold and stock options, in its definition of financial instruments. See Fabozzi *The Handbook of Financial Instruments* (2002) 2-3.


largely influenced by international developments and controls, like anti-money-
laundering initiatives and the Basel Accords. I submit that the main criticism against
the South African model is the fragmented manner in which legislation and oversight
mechanisms are structured.40

The first South African unit trust was launched by Sage in 1965 and this instrument
suddenly offered the average man in the street access to listed companies. With low
investment amounts everyone had the opportunity to diversify, to purchase blue-chip
shares and to rely on the expertise of professional fund managers.41

Today's complement of financial instruments are a far cry from the first collective
investment initiatives and have been transformed into a mega-choice of unit trusts,
structured products, listed and unlisted securities, bonds, negotiable instruments,
settlement products, derivatives, commodities, equities, forwards and options,
 Futures, hedging instruments, promissory notes, interest rate and deposit swaps,
money markets, spot markets, warrants, etcetera.

5.2.1 REGULATORY INFRASTRUCTURE

The development of a wide variety of financial products and instruments cannot take
place in a vacuum and can only prosper within a sound regulatory environment. The
objectives for regulation of the financial milieu are fourfold:42

(a) to secure systemic stability in the economy and prevent unnecessary shocks
from shaking the markets;

(b) to ensure institutional safety and soundness by way of an effective system;

(c) to promote consumer protection and prevent exploitation of the public;

(d) to ensure fair, efficient and transparent markets.43

40 See fn 29. See in general on regulation Pacces 479-511.
41 Profile’s Unit Trusts and Collective Investments (September 2011) 24. Most of the first unit trust
funds were equity funds.
42 Falkema, Bamber, Llewellyn & Store “Financial Regulation in South Africa” 2-3 Paper by SA
Financial Sector Forum 2001 http://www.esaf.org/internet/Publication.nsf/ (accessed 21-06-
2011). See Smith & Walter 153-184 on the international regulatory environment of banks, the
main objectives being financial-system performance, the maintenance of a safe and sound
banking system, and efficient and effective compliance.
43 Van Zyl et al (eds) 121-125.
Financial regulation should be regarded as an evolving process, responsive to changes in the market environment and ensuring that all national forms of regulation are harmonised with that set by international bodies. Aspects to be regulated should include capital adequacy and reserve requirements, minimum entry requirements, standards of behaviour, specific functional responsibilities of different role players, sanctions for errant behaviour, and market support mechanisms.

The economic policies of a country will determine whether a market-oriented approach to regulation, a state-oriented approach, or a mixture of the two, will be followed. The specific regulatory approach has an effect on costs, efficiency, and the competitiveness of the local economy in relation to others. Pacces submits that regulation itself, and not only the lack thereof, can contribute towards financial instability. This can be caused by the false sense of security that regulatory interventions, such as credit ratings, capital adequacy requirements, and corporate governance best practices, can install in financial intermediaries.

In a market-oriented economic environment the regulatory emphasis is not so much on control, but rather on protection of the consumer and the markets. Financial instruments accessible to the general public need more stringent regulatory intervention than those used only by financial institutions and other professional players. The elements of regulation include legislation, the monitoring thereof and enforcement in case of non-compliance.

The first legislation regulating and supervising the unit trust industry was promulgated as early as 1947. The Unit Trusts Control Act was amended a number of times and by the end of the twentieth century it was time for drastic measures. The CISCA was designed to accommodate a range of investment products. Besides CISCA

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44 Falkema et al 10. The most important international bodies involved in the setting of financial regulatory standards are the International Accounting Standards Committee; the Basel Committee of Banking Supervision; the International Organisation of Securities Commissions; and the International Association of Insurance Supervisors.

45 Van Zyl et al (eds) 20. The modern trend is to regulate in terms of standard-setting, like the King Reports in South Africa, the international Basel Accords, the United States Sarbanes-Oxley Act and the United Kingdom’s Combined Code.

46 Pacces 480.

47 See Van Wyk in Van Zyl et al 121-125. The writer includes the following objectives: consumer protection; ensuring fair and efficient markets; ensuring safe and sound financial institutions; and ensuring systemic stability.
there are a number of regulatory instruments and institutions involved in the regulation of the South African financial markets.

The most important legislation include the South African Reserve Bank Act, the Banks Act, the Financial Services Board Act, the Mutual Banks Act, the National Credit Act, the National Payment System Act, the Financial Institutions (Protection of Funds) Act, the Financial Advisory and Intermediary Services Act, the Financial Intelligence Centre Act, the Long-term Insurance Act and the Short-term Insurance Act, the Pension Funds Act, the CISCA and the SSA. Many of these institutions are operated within the ambit of other relevant legislation, such as the Companies Act, the TPCA and the Friendly Societies Act.

Banks are regulated by the Banking Supervision Department of the Reserve Bank, while non-banking financial institutions (including collective investments, financial intermediaries, capital markets, insurance companies, and retirement funds), are regulated by the Financial Services Board (FSB). Aforementioned supervises and enforces compliance with all laws regarding the regulation of financial institutions and the provision of financial services. The primary objective of the Reserve Bank is the protection of the value of the local currency in the interest of balanced and sustainable economic growth in South Africa.

The SSA brought South African securities’ legislation in line with international best practice, and also makes provision for certain self-regulatory organisations, such as the Johannesburg Stock Exchange, the Bond Exchange and the Central Securities

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48 The Financial Markets Bill of 2011 will, when it comes into force, replace and repeal the Securities Services Act in its entirety. See 9.2.9.1 for discussion on the Bill.

49 Some of these are discussed in more detail elsewhere in this thesis. In the National Treasury Policy Document 2011, “A Safer Financial Sector to Serve South Africa Better” (23-02-2011) www.treasury.gov.za (accessed 03-06-2011), it is stated, with reference to the financial sector, that the Reserve Bank has been given lead responsibility for prudential regulation and the Financial Services Board for consumer protection. This is a reference to the so-called “twin-peak” model of regulatory and supervisory control. One of the initiatives flowing from this document will be the establishment of a new Financial Stability Oversight Committee, comprising of the Reserve Bank, the Financial Services Board and the National Treasury. See in general www.treasury.gov.za. The “twin peaks” approach” is discussed in more detail in 9.3.4.

50 The FSB is divided into a registration, supervision and enforcement department. The Capital Markets Department of the FSB regulates the capital markets in terms of the Securities Services Act. See Majoni “Compliance in Bank Matters” 2012(6) De Rebus 38-41.

51 See s 1 of the Financial Services Board Act 97 of 1990.
Depositary (Strate).\(^{52}\) This Act also established a Directorate of Market Abuse, concentrating on abusive tactics such as insider trading, manipulative and other improper trading practices, and false or misleading statements, promises or forecasts by market participants.\(^{53}\) Other role players in the financial sector are the newly formed Companies and Intellectual Properties Commission, the Registrar of Medical Schemes, the Financial Intelligence Centre,\(^{54}\) and the National Credit Regulator. The Council for Overseeing Recognised and Statutory Ombudsman Schemes regulates the various ombudsmen for the different sectors. Both the Financial Advisory and Intermediary Services Act, and the CISCA, make provision for industry associations which act as self-regulatory organisations.\(^{55}\)

The South African legislator must be commended for its diligent efforts to comply with the international standards set by the Basel Accords — focusing on the three pillars of minimum capital requirements, supervisory review processes and market discipline.\(^{56}\) It is submitted, however, that some legislation has been passed without a holistic evaluation of the current financial regulatory environment, which has led to fragmentation of the financial market regulatory and oversight structure that holds specific challenges for the future.\(^{57}\)

Here follows an outlay of the current financial regulatory framework:

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\(^{52}\) The term "securities" includes shares, stocks, equities, notes, derivatives, bonds, debentures, and units in collective investment schemes.

\(^{53}\) The Directorate of Market Abuse was originally established by s 12 of the now repealed Insider Trading Act 135 of 1998.

\(^{54}\) This Centre (FICA) focuses on the prevention, detection and investigation of money laundering and is as a result of South Africa’s signature in 2000 of the UN Convention on Transnational Organised Crime. See Profile’s Unit Trusts and Collective Investments September 2011 75-77.

\(^{55}\) Trust companies are self-regulatory by way of the Association for Trust Companies of South Africa.


\(^{57}\) See presentation by National Treasury, “A Safer Financial Sector to Serve South Africa Better”. The Council of Financial Regulators may fulfil the necessary role in future to coordinate regulatory aspects more efficiently. See Van Zyl et al 127.
ILLUSTRATION 1: FINANCIAL REGULATORY FRAMEWORK

Banking Supervision Department

Regulate Banks

Tasked with the Protection of the Value of the Rand

Required Outcome:
Balanced and Sustainable Economic Growth

Financial Services Board

Regulate Collective Investments; Financial Intermediaries; Capital Markets; Insurance Companies; Retirement Funds

Tasked with Regulation of Non-Banking Financial Institutions and the Provision of Financial Services

Required Outcome:
Sound Financial Investment Environment

- Directorate of Market Abuse
- Registrar of Medical Schemes
- Self-Regulatory Organisations
- Financial Intelligence Centre
- National Credit Regulator
- Council for Overseeing Ombudsman Schemes
- Companies and Intellectual Properties Commission
5.2.2 FINANCIAL MARKETS

More stringent regulatory interventions often lead to new product and process innovations – some more successful than others. Smith & Walter\(^{58}\) submit that

“\(i\)t is against a background of continuous innovation and pressure for dynamic efficiency that financial markets and institutions have evolved and converged.”

Financial markets are markets where financial instruments are exchanged and include, in the broad sense, the institutions, infrastructures and procedures used to exchange financial assets and risk exposures, using a variety of structures and instruments. Although the insurance markets are usually excluded from the term “financial markets”, the gap between the insurance and the financial market is becoming narrower.\(^{59}\)

Although the main purpose of financial markets is of a profit-seeking nature, it has to be balanced in practice with other important factors such as the provision of credit, the pooling and mobilisation of savings, financial intermediation, risk sharing, price discovery, the provision of liquidity, the facilitation of payments, and the trading of risks, such as interest rates, share prices, commodities and credit.\(^{60}\)

The primary markets deal with the creation of financial instruments, and participation is often restricted to authorised dealers, while non-banking institutions and even individuals may have access to some products in the secondary markets, where mainly subsequent transactions take place. Banks have traditionally acted as the main financial intermediaries, but a major move from depository institutions, like

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\(^{58}\) See 189-190 for the principles of “static” and “dynamic efficiency” which ultimately leads to the so-called “seamlessness” of financial markets. There is a tension between over-regulation and deregulation in the search for an efficient financial services industry. It is submitted that some aggressive attempts in some jurisdictions to deregulate have contributed to the 2008 international financial crisis.

\(^{59}\) Van Zyl \textit{et al} 7. The introduction of Alternative Risk Transfer (ART) mechanisms has played a role in this. Investors in financial assets are building securities around pure risk factors, like natural disasters. Smith & Walter 188 submit that “if permitted by financial regulation” various kinds of financial firms emerge to perform one or more of the roles in financial contracting and processing — like commercial banks, savings banks, postal savings institutions, savings cooperatives, credit unions, securities firms, mutual funds, insurance companies, finance companies, and finance subsidiaries of industrial companies.

\(^{60}\) \textit{Ibid} 8, 14-15. Fabozzi 8-9 summarises the main purposes of financial markets as follows: it provides for the necessary interactions between buyers and sellers to determine the price of the traded asset; it provides a mechanism for an investor to sell its financial instruments; it reduces the cost of the transaction.
banks, to institutional investment institutions, like capital markets, pension funds and mutual funds, have taken place during the last fifty years.\footnote{Modern investment institutions include collective investment schemes, investment trusts, hedge funds, property loan-stock companies, public investment corporations, and investment managers. See Van Zyl et al (eds) 193-205. See further Fabozzi 9. Smith & Walter 185 state that the dynamics of alternative financial intermediation had a major impact on the positioning and performance of banks and some other financial firms, and ultimately on the competitiveness of the larger financial system.}

In times of financial instability, however, the capital markets often shrink and borrowers tend to return to banking institutions for their financing needs. For certain types of financing, like short-term lending for mergers and acquisitions, and some medium-term lending needs, like project financings, bank loans often remain ideal.\footnote{Smith & Walter 19.}

In financial markets a reference to “cash” implies an immediate (or short period) physical delivery of an instrument (or commodity), while a “derivative” refers to a transaction where physical delivery is often not a prerequisite, but rather a settlement of the difference between a pre-agreed price and the price in the market at maturity.\footnote{Van Zyl et al 12. It is called either the “cash market” or the “derivative market.”}

In comparison to the average emerging market, the South African capital and derivatives markets are quite advanced. The capital market is the market in which long-term financial instruments are traded. Instruments with a maturity of longer than 12 months are usually regarded as capital market instruments. In South Africa it consists of the bonds market and the equities market.

There are only two licensed exchanges in South Africa, namely the Johannesburg Securities Exchange (JSE)\footnote{This exchange was established in 1887 and currently has a total of more than 420 companies listed on the main board and the AltX, for small and medium cap companies, with a total market capitalisation of more than R6 trillion by 2008.} and the Bond Exchange of South Africa (BESA).\footnote{The exchanges are licensed in terms of the Securities Services Act 36 of 2004 and operate under the auspices of the Registrar of Securities Services. As at the end of March 2008, 976 bonds, with a nominal value of more than R762 billion, were listed on BESA.} On the JSE trading takes place in equities, derivatives, agricultural products and interest rate products. BESA act as capital market for the listing of Rand-denominated debt securities, with government bonds dominating the local bourse in terms of the nominal value of all listed bonds. The securities, issued by government, public
enterprises, parastatals, municipalities and large corporations, include fixed interest-bearing bonds, zero coupon bonds and variable interest rate bonds.\textsuperscript{66}

The financial markets in South Africa are currently regulated by the SSA, which consolidated the laws relating to the regulation and control of exchanges and securities trading.\textsuperscript{67} It may be replaced in the near future by the Financial Markets Act, which is currently in bill form.\textsuperscript{68} The Memorandum to the Bill indicates that the test was whether the SSA “was still sufficiently robust to continue to meet its objectives and the objectives of securities regulation in general, was aligned with international developments and standards, and was and is effective in mitigating the impact of the financial crisis and any potential future financial crisis”. The review of the current legislation proved it to be lacking in many respects.

\subsection*{5.2.3 FINANCIAL INSTITUTIONS}

Mminele submits that, although international financial institutions or regulators make invaluable contributions in developing international best practices and in assisting national regulators with their role of supervising their financial products, each country must be allowed to “tailor conventional wisdom and advice to best effect” and to implement internal processes “against the background of a careful assessment of their unique circumstances.”\textsuperscript{69} The liability of financial institutions for the products they provide is not only governed by legislation, but also by the specific contract between the parties.\textsuperscript{70}

The SSA includes in the definition of “financial institutions”, pension fund organisations, friendly societies, collective investments schemes, long- and short-

\begin{itemize}
\item \textsuperscript{67} It replaced the previous Stock Exchanges Control Act of 1985 and the Financial Markets Control Act of 1989.
\item \textsuperscript{68} The Financial Markets Bill was published in August 2011 and is discussed in more detail in 9.2.9.1.
\item \textsuperscript{69} Mmilele 9.
\item \textsuperscript{70} Overlapping with the contractual liability of the product provider is its delictual liability. The contractual relationship is further formed in a specific legal and political context, such as the consumer protection requirements and the Bill of Rights entrenched in the Constitution, which includes aspects such as public policy issues.
\end{itemize}
term insurers, intermediaries acting in terms of the long- and short-term insurance legislation, and banks.

The Financial Services Board Act\(^{71}\) has a much wider definition of the term and further includes any exchange (as defined in the SSA), any authorised financial services provider or representative, and

“any other person who or which deals with trust property as a regular feature of his, her or its business, but who is not registered, licensed, recognised, approved or otherwise authorised to deal so in terms of any Act, other than the Companies Act, 1973 (Act No. 61 of 1973), the Close Corporations Act, 1984 (Act No. 69 of 1984), and the Trust Property Control Act. 1988 (Act No. 57 of 1988)”.\(^{72}\)

The reference to “banks” in the SSA is much wider in the Financial Services Board Act, which also refers to mutual banks and co-operative banks.

For the purposes of this thesis the term “financial institutions” shall not be limited to either of the two definitions in the aforementioned legislation, but shall refer to those institutions that are part of the financial corporate sector, namely the Reserve Bank, commercial banks (including mutual banks, the Post Bank and the Land Bank), insurers (including medical schemes and pension funds), other financial intermediaries (including collective investment schemes), and financial auxiliaries (including trust companies, insurance brokers and agents). One of the main purposes of these financial intermediaries (excluding the Reserve Bank) is to facilitate the process of assimilation of financial information on behalf of the investor, by way of identification and evaluation of investment opportunities.

The primary objective of the South African Reserve Bank\(^{73}\) is “to protect the value of the currency of the Republic in the interest of balanced and sustainable economic growth in the Republic”.\(^{74}\) This is firstly achieved by stabilising the price of the local

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\(^{71}\) Act 97 of 1990 (as amended). The definition of “financial institution” has been amended in the Financial Services Board Act on a number of occasions. The Financial Institutions (Protection of Funds) Act includes an outdated definition of the term, as defined in the Financial Services Board Act before the latest amendment of the definition.

\(^{72}\) It further extends the definition of the term “intermediary” and also extends the definition to include “services delivered in terms of the Insurance Act, and Lloyds underwriters. The 1973 Companies Act has been replaced by the Companies Act 71 of 2008 and the Close Corporations Act has also been amended by the aforementioned.


\(^{74}\) South African Reserve Bank Act 90 of 1989, s 3, read with s 224 of the Constitution of the Republic of South Africa Act 108 of 1996, s 224. Other functions are the issuing of banknotes,
currency, and secondly by contributing towards the general internal financial stability of the country. To fulfil the aforementioned role, the Bank must monitor the financial risks undertaken by the commercial banks, and oversee the soundness of the banking system by way of the Bank Supervision Department.\textsuperscript{75}

Banks are the most important financial institutions with respect to the general public. They take deposits, extend loans, facilitate transactions between different parties, provide a variety of financial products and reduce the cost and risk of investments.

Another role player is Strate Ltd, which acts as the authorised central securities depository for the electronic settlement of securities in South Africa.\textsuperscript{76} It currently handles the settlement of equities, warrants and bonds for both the Johannesburg Stock Exchange (JSE) and the Bond Exchange of South Africa (BESA), which has been consolidated into the JSE. Its core purpose is “to mitigate risk, bring efficiencies to the financial markets and improve South Africa’s profile as an investment destination.” For these purposes it has aligned itself to international best practices.\textsuperscript{77} Strate handles securities (e.g. equities and bonds), derivative products (e.g. warrants, exchange traded funds, retail notes and tracker funds), as well as some money market securities.\textsuperscript{78}

Investment institutions play a major role in the financial institution market and provide finance, create wealth, improve market efficiency and assist in price discovery.\textsuperscript{79} All investment managers must be registered with the Registrar of Financial Service

\begin{itemize}
\item making loans on current account; acting as custodian of cash reserves, gold and foreign exchange; acting as clearance house between banks; and providing liquidity to banks when needed.
\item The clearance and settlement function of the Reserve Bank remains a priority function. The well-developed National Payment System (NPS) makes use of the SA Multiple Option Settlement system (SAMOS), which provides various options in facilitating final and irrevocable settlements. The NPS is regulated by the National Payment System of South Africa Act 78 of 1998. See Lawack-Davids “The legal and regulatory framework of the National Payment System: peeling the layers of the onion” 2008(3) \textit{Obiter} 453-471.
\item “Strate” is the acronym for “Share Trading Transactions Totally Electronic”. A central securities depository participant is a person that holds in custody and administers securities or an interest in securities.
\item See \url{http://www.strate.co.za/default.aspx} (accessed 20-03-2012).
\item Chapter IV of the Securities Services Act deals with the custody and administration of securities. See Lawack-Davids & Coetzee “Impact of Failure of a Central Securities Depository Participant on Finality and Irrevocability of Settlement of Securities” 2009(3) \textit{Obiter} 628-655.
\item Van Zyl et al (eds) 192-193. “Price discovery refers to the process of ascertaining the correct economic value of assets.”
\end{itemize}
Providers in terms of the Financial Advisory and Intermediary Services Act. They may invest in securities and instruments, foreign currency-denominated investments, pension fund investments, long-term insurances, and collective investments. Other investment institutions include investment bankers, specialising in mergers and acquisitions, and private bankers, specialising in financial services for high-net-worth clients.

5.3 THE LEGAL NATURE OF FINANCIAL INSTRUMENTS

National and international payment systems deal with both the circulation of physical money and the facilitation of other monetary instruments, and include “the entire process of making payment”. Ongoing innovation in financial markets necessitates the need for the development of new financial instruments and new uses of existing instruments.

Investors are continually looking for effective ways of diversifying their portfolios, resulting in financial intermediaries developing new and ingenious instruments to satisfy the need. Banks, investment institutions, financial conglomerates (combining banking, insurance and investment), security dealers, brokers and financial advisors, are all involved in the process of developing new asset classes and investment instruments. There is a continuing tendency, however, towards financial instruments of an ever-creasing complexity.

The purpose of financial instruments is to create vehicles, other than banknotes, coins, bills of exchange and promissory notes, to be used for exchange purposes in

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80 Major international lending facilities are often syndicated. These syndications involve the combined involvement of a number banks – working together to facilitate a large loan. It decreases the financial exposure for the individual banks and at the same time increases the potential size of the loan and the costs thereof to the borrower. See Smith & Walter 22-23.

81 Van Zyl et al (eds) 204-205. The term “investment institutions” is broad enough to include collective investment schemes, investment trusts, hedge funds, property loan stock companies, public investment corporations, and investment managers. See Van Zyl et al (eds) 193-205. See Smith & Walter 4 on international retail and private banking.


83 See Van Zyl et al 48-50 for discussion on the South African National Payment System. See Lawack-Davids 2008(3) Obiter 455-471 for the working of the payment system and the role it fulfils in the financial environment.

Foreign exchange and credit risk, amongst others, have developed into distinct asset classes. It is submitted that the unlimited elevation of financial instruments to the level of currency may have devastating results to the international financial system. In some jurisdictions even carbon credits have been included in the term “financial instruments”, but in the South African context it apparently carries a more conservative and limited meaning.

“Financial instrument” is defined in the South African Reserve Bank Act as follows:

“(a) security as referred to in the definition of “securities” in section 1 of the Stock Exchange Control Act, 1985 (Act 1 of 1985);

(b) any financial instrument as defined in section 1 of the Financial Markets Control Act, 1989 (Act 55 of 1989), irrespective, in the case of such instrument that is an instrument creating or acknowledging indebtedness, of the term for which it has been issued;

(c) any right or other benefit in respect of or accruing to a security referred to in paragraph (a) or a financial instrument referred to in paragraph (b); and

(d) any other instrument, right or benefit declared by the Minister by notice in the Gazette to be a financial instrument for the purposes of section 10(1)(h)."

The effect is, after the Financial Markets Control Act 55 of 1989 was repealed, that financial instruments are limited to securities; any right or other benefit in respect of a security; and any other instrument, right or benefit declared by the Minister as a financial instrument, for the specific purpose of the Reserve Bank to buy, sell or deal with.

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85 See the definition of “banknotes” and “current coins” in s 1 of the Prevention of Counterfeiting of Currency Act 16 of 1965, and the definitions of “bill of exchange” and “promissory note” in s 2 and 87 respectively of the Bills of Exchange Act 34 of 1964. Banknotes and coins are collectively referred to as “money” in terms of s 1 of the National Payment System Act 78 of 1998 and as “legal tender” in terms of s 17 of the South African Reserve Bank Act 90 of 1989.


87 South African Reserve Bank Act 90 of 1989 s 1 as inserted by subs 1(b) of Act 2 of 1996.

88 The Stock Exchange Control Act 1 of 1985 has been repealed by the Securities Services Act 36 of 2004 and the definition of “securities” has been included in s 1 of that Act.

89 The Financial Markets Control Act 55 of 1989 has been repealed by the SSA and the definition of “financial instrument” has been included in the South African Reserve Bank Act 90 of 1989 as indicated above.

90 Subs 10(1)(h) determines that the Bank may, subject to certain provisions, buy, sell or deal in financial instruments, hold such instruments in safe custody, or cause such instruments to be held in safe custody, for other persons.

91 This is subject to the prohibitions in s 13 of the Reserve Bank Act 90 of 1989.
Excluding the reference to “the specific purposes of the Reserve Bank”, one can therefore understand the term “financial instrument” to be a reference to a “security”, as defined in the SSA, which includes shares, stocks, notes, derivatives, bonds, debentures, and participatory interests in collective investment schemes; or “any right or benefit in respect of such a security”. It seems as if the terms “financial instrument” and “security” currently refer to the same type of instrument.

The question may indeed be asked whether all structured finance instruments fall within the definition of a “security”. It is submitted that, if it fails to, the definition of “financial instrument” should be adopted by the legislature, as it may place some instruments beyond the reach of the current legislation. Such a potential lacuna shall have a negative impact on the soundness of the regulatory infrastructure created for structured financial instruments and may create unnecessary regulatory arbitrage opportunities, which may have a negative impact on the integrity of the South African financial environment.92

One party to a financial instrument incurs certain liabilities towards another, which may be in the form of a debt or a security. The legal nature of all transactions involving financial instruments, are not always evident as the underlying transaction must often be investigated to determine whether a debt or a surety was created. A commercial bank, holding money on deposit, is not necessarily a debtor of the depositor, but may merely hold a surety on behalf of the depositor.

Because of the very nature of financial instruments it is possible to increase the claims on money without a corresponding increase in actual money. As these transactions can be repeated, without limit, a serious distortion can occur between actual money and the claims made on money.

When a legal demand for fulfilment of all the contractual terms created by these transactions, is made, the over-subscription shall lead to a dysfunctional system. As most of these contracts call for the payment of interest, more will be due than what

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92 See 5.9 for a discussion on regulatory arbitrage.
was deposited, which in turn calls for an acceleration of the increase in debt obligations.\textsuperscript{93}

The creation of currency is indeed the source of a higher demand for goods, which increases the gross domestic product, and to maintain the increased economic activity, new credit must be granted to result in new deposits. As debt must increase faster than income to sustain the financial system, financial instruments (securities), coupled with interest, are utilised.

The widely accepted theory regarding the legal nature of financial instruments is that they always create either a debt or a surety, both of which constitute a right by the one party versus an obligation by the other. The instrument represents an amount of money which will be determined by a number of market related factors.

While it seems obvious that a bank account is a financial instrument in the sense that the bank is in debt to the holder of the account, it is not necessarily so simple when analysed closely. Kutyn argues quite convincingly, with reference to a number of examples to illustrate the relationship between banks and its clients, that the modern banking system creates, by what he calls deception, the impression that certain legal liabilities are present when that is not the case. As the charging of interest on the promises from the client to the bank is higher than the interest paid on the original bank deposit, an increase in the claims on money occurs, without a corresponding increase in actual money. As these transactions can theoretically be repeated over and over again, a serious distortion ultimately occurs between the actual money in the system and the total claims on money.\textsuperscript{94}

5.4 SECURITIES

Direct financing takes place when borrowers and lenders interact without financial intermediaries acting as facilitators. The borrower issues a financial instrument, called a security, which may be in the form of a debt or an equity (or a combination:

\textsuperscript{93} In 2010 it was estimated that the United States national debt alone was more than all the physical money in the world together.

\textsuperscript{94} Kutyn \textit{Banking and Systematic Risk}. Hetzer 32 submits that interest is not the reward for renouncing the right of consumption, but is the price for giving up the liquidity advantage of money. The interest must therefore always be high enough to outweigh the liquidity advantage. Aristotle claimed in the third century already that "(m)oney was established for exchange, but interest causes it to be reproduced by itself. Therefore this way of earning money is greatly in conflict with the natural law."
the hybrid), and the lender makes the required funds available. Securities are first issued in the primary market and offered to investors. Thereafter they are traded in the secondary market where the necessary liquidity is needed for investors to sell the security again to another investor.\footnote{See Melicher & Norton 236.}

In the case of an equity security, the lender takes part ownership of the borrowing company, while a debt security functions as a loan. The direct market is often referred to as the capital or security market and is known for its tradability, liquidity and price visibility.\footnote{Van Zyl \textit{et al} 6-7. See also Davis \textit{et al} (eds) 51-53. On 53 they state that the classification of a security depends mainly on whether the relationship between the parties is that of debtor and creditor, or whether the seller is entitled to a fixed predetermined return.}

Indirect financing refers to the role of intermediaries who facilitate the relationship between borrowers and lenders. In this process, financial asset transformation takes place and in some cases the intermediaries will even issue securities themselves. Commercial banks are some of the central players in this so-called bank-based market.\footnote{Van Zyl \textit{et al} 6.}

Rosenthal \textit{et al}\footnote{Rosenthal \& Ocampo \textit{Securitization of Credit} (1988) 25.} defines in a functional rather than legal manner a “security” as “a financing in which the originator is not the investor”, compared to a “loan”, which is “a financing in which the originator is the investor”. The definition supplied by Van Zyl \textit{et al} is also practical, namely “paper certificates or electronic records evidencing ownership of equity (stocks), debt obligations (bonds) or related instruments”.\footnote{Van Zyl \textit{et al} 488.}

“Securities” is defined in the Securities Services Act\footnote{SSA, s 1. Board Notice 80 of 2012, published in GG35321 on 10-05-2012, Chapter 1, has a different definition for the term “securities” for the purposes of that Chapter and specifically includes unlisted participatory interests in a collective investment scheme in securities and listed participatory interests in a collective investment scheme in property. It further includes a list of specific listed and unlisted financial instruments, such as futures and options contracts and forward currency, exchange rate and interest rate swaps.} 100 as:

- (i) shares, stocks, and depository receipts in public companies and other equivalent equities, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act 59 of 1980);
- (ii) notes.\footnote{\textsuperscript{101}}
(iii) derivative instruments;¹⁰²
(iv) bonds;¹⁰³
(v) debentures;¹⁰⁴
(vi) participatory interests in a collective investment scheme¹⁰⁵ as defined in the Collective Investment Schemes Control Act, 2002 (Act 45 of 2002), and units or any other form of participation in a foreign collective investment scheme¹⁰⁶ approved by the Registrar of Collective Investment Schemes in terms of section 65 of that Act;
(vii) units or any other form of participation in a collective investment scheme licensed or registered in a foreign country;
(viii) instruments based on an index;¹⁰⁷
(ix) the securities contemplated in subparagraphs (i) to (viii) that are listed on an external exchange; and
(x) an instrument similar to one or more of the securities contemplated in subparagraphs (i) to (ix) declared by the registrar by notice in the Gazette to be a security for the purposes of this Act;
(xii) rights to the securities referred to in subparagraphs (i) to (x)."

¹⁰¹ “Note” is defined in s 1 of the Bills of Exchange Act 34 of 1964 as “a promissory note”, which is defined in s 87 as “an unconditional promise in writing made by one person to another, signed by the maker, and engaging to pay on demand or at a fixed or determinable future time, a sum certain in money, to a specified person or his order, or to bearer.” In short it is a negotiable debt instrument.

¹⁰² “Derivative instrument” is defined in s 1 as “any (a) financial instrument; or (b) contract, that creates rights and obligations and that derives its value from the price or value, or the value of which may vary depending on a change in the price or value, of some other particular product or thing.” They are in the form of instruments such as futures, forwards, swaps, options and warrants. See the definition offered by Skerritt in Van Zyl et al 378 and the discussion on the contents of the definition 376-379. It is further discussed in this Chapter.

¹⁰³ A “bond” is a debt instrument that promises that the issuer will pay the investor interest over a certain period of time. The face value of the instrument must be repaid at maturity.

¹⁰⁴ “Debentures” are unsecured long-term debt instruments.

¹⁰⁵ “Collective investment scheme” is defined in the CISCA as “a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which, (a) two or more investors contribute money or other assets to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and (b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed, but not a collective investment scheme authorised by any other Act.”

¹⁰⁶ The term “foreign collective investment scheme” is not defined in the CISCA, although it is regulated in terms of Part VIII of that Act. It is, however, defined in the SSA as “a scheme, in whatever form, carried on in a country other than the Republic, in pursuance of which members of the public, (a) are invited or permitted to invest money or other assets in one or more groups of assets (whether called a portfolio or by any other name) of such scheme; (b) acquire an interest or undivided share (whether called a unit or by any other name) in such a group of assets upon such investment; and (c) participate proportionately in the income or profits and the risk derived from such investment.”

¹⁰⁷ Industry-specific debt indices, like credit mortgage bond securities and asset-backed securities, started developing in 2006 only.
The following are excluded from the definition of securities:

(i) money market instruments except for the purposes of Chapter IV, and

(ii) any security contemplated in paragraph (a) (meaning (i) to (xi) above) specified by the registrar by notice in the Gazette.

In the Companies Act 2008 “securities” is defined as “any shares, debentures or other instruments, irrespective of their form or title, issued or authorised to be issued by a profit company”, and a “share” as “one of the units into which the propriety interest in a profit company is divided”. A “profit company” means “a company incorporated for the purpose of financial gain for its shareholders.” As the term “company” includes all juristic persons incorporated in terms of the 2008 and the 1973 Companies Acts and the Close Corporations Act, “securities” for the purposes of this Act clearly includes shares in both private and public companies, and even membership holdings in close corporations.

It is submitted that the reference to “other equivalent equities” in the definition of “securities” in section 1 of the SSA, and thus as “financial instruments” for the purposes of the Reserve Bank Act, in its widest form also includes equity holdings in private companies and even in close corporations. It is unfortunate that the definitions in these two Acts have not been synergised.

Securities are used as the underlying instruments in securitisation. “Securitisation” is a structured finance process in which non-traded, cash-flow producing assets (e.g. bank loans) are pooled together and then repackaged before being sold off to investors. The securities are utilised to back the loans and the process of changing these outstanding loans into securities are referred to as credit securitisation.

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108 SSA 36 of 2004, s 1.
109 Chapter IV of Act 36 of 2004 regulates the custody and administration of securities. Money market instruments are administered as if they are securities and are included in the definition of “securities” for the specific purposes of that Chapter only. Money market instruments are regarded as short-term debt securities. The SA money market is self-regulated and therefore excluded from security legislation, except for Chapter IV purposes.
110 The Registrar of Security Services may, by way of notice in the Government Gazette, exclude any security from the definition of “security”.
111 The term “listed security” and alternatively “exchange security” have been defined in three different ways in the SSA, the Companies Act of 2008 and the CISCA.
112 Securitisation is discussed in more detail elsewhere in this Chapter.
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Exchange-traded funds (EFT’s) are financial instruments representing ownership in an underlying security portfolio. EFT shares are purchased and sold on an exchange just like any listed share, and qualifies as securities.

5.5 COLLECTIVE INVESTMENT SCHEMES (CIS)

The term "collective investment scheme" became a generic term internationally for a variety of financial instruments. When the CISCA became effective on 3 March 2003, it unified the so-called linked product environment and introduced a single pricing mechanism. It allowed the local unit trust industry the flexibility to be on a par with international best practice and consumer protection trends. The Act not only brought all open-ended investment products under the same blanket, but also introduced investment vehicles not previously available in South Africa.

In general it can be described as a manner of investing money collectively with others with the purpose of participating in a wider range of investments than would normally be feasible for an individual. A collective investment scheme is a scheme in terms of which funds from various investors are pooled together for investment purposes. By pooling their resources together the investors achieve the critical mass needed for proper portfolio diversification and cost-effective structuring. The investment strategies and preferences are executed by a team of professional fund managers. Each investor has vested rights in a proportional share of the underlying assets by purchasing units in the particular scheme – either directly or through an intermediary.

These assets are usually held in a trust (often referred to as unit trusts) and can consist of a portfolio of securities (e.g. shares, bonds or money market instruments), property shares (excluding residential property and including only commercial

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113 Linked Investment Service Providers (LISP’s) are independent investment companies that offer investors access to collective investments across a number of different management companies.


115 See Wille et al 62-63.

116 Van Zyl et al 196-198. See 200-204 for other investment institutions, such as investment trusts, hedge funds, property loan stock companies, and the public investment corporation.
property portfolios listed on an exchange) or participation bonds.\footnote{Ibid 193. These schemes are governed by the CISCA, which has replaced the Unit Trusts Control Act and the Participation Bonds Act. An updated Notice with new categories of investment is anticipated in 2012, which may include collective investment schemes in hedge funds.} They include a variety of arrangements, like mutual funds, investment trusts, and managed investment schemes.\footnote{Investment trusts are not trusts, but listed holding companies that invest in listed companies and are largely regulated by the Companies Act.} The operators of schemes may be in the form of entities referred to as fund managers, asset managers, investment managers, or mutual fund advisers.\footnote{See MacNeil & O’Brien (eds) 335. More than USD 18 trillion in net assets are managed in collective investment schemes in the United States, and more than R1 trillion in South Africa.} Schemes are often classified by way of their investment objectives (e.g. balanced or income funds), asset allocation (e.g. equity or bond funds), or locality (e.g. domestic or global funds).

It is estimated that the local CIS industry has more than one trillion rand in assets under management, across 947 different funds.\footnote{See “The Performance Standard for Collective Investments” April 2012 Financial and Advisory News 46.} In South Africa they are currently broadly classified as equity funds, asset allocation funds, fixed interest funds and real estate. Funds of funds and index funds are not separately classified any longer and multi-manager funds are not regarded as a type of fund but rather a management method. Exchange traded funds are often registered as collective investment schemes and are similar to index funds. Hedge funds use leveraged strategies, often involving derivatives, and are not yet formally part of the collective investment industry. \footnote{They are licensed and regulated by the Financial Services Board and must comply with the requirements of the Financial Advisory and Intermediary Services Act (FAIS), but not the Collective Investment Schemes Control Act.}

Collective investment schemes mostly manifest in the form of unit trusts, although not all collective investment schemes are necessarily unit trusts.\footnote{A unit trust allows an investor to own part of a diversified, professionally managed portfolio with a modest cash investment.} It can be described as “a trust based scheme that comprises a pool of assets that is managed by a collective investment scheme manager”.\footnote{www.asisa.co.za/index.php/collective-investment-schemes/an-introductory-course-to-collective-investment-schemes.html (accessed 15-02-2011).} All collective investment schemes
(including a manager, trustee, custodian, or nominee, company) are “financial institutions” in terms of section 1 of the Financial Services Board Act 97 of 1990.¹²⁴

The workings of a CIS in participation bonds can be explained as follows:

Each participant in participation bonds has a proportional stake (participatory interest or unit) in the specific collective investment scheme in participation bonds. The trust deed, registered with the Registrar of Collective Investment Schemes, situated at the FSB, is the financial instrument used to manage and administer the investment on behalf of the investors. This scheme enables individuals to invest in a cost-effective way on the stock exchange and in the money markets.

The portfolio is made up of cash contributions by a large number of individuals, investing in shares, bonds, cash, property and other securities. Each unit or participatory interest is in proportion to the amount invested by the specific individual. The total collection or pool of units is representative of the proportional ownership of each participatory interest.¹²⁵ The main advantages of collective investment schemes are their transparency, the availability of their prices and performance data, their regulation, the professional management of the investments, and the fact that the investor has a guaranteed purchaser of his participatory interests.¹²⁶

While the portfolio manager, armed with a specific portfolio mandate, uses the pool of money to invest in a diversified portfolio of investments on the stock exchange, in international equities, bonds, derivatives and other financial instruments, the scheme manager acts as the bridge between the investors and the portfolio manager and handles the administration and marketing of the collective investments.¹²⁷

The trustee (or custodian) is independent and acts as the caretaker of all cash and securities in a specific collective investment scheme. He also ensures that the scheme is managed in accordance with the trust deed and the Act.¹²⁸ In the case of participation bonds, the mortgagor is the party who applies the money as security for

¹²⁴ As well as in terms of s 1 of the SSA.
¹²⁵ Profile’s 34.
¹²⁶ Ibid 45-47.
¹²⁷ Ibid 36 for a list of potential underlying assets making up the portfolio of a collective investment scheme.
¹²⁸ Compare Wille et al 67-69 for more details on the role of the trustee.
repayment of the loans taken against the mortgage bonds over the immovable property. ¹²⁹

Foreign investment schemes (offshore schemes), domiciled elsewhere and denominated in foreign currency, which wish to market their product in South Africa, are also regulated by CISCA, and must therefore also be approved and registered with the Registrar. They are licensed elsewhere and will use the licence from that jurisdiction to be approved locally. ¹³⁰

Although a CIS can generally be in the form of a trust, a company, a close corporation, a partnership, or an association, a CIS that is structured as an open-ended investment company, can only be housed in a company incorporated or registered in terms of the Companies Act. ¹³¹

Here follows a simple outlay of a CIS structure: ¹³²

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¹²⁹ See Fedbond Participation Mortgage Bond Managers (Pty) Ltd v Investec Employee Benefits Ltd 2010 4 All SA 467 (SCA) [23] and [24], where the court has confirmed that a participant can claim repayment of its investment in a collective investment scheme from the mortgagor only, and not from the manager. The relationship is, however, tripartite in nature. The manager is not a debtor to the participant, but the agreement still creates certain obligations for both. Confirmed by Syfrets Participation Bond Managers Ltd v Commissioner, South African Revenue Services 2001 2 SA 359 (SCA). In a dissenting minority judgment Harms DP held that there is indeed a debtor-creditor relationship between the manager and the participant [41].

¹³⁰ A foreign investment fund differs from a foreign fund, which is a rand-denominated South African-domiciled fund, investing offshore. The Association of Investments and Savings SA (ASISA) is a voluntary, self-regulating body, with the majority of unit trusts as members. ASISA classifies funds or portfolios geographically as domestic, foreign, regional and worldwide, in terms of the locality of the major portion of its investments.

¹³¹ The application of trusts as collective investment scheme instruments will be discussed in more detail in Chapter 7.

¹³² See Profile’s Unit Trusts and Collective Investments September 2011 35.
5.6 SHARES, BONDS, DERIVATIVES AND DEBENTURES

Shares, bonds, debentures and derivatives are not collective investment scheme instruments, although they are securities. The terms shares, stocks and equities are used together in the definition of “securities” in section 1 of the Securities Services Act and are mostly interchangeable. These terms can either describe trading companies on the stock exchange or can refer to marketable financial instruments. “Shares” represent ownership of the assets of listed companies and are traded on
the stock exchange. As co-owners of a company, the shareholders are entitled to share in the profits and gains of the company.\textsuperscript{133}

As private companies are prohibited from offering their shares to the general public, only public companies may list on the stock exchange.\textsuperscript{134} The purpose of listing is mainly to access additional funding required for growth, but may also be aimed at enhancing the profile of the company or purely to make its shares more tradable. It is very costly to list, maintain the listing and adhere to all the ongoing compliance requirements for listed companies.\textsuperscript{135}

For the investor it is much safer to invest in the shares of a listed company than that of a private company, because of the high levels of compliance and the general tradability of the share. Shareholders generally share in the after-tax profits of the company by way of declared dividends.

Bond issues are loans usually made by sophisticated investors (banks, insurance companies, etc.), evidenced by transferable debt securities issued by the issuer to the subscribers.\textsuperscript{136} It is an instrument that promises the bond-holder that he will be paid interest and will be repaid his capital investment over a certain period of time, by the borrower (the one that has issued the bond). The bond-holder has no ownership in the company – he is only a creditor of the issuer. The bond-holder can trade his debt as it is in the form of a financial instrument, like a debenture. The issuer must pay the coupon rate (interest) during the lifespan of the instrument and must repay the principal debt on the maturity date (expiry date) of the bond.\textsuperscript{137} The securities may be listed to involve certain large corporate investors.

The risk for the investor in bonds is directly linked to the quality of the issuer (debtor) and the investor largely relies on the credit rating for the particular borrower, issued by the rating agency. It offers a dependable income, is relatively safe and allows for

\textsuperscript{133} Van Zyl \textit{et al} (eds) 322-323. Fabozzi (ed) 67 refers to “common stock” as “equity securities”, which represent “an ownership in a corporation”.

\textsuperscript{134} See s 96 of Companies Act 71 of 2008 for offers that are not regarded as offerings to the public.

\textsuperscript{135} Van Zyl \textit{et al} 328, and 328-333 for the methods and types of trading in listed shares and the involvement of STRATE (Share Transactions Totally Electronic).

\textsuperscript{136} Wood 159.

\textsuperscript{137} Van Zyl \textit{et al} (eds) 272, 322, and 274-283 on the prices and yields of bonds. Compare Wille \textit{et al} 95.
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diversification of a portfolio. The majority of bonds traded in South Africa are issued by the central government and are in the form of fixed rate bonds, zero-coupon bonds, inflation-linked bonds, variable rate bonds and foreign currency bonds. Many municipalities and parastatals are also issuing bonds, sometimes to fund specific projects. One of the first securitisation transactions done in South Africa took place by way of a bond issuance, when the Thekwini Fund of SA Home Loans was backed by a home loan pool.

Financial market instruments are often broadly categorised as either cash or derivatives, with “cash” referring to an instrument that is available to be delivered within a very short period of time (like a few days), and derivatives only available over a longer period. In cash transactions the underlying instrument usually changes hands, while derivatives are based on a settlement based on the difference between a pre-agreed price and the market price at maturity.

Derivatives are defined in Van Zyl et al as “a financial instrument which embodies different terms, rights or obligations to those prevailing in the underlying, cash or physical market to which the instrument relates”. Derivatives are common to most financial and commodity markets and usually appear in the form of futures, forwards, swaps, options or warrants. The underlying instrument may be a share, the price of a specific metal, or a specific rate of interest (or a variety of other future possibilities) and are often classified according to the underlying market, like money market, bond, commodity or equity derivatives. They derive their value from the

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138 See Wille et al 95.
139 Van Zyl et al 287-296. The Bond Exchange of South Africa (BESA) was established in 1989 and is a very active and relatively large bond market. Government bonds are distributed by a number of local and foreign banking institutions as primary dealers.
140 Ibid 310 for the use of special-purpose institutions in the catastrophe-linked bond market. The aspect of securitisation in the bond market will be discussed in more detail in Chapter 6.
141 Ibid 12. Smith Implications of Basel II 115 defines a derivative contract as “a bilateral contract whose value derives from the value of some underlying asset or index”.
142 378. Skerritt explains on 376-379 why some common definitions for “derivatives” are unsatisfactory. Compare with the definition in the Securities Services Act.
143 See Smith Implications of Basel II 115-128 for a detailed discussion of credit derivatives and different types of contracts, like “total return swaps”, “credit default swaps”, “basket swaps”, and “portfolio” and index default swaps”. See Fabozzi 13. In South Africa derivatives are traded on the South African Futures Exchange (Safex), a division of the JSE. In 2007 the turnover in exchange-traded derivatives amounted to R1.2 trillion. The over-the-counter (OTC) derivative market had a R30 trillion turnover in 2007.
144 See Van Zyl et al, Chapter 13, for a detailed discussion on derivatives. See Fabozzi for other instruments, like interest rate derivatives (755) and credit derivatives (785).
“behaviour” of the underlying instruments (like stocks, indexes, bonds, currencies or commodities). Derivatives are not limited to financial instruments. The underlying asset may be a financial asset, a stock index, an interest rate or a credit spread.

Derivatives have become a very popular financial instrument lately as a response to some of the modern tendencies in the international financial markets, like interest-and exchange-rate volatility, equity market developments, and price and currency arbitraging. As derivatives and some synthetic securities make trading in underlying cash instruments more viable, they become good substitutes for many traditional securities. As most derivatives are contracts for differences between the current price and the future price, their objective is actually insurance. The more volatile the market, the stronger the need for some form of “insurance” become.

Debentures are long-term private sector debt instruments, like bonds. They are issued by private or public companies, but without being secured by any specific assets of the issuing company. The South African Reserve Bank (SARB) also issues debentures in the form of short-term transferable securities as a supplementary facility for banks to invest surplus short-term funds on their books. The SARB promises to pay the principal debt plus the specified interest on the due date.

Locke refers to a debenture as “a claim against a company, issued by a company to meet its capital requirements, where the holder is usually entitled to interest at specified intervals and repayment of the capital amount at a specified time”. They are non-negotiable, except if it is a bearer debenture. The debenture-holder is, as a creditor of the company, entitled to interest and repayment of the capital. As

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145 Fabozzi 723.
146 Ibid 13.
147 Smith & Walter 203-206. See also paragraph 5.6 on derivatives as a securitisation asset class. Compare Swart The Legal Framework Pertaining to Selected Segments of the Financial Market (2011) LLM dissertation Nelson Mandela Metropolitan University Annexure A 210-234 for extended list of definitions of financial instruments.
148 Wood 425-426.
149 The purpose of Reserve Bank debentures (RDB) is monetary control by way of money market liquidity management. See Van Zyl et al 241. Locke states on 211 that the term “debenture” has not adequately been defined in South African law. The only reference to “debentures” in the Companies Act of 2008 is in the definition of “securities”, but without any explanation of the meaning of the aforementioned term.
150 Locke 215.
debentures forms part of securities for the purposes of the Companies Act, they are treated similarly for the purposes of issuance, transfer, etc.

5.7 MONEY MARKETS

The money markets are considered as being part of the financial markets. Organised international money markets have been in existence for more than five hundred years and developed as a direct result of the need for finance in international trade. They were traditionally used as part of currency exchange, deposit collecting and loan-making processes internationally. The modern money market instrument is used in many domestic markets as short-term government agency paper, commercial paper, bankers’ acceptances, and bank certificates of deposit.\(^\text{151}\)

Although these instruments are excluded from the definition of “securities”, they are administered as if they were securities.\(^\text{152}\) Section 1 of the SSA excludes money markets and “any security specified by the registrar by notice in the Gazette” from the definition of securities. In terms of section 29, for the purposes of Chapter 4 only, which include custody settlements, a money market instrument is also a “security”. The registration and administration of money markets must therefore adhere to the same requirements as all other securities, although they do not have to be registered in the name of a central securities depository or its wholly owned subsidiary, like other securities.\(^\text{153}\)

As money markets include both direct and indirect financing activities, the buying and selling of negotiable money market instruments occur side by side with the dealing in short-term loans.\(^\text{154}\) The money markets trade in short-term financial claims and assets, and create financing facilities for the corporate and banking sectors, as well as for government financing and central bank liquidity.

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\(^{151}\) Smith & Walter 215. See Fabozzi 143-183 for detailed discussion on money market instruments in the US economy.

\(^{152}\) They are regarded as securities for the purposes of Chapter IV of the Securities Services Act.

\(^{153}\) See s 40(1) of the SSA.

\(^{154}\) Van Zyl et al 7. Securitisation has played a role in the blurring of the traditional differences between direct and indirect financing.
management. Companies and individuals usually park excess cash in the money market. Their interest rates are determined by factors such as the credit risk of the issuer of the security, and the liquidity of the particular instrument.

The money market itself is not a security and also not a financial instrument. It does utilise securities to create new financial instruments, which are then traded in the market itself. It is, therefore, submitted that there are currently no other financial instruments in the South African market besides those falling within the definition of securities.

The South African Reserve Bank Act defines “financial instrument” as securities and “any other instrument, right or benefit declared by the Minister by notice in the Gazette to be a financial instrument for the purposes of section 10(1)(h).”

Section 10(1)(h) reads as follows:

“The Bank may, subject to the provisions of section 13, buy, sell or deal in financial instruments and, in accordance with the provisions of any law regulating the safe deposit of securities, hold such financial instruments in safe custody, or cause such financial instruments to be held in safe custody, for other persons.”

Section 13 prohibits the Reserve Bank to purchase or finance its own shares or that of other banks; to lend money against mortgage bonds of immovable property; to buy certain bills of exchange and promissory notes for commercial and agricultural purposes; or, to hold government stocks above a prescribed sum. The Reserve Bank may therefore deal in financial instruments, but is limited in the extent to which it may compete with commercial financial institutions, and as far as excessive risks are concerned.

As new financial instruments are developed by banks and other business institutions, the regulator has to follow suit and determine at what stage to intervene and protect the general public and the integrity of the markets, by way of formally regulating such initiatives.

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155 Money market securities include a variety of instruments, such as banker’s acceptances, promissory notes, treasury bills, commercial paper, repurchase agreements, bridging bonds, capital project bills, coupon stocks, call bonds and reserve bank debentures. Compare Swart 47-48 for definitions on these different instruments.

156 Van Zyl et al 210-211. Banks are the most prominent players in the money market. See Botha “The Money Market”, Chapter 9 in Van Zyl et al 209-271 for an extensive discussion on the money market and the securities traded therein.
In South Africa the Bank Supervision Department monitors new financial innovations and had to become involved in regulating new instruments, such as preference-share investment structures, credit-derivative instruments and securitisation schemes. Each new instrument must be evaluated to determine whether it qualifies as a security in terms of the SSA.

5.8 STRUCTURED FINANCING

In the wide sense “structured finance” is a reference to all non-conventional financial arrangements, with the purpose of refinancing and hedging certain economic activities. It goes beyond the standard debt, bond and equity instruments and features specific qualities, like its off-balance sheet status and its lower capital cost structures. Most structured investments either combine traditional asset classes, or replicate traditional asset classes through synthetication or new instruments.

In the narrow sense “structured finance” is often equalised with asset securitisation, by basing it on three characteristics, namely the pooling of assets, the tranching of liabilities backed by the asset pool, and the de-linking of the credit risk of the collateral asset pool from that of the originator, by way of a special-purpose instrument.

Coval et al submit that the essence of structured finance activities is “the pooling of economic assets (e.g. loan, bonds, mortgages) and subsequent issuance of a prioritized capital structure of claims, known as tranches, against these collateral pools.” When these investment pools are structured, the inherent claims are prioritised, which often leads to much safer tranches than the average individual asset in the underlying pool.

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157 Preference-share investment schemes were considered being operated in contravention of some provisions of the Banks Act and credit-derivative instruments. Although having been recognised by the Basel Capital Accord as a potential credit-risk mitigation instrument, it was critically analysed by the Bank Supervision Department in their 2002 Annual Report.

158 Jobst “A Primer on Structured Finance” 2-4. “Synthetication” is a reference to the process of combining financial instruments to create, or replicate, the economics of another instrument.

159 *Ibid* for reference to the definition by the Commission on the Global Financial System. Other structured financial transactions, like factoring commercial paper issues and the sale of participations in syndicated loans are distinguishable from securitisation. See Locke 89-91.

This ability of the structured financial process to create safer assets, has contributed to the popularity of structured securities.\textsuperscript{161} Many of them have been regarded by investors to be virtually risk-free and have been certified as such by the rating-agencies. The recent financial market crisis, however, highlighted the inherent risks of these structures.\textsuperscript{162} Coval \textit{et al} indicates how the perceived strength of structured finance has become its Achilles’s heel. The inherent flaw of structured finance, namely the substitution of largely diversifiable risks for highly systemic risks, has made it far more susceptible for “a severe economic downturn than traditional corporate securities of equal rating”.\textsuperscript{163} They use the collateralised debt obligation (CDO) as the so-called prototypical structured finance security in their analysis.

Caselli\textsuperscript{164} summarises the requirements for a structured financial transaction, which also establishes its “off-balance sheet financing” status, as follows:

1. The recipient of the funds raised is a separate entity from the party sponsoring (originator) the transaction, by creating a special-purpose vehicle (SPV), designated to take on the initiative and to secure cash receipts and payments. This can be called the \textit{isolation factor} because the loans are isolated from the originator’s balance sheet.

2. All economic consequences generated by the initiative are attributed to the SPV and the financiers grant finances to the SPV and not to the originator. This can be called the \textit{splitting factor} as the credit risk is consequently split into a number of tranches and placed with institutions that are hopefully better positioned to absorb the risk.

3. As the SPI receives the finances and has its own net worth, the assets necessary to manage the project are separated from the remaining assets of

\textsuperscript{161} Ibid 3-4 & 22. There were more than 37 000 structured finance issues in the United States in 2007. The issuance of structured finance products peaked in 2007 with a turnover of 100 billion US dollar per quarter and then fell to the lowest level of 5 billion US dollar per quarter in 2008.

\textsuperscript{162} Ibid 2. See 10-19 for the challenges faced in the rating process of structured finance instruments.

\textsuperscript{163} Ibid 3.

\textsuperscript{164} Caselli & Gatti \textit{Structured Finance: Techniques, Products and Market} (2005) 1. Rosenthal & Ocampo 9-11 summarizes the main processes of credit securitisation as follows: (a) it isolates the loans from the originator’s balance sheet; (b) it splits the credit risks; and, (c) it segments interest rate risks. In this the term “special-purpose instrument” (SPI) is used instead of “special-purpose vehicle” (SPV).
the originator. The SPI's assets, and not the originator’s, therefore become collateral for the creditors. This can be called the separation factor as the interest rate risk is also segmented and tailored for the most appropriate investors.165

Rosenthal et al use the term “structured finance” with respect to asset-backed financings in the sense of a transaction that has been structured to achieve the following:

(a) the cash flow from the underlying assets is packaged to be attractive to specific investors;
(b) the tax and accounting needs of both the borrower and the investor are satisfied;
(c) the credit criteria applied to the asset pool will generate an efficient cost of funds; and,
(d) insolvency of the originator will not interfere with the use of proceeds from the assets to make timely payments to investors.

In the most recent Credit Ratings Services Bill of 2011 a “structured finance instrument” is defined as

“a financial instrument or other assets resulting from a securitisation transaction or scheme”.166

The tax consequences are often driving factors in securitisation transactions. It is generally accepted that the potential of the instrument is measured by way of the cost ratios to avoid the legal, regulatory, tax and accounting challenges. The minimisation of tax is a major profit and marketability element. It was submitted that

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165 SPIs are also used by offshore financial centres (OFCs) to engage in financial activities in more favourable tax jurisdictions. The SPI issues asset-backed securities and the onshore company assign a set of assets to the offshore SPI. As the SPI receives the OFCs favourable tax treatment, the onshore entity also benefits from it. See http://www.imf.org/external/np/mae/oshore/2000/eng/back.htm (accessed 16-08-2011).

166 S 1 of the Bill.
“(I)legal engineering is about having your cake and eat it”. 167 Assets are sometimes created with the sole purpose of securitising them. 168

Securities created by way of a structured finance process are usually very flexible and have distinct profiles in terms of maturity, security and asset type. Although a security contributes to a more complete capital market, its complexity and the huge variety of products often create new challenges as far as management and information transfer are concerned. Structured finance is mainly used to combine different asset classes in an attempt to diversify risk. 169

The old saying, “cash is king”, is as relevant today as ever. More eloquently put, any financial institution has to protect its liquidity 170 effectively or it may experience serious challenges. One of the major instruments to finance such liquidity, with the specific purpose of raising extra funds for application in the financial markets, was developed in the 1960s in the form of the agency of securities, which process became known as “securitisation” in the 1970s. 171

Asset securitisation is a result of the savings and loan crisis of the 1970s in the United States of America when depositors withdrew their investments for fear of losses, resulting in serious liquidity problems for deposit-taking institutions. 172 The first appearance of the word in the Wall Street Journal took place in 1977 after the

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167 MacNeil & O’Brien 74-75. “Hybrid capital” is used as example as it was allegedly designed to achieve both the capital adequacy advantages of equity and the tax advantages of debt.

168 Ibid 75.


170 Liquidity represents the degree to which assets can be traded freely, or not. Liquidity can be defined as the ability to meet financial commitments on time. “Cash-flow” is the main requirement for any group of assets to be securitised.

171 Rosenthal & Ocampo 3. The term “securitisation” is derived from the word security, because usually illiquid or intangible assets that generate a constant cash flow are formed into a tradable security and are floated on the debt market. Credit securitisation started in the US with the development of the residential mortgage-backed securities business and then developed into a whole range of loans and receivables. The sale of pooled mortgage loans was guaranteed by US government agencies such as the infamous Ginnie Mae (Government National Mortgage Association), Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation). The first securitisation transactions outside the mortgage loan market was only launched in the middle 1980s. Different terms for basically the same phenomenon are used by writers and financial instrument practitioners. The terms “asset-backed securitisation” and “credit securitisation” refer to the same process, namely the use of pooled credit facilities against assets to create a new financial instrument. Some terms refer to a certain type of asset which is securitised.

172 Saayman Securitisation and Bank Liquidity 3. Securitisation forms a central part of the concept of structured finance and will be discussed in more detail in Chapter 6.
first securitisation transaction, focusing on funding for the home loan market, was concluded by the Bank of America through Salomon Brothers,\(^{173}\) becoming a vital funding source representing more than 8 trillion US dollars by the end of 2005.

Smith explains that the term was initially used to refer to the process of disintermediation, or the substitution of securities issued for bank lending, and is only more recently used in reference to structured finance transactions.\(^{174}\) Financial intermediation (the using of intermediaries between the savers and borrowers) became very expensive because of the regulatory capital requirements to be adhered to by the intermediary. The financial reality of this made securitisation, in the form of disintermediation, attractive to both parties.\(^{175}\)

Jobst states that securitisation initially started as a way of non-banking institutions to explore new sources of asset funding corporations, either by way of moving assets from their balance sheets, or by raising capital against their balance sheets (so-called “liquifying”), without increasing the capital base. This was further motivated by the increasing regulatory requirements of capital adequacy by the industry and regulators. Securitisation has, however, since then developed from a regulatory arbitrage tool into “an efficient and flexible funding and capital management technique”.\(^{176}\)

Dreyer states the major original motivations for securitisation were as follows:

(a) the mismatch of funds due to regional imbalances, caused by interstate banking regulation, in the United States;

(b) interest rate regulation, which caused mortgage-lenders to lend out at a fixed rate, while borrowing at a floating rate; and lastly,

\(^{173}\) See the history and motivation as discussed by Dreyer “Securitisation 101 – An Introduction” [http://www.sasf.co.za/aboutsecuritisation/introsecuritisation.htm](http://www.sasf.co.za/aboutsecuritisation/introsecuritisation.htm) (accessed 19-10-2010). Shortly thereafter Freddie Mac and Fannie Mae started creating a liquid secondary mortgage market in the US.

\(^{174}\) Smith *The Implication of Basel II* 27. “Disintermediation” is described by Smith on 14 as “the process whereby financial intermediaries are bypassed and savers contract directly with borrowers”. See also Meiring & Du Plessis 8 for discussion on securitisation.

\(^{175}\) It can be argued that the Basel requirements back-fired to a certain extent by motivating banks to find alternative methods to adhere to prescribed liquidity requirements.

\(^{176}\) Jobst *Structured Finance* 4. Locke submits that the “main objective of securitisation is for the originator to obtain financing.”
(c) growth in demand for home finance as the baby boomer generation reached home-buying age in the 1970s.\(^{177}\)

To this one can add the need by banks to find ways to transfer risk off their books, which accelerated product innovation initiatives by the early 1980s. By 1983 it was a commonly accepted practice to treat debt as a form of equity, which encouraged companies to borrow as much as possible – as long as the value generated was positive.

All assets can be securitised so long as they are associated with cash flow. The securities created by way of securitisation are often referred to as asset-backed securities (ABS) as the cash-flow generating assets are the spine of the transaction.\(^{178}\)

From the beginning it was foreseen that credit securitisation can:

(a) ensure more effective deployment of capital, which will result in more effective covering of risk;

(b) the cost differential between historical credit management and securitisation will reduce bad lending practices; and

(c) it would ultimately lead to a more stable and less costly financial system.\(^{179}\)

Dreyer mentions the following advantages of securitisation: lower inherent and weighted average cost; alternative institutional and retail investor bases are created; the matching of assets and liabilities; the multiplication of asset creation abilities; the freeing up of regulatory capital; improvement of the capital structure; higher trading on equity, with no increased risk; extension of the credit pool; reduction of credit concentration; risk management by way of risk transfers; arbitraging opportunities; and the repackaging of transactions.\(^{180}\)

\(^{177}\) Dreyer 2.

\(^{178}\) See Locke 89-91, where the writer states that the term “securitisation” is sometimes erroneously also used for other transactions, like the sale of participations in syndicated loans, factoring and commercial paper issues.

\(^{179}\) Rosenthal & Ocampo 18-21.

\(^{180}\) Dreyer 3. See also Itzikowitz & Malan 175-189.
Locke states that South African companies will only utilise securitisation if it is more beneficial than traditional loan financing, with factors such as the interest payable and the financing costs being prevalent. Locke further lists the most important advantages of securitisation as follows: improved liquidity; diversification of funding sources; better interest rates if a high credit rating can be achieved; improved risk management; and, some possible accountancy-related advantages. The writer acknowledges that securitisation may be driven by some non-rational motivations, like the following of a trend, initiated by connected professionals; or even illegal motivations, like judgment-proofing, money-laundering or other fraudulent initiatives.181

The first credit default swaps (CDS) and collateralised debt obligations (CDO) structures were created in 1995, which created more opportunities for accounting and regulatory arbitrage, which was later followed by rating arbitrage strategies. When hedge funds became more popular during the early 2000s, a higher demand was created for new structured products with much higher yields.182

Securitisation in general has, according to Jobst, become “an alternative and diversified market-based source of refinancing economic activity, which substitutes capital market-based finance for credit-finance by sponsoring financial relationships without the lending and deposit-taking capabilities of banks.”183

Two of the additional advantages of securitisation highlighted by Jobst are the diversification of asset exposures and the effective redistribution of asset risks, both for the investors and the capital markets in general.184 The fact of the matter is that securitisation has not resulted in stabilised financial markets, as was envisaged. The risk-taking behaviour of investors, banks, consumers and other market participants, contributed to poorer quality assets being placed in securitisation vehicles, conduits and special investment vehicles.185

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181 "Judgment-proofing" is the practice of splitting a business into different components for protection against creditors.
182 See Fabozzi 605-669 for detailed discussion on hedge funds.
183 Jobst Structured Finance 4-5. This process is described as disintermediation.
184 Ibid 5.
185 Compare Coval et al 2-3.
Coval et al\textsuperscript{186} submit that few investors were worried that the underlying assets were overvalued. Although there is evidence that the rating agencies made some significant mistakes and did not fully understand the flaws in their assumptions, some of the blame must lie with the regulators and the investors. It seems as if no one appreciated that small judgment errors in the rating of individual securities are magnified when collateralised debt obligations are created.

They conclude that future investors need to recognise the difference between single securities and structured securities, as far as systemic risk exposure is concerned. Traditional instruments are primarily driven by “firm-specific considerations”. Asset pools, however, are strongly affected by the performance of the larger economy as a whole.\textsuperscript{187}

5.9 REGULATORY ARBITRAGE

Regulatory arbitrage has become a reality in financial markets and can be described as the process in which parties manipulate a deal to “take advantage of a gap between the economic substance of a transaction and its regulatory treatment”.\textsuperscript{188}

The main purpose of regulatory arbitrage is to reduce regulatory costs without losing the financial benefits of the deal. Every jurisdiction is enacting securities and corporate laws with the purpose of providing “an efficient social order for investment and production”.\textsuperscript{189} While Fleischer rejects the necessity of regulatory arbitrage, Frachot submits arbitrage shall always be necessary as one cannot make a sustainable profit from a “zero-cost strategy”. He states that a “no arbitrage strategy” will increase the risk-taking factor dramatically. His submission is that the no arbitrage model is partly to blame for the latest financial crisis, and it has proved that

\begin{footnotesize}
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\item\textsuperscript{186} Ibid 24-26. They state on 26 that there is at least some evidence that “perverse incentives induced questionable behaviour on the part of (some) market participants.”
\item\textsuperscript{187} Ibid 29.
\item\textsuperscript{188} Fleischer “Regulatory Arbitrage” 2010 (89)2 University of Colorado Law School. It “exploits the gap between the economic substance of a transaction and its legal or regulatory treatment” http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1567212 (accessed 06-07-2010). Later published under the same heading in 2010 89(2) Texas Law Review 227-290. Smith 19 says it is “the process whereby banks restructure their asset categories so as to attract a lower regulatory capital adequacy charge”.
\end{itemize}
\end{footnotesize}
“one can make a sure and durable profit from a zero-cost strategy . . . but not forever”.  

In a globalised business arena it is necessary for the prudent business person (and his lawyers) to investigate the regulatory environments of the different legal jurisdictions when tailoring a specific deal. Not everyone, however, is excited about the idea of regulatory arbitrage. Fleischer argues that regulatory arbitrage “undermines the efficiency of regulatory competition, shifts the incidence of regulatory costs, and fosters a lack of transparency and accountability that undermines the rule of law”.  

The reality is that there are always three parties at the business negotiation table, namely the buyer, the seller, and the government, who acts by way of legislation and regulation. It is imperative for the parties to consider the regulatory environment when structuring a business deal and in that sense regulatory arbitrage is often referred to as “planning” or “regulatory engineering”. There should, however, be a clear distinction between business planning and regulatory manipulation.

According to Fleischer one of the following conditions must be met to make room for regulatory arbitrage, namely:

(a) **regulatory regime inconsistency**, which entails that the same transaction receives different treatment under different regimes;

(b) **economic substance inconsistency**, where two transactions with identical cash flows receive different treatment under the same regime; or,

(c) **time inconsistency**, where the same transaction receives different treatment in the future than it does today.

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190 Frachot “Regulatory Arbitrage and Model Sophistication in the Financial Crisis” 2010(2) *Journal of Risk Management in Financial Institutions* 125. Off-balance sheet finance has often been regarded as undesirable regulatory arbitrage as capital requirements are reduced without comparatively reducing the risk. See Calomiris & Mason “Credit Card Securitisation and Regulatory Arbitrage” 2004(1) *Journal of Financial Services Research* 5-27, 7.

191 Fleischer 2. The underlying principle is to “(m)eat the letter of the law while undermining its spirit”.

192 *Ibid*. On 17 he explains that “financial arbitrage” differs from “regulatory arbitrage” in that it is “the simultaneous purchase and sale of the same, or essentially similar, security in two different markets for advantageously different prices”.

These inconsistencies will result in regulated entities either “migrating to jurisdictions imposing lower regulatory burdens” or, remaining in their current jurisdiction, making use of the regulatory jurisdiction of another state. The inconsistencies between legal jurisdictions may be the result of different policy goals, inept legislation, or outdated legislation, failing to keep up with the development of new financial products or business opportunities.

In an analysis of the interaction between legal regimes of securities regulation, Licht comes to the conclusion that legal rules can have an economic value like any other aspect of the business transaction. This stresses the need for all parties (legislators, business leaders, lawyers and academics) to develop a better understanding of the causes and results of regulatory diversity.

One of the potential results of securitisation is the application of this process as a regulatory arbitrage opportunity. Through arbitrage the prescribed minimum capital requirements may be side-stepped. Banks, and especially their capital adequacies, are heavily regulated by both their national governments and the international financial community, because of the important role that banks fulfil in both financial intermediation and the payment system in any economy. When banks fail it can have a devastating effect on a national economy.

The Basel I Accord of 1988 has created a further ideal situation for regulatory arbitrage to take place, because it provided for flat rates on loans, without taking into account

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194 Licht 567. On 633 he states that the term “regulatory arbitrage” is “commonly used to indicate a migration trend toward the more lenient regulatory regimes”.

195 Fleischer 19.

196 Licht 636.

197 Cardone-Riportella, Samaniego-Medina & Trujillo-Ponce “What Drives Bank Securitisation?: The Spanish Experience” 2010 *Journal of Banking and Finance* 2640. They confirm on 2649 that liquidity and the search for improvements in efficiency have been the main driving forces behind securitisation initiatives by Spanish banks between 2000 and 2007, while the hypotheses regarding the transfer of credit and regulatory arbitrage could not be confirmed by their research. Other factors which may play a role are the type of bank (commercial bank, savings bank, credit institution, investment bank, etc.) and the size of the bank.


199 The Basel Committee on Banking Supervision is a committee of international central bankers and supervisors who published a set of regulations that established levels of bank capital. The secretariat for the committee is in the Bank of International Settlements in Basel. The Basel I regulations originally succeeded in its aims and its shortcomings were only identified after a few years.
account the underlying credit quality of the borrower.\textsuperscript{200} This resulted in the banks being required to hold more capital on high-quality assets than on the underlying economic risks itself. When regulations assign the same risk weight and capital cost to all loans in a certain asset class, it becomes an incentive for banks to focus on riskier assets as it will increase their profits (so-called “cherry picking”).

This uneven situation is all the bankers needed to practise arbitrage, and provided the necessary incentive for banks to shift towards riskier asset portfolios with higher interest rates, but without having to increase their capital holdings. The classical method of regulatory capital arbitrage, namely the assumption of greater risk without an increase in capital requirements, is now competing with the new form of arbitrage—securitisation. If the credit enhancement resulting from a securitisation transaction amounts to less than the prescribed minimum capital to risk-weighted asset ratio,\textsuperscript{201} the bank has effectively reduced its regulatory capital requirement, although it is actually exposed to the same risk it faced before securitisation.

It is submitted that a financial institution that holds less regulatory capital will have a greater incentive to securitise its assets, because of the capital adequacy ratios and the equity versus total assets ratios. The weaknesses of the Basel I accord were supposed to have been addressed in such a manner by Basel II (2004), that securitisation as a regulatory arbitrage tool was not as attractive in future. The theory was that the possible reduction in capital requirements in terms of Basel II is “closely associated both with the quality of the underlying portfolio and with the amount of risk exposure retained by the originating entity, which would prevent the possible arbitrage of capital.”\textsuperscript{202}

Basel II, by way of the Advanced Internal Ratings Based (AIRB) approach, imposes more restrictions on banks attempting to reduce their capital requirements by way of

\textsuperscript{200} A flat 8% capital charge on corporate assets and a 4% charge on residential mortgage loans were prescribed. It also prescribed flat ratios on the four different asset groups it identified and this “one size fits all” approach opened the door for regulatory arbitrage. See Smith \textit{Implication of Basel II} 20.

\textsuperscript{201} The ratio represents capital as a percentage of the total of risk-weighted on-balance sheet assets, plus the risk-weighted credit equivalent for off-balance sheet exposures. Basel I prescribed an 8% ratio, but in South Africa the current prescribed ratio is 10%. As long as the credit enhancement is less than 8% of the securitised asset portfolio, the bank does not have to increase its capital. See Smith \textit{Implication of Basel II} 20-21.

\textsuperscript{202} Cardone-Riportella \textit{et al} 2640. Basel II was implemented in South Africa in 2008.
securitisation, and Smith submits that the Basel II framework was indeed designed to curb regulatory arbitrage activities of banks.\textsuperscript{203} Basel II was indeed designed to align bank capital with risk in a closer manner and this should further minimise arbitrage opportunities.\textsuperscript{204}

Whether this new regulatory capital treatment indeed had the desired effect on the involvement of banks in securitisation transactions, will have to be seen. It is submitted that the implementation thereof came too late to prevent the 2008 financial crisis. The question is whether it was too little, too late, or not. According to Frachot\textsuperscript{205} is the “no arbitrage pricing model” at the heart of the International Financial Reporting Standard (IFRS) and of the Basel II framework. He submits that this model, however, can only work when certain other assumptions are also satisfied, and will ultimately lead to an “ever-growing imbalance, culminating in a meltdown such as that which has been ongoing for the past couple of years”.

Many believe that regulation, and not only the lack thereof, can sometimes contribute to financial instability. When regulators institute well-intended controls, financial intermediaries react to the best of their knowledge and interest. It is a fallacy to believe that credit ratings, capital adequacy ratios and best practices in corporate governance will necessarily prevent instability.\textsuperscript{206} Financial institutions often profit from new innovations at the expense of society, which come about as a reaction to the regulatory standards which imply a false sense of safety.\textsuperscript{207}

Smith\textsuperscript{208} identifies the following types of regulatory capital arbitrage:

\begin{itemize}
\item \textsuperscript{203} Smith \textit{Implication of Basel II} 269. See Smith 360–427 for a summary of the minimum capital requirements in terms of the Basel II framework. The AIRB places substantial reliance upon banks’ internal date, risk measurement and management processes.
\item \textsuperscript{204} The applicable South African regulations were brought in line with the latest international regulatory, supervisory and market best practices and policy-related developments. SA Reserve Bank Directive 3 of 2009, dated 05-02-2009, provided further clarity relating to banks, controlling companies and branches of foreign institutions’ effective net open foreign currency positions and matters related to unencumbered assets held.
\item \textsuperscript{205} Frachot 126.
\item \textsuperscript{206} It is therefore debatable whether the introduction of the new Credit Rating Services Bill, approved by Cabinet on 26 July 2011, is necessarily a step in the right direction.
\item \textsuperscript{207} Pacces 480-481.
\end{itemize}
Chapter Five: Financial Environment

(a) cherry picking: the practice of changing the asset portfolio towards higher risk assets with better returns;

(b) securitisation with partial recourse: a sophisticated form of cherry-picking, whereby higher quality assets are sold off;

(c) remote origination: the practice where the special-purpose vehicle instead of the bank originates the assets without the bank ever formally owning the assets;

(d) indirect credit enhancements: transactions structured with indirect credit enhancement, such as reserve accounts and early amortisation provisions that reduces the amount of credit enhancement required from the sponsoring bank.

Frachot uses three types of model arbitrage opportunities as example. He refers to banking-based arbitrage made possible by banking regulation. Securitisation is an example of this. The second type is arbitrage between banks and rating agencies, partly because of either flawed rating models or widely publicised models that could be reverse-engineered by banks. Thirdly is the close similarity between insurance and banking regulations misused by way of so-called transforming vehicles. He submits that these forms of regulation distortion, modelling and internal regulation loopholes will always result in a financial crisis as was recently seen.209

Acharya submits that the credit transfer mechanisms (like securitisation) may have economic value as a risk-transfer tool and much of it may be clever innovations by the financial sector to actually arbitrage regulations.210 A stricter regulatory package does therefore not necessarily lead to a better regulated financial environment as it may become counter-productive if it causes new methods of arbitrage.211

209 Frachot 127-130.
210 Acharya & Schnabl “How Banks Played the Leverage Game” 2009(2) Financial Markets, Institutions and Instruments 144.
211 Acharya & Schnabl 145 states that banks that were more funded through asset-backed commercial paper relative to their equity and who had more capital-light investments, suffered the highest losses and equity price declines during the recent economic crisis.
It is submitted that the future of the securitisation scheme as regulatory capital arbitrage tool shall remain for certain asset classes, but will be overshadowed by the role of securitisation as a funding mechanism by credit institutions.\textsuperscript{212}

The trust as an instrument of arbitrage will be evaluated in Chapter 7. The relationship between regulatory arbitrage and regulatory differentiation will be discussed in Chapter 8.

\textbf{5.10 CONCLUDING REMARKS}

South Africa has a well-developed financial sector, with a good financial infrastructure and high-level technology. The system is efficient and stable, although there are some reason for concern regarding money-laundering in investment funds, bearer securities and bills of exchange. Local financial markets and institutions have been discussed, as well as a variety of instruments, such as collective investment schemes, securities, money markets and structured finance.

Some of the major aspects that protected South Africa from the full blow of the global financial crisis were sound financial regulations, well-regulated institutions, conservative risk management practices by domestic banks, limited foreign asset exposure, subsidiary banking structures, rigorous listing requirements for banks, a robust monetary policy framework, a strong fiscal policy, and high capital adequacy requirements.\textsuperscript{213}

South Africa has a very new, but fairly developed, structured finance milieu, and within this context securitisation will in general, and its specific regulation and application, be investigated in the next Chapter.

The current legislation on securities may be replaced shortly with the Financial Markets Bill of 2011, which will be referred to in 7.7.14.

\textsuperscript{212} See also Smith \textit{Implication of Basil II} 295 in this regard.
CHAPTER SIX

SEURITISATION

6.1 INTRODUCTION

In the previous Chapter the financial environment in general has been investigated. One of the modern phenomena in this environment is that of structured finance, with securitisation as the central process. In this Chapter the application of securitisation in general, and then specifically in South Africa, will be discussed. Securitisation is a relatively new, innovative method of transferring certain (often illiquid) assets into another financial entity, with the purpose of creating a new asset class at a lower cost base and supposedly less risk.

Mminele\(^1\) stated that

“(f)inancial innovation, in the positive sense of the word, can be regarded as any new development in the financial system that either enhances its capital-allocation or operational efficiency. However, financial innovation is often driven by risk/return incentives at the level of the individual trader, structured financier or institution.”

The process of “securitisation” is often interchangeably referred to as asset or credit securitisation. It is the process of converting a pool of financial assets into a tradable liability and equity obligations. These contingent claims are secured by definite cash flows from payment obligations linked to the underlying debts. In this process outstanding loans are changed into securities and the originator being effectively separated from the ultimate investors.\(^2\)

Although the end result of securitisation is financing, it is not financing in the ordinary sense of the word, as since the entity securitising its assets is not really borrowing


\(^{2}\) Rosenthal & Ocampo 25. See Locke 15, for explanation of traditional securitisation and distinction from synthetic securitisation. Compare Smith The Implication of Basel II 16, for the building blocks of the securitisation process.
money, but is selling a stream of cash-flows, that were otherwise accruing to the originator. The asset used for the financing is transferred to the investor, but the originator (seller) continues to administer and manages it. This concept is analogous to the owner of a property who borrows money from a bank against the cash flows generated by the property. The owner continues to manage the property and to receive all excess income. The property is not, however, transferred to the bank, but the bank registered a mortgage bond over it to secure its position.

As it is impractical to secure thousands of different debt instruments, a special-purpose vehicle is used as transformation device – to convert a large number of smaller financial assets into one tradable capital market security. The major benefits of the securitisation process is summarised by Schwarcz as the enablement of the originator to obtain financing at a lower cost, to deploy the capital more advantagely, to increase its internal liquidity, and to distribute the risk more efficiently.3

The generic term for securitisations is asset-backed securities, which may include a number of different types of transactions, such as collateralised loan or bond obligations (the receivables are bank loans and bonds respectively), collectively referred to as collateralised debt obligations; or, commercial and mortgage-backed securities (the receivables are loans secured by mortgages of commercial or residential properties respectively).4

### 6.2 THE CONCEPT OF SECURITISATION

Securitisation is the conversion of a pool of assets with a regular and predictable cash income, such as mortgage repayments or credit card receivables, into a security or marketable instrument. This process enables a company to sell some of its assets to a specially formed company or trust (the SPI). The transaction is funded by way of the issuance of debt securities in the capital markets. The cash flows derived from the asset will serve as principal and interest payment obligations under the marketable securities.5

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3  Schwarcz “Securitisation Post-Enron” 2003 Cardozo Law Review (Symposium Issue on Threats to Secured Lending and Asset Securitisation) 2.
4  Wood 452.
Securitisation is largely used by banks and companies. Banks use it to manage their capital requirements better and companies use it to raise cheaper funding for capital projects. It also became an additional source of funding and a diversification of funding opportunities, both for banks and companies. Banks fulfils a central role in the financial sphere as they channel two vital resources in modern economies, namely money and savings. They are tasked to act as intermediators of financial resources between parties by matching borrowers and lenders – even where they have totally different time horizons. They thus borrow short term from lenders and lend long term to borrowers. This “maturity transformation” is the place where the bank ultimately must make its profits. Lenders, however, must trust the banks’ ability to cope with this process successfully.

In terms of traditional lending practices the commercial bank or other credit provider managed their credit risks with a two-prong approach: firstly by way of the review process before granting the credit and secondly through a continuous monitoring and servicing process. The finance institution holds the risk in its own portfolio and, therefore, backed its obligations to the depositors effectively. This absorption of the risk requires high volumes of equity capital from the credit giver and is extremely expensive and risky. The lending institution must further back its borrowings from the capital markets with equity capital proportionate to its risk of default.

Securitisation can be used to reduce greatly the risk and uncertainties that arise from the lender’s discretion, portfolio concentration and its exposure to non-credit losses. Coupled with the fact that securitisation increases the transparency of the expected credit risk, which collectively has an effect on the capital markets’ view of the risk, it lowers the costs of lending by decreasing the required levels of equity and consequently increases the yields.

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6 Smith Implication of Basel II 110.
7 Pacces 485.
8 Rosenthal & Ocampo 6 state that in 1988 it was estimated that the equity capital requirements of lending institutions in the US constituted 25% per annum of the pre-tax income.
9 Ibid 8 explains some of the reasons why the capital markets are insisting on such high levels of protection, such as the undiversified character of the balance sheets of most banks which increases the risk during certain unforeseen catastrophic incidents: the risk that the bank uses the capital to fund new discretionary loans whose risk may be greater; and, the fact that banks face non-credit risks, such as interest and pre-payment risks, which may outweigh the credit risks and cannot be isolated on the balance sheet.
10 Ibid 8-9.
Investors who become involved in securitisation transactions have to rely on the credit ratings achieved by the pool of assets. The rating agency evaluates factors such as the securitisation structure, future cash flows, the credit enhancement and the administrative ability of the originator (often a bank) in the determination of a specific rating.\footnote{Smith \textit{Implication of Basel II} 18. The rating agency monitors the transaction on an ongoing basis and may change the rating from time to time. Credit enhancement is a feature in securitisation transactions that absorbs some of the credit losses. Its purpose is to protect investors from losses occurring in the pool of assets or risk exposures acquired by the SPI.}

The securitisation process starts with a bank or company identifying certain income-generating assets it wants to securitise and then pooling these assets and transferring them to a specially formed vehicle (a company or trust). Aforementioned issues securities against these assets and uses the cash flows from the assets (repayment by borrowers) to repay the investors in the securities.

The phenomenon of securitisation has been described as “a financial technique that allows a batch of illiquid assets to be transformed into a liquid tradable instrument with a known flow of income payments.”\footnote{Cardone-Riportella \textit{et al} 2639. Both assets and liabilities are securitised. In Spain 80\% of securitisation transactions are linked to assets and the balance to liabilities.} Smith defines it as “a financing tool for selling assets in the form of receivables.” He further states that, “(t)hrough the process of securitisation, assets from corporations or banks are pooled, repackaged and sold as asset-backed securities.”\footnote{Smith \textit{The Implication of Basel II} 26. Tett \textit{Fool’s Gold} (2009) 320 describes asset-backed security as “a security backed by a portfolio of assets or cash flows from assets that are normally placed in a specially designated vehicle.”} It is thus an effective way to transform a non-negotiable asset (or right) into a fixed-income, tradable instrument.

The goal and effect of the securitisation transaction are to isolate the financial aspects that support the payments on the identified security, and to ensure that the payments derive from a specific pool of assets and not from the entity from which the assets originate. In this sense it differs from traditional debt and equity financing where the investors rely for their returns on the performance of the financed enterprise itself.\footnote{See Smith \textit{Implication of Basel II} 32.}

By entering into a securitisation process, a lower-rated entity can access capital that would usually be preserved for higher-rated institutions successfully. The process
involves a number of participants. The issuer (special-purpose institution) acquires the assets from the originator (often a bank), with the underlying asset pool being held separately from the other assets of the originator. Third parties guarantee the quality of the credit facility to enhance the credit rating of the investment. The liability side of the SPI consequently carries a lower cost than the asset side of the SPI. The originator can thus secure lower cost funding than in the usual unsecured market.

Dreyer describes the typical securitisation process as follows:

Step 1: the originator makes a loan to a borrower;

Step 2: the loan is kept by the originator until it has a sufficient volume of similar loans;

Step 3: the originator sells the loans to a special-purpose institution, created by the originator;

Step 4: the special-purpose institution pays the originator for the loans by simultaneously selling certificates, representing ownership of the loans, to investors, while a credit rating agency rates the securities issued by the special-purpose vehicle;

Step 5: a servicer (administrator) is appointed, who serves and monitor the repayment of the loans;

Step 6: the borrower makes payments to the servicer.

Karoly identifies three phases in the securitisation process, namely:

- the asset origination phase, when the asset portfolio is created on the balance sheet;

- the structuring and issuance phase, when the legal and financial feasibility is investigated, the selection of assets is done and the legal structures, like the special-purpose vehicle, are set up; and lastly,

- the holding and trading phase.

Dreyer 3. MacNeil & O’Brien 229 summarises the process as follows: (a) the recognition of the legal rights to assets that are, in effect, obligations of payment to an originator; (b) the transfer of these legal rights to a clean, unencumbered legal vehicle in the form of a trust or corporation, with bankruptcy remoteness; and, (c) the sale of the rights to the cash flows of the assets in the SPV to investors.

See Karoly 31-32.
Virtually any asset that has an ascertainable value or that generates a predictable income stream can be securitised. The universality of the process allows it to be used in different countries under a variety of legal and regulatory jurisdictions. Smith states, however, that “both the science and the art of securitisation lie in the structure”, which includes all the relevant accounting, tax, legal and regulatory aspects. Other considerations are the appropriate liquidity and credit enhancement facilities as well as the particular asset class to be securitised.  

The following chart illustrates a very basic securitisation process:

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17 Smith Implication of Basel II 32 - 33. See 34 for an illustration of a generic securitisation structure, including the cash flows and major participants.

18 Ibid 303-304 and Locke 29 for more detailed illustrations of the securitisation process.
ILLUSTRATION 3: SECURITISATION PROCESS

Originator

Asset Pool

SPI

Credit Enhancement

Issue Proceeds

Note Issue

Class ‘A’ Note

Investors
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The transformation of illiquid assets into liquid assets is made possible by using an instrumental vehicle, called a special-purpose institution (SPI). The SPI is a separate legal entity from the entity with the rights to the instrument. Mortgage loans, credit card receivables, bonds, vehicle finance and loans to small and medium-size enterprises can be securitised in this way.19

The SPI obtains the financing for a specific initiative and the loan repayment is consequently guaranteed primarily by the generation of cash from the specific assets. The net worth of the originator is thus actually irrelevant in assessing the sustainability of the loans. SPIs are applied in a variety of situations, such as in securitisation, where the SPI issues bonds on the market against real or financial assets segregated in that same vehicle, in project finance transactions, where industrial projects are segregated in a contractually secured SPI, in leasing transactions (i.e. airplanes, ships, large real estate projects), and, in leveraged buyouts.20

The goal in locking a pool of assets in an ad hoc organisation (the SPI) is to isolate the fate of these assets in relation to those of the originator. This separation also means that the two parties (originator versus SPI) can have very different credit ratings. The principal determining factor for securitisation has been determined being the need for liquidity. This need is addressed by way of structured financial transactions which firstly reduce the cost of funding of new financial resources for the specific initiative, and secondly separating the initiative from the originator, which prevent existing credit lines and funding programmes of the originator to be affected by the new initiative.21

The result of securitisation is four-fold:22

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19 Cardone-Riportella et al 2639. In Europe the volume of securitised assets grew from 78.2 billion Euros in 2000 to 711.1 billion in 2008 – a ten-fold increase. Tett 321 defines an SPV as “(a) shell company that is created to hold a portfolio of assets, such as bonds or derivatives contracts, and then issue securities backed by those assets”. Rosenthal et al 47 explains that SPVs in the US can be in the form of corporate entities (like companies), unincorporated entities (like trusts), or as associations of persons (like partnerships).

20 Caselli & Gatti 2. Coval et al 5

21 Caselli & Gatti 3. See Cardone-Riportella et al 2640.

22 Cardone-Riportella et al 2640. They confirm on 2649 that liquidity and the search for improvements in efficiency have been the main driving forces behind securitisation initiatives by Spanish banks between 2000 and 2007, while the hypotheses regarding the transfer of credit and regulatory arbitrage could not be confirmed by their research. Other factors which may play
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(a) as a funding tool: it creates new sources of financing as the SPI issues notes to fund the assets purchased from the originating bank;

(b) as a risk transfer tool: it allows banks to fund riskier financial assets because the risk is taken from their balance sheets which result in less spending on insurance to cover the risk;

(c) as a regulatory arbitrage tool: it may reduce the bank's capital requirements;\(^{23}\) and

(d) as a performance tool: it may improve the potential growth of the originating institution.\(^{24}\)

The process in structured finance often has the effect that the issued tranches can end up with higher credit ratings (often unjustified) than the average rating of the underlying pool of assets.\(^{25}\) Investors more often than not underestimate the underlying economic risks of the structured financial market and it can be argued that much of this can be laid before the door of risk analysts and rating agencies.

Asset liquidity is sourced by way of interbank lending, investments in short-term government securities, commercial paper, bankers’ acceptances, and the purchasing of negotiable certificates and repurchased securities. Liability liquidity sources include Reserve Bank and interbank borrowing, the sale of repurchased securities

\(^{23}\) A financial institution that holds less regulatory capital will have a greater incentive to securitise its assets, because of the capital adequacy ratios and the equity versus total assets ratios. It is submitted by Cardone-Riportella et al 2640 that the weaknesses of the Basel I accord has been addressed in such a manner by Basel II that securitisation as an arbitrage tool should not be as attractive in future as the possible reduction in capital requirements in terms of Basel II is “closely associated both with the quality of the underlying portfolio and with the amount of risk exposure retained by the originating entity, which prevents the possible arbitrage of capital.” Smith Implication of Basel II 269 states that “the major objective of Basel II has been to align banks’ regulatory capital requirements more closely with economic capital”.

\(^{24}\) Some commentators are of the opinion that the search for improved measures of performance by banking entities is also a major contributor to the popularity of structured finance, but Cardone-Riportella et al do not concur. If it did, however, play a role, the possible reasons would be return on assets and return on equity ratios as well as cost-to-income ratios. In reference to Bannier & Hänsel (2008), Cardone-Riportella 2650 states that a European bank with “greater credit risk exposure, lower liquidity and worse performance measures is more likely to securitise”.

\(^{25}\) Coval et al 7-8. The recent international financial crisis has illustrated exactly how imprecise these risk ratings can be in the case of collateralised debt obligations. See Coval et al 16 for the connection between structured finance and the subprime crisis. The subprime mortgages were ineligible for securitisation by government sponsored agencies, but found their way into capital markets by way of non-governmental mortgage-backed securities. Many subprime mortgage-backed bonds were even resecuritised into so-called collateralised mortgage obligations.
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and negotiable certificates and deposits, the issue of commercial paper, and asset securitisation.26

The ability of a financial institution to borrow at reasonable rates depends largely on the market’s perception of its assets and capital base. Securitisation has become a vehicle used to strengthen the financial institution’s underlying capital base, while, at the same time, it spreads the risks.

Asset securitisation is “the process where pools of loans, receivables or debt instruments are packaged in the form of securities, the credit rating of the securities enhanced, and (then) distributed to investors.”27 It thus turns assets into marketable securities, by transferring the rights to the assets to investors, in return for cash.28 The purpose is to convert generally illiquid assets with fairly predictable cash flows into tradable securities.29

Gorton summarises the securitisation process somewhat differently:

(a) the originator sets up an insolvency remote SPI and sells the pool of assets to it;
(b) cash flows are tranched into asset-backed securities and the proceeds used to pay the sponsor for the pool of assets;
(c) the old assets are used to buy new assets; and
(d) during the final amortisation period all cash is used to pay the principal amounts of the tranche.

6.3 SECURITISATION IN SOUTH AFRICA

Securitisation started slowly in South Africa, largely because of the lack of a satisfactory regulatory environment, the limited knowledge and understanding by

26 Saayman 4. Smith Implication of Basel II 31 states that one of the advantages of securitization from the perspective of the regulatory authorities was the diversification of funding away from the short-term interbank market.

27 Saayman 2.


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local investors about this technique of financing, and the lack of local rating agencies.30

The first two transactions in South Africa in 1989 and 1991 respectively were to a combined value of R210 million only. In the very first transaction the United Building Society acted as the originator of pooled mortgage loans, which were sold to a special-purpose vehicle in company form. Since then the market for alternative instruments has grown significantly and by 2009 the monthly turnover in derivative instruments in South Africa fluctuated between R4 billion and R7.6 billion.31

When the 2001 regulations determined that the operation of a securitisation scheme, subject to certain requirements, was not regarded as “the business of a bank”, banking originators grabbed the opportunity and within a matter of a few years transactions worth billions of rand were concluded. The 2001 regulations, by widening the definition of securitisation, also allowed banks to fulfil multiple roles in these transactions.32 The result was that the acceptance of money from the general public by SPIs against the issue, by the SPI, of commercial paper in respect of a securitisation scheme, was classified as an activity not falling within the meaning of “the business of a bank”.33 Notice No. 1375 repealed the 1992 Notice and introduced a combined regulatory regime, incorporating both international best

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30 Smith *The Implication of Basel II* 287. Van Vuuren submits that in just three years “a thriving, sophisticated securitisation market has emerged in South Africa from virtually nothing”, referring to the period 2001, when the new securitisation regulations, under the Banks Act of 1990 were published, to 2004, when the article was published. Before 2001 securitisation in South Africa was regulated by the 1992 and 1994 notices – the contents of which created specific uncertainties in the financial community.

31 See the 2009 Annual Report by the Reserve Bank Supervision Department. See also the discussion by Itzikowitz & Malan 175-189. According to Mminele 2, the South African securitisation industry grew by 31 percent in 2007 to an amount of R41.5 billion. See in general Moyo & Firer “Securitisation in South Africa: 2000-2007” 2008(1) *South African Journal of Business Management* 27-34.

32 Notice 1375 of 13 December 2001 was preceded by Notice 153 of 3 January 1992 (GG 13723) and Notice 2171 of 14 December 1994 (GG 16167). By 2000 ongoing concern worldwide about financial-sector stability necessitated reviews of the minimum required capital-adequacy ratios of banks. The amended capital requirements for SA banks was published under GN R1003, and that for mutual banks under GN R1007, both in GG 22737, dated 05-10-2001. Thereafter, first the 2004 and then the 2008 Regulations were published.

33 The amended regulations for banks and mutual banks respectively were published in GN R1004, R1006 and R1008, in GG 22737, dated 05-10-2001.
practices and the guidelines on the regulatory aspects of asset securitisation published by the Basel Committee in 1990 (Basel I).\textsuperscript{34}

The 2001 regulations broadened the definition of securitisation by allowing banks to act as originators, remote originators, sponsors or repackagers in relation to a securitisation scheme, and incorporated all commercial paper aspects, which were previously regulated separately, but were replaced in June 2004 with new the Regulations.\textsuperscript{35}

In 2004 the Basel Committee on Banking and Supervision published a revised Capital Accord for banks entitled “International Convergence of Capital Measurement and Capital Standards: A Revised Framework”. This document introduced specific capital adequacy requirements for securitisation schemes and became known as Basel II. Its purpose was to further strengthen the safety, soundness and stability of the international banking system.

The Basel II Accord led in South Africa to the Banks Amendment Act 20 of 2007 and ultimately a new set of Regulations, which replaced the 2004 Regulations.\textsuperscript{36} As from 1 January 2008, banks had to report formally and manage their capital requirements in terms of the amended legislation. In addition to the Regulations, the Exemption Notice relating to Securitisation Schemes was also issued.\textsuperscript{37}

If banks do not comply with the prescribed Regulations, assets transferred in terms of a traditional securitisation scheme will, for purposes of the bank’s capital requirements, be reflected as assets on the balance sheet of the specific bank. In cases of synthetic securitisation schemes, the risk transferred by the bank, will be reported as if the bank had not obtained any credit protection. The compliance or not

\textsuperscript{34} GN 1375, published on 13-12-2001 in GG 22948, replaced both the previous GN 153, published on 03-01-1992 in GG 13723, and provides for the issue of commercial paper, previously regulated by GN 2172, published on 14-12-1994 in GG 16167.

\textsuperscript{35} See Locke 259-274 for a detailed discussion on the regulatory history of securitisation in South Africa. See Prinsloo \textit{Real Estate Securitisation in South Africa} in general. GN R681 was published on 04-06-2004 in GG No 26415.

\textsuperscript{36} GN R3 was published on 01-01-2008 in GG No 30629 and came into operation on the same date. The Basel II regulatory framework has been fully implemented as from January 2008. See Mminele 8.

\textsuperscript{37} GN R1 in GG No 30627 of 01-01-2008 deals with the “Conditions for the Conducting of the Business of a Bank by a Foreign Institution by means of a Branch in the Republic”. The Exemption Notice was issued in terms of GN2 in GG No 30628 on 01-01-2008 and it repealed the 2004 Regulations and Notices in their entirety.
by an SPI must, however, be assessed independently from that of the bank concerned with the transaction.

The 2008 Notice confirmed the position that the acceptance by a SPI of money from the general public, against the issuance of commercial paper, in respect of a traditional securitisation scheme, is not an activity regarded as “the business of a bank”, subject to adherence to the provisions of the Notice.

The two key steps are, therefore, the pooling of assets and the tranching thereof. The pooling process minimises the risk of wrong selection, while tranching divides the risk of loss by purchasing the cash flows and issuing securities based on different seniorities. Ultimately the process is all about minimising risk.38

Smith39 gives the following motivations for the different parties to make use of securitisation:

- for the corporate companies it is a cheaper option and it creates alternative and higher funding opportunities;
- in the case of banks it supports the capital, credit and asset-liability management processes, it creates new funding diversification and additional funding opportunities, it allows client relationship continuation while the risk is transferred, and it creates additional products and income streams; and that;
- while the investor gains access to relatively secure, transparent and flexible investments, with more diversification options, in a product that comes with a security rating.40

These benefits clearly illustrate why securitisation became so popular during the last decade. Even the regulators supported this mechanism as they recognised it as a valuable financing tool that can improve the management of banks’ exposure to certain asset classes.

39 Smith Implications of Basel II 29-32.
40 See also Itzikowitz & Malan 185-188 for some of the advantages of securitisation, namely a broadened funding base of financial institutions, reduced borrowing costs, fee generating opportunities, and reduced capital-adequacy requirements.
In a 2008 investigation on the risks posed by securitisation in South Africa, the following observations about the securitisation process in South Africa were made:\footnote{See the 2008 Annual Report of the Bank Supervision Department of Reserve Bank at \url{www.resbank.co.za} (accessed 20-05-2011).}  

1. the structures were less complicated than in the United States and some European jurisdictions;  
2. a high level of transparency was present in the assets placed in securitisation vehicles;  
3. good credit processes were followed;  
4. risks were appropriately managed;  
5. on average South African banks only sourced about 4 per cent of their total funding from securitisation;  
6. accounting transparency could be improved;  
7. regulatory compliance was satisfactory.  

These findings largely explained the relative ease with which the South African financial environment survived most of the devastation caused by the recent international financial crisis. In May 2011 the Registrar of Banks further issued a directive requiring specific information from banks, controlling companies and branches of foreign institutions in respect of their issuer SPIs.\footnote{South African Reserve Bank Directive 1 of 2001 dated 03-05-2011, issued in terms of subs 6(6) of the Banks Act of 1990. This directive is applicable to both traditional and synthetic securitisation schemes.}  

The following illustration reveals the process flow in the interaction between the respective stakeholders in a CIS:
ILLUSTRATION 4: PROCESS FLOW OF COLLECTIVE INVESTMENT SCHEME
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The Registrar of Collective Investment Schemes has recently determined the limits and conditions applicable to third party-named portfolios of collective investment schemes. The practice of so-called “white labelling”, whereby a third party, who does not have the capacity or intention to establish a collective investment scheme, requests a manager to establish a portfolio in the name of the third party under the manager’s registered scheme, has emerged even before the enactment of CISCA. This Notice acknowledges and regulates two categories of white-labelling arrangements, namely incubator portfolios and co-named portfolios.

The incubator concept permits a financial services provider (FSP), who intends to be approved as a collective investment scheme (CIS) manager within the stipulated period, to white-label a fund, bearing the provider’s name. This allows the FSP to attain the required level of skills and experience to become an authorised manager. A co-named portfolio consists of an agreement between a CIS manager and a FSP, bearing the name of both parties, without the FSP intending on becoming a CIS manager. This co-branding exercise does, however, hold a definite reputational risk for the parties thereto.

6.4 THE IOSCO PRINCIPLES

The International Organization of Securities Commissions (IOSCO), representing more than 90% of the world’s securities markets in more than one hundred jurisdictions, has issued a policy document in May 2003, based on three objectives, namely, the protection of investors; the creation of fair, efficient and transparent markets; and the reduction of systemic risks. This document has set out the thirty basic principles of securities regulation, grouped into eight categories, namely the regulator; self-regulation; enforcement; cooperation; issuers; collective investment schemes; market intermediaries; and the secondary market.

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The principles can be summarised as follows:

**The Principles Relating to the Regulator**

1. The responsibilities of the regulator should be clear and objectively stated.
2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.
3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4. The regulator should adopt clear and consistent regulatory processes.
5. The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.

**The Principles for Self-Regulation**

6. The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

**The Principles for the Enforcement of Securities Regulation**

8. The regulator should have comprehensive inspection, investigation and surveillance powers.
9. The regulator should have comprehensive enforcement powers.
10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance programme.

**The Principles for Cooperation in Regulation**

11. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

The Principles for Issuers

14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors’ decisions.

15. Holders of securities in a company should be treated in a fair and equitable manner.

16. Accounting and auditing standards should be of a high and internationally acceptable quality.

The Principles for Collective Investment Schemes

17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.

18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor’s interest in the scheme.

20. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

The Principles for Market Intermediaries

21. Regulation should provide for minimum entry standards for market intermediaries.
22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.

23. Market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accept primary responsibility for these matters.

24. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

The Principles for the Secondary Market

25. The establishment of trading systems, including securities exchanges, should be subject to regulatory authorization and oversight.

26. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

27. Regulation should promote transparency of trading.

28. Regulation should be designed to detect and deter manipulation and other unfair trading practices.

29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

The South African regulator and security market have initiated many interventions during the last decade to comply with these principles as can be deducted from the 2010 IMF assessment. In para 9.2.3 the relevance of some of these principles in future developments of a regulatory model for trusts, is evaluated.

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6.5 TRADITIONAL SECURITISATION

The term “securitisation scheme” (which will include an asset securitisation scheme) was defined in the Banks Act as “a synthetic or traditional securitisation scheme as defined in Government Notice R681”. This Exemption Notice was repealed and replaced on 1 January 2008 in reaction to the Basel II Accord.

Basel II describes traditional securitisation as a structure where the cash flow from a pool of exposures is used to service two or more different stratified risk positions or tranches reflecting different degrees of credit risk. The potential payments to the investors are determined by the performance of the specified exposures.

Locke defines traditional securitisation as

“The pooling of a homogenous group of income-producing assets, the sale of these assets by the original holder to an insolvency-remote third-party and the issue by the SPI of marketable securities to finance the purchase of the assets.”

In terms of the 2008 regulation a traditional securitisation scheme is a scheme whereby an SPI issues commercial paper to investors and uses the proceeds primarily to obtain or invest in assets. The SPI makes payments primarily in respect of the commercial paper so issued, or to an institution acting in a secondary role. The payments are made from the cash flows from the transferred assets, the cash flows from other assets the SPI has invested in, or any other facilities granted to the SPI.

Asset securitisation permits a company to sell a pool of assets to a SPI, created for that purpose. A certain minimum percentage equity investment is required from an independent third party investor, which represents a legal equity ownership in the

46 Banks Act 94 of 1990, s 1.
47 GN R3, published in GG No 30629 of 01-01-2008, replaced GN R681 of 04-06-2004. The previous definition of a traditional securitisation scheme was consequently also amended.
48 Locke 15. She further categorises traditional securitisation schemes as either asset-backed (property and claims) or revenue stream-backed (intellectual property and whole business) securitisation.
49 The secondary party can be in the form of a provider of a credit-enhancement or liquidity facility, or an underwriter, purchaser, servicing agent or counterparty to the transaction.
50 See Meiring & Du Plessis 8-10.
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SPI. The third party investment is at risk and the percentage equity investment is based upon the market value of the assets.51

Businesses which generate assets that produce a steady stream of cash, such as credit card financing, fixed property mortgages and credit agreements on vehicle purchases, often experience cash flow pressures and need ingenious methods to provide them with the necessary cash in their businesses. A constant cash inflow is needed to enable these businesses to increase their books of credit and to sustain the momentum of providing for the needs of the constant credit hungry market. The current model for economic growth used in the developed world is debt and it is expected of credit providers to be able to address this need and in this way to stimulate the local and national economies.

One of the effective ways to satisfy these cash requirements is by the issuance of debt or equity securities, backed by the assets. The assets are, therefore, given as security against cash loans from investors. In this way the credit-giver becomes a borrower against the assets it has lent against to the general public. It was discovered that when the assets used as security are separated from the company who is borrowing the money from the investor, the funds can be raised at significantly lower costs. The reason for this phenomenon is the effective reduction of risk for the investor in cases where the borrower company, called the originator, lands in financial difficulties.52 The issuer benefits from the increased flexibility, lower cost of funds and better access to public and private capital markets, while the investor can diversify more effectively (beyond government bonds only) and receives a superior yield in a market that has previously been dominated by the banks.53

This process of structured finance needs to be available for financial institutions which are under pressure, but investors may be risk-averse when dealing with these companies. When the originating company can, therefore, effectively put some distance between itself and the investor, it creates a more affordable instrument, because the cost of credit is often relative to the risk associated with the credit.

This separation of risk is often accomplished by the originating company selling the assets to another entity, specially created for this purpose, and that special-purpose company then issues the securities, supported by the assets. These transactions are referred to as “structured financing” or “asset-backed securitisations”.

The main purposes of asset securitisation transactions are to raise capital and to share the risk of default on debt. This is achieved by the SPI issuing securities to investors in the capital markets, at a fixed or variable interest rate. The interest and principal debt due to the investor are paid from the income stream of the pool of assets purchased from the company.

In practice the lender (e.g. bank) does make a loan to the borrower. Then the lender sells the loan to a SPI. The SPI issues asset-backed instruments for cash to the investors and use the money to pay for the loans it bought from the lender. The borrower settles its obligations to the lender through the servicer. In some cases a trust will be appointed to monitor the servicer, thereby protecting the rights of the investor.

Historically, structured finance has been a business model for financially healthy businesses, but more recently it also became attractive to those experiencing financial difficulties. In the USA there are examples of officially bankrupt companies tapping into the public credit market by way of structured financing.

The two main purposes of the SPI is to insulate the asset from the lender’s risks – the so-called “insolvency remoteness”, and to ensure that the transfer of funds from the lender to the SPI cannot be interfered with, the so-called “off-balance sheet transaction”.

For a securitisation transaction to be effective, the sale of the assets must be in the form of a true sale transaction. If not, the asset will not be protected against the
potential insolvency of the seller and the purchaser will carry that risk. If a true sale took place, the sold assets may be removed from the balance sheet, and in the case of a bank, that will lower their regulatory capital requirements. The 2008 Exemption Notice prohibits the originator and its associated companies from having any rights to impose restrictive conditions on the ability of investors to exchange the securities issued by the SPI. The transferor may not retain any effective or indirect control over the assets. It is clear that the integrity of each transaction in the scheme must be protected to ensure that it cannot be regarded as a scam.

The SPI can fund only the purchase of the assets from the seller by way of the issuance of asset-backed securities in the capital market. The investors find the insolvency remoteness attractive and the SPI uses the cash flows generated by the assets to repay the investors.

The prescribed operational requirements for traditional securitisations are closely linked to the requirements for the true sale to take place and are, therefore, discussed as part of the true sale prerequisite.

6.6 SYNTHETIC SECURITISATION

Securitisation transactions where the assets are sold by the originator (often a bank) to the SPI, are called cash transactions, while a transaction where the assets are not sold, but only the credit risk of the assets are sold by way of credit derivative instruments, it is called a “synthetic securitisation scheme”, which is actually a combination of securitisation and credit derivative techniques. No real sale takes

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61 This will only be the case if the transaction also complies with the securitisation regulations. The requirement that the transfer of the assets to the SPI must divest the originator of all rights and obligations connected with the underlying claims and risks was again confirmed in the 2008 Exemption Notice.

62 The 2008 Notice created a new concept, namely the “clean-up call”. In a traditional scheme it is an option that makes provision for the commercial paper issued to be called or repaid before all the underlying exposures have been repaid. In a synthetic scheme it is a provision for the termination of credit protection when the amount of the underlying exposures is less than a specified amount. See Locke 274, who submits that the clean-up call provisions are only applicable to banks.

63 See 6.9.4 below.

64 Derivative contracts assume their value (a future price for a specific asset) from the price of an underlying item, such as a commodity (e.g. wheat or gold), a financial asset (e.g. equities or bonds) or an index. See Hudson “Dealing with Derivatives” www.alastairhudson.com (accessed 12-01-2011).
place in the case of a synthetic transaction and the assets remain on the bank’s balance sheet.

Basel II describes synthetic securitisation as a structure with at least two different stratified risk positions or tranches that reflect different degrees of credit risk. The credit risk of the pool of exposures is transferred by way of credit derivatives (e.g. credit-linked notes or credit default swaps) or guarantees, with the purposes of hedging the credit risk of the portfolio. The investors’ risk is, therefore, directly linked to the performance of the asset pool.65

The Exemption Notice defines a synthetic securitisation scheme as a scheme through which an SPI issues commercial paper to investors and uses the proceeds primarily to obtain credit-risk exposure relating to an underlying asset, by using credit-derivative instruments, guarantees, or other assets, as collateral.66 The payments are made by the SPI from the cash flows arising from the assets that serve as collateral and from the premium paid to the SPI by the originator.

During the synthetic process the originator does not sell the physical asset to the SPI, but only transfers the pool of risk by way of a credit derivative instrument. The purpose of credit derivatives is to isolate and transfer the risk similar to an insurance contract against credit losses. One of the advantages of credit derivatives is the fact that they are tradable instruments. Synthetic securitisation is the combination of credit derivatives (often in the form of a credit default swap) and securitisation.

As no actual sale of assets takes place, the process is often quicker and simpler to implement than with traditional securitisation. The most popular transaction is the synthetic collateralised debt obligation (CDO), with the underlying assets being loans or bonds. CDOs are popular for both balance sheet purposes and for regulatory arbitrage.67

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65 The exposures in a securitisation transaction may manifest in many different forms: asset-backed securities, mortgage-backed securities, credit derivatives, liquidity facilities, credit-enhancement facilities, interest swaps or currency swaps, etc.

66 GN R3 in GG No 30629, dated 01-01-2008.

67 Smith 289-290. Regulatory arbitrage is elsewhere described as the process in which parties “take advantage of a gap between the economics of a deal and its regulatory treatment”, with the main purpose being the reduction of regulatory costs without losing the financial benefits of the deal. The central regulatory issue is that of minimum capital requirements.
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The operational requirements for synthetic securitisation transactions have been extended in accordance with the Basel II requirements\(^\text{68}\) to include the following:

(a) when calculating a bank’s required capital and reserve funds, the provisions for credit-risk mitigation instruments (including credit derivatives) now also apply to synthetic securitisation schemes;

(b) eligible collateral in respect of a bank’s risk exposure is limited to specific instruments only;

(c) banks must calculate any maturity mismatches in respect of credit protection obtained in accordance with the relevant requirements;\(^\text{69}\)

(d) banks and institutions that wish to recognise the risk mitigation effect on a scheme must obtain an independent legal opinion to confirm the bank’s compliance with the prescribed conditions and the enforceability of the contracts;

(e) all contractual arrangements relating to a clean-up call in respect of risk transferred to the SPI must comply with the specified conditions.\(^\text{70}\)

6.7 THE KEY PARTIES TO THE TRANSACTION\(^\text{71}\)

6.7.1 THE ORIGINATOR

The term “originator” is used in a securitisation transaction with reference to the seller of the assets who usually continues to administer and collect the cash flows from the assets.\(^\text{72}\) It either extends finance to the borrower or it purchases the asset portfolio form a third party. Banks are the most obvious originators, but any financial institution, many businesses, and even national governments or local government

\(^{68}\) See para 5(2) of the Exemption Notice R3 of 01-01-2008. See Meiring & Du Plessis 41-43 for a detailed discussion of the effect of the regulations on synthetic securitisations.

\(^{69}\) A maturity mismatch occurs when the residual maturity of the credit protection obtained in the form of eligible collateral, guarantees or credit derivative instruments, is less than the residual maturity of the underlying credit exposure.

\(^{70}\) A clean-up call is an option that permits the securitisation exposures to be called before all of the underlying exposures have been repaid. In the case of synthetic transactions it takes the form of a clause that extinguishes the credit protection.

\(^{71}\) See Smith Implication of Basel II 39-43.

\(^{72}\) Smith Implication of Basel II 26. See also Prinsloo 2.
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authorities can act as originators. The originator often also acts as servicer of the
debts and collects the payments from the borrowers.

It is described in the regulations, in relation to a *traditional securitisation scheme*, as
“an institution that transfers assets from its own balance sheet”, and, in relation to a
*synthetic securitisation scheme* as “an institution that uses a credit-derivative
instrument to transfer the risk associated with a specified pool of assets to investors
without actually selling the assets”. 73

In the securitisation process the originator not only controls the cash flow but also
retains some of the profits generated by the assets.74 The originator is really the
seller of the assets and contracts with the special-purpose institution. In traditional
securitisation schemes the originator transfers the assets by way of a sale
transaction to the SPI, which process must divest the originator of all rights and
obligations connected with the underlying claims. All risks in connection with the
assets must also be transferred to the SPI. In the 2008 Notice this requirement was
extended to the associated companies of the originator being prohibited from having
any right to impose restrictive conditions on the ability of investors in the SPI to
pledge or exchange the securities issued by the SPI.

The originator is expressly prohibited from retaining any effective or indirect control
over the assets after it was transferred to the SPI. The assets must be beyond the
reach of the originator – even in the event of insolvency. The originator may,
however, still service or administer the asset, as that is not regarded as a controlling
function. In practice the originator usually continues to administer the asset pool.75

6.7.2 THE BORROWER

The borrower76 takes a loan from the originator against its assets being securitised.
Its repayments create the cash flows which service the securitisation transaction.
The parties to the transaction put their trust in the future payments by the borrower.
The borrower is not a direct party to the securitisation transaction and would usually

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73 GN R2 in GG 30628, dated 01-01-2008, in terms of the Banks Act 94 of 1990 (as amended).
The term “originator” has to be read with the definition in the regulations of the terms of “remote
originator” and “repackager”.
76 Often referred to as the “obligor”.

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not even be aware of the scheme. The borrower does, however, fulfil a crucial role in the scheme as the cash flows needed for the transaction to be successful is dependent upon the borrowers’ regular repayments.

6.7.3 THE SPECIAL-PURPOSE INSTITUTION

The special-purpose institution (SPI)\(^{77}\) is a company (public or private) or a trust that purchases the assets to be securitised, from the originator, and pays for the transaction by the issuance of securities, like debt instruments.\(^{78}\) The SPI acts only as the issuer of the securities which are backed by the securitised assets, and has no other obligations and should not incur any other liabilities.\(^{79}\)

In the South African model of securitisation one finds two SPIs, namely the issuer SPI and the security SPI. The issuer SPI is established with the purposes of purchasing specific assets and then funding them in the capital markets. The role of the issuer SPI is, therefore, to isolate the assets from the originator, which process results in lower funding costs compared to the process of factoring, which is relatively expensive.\(^{80}\)

SPIs are firstly used to isolate identifiable assets or risks into a stand-alone, self-sustained entity which does not have any other substantive operations, and secondly to facilitate the true sale nature of the transaction. The issuer SPI has no other business interest except its role as a separate legal instrument.\(^{81}\) The security SPI holds the security note and guarantees the obligations of the issuer SPI to the

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\(^{77}\) In South Africa the securitisation regulations refer to a special-purpose institution (SPI), which is in some jurisdictions called a special-purpose vehicle (SPV), a special-purpose entity (SPE), or a special-purpose corporation (SPC). The structured investment vehicle (SIV) normally refers to an entity that operates in a manner similar to a conduit, but which does enjoy credit support from a bank. See the definitions in Tett 320–323. In South Africa the term “special-purpose institution” has been legislated and shall, therefore, be used in this thesis, except where reference is made to certain foreign jurisdictions where SPVs or SPEs are used. The SPI is also discussed in 6.7.3 as a feature of the securitisation transaction.

\(^{78}\) Wood 459 refers to legislation in some jurisdictions, such as France and Argentina, providing for the use of the trust in securitisation structures.

\(^{79}\) In terms of the Exemption Notice (GN R3, published in GG 30629, dated 01-01-2008) the SPI may not be involved in any transactions that are not directly linked to a securitisation scheme.

\(^{80}\) Smith Implications of Basel II 26-27.

\(^{81}\) Dreyer 2.
investors. In return for this guarantee, the issuer SPI cedes its mortgage rights to the security SPI.\footnote{Karoly 44. In the case of commercial mortgage-backed securitisation, a third SPI, the borrower SPI, is created.}

According to Gorton\footnote{Gorton & Souleles 1. See further Schwarcz “Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures” 2002 University of Cincinnati Law Review.} the existence of the SPI “depends on implicit contractual arrangements, that avoid accounting and regulatory impediments”, with the purpose to reduce the costs of a possible insolvency.

A “special-purpose institution” is defined in the regulations to the Banks Act as

\begin{quote}
“a company or a trust, insolvency remote, incorporated or created solely for the purpose of the implementation and operation of a traditional or a synthetic securitization scheme”\footnote{GN R681, s 1, and later replaced by GN R3 of 01-01-2008.}
\end{quote}

and it is, therefore, clear that special-purpose entities in the South African context can be created by making use of a company or a trust.\footnote{Companies are statutory creations regulated by the Companies Act 71 of 2008. Trusts are mainly regulated by the common law, assisted by the TPCA. Rosenthal & Ocampo 47 states that the SPV in the US may be in the form of a corporation, a trust or a partnership. Tax considerations often play a central role in determining the form of legal entity to be used as SPV. In some cases the SPV is in the form of a company and its shares are held by a trust, called an “issuer owner trust” which stands surety for the performance of the issuer (SPV) by pledging its shares in the issuer as security.} Non-banking institutions may also initiate special-purpose vehicles and as there is no prohibiting legislation, it is submitted that these entities may also be in the form of either a private or public company or a trust.

The transaction between the originator\footnote{See Banks Act regulation definitions of “originator” and “remote originator”.} and the SPI must be at arms-length to ensure that the assets held by the SPI are adequately protected against the originator’s potential creditors. This aspect of “legally segregating the collateral” from the originator or seller for the benefit of the asset-backed securities holder is often referred to as “bankruptcy remoteness”.\footnote{http://thismatter.com/money/bonds/types/abs/special-purpose-entity.htm (accessed 17-04-2010).} The only risk that the SPI takes is with respect to the securities issued to the investor, and as the securities are covered by the assets, the risk is minimal. To ensure this feature the SPI should not appear on
the originator’s balance sheet, and in the case of a traditional securitisation scheme the transaction between the two parties must be an outright sale.  

The United States Financial Accounting Standards Board identifies the SPI as an investment entity with the following characteristics: it is “demonstrably distinct” from the originator; it has a limited purpose; it holds passive receivables; and it retains the right to sell non-cash receivables if it needs cash to reimburse investors.  

The SPI is a global term and can be either onshore or offshore. Tavakoli describes it as “powerful structured finance tools” and states that they are used to facilitate bank balance sheet management and the creation of new investment classes, which have been to the benefit of both the banking and the investment community. She does admit that SPIs are vulnerable to illegitimate uses, such as money laundering, revenue contraventions, embezzlement and accounting improprieties, and even its legitimate uses are sometimes “ethically marginal”.  

The SPI normally has no office and no employees, with minimum capital outlay. Its administration is performed by a trustee who follows specific rules with regard to the receipt and distribution of cash. The assets are serviced in terms of a servicing agreement. SPIs have been referred to as “essentially robot firms”. They are sometimes also purely used for tax arbitrage-related transactions.  

It is often beneficial to have an offshore SPI. In the United States, jurisdictions like Bermuda, Cayman Islands and British Virgin Islands are popular for these purposes, because of their tax friendly regimes. Because of the fact that the SPI is normally

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88 See Tavakoli. This “true sale at law” is also sometimes referred to as a “conveyance”.
90 Takavoli 1. She is of the opinion that the negative publicity that SPVs receive is a result of the fact that the underlying causes of certain financial scandals have not been addressed.
91 Ibid 1. See Locke 34 in this regard. In the US the Sarbanes-Oxley Act 2002 instituted minimum reporting standards in financial statements regarding off-balance sheet transactions and the activities of special-purpose entities.
92 Gorton & Souleles 1-2. They are real entities and not merely virtual firms, although they operate in a virtual manner, without any infrastructure of note.
93 Ibid 2.
94 According to ibid 8 the profits in an SPV should not be taxable as it is already taxed in the sponsoring entity.
more concerned about the fulfilment of a specific purpose than about the benefit of a beneficiary, it became known as the “purpose trust” in some jurisdictions.\footnote{Ibid 7.}

Smith identified the following criteria for establishing and operating an SPI.\footnote{Smith Implication of Basel II 300-302. In case of a trust as SPI, its deed should make provision for these principles, which are mostly set out in the Securitisation Regulations and are broadly in line with the rating agencies’ standards. Some of these provisions may not necessarily be included in the trust deed, but must be then at least in the agreement between the SPI and the originator.}

(a) the SPI should be restricted to the purchasing of shares and the issuance of securities to fund such purchase;

(b) the income from the issuance of securities by the SPI should not be exposed to any third parties, but only to meet its obligations towards the investors;

(c) the SPI should be restricted from incurring liabilities other than the issuing of securities for the purpose of the specific transaction;

(d) the SPI should be restricted from changing control, or to merge, consolidate, liquidate or dissolve while the securities are still outstanding;

(e) the SPI should be restricted from transferring or selling the assets while the securities are outstanding;

(f) the deed and other organisational documents should not be changed while the transaction is on-going;

(g) there must be at least two independent trustees, which shall exclude shareholders, directors, employees, major suppliers or professional advisors (lawyers and accountants) of the originator;

(h) the assets and funds of the SPI may not mix with those of the originator;

(i) the SPI must have its own separate bank accounts, books of account and financial statements;

(j) the SPI must have adequate funds for its purposes and scope and must pay its liabilities from its own funds;

(k) the originator must not provide any guarantees to the SPI;
(l) all transactions with the originator and its affiliates must be at arms’ length;

(m) the SPI must maintain good corporate governance;

(n) the SPI must conduct its business in its own name;

(o) the SPI must operate as an independent business and even have separate stationary, etc.;

(p) the SPI should insist on an undertaking from the originator not to apply for the winding-up or administration of the SPI within two years of all investors being paid in full (the non-petition clause);

(q) the SPI should insist on an undertaking that no party shall enforce any claim against the assets of the SPI, except to the extent provided for in the priority of payments according to the securitisation transaction (the limited-recourse clause).

The special-purpose institution is further discussed in 6.7.1 as one of the key features of the securitisation transaction.

6.7.4 THE ADMINISTRATOR

The administrator manages the flow of cash, the accounting responsibilities, recordkeeping, tax and other statutory returns, as well as all other administration services necessary to ensure the efficient and effective administration of the issuer. The originator often continues to act as administrator, even after a true sale of the assets to the special-purpose institution has taken place.

Although the originator is expressly prohibited from retaining any effective or indirect control over the assets after these were transferred to the SPI, the originator may continue to act as administrator regarding the asset, as that is not regarded as a controlling function.97

6.7.5 THE INVESTOR

The investor is the one who invests in the security issued by the special-purpose institution and in return holds the security associated with the assets. They are

commonly referred to as note holders and are usually pension funds, banks, unit trusts, hedge funds, insurance companies, or other business enterprises.

6.7.6 THE TRUSTEE

The trustee acts on behalf of the holders of the securities to ensure orderly payment of the interest and the principal debt to the investors. The trustee acts as intermediary between the issuer and its creditors and can act in the event of default by the issuer. The trustee holds a fiduciary position in relation to the investor. The trustee also appoints the directors of the issuer owner trust and the security special-purpose institution trust.

6.7.7 THE RATING AGENCY

Although the rating agency stands separate from the functioning of the securitisation transaction itself, it is one of the most important parties in the scheme, because it must provide the investors with an independent opinion on the creditworthiness of the financial instrument.98

Without the support of a rating agency the transaction will not find that the support of investors and the transaction will wither. The role of the rating agency is ongoing through the life of the instrument. The rating is concerned with both the regulatory issues and the structural protections built into the transaction, as a poorly structured transaction may jeopardise the effective transfer of ownership of the assets, which may be detrimental to the legal position of investors. In general, rating agencies evaluate three types of risk, namely credit risk (risk of default), structural risk (structure of the transaction) and legal risk (regulatory environment and aspects).99

Securitisation transactions are often complex and intricate, which make them difficult for investors to analyse and institute proper due diligence processes. In this sense rating agencies became indispensable mechanisms in the securitisation environment. The agency’s task is to assess the risk level of the instrument by a determination of the borrower’s ability and preparedness to make full and timely payments.98

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98 See Coval et al 1-36 for detailed discussion on the “spectacular rise and fall” of structured finance and specifically the role of the rating agency in this process.

99 Smith Implication of Basel II 290-291. See Locke 50-57 for detailed discussion on the role, the mechanisms and the regulation of rating agencies.
payments of the contractual principal and the interest. It does not evaluate the SPI as such, but the probability of default of the specified class of securities.

Credit ratings provide an objective assessment that allows investors to compare the risk of different transactions as the ratings of the agencies are generally comparable. Coval et al, however, show how slight misinterpretations by rating agencies of some underlying and systematic risks in structured financial transactions can have major negative results for the parties to the transaction. The transaction is completed by way of the two-set process of pooling and tranching. During the pooling process a collection of credit sensitive assets is placed in a portfolio, which is called the special-purpose institution. The portfolio would justify a credit rating equal to the average rating of the underlying pool of assets. In the second process a capital structure of prioritised claims are put in tranches, based on their potential to absorb losses from the underlying pool.

This is done with the purpose of enhancing the credit rating, as a larger number of securities included in the underlying pool can effectively result in a higher credit rating than the average rating of the individual underlying assets. The reality is, however, that the precise structure of the collateralised debt obligations has a major effect on the inherent default risks. It is so much harder for rating agencies to evaluate correctly the joint risks of the underlying pool of assets, compared to single-name securities.  

The quality of the underlying asset pool is only one of the factors to be taken into consideration by the rating agency. The full transaction structure, including the legal issues such as the insolvency remoteness of the SPI, the true sale nature of the asset transfer, the legal obligations of the originators, the enforceability of security by the note holders, regulatory requirements, and the local and international tax implications of the transaction are considered by the rating agency. Other aspects, such as the credit enhancement facilities built into the structure, shall also be evaluated.

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100 Coval et al 5-11.
101 Smith Implication of Basel II 157-158. In assessing the risks in asset-backed securities, three types of risk are considered, namely credit risk, structural risk and legal risk.
The Ministry of Finance has announced that currently unregulated activities, such as the functioning of rating agencies, will be affected by future regulatory initiatives.\footnote{See “A Safer Financial Sector to Serve South Africa Better” National Treasury Policy Document 2011 \url{www.treasury.gov.za} (accessed 03-06-2011).} This was indeed followed by the Credit Rating Services Bill of 2011.\footnote{The Bill was published for comment after having been approved by Cabinet on 26 July 2011.}

### 6.7.8 THE SERVICING AGENT

The servicing agent fulfils an important administrative function and is responsible for the collection of the principal debt and the interest payable by the debtor, derived from the pooled asset. The income is transferred to the special-purpose institution or to the trustee, who in turn, must pay the investor. The originator often acts as the servicing agent.

Other parties to the securitisation process can include the following: third party creditor, issuer owner trust, security SPI, liquidity provider, credit enhancement provider, hedge facility provider, arranger, lead manager, placement agent, underwriter, auditors, settlement agent and account bank.

The following chart illustrates the interaction amongst the different role players in the traditional securitisation transaction:
ILLUSTRATION 5: INTERACTION IN TRADITIONAL SECURITISATION TRANSACTION

- BORROWER
- ORIGINATOR
- SPI
- INVESTOR
- ADMINISTRATOR
- SERVICING AGENT
- RATING AGENCY
- TRUSTEE
6.8 LEGAL STRUCTURING OF THE TRANSACTION

The legal structuring of securitisation transactions is of some importance. The legal position of all the parties to the transaction is affected by the structuring. Especially the investors in securitised products should be properly protected as far as their legal position over the assets, relative to that of the originator, is concerned. If the necessary protection between the respective parties is not provided or the enforceability of the terms of the agreements is not adequately included, the transaction may become extremely risky. The rating agencies usually require legal opinions as to the viability and correctness of the structuring. Poor or faulty legal instruments can, therefore, affect the rating and the consequent performance and viability of the transaction.

The legal entity used as SPI, whether a company or a trust, must be duly incorporated. The memorandum of incorporation or the trust deed must authorise the transaction parties and the SPIs to enter into the different agreements and to perform their respective obligations. In the case of a trust the deed must comply with all the requirements of a valid trust to ensure that an independent entity comes into being. If no valid trust exists the trustees may be personally liable or the assets of the bogus trust may have vested in the beneficiaries, or in the originator, whose insolvency may be catastrophic to the investors.

The legal structure must further ensure that a true sale can take place and that the investor’s claims are adequately secured. The insolvency remoteness of the issuer SPI and the non-consolidation of the issuer’s and the originator’s assets must be protected by the structure and the underlying documentation.\(^{104}\)

\(^{104}\) Karoly 69-70, with reference to Fitch Ratings 2004 and 2006. See the reference on 70 to the aspects to be addressed in terms of the Fitch Ratings when the originator makes use of a multi-issuance vehicle. Aforementioned must achieve the same desired results for the investors as a single issuance would have had.


6.9 **KEY FEATURES OF THE TRANSACTION**

For the purposes of this thesis only a few relevant features shall be discussed in any
detail. Aspects such as assets, securities, and liquidity support will not be discussed
although they are important features of these transactions.

The combination of special features of securitisation transactions makes them unique
and is the real reason why these structures are used in the financial environment.
Without these characteristics these transactions will have no justification in the first
place. The vehicles used, such as trusts, must, therefore, be equipped with these
traits to justify their inclusion in the process.

6.9.1 **SPECIAL-PURPOSE INSTITUTIONS**

The special-purpose institution has been discussed in 6.6.3 as one of the key parties
to the securitisation transaction.

Although special-purpose institutions (SPIs) are not unique to securitisation
schemes, they can be regarded as the most important feature of these transactions.
The SPI fulfils a central role in the securitisation process and may be established as
either a company or a trust.

The originator transfers ownership of a pool of loans to the SPI by way of a sale
transaction and the aforementioned pays for the assets by the issuance of securities,
which are again backed by the asset pool. The SPI is actually a shell with its main
purpose the holding of the assets on behalf of the investors. The risk is transferred
from the originator to the investor through the SPI, as the investors have to absorb
the risk of non-payment by the borrower. The SPI forms a wall between the two
levels of risk. It protects the investor from the credit risk of the originator and it
protects the originator from the risk of non-performance on the assets.

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105 See Smith *Implication of Basel II* 43–57. He states that the structures shall vary according to
the objectives of the originator, the targeted investors and the type of assets involved, but there
are some common features. See Smith 43-46 for the different attributes of the assets and the
types of bonds as securities. The investors in a securitisation transaction have the right to
receive payment of the interest and principal in terms of the loan agreement.

106 The special-purpose institution has already been discussed as one of the central parties to the
securitisation transaction. Special-purpose institutions have been used for a variety of other
financing purposes, like joint ventures, isolation of certain assets or operations, and in economic
empowerment transactions. The SPI was also discussed in 6.7.3 as part of the parties to the
securitisation transaction.
Chapter Six: Securitisation

The cash needed to serve the SPI’s obligations towards the investors, to manage the process and to ultimately repay the principal debt, is generated from the underlying asset. The purchaser SPI is owned by an owner trust that is established with the sole purpose to own, as beneficial shareholder, all the ordinary shares in the capital of the SPI.\(^{107}\)

6.9.2 INSOLVENCY REMOTENESS

SPIs are normally designed in such a way that they cannot become insolvent and securitisation as instrument, therefore, reduces the amount of assets that are subject to the potential insolvency of the originator.\(^{108}\)

The term “insolvency remote”\(^ {109}\) in respect of a special-purpose institution means that the assets of the SPI shall not be subject to any claim of an institution\(^ {110}\) which is transferring assets in terms of a traditional securitisation scheme, or is transferring risk in terms of a synthetic securitisation scheme, to the SPI, as a result of such a transferring institution’s insolvency.\(^ {111}\) The main focus of the insolvency remoteness principle of SPIs lies not in the non-insolvency of the SPI, but in the protection of the SPI from the potential insolvency of the originator. The SPI itself should in any event never undertake any action that may put it at risk.

Smith\(^ {112}\) submits the following requirements for a SPI to achieve insolvency remoteness:

(a) the SPI must neither be owned nor controlled by the originator;\(^ {113}\)

(b) the SPI must have its own board with independent directors;

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\(^{107}\) Smith *Implication of Basel II* 300.

\(^{108}\) Gorton & Souleles 187 for an analysis of the questions of choice of law when dealing with insolvency of parties to securities in the international financial arena. Although they are structured against insolvency it does not necessarily mean that SPIs can never become insolvent.

\(^{109}\) GN R2 in GG 30628, published on 01-01-2008.

\(^{110}\) “Institution” includes a bank or any other institution within a banking group.

\(^{111}\) See the difference between a traditional and a synthetic securitisation scheme in terms of the definitions in the aforementioned Regulations.

\(^{112}\) Smith *Implication of Basel II* 47.

\(^{113}\) To achieve this position effectively the shares or other form of ownership in the SPI is normally held by an independent trust.
(c) the SPI deed (in case of a trust) must restrict its ability to declare insolvency (except when approved by the board);

(d) the SPI must not be involved in any other business activities besides the securitisation;

(e) the SPI’s assets, bank accounts and record keeping must be kept separate from those of the originator;

(f) the SPI must carry its own expenses and must not be subsidised by the originator;

(g) the originator must disclose to its creditors that the assets of the SPI are separate and not available to satisfy their claims;

(h) all dealings between the originator and the SPI must be an arm’s-length transaction.

6.9.3 OFF-BALANCE SHEET FINANCE

One of the reasons for the severity of the 2008 financial crisis was that many national banking sectors had built up excessive on-balance-sheet and off-balance-sheet leverage, from a low and poor quality capital base.\(^{114}\)

If a bank creates a securitisation vehicle and sells a pool of mortgage bonds to a SPI by way of a proper sale transaction, the assets are moved from the balance sheet of the lender to the balance sheet of the SPI. This is then referred to as an off-balance sheet financial transaction from the bank’s perspective.\(^{115}\) Off-balance sheet finance takes place by way of carefully designed SPIs, to avoid insolvency. It is a way to separate the control rights to the business decisions effectively from the financing decisions. The SPI sponsor maintains control over the business decisions, while the

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\(^{115}\) On 31 December 2009, 13.4 per cent of the banking sector’s total assets were expressed as off-balance sheet items.
financing is done in the passive SPI, without any involvement by it in the business decision-making process.\textsuperscript{116}

Off-balance sheet financing makes it possible for the sponsor to actually finance itself by separating control right over assets from the financing itself. The SPI receives minimum control rights and only acts as administrator, but in theory it is a remote entity. The sponsor, therefore, can finance new projects by using cash flows already generated as collateral on previous projects.\textsuperscript{117}

It is important to realise that there is a distinction between an “accounting” balance sheet and a “regulatory” balance sheet. Assets sold by way of cash flow securitisation or synthetic securitisation, are treated as off-balance sheet from a regulatory perspective although they remain on the bank’s balance sheet for accounting purposes.

\textbf{6.9.4 TRUE SALE PRINCIPLE}

The true sale principle is applicable to all traditional securitisation schemes and is also regulated by the Exemption Notice in terms of the Banks Act.\textsuperscript{118}

One of the purposes of the securitisation process is to separate the credit risk of the asset pools from that of the originator. To achieve this, a proper transfer of the asset pool to the SPI is necessary, to separate the assets legally from the originator and consequently protect the assets effectively from the potential insolvency of the originator. The insolvency-remoteness principle will not grant any protection to the asset pool if the sale of the assets is not real.

If the creditors of the originator are successful in any attempt to get their hands on the securitised asset pool, the investors in the SPI would have no protection and the insolvency remoteness of the SPI would be meaningless. In this scenario the SPI investor cannot even institute a claim against the originator as his only recourse is against the SPI itself.

\textsuperscript{117} Gorton & Souleles 45-46.
A true sale, therefore, requires the transfer of all the risks and benefits of the assets to an SPI. In terms of South African law a true sale can only be achieved by way of a sale and cession of the assets. The seller sells the assets to the SPI and then cedes all related rights also to the SPI.\(^{119}\)

The seller shall not retain any legal rights in the form of beneficial ownership over the assets as such transaction may give effect to a secured or unsecured loan. An unsecured loan will expose the SPI to the risks of the seller and its investors will rank below the seller's secured creditors. If it is regarded as a secured loan the assets will also remain part of the property of the seller and the SPI's interests may be subject to the seller's other secured creditors.

It is even possible that the seller's other creditors will be able to claim amounts paid in respect of the securitised assets, including amounts already paid over to investors in the SPI.\(^ {120}\) Wood\(^{121}\) submits that the receivables must not remain assets of the originator, the financing notes must not be a liability of the originator for the purposes of its insolvency, or reflected on its balance-sheet, or the transaction being re-characterised as a security interest of the originator.

Certain dispositions by the seller may, in the event of the seller's insolvency, run the risk of being of no effect. In terms of the Insolvency Act 24 of 1936 (as amended) dispositions made without value (section 26), voidable preferences (section 29), undue preferences (section 30), collusive dispositions (section 31), and voidable sales of businesses (section 34), are all examples of situations under which a true sale did not take place. A court may also set a disposition aside in terms of the \textit{actio pauliana} if it is proved that it had been made by the insolvent party with the intention of giving one creditor an unfair advantage over other creditors. Part of the rating agency's functions would be to ensure, by way of proper due diligence processes that these risks do not exist.

It is important that the seller has the legal right to sell the asset and that such sale is not prohibited in terms of the underlying contract between the originator and the

\(^{119}\) See Schwarcz "Securitisation Post-Enron" 4-9, for the potential negative impact that re-characterisation-legislation in the US may have on the true sale principle and ultimately on the whole securitisation process.

\(^{120}\) Smith \textit{Implication of Basel II} 298.

\(^{121}\) 452-453.
borrower. Where no prohibition is operative, the seller does not need the consent from the borrower and does not even have to give him notice of its intention to sell the assets.122

Smith123 mentions a few factors which may be effective presumptions against a true sale:

(a) an obligation on the part of the originator to repurchase or exchange any or all of the assets in the pool;

(b) any legal recourse through which a risk of loss from the asset pool could be retained or returned to the originator;

(c) any obligation of the originator to a third party for the payment of interest and/or principal with regard to the asset pool;124

In terms of the Exemption Notice,125 a true sale is likely to occur when the conditions relating to a limited association are met. Some of the most important aspects of these conditions, which have been brought in line with the Basel II requirements, are the following:126

(a) total divesting by the originator of all rights, obligations and risk originating from the underlying transactions and all risks in connection with the transferred assets;

(b) any holder of an instrument subsequently issued by the SPI must have the right to pledge or exchange the instrument without restriction;

(c) the transferor must not maintain any effective or indirect control over the assets transferred;

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122 Smith Implication of Basel II 296.
123 Ibid 48.
124 The originator may provide specific paid services in regards to the management of the asset pool, but such must it be as an independent third party and not linked to its position as originator.
125 GN No R3, dated 01-01-2008.
126 See Meiring & Du Plessis 8-10.
(d) if the transferring institution is a bank, it must obtain an opinion from an independent legal adviser to confirm that it has complied with all the requirements;

(e) commercial paper issued to investors by the SPI in respect of assets transferred, must not constitute a direct or indirect obligation of the transferring institution;

(f) the transaction must not contain any provisions that require the transferring institution to alter the underlying exposures, resulting in the improvement of the credit quality; or, allow for increases of a credit-enhancement facility by the transferring institution to the SPI; or, increase the yield payable to third parties involved in the scheme;

(g) any contractual arrangement relating to a clean-up call in respect of the assets transferred to the SPI must comply with specified conditions.\textsuperscript{127}

Other requirements are that no right of recourse for costs, expenses or losses by the SPI regarding the assets, may be created; where the funds are to be collected by another institution, the SPI may receive only funds actually collected by this other institution; and the assets may be replaced only or substituted as prescribed in the Notice.

It is submitted that, over and above the above requirements, the transaction must also be a valid contract in all respects and consensus regarding the asset (merx) and the price thereof must be present. It is imperative for the parties to have the necessary intention to effect a sale.\textsuperscript{128}

6.9.5 CREDIT ENHANCEMENT

Credit enhancement is defined in the 2008 Regulations as “any facility or arrangement in terms of which the provider of such a facility or obligor under the

\textsuperscript{127} A clean-up call is an option that permits the securitisation exposures to be called before all of the underlying exposures have been repaid. In the case of traditional securitisations this is done by repurchasing the remaining securitisation exposures, as soon as the outstanding securities are below a certain level. See Meiring & Du Plessis 41-43.

\textsuperscript{128} See Gerstle “True Sale requirements for Securitisation Schemes” 2007(11) \textit{Without Prejudice} 33-35 for a discussion on the necessary intention of the parties. See also the summary by Wood 468 of the main aspects of the true sale principle.
arrangement is obliged to absorb losses associated with the assets transferred in terms of a traditional securitisation scheme; or the risk transferred in terms of a synthetic securitisation scheme”.

As all the claims transferred to the SPI must be adequate to cover the payments due to the investors, shortfalls are often covered by credit enhancement mechanisms. The purpose of credit enhancement is, therefore, to protect investors from unnecessary credit risks. The third party who issues the credit enhancement must have a credit rating equal to that of the SPI or higher. The enhancement process absorbs some of the potential losses and, therefore, improves the credit rating of the structure which makes it much more attractive to investors. To market a securitised product to investors effectively, one of the major requirements is the potential built into the product that the investor will receive the payments due to him.

Smith\textsuperscript{129} submits that credit enhancement can provide a source of funds to supplement the payment of scheduled interest and principal to investors, and, can be used to allow different tranches of securities to achieve ratings that are even higher than what the assets themselves can support. The rating agency often creates a credit enhancement, reflecting the potential loss level relative to pre-determined risk scenarios.

The enhancement, structurally or externally, may cover the historical default rate of the assets several times. External enhancement normally involves letters of credit, insurance or third party guarantees. Structural (or internal) credit enhancement usually reallocates losses amongst the participants in the structure without the involvement of outside resources, by using a variety of methods, such as subordination (subordinated tranches absorbing the losses of senior tranches), excess spreads (the difference between the return and the debt), cash reserve accounts and hedging facilities (e.g. currency swaps).\textsuperscript{130}

\textsuperscript{129} Smith Implication of Basel II 48.
\textsuperscript{130} See Smith Implication of Basel II 49-57 for a detailed discussion of these and other internal (structural) credit enhancement techniques, such as “overcollateralization”, trigger events, early repayments, prepayment risks, profit extraction, liquidity support, default events, and payment priorities. Compare Locke Traditional Securitisation 48-50 for detailed discussion on some credit enhancement techniques.
The credit enhancement provider is a highly rated party and often issues a financial guarantee to achieve the desired rating for the security.

6.9.6 UNDERWRITING AND PLACING

The term “underwriting” is defined in the regulations as

"exposure that includes all underwriting commitments, whether in writing or verbally, including all note-issue facilities and revolving underwriting facilities in respect of which the contingent risk arises from the bank’s role as underwriter of such issues, guaranteeing to provide funds when other parties have refused to do so."131

It is unfortunate that the definition refers to banks only as it should have included all underwriting parties.

Underwriting takes place when one party (the dealer) purchases the issue of a new security and accepts the risk of selling the security again in the market. The difference between the price at which the bond is purchased from the issuer, and the price at which it is offered to the public, is the underwriting fee.132

6.9.7 HEDGING

Hedging is a strategy to protect parties against the risk of an adverse outcome.133 As investors in securitisation transactions should not be exposed to currency and interest rate risks, the special-purpose instrument often enters into a hedging facility, like a currency or interest rate swap. In a currency swap an asset or liability can be switched from one currency to another and swapped back to the original currency at maturity. In an interest rate swap the asset or liability is switched from a fixed rate basis to a floating-rate basis, or *vice versa*.134

6.9.8 SERVICING

The “servicing agent” is defined as “an institution that acts as servicing agent in relation to the collection of the amounts due in terms of a traditional or synthetic

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131 S 1 of Notice 2, GG 30628 dated 01-01-2008.
132 Van Zyl et al 312. See Smith *Implication of Basel II* 42.
133 Van Zyl et al 478.
securitisation scheme”.135 The originator often acts as servicer in the collection of the principle debt in the form of securitised claims, and provides the debtor collections on behalf of the issuer. The servicer transfers the claims and interest to the trustee or to the special-purpose instrument.

The investors rely on the cash generated from the assets and expect the servicer to deliver, as he has no recourse against the originator. If the servicing agreement is closely related to the sale agreement, it may raise questions about the proper compliance with the true sale principle.136

6.10 SECURITISATION ASSET CLASSES

6.10.1 ASSET-BACKED SECURITIES (ABS)

Any asset with a steady revenue stream can be securitised into a negotiable debt security. Asset-backed securities are normally collateralised by loans or other financial assets, with asset-backed securitisation being defined as “a creative way of raising funds through the issuance of marketable securities backed by future cash flows from revenue-producing assets.”137 Simply put, it is a “set of legal and financial techniques that transforms illiquid assets into tradable financial instruments”.138

An asset-backed security is a form of corporate debt financing and is a security backed by a portfolio of assets or cash flow from assets that are normally placed in specially designated vehicle.139 The special-purpose entity is formed to securitise the assets in a package and then to sell them as asset-backed securities. Most ABSs are sold to institutional investors that require a high investment grade credit rating, which is achieved by way of the safety characteristics of the SPI, namely bankrupt remoteness from the seller of the assets (originator). This causes the SPI to have a

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135 S 1 of GN 2, GG 30628 dated 01-01-2008. The terms “traditional” and “synthetic securitisation” are defined in the notice. See 6.4 and 6.5 for discussion on these aspects.
136 Locke 22.
138 MacNeil & O’Brien 229.
139 Tett 320. These assets are often loans and usually diversified to help reduce the risk.
higher credit rating than the bank or finance corporation which packaged the structure.\footnote{http://thismatter.com/money/bonds/types/abs/special-purpose-entity.htm (accessed 17-04-2010).}

The first ABS issued in South Africa by a local financial institution was the Blue Titanium Conduit of Standard Corporate and Merchant Bank, a division of Standard Bank, which was introduced in June 2002. It was in the form of commercial paper\footnote{“Commercial paper” is defined in the Bank Acts regulations (GG R681), amongst others, as (a) any written acknowledgement of debt, or (b) debentures or any interest-bearing written acknowledgement of debt issued for a fixed term in accordance with the Companies Act, or (c) preference shares, excluding bankers’ acceptances. In this instance a company was used by the issuer.} (promissory notes) issued to finance the purchase of financial assets, such as consumer loans, instalment sales, trade receivables, corporate loans, credit card receivables and equipment leases. Its objective was to provide flexible and competitive low-cost financing to customers, by financing, combining the assets of corporate clients into a diverse portfolio and then issuing commercial paper, backed by assets, to investors. The funds received from investors were then used to purchase the assets.\footnote{http://www.standardbank.co.za/site/about/aboutPressHistory49.html (accessed 13-06-2010).}

\subsection*{6.10.2 MORTGAGE-BACKED SECURITIES}

Residential mortgage loans were the first assets to be securitised and are globally still very popular because of the fixed asset supporting the loan.

The most basic structure is the so-called pass-through, where the monthly repayment (capital plus interest) on the loans are passed-through the SPV to the holders of the security. The investors effectively purchase shares (or participation certificates) in the pool of cash flows from the under-lying loans against the residential property.\footnote{There were at this stage already local mortgage backed securities on offer in South Africa. Mortgage-backed securities are collateralised by a pool of individual mortgage loans only, compared to asset-backed securities that are collateralised by a variety of receivables.} The risk of pre-payment, underlying the pass-through structure, is often addressed by

\begin{footnotesize}
\footnotetext{\footnotesize \hspace{1cm} 140 http://thismatter.com/money/bonds/types/abs/special-purpose-entity.htm (accessed 17-04-2010).}
\footnotetext{\footnotesize \hspace{1cm} 141 “Commercial paper” is defined in the Bank Acts regulations (GG R681), amongst others, as (a) any written acknowledgement of debt, or (b) debentures or any interest-bearing written acknowledgement of debt issued for a fixed term in accordance with the Companies Act, or (c) preference shares, excluding bankers’ acceptances. In this instance a company was used by the issuer.}
\footnotetext{\footnotesize \hspace{1cm} 142 http://www.standardbank.co.za/site/about/aboutPressHistory49.html (accessed 13-06-2010).}
\footnotetext{\footnotesize \hspace{1cm} 143 Smith Implication of Basel II 57-58. This is the structure that was used by the infamous Ginnie Mae, Freddie Mac and Fannie Mae agencies, which represent different types of pass-through guarantees. One of the major risks of the pass-through security is pre-payment, which is often triggered by lowering interest rates. See in general Karoly A Case Study of South African Commercial Mortgage Backed Securitisation.}
\end{footnotesize}
collateralised mortgage obligations, which constitute a spreading of risk amongst a number of tranches.144

Commercial Mortgage-Backed Securities (CMBSs) are different in that the assets which have been securitised are property linked to their own income stream over and above the income generated from the bond-holder. The main risks are associated with pre-payment and default. Pre-payment on commercial mortgage loans is usually penalised which is an inherent deterrent and safety mechanism for the investor. The default risk is, however, higher because the loan is often granted on the strength of the tenant of the borrower and is also affected by factors such as balloon payments. A pool of commercial mortgage-backed securities representing properties diversified as far as location and type (factories, offices, shopping centres, etc.) are concerned, has a better chance of surviving drastic changes in market conditions.145

The standard structure for a commercial mortgage-backed securitisation includes the sale of a pool of loans to a SPI. The monthly repayments service the obligations of the SPI, but the borrower often needs refinancing to secure the final balloon repayment. If the borrower fails, the SPI will enforce the security over the property by way of a forced sale of assets to repay the principal debt on the notes.146

6.10.3 CREDIT CARD SECURITISATION

Credit card securitisation transactions differ substantially in underlying risk and form from mortgage-backed securities and vehicle finance securitisation. Credit card companies earn high interest on short-term assets and the type of loan results in a steady stream of income which is ideal for securitisation transactions. The credit card lender specializes in the type of risk and monitors the creditworthiness of its customers closely and effectively. The assets are constantly revolving and they differ from most other processes in that the originator remains the owner of the accounts,

144 See Smith Implication of Basel II 62-67 for detailed discussion on the different variations of collateralised mortgage obligations.
145 Ibid 68-72.
146 Credit-tenant lease transactions involve a sale and a leaseback whereby the borrower sells the property to the SPV, which in turn leases it back to the borrower. See Smith Implication of Basel II 71-72.
but transfers the receivables to the SPI. The revolving nature of the credit provides the investor with a predictable schedule of interest and principal payments. \footnote{Smith \textit{Implication of Basel II} 74-75.}

Smith explains\footnote{Ibid 75-76. During high credit volume periods, liquidity facilities may be arranged as part of the scheme.} the three different cash flow periods in the structure, namely, revolving, amortisation, and early amortisation, with each performing a specific function. Off-balance sheet credit card securitisation is generally regarded as resulting in regulatory arbitrage and in saving capital for banks. The desirability or not of it is questionable as some argue that it is an undesirable sidestepping of capital requirements as safety net, while others submit that it is an efficient business model. \footnote{See Calomiris & Mason 26.}

\subsection*{6.10.4 VEHICLE FINANCE SECURITISATION}

Vehicle finance transactions\footnote{Vehicle leases and vehicle loans are securitised, but the securitisation of leases is limited. Most schemes include only loans as issues such as vehicle ownership, residual value risk and conflicting tax and accounting goals of originators have hampered the securitisation of vehicle leases. See Smith \textit{Implication of Basel II} 77-80.} are fairly attractive for securitisation purposes because of the physical assets available (compared to credit cards), the importance for borrowers to retain their mode of transport and comfort (a priority item for the debtor) and the diversification of the credit pools involved. The SPV purchases both the right to the monthly receivables and the right to retain possession of the vehicle from the originator where it was a \textit{loan} transaction.

A balloon payment at maturity of the loan creates the largest risk for all parties and losses are passed on to the securitisation structure to absorb. To address this risk, most transactions include a cash reserve account.

Investors in vehicle finance securitisation transactions can be paid by way of pass-through or pay-through structures. In first-mentioned structure the cash flows mirror the cash flows of the underlying loans, while in the pay-through structure the cash flows are reallocated amongst senior and subordinated structures. \footnote{Smith \textit{Implication of Basel II} 77.}
In case of a vehicle lease securitisation transaction the vehicle and the lease contract together forms the asset sold to the SPI. As the vehicle, however, must be registered in the name of the owner, the risk is that a true sale did not take place. To overcome this predicament, the SPI registers the vehicle in its name and not that of the originator and then transfers a beneficial interest to the lessor (originator) in all the vehicles and leases owned by the SPI.

6.10.5 EQUIPMENT LEASE SECURITISATION

In equipment leases (both operating and finance leases) the lessor purchases the equipment and leases it under a contract to a lessee, who must repay according to a set schedule.

In case of the operating lease the ownership of the equipment remains with the originator (lessor) and the lease payments are not part of a purchase price. In a finance lease the lessor normally remains the owner of the asset until the final payment has been made, at which stage ownership passes to the lessee. All payments from the lessee, therefore, count toward the purchase price and equity is required by the lessee (purchaser) during the lease period.¹⁵²

In equipment lease securitisation transactions the originator sells the lease to the SPI, which issues asset-backed securities as funding mechanism. In the operating lease the SPI becomes the new lessor of the equipment and the originator acts as servicer of the lease agreement. In finance leases the originator remains the lessor and only sells the receivables – which transactions are in practice actually instalment sale agreements.¹⁵³

6.10.6 BUSINESS SECURITISATION

Securitisation transactions that include whole businesses rely on the future income of the entire business operation. It is often difficult to predict the future revenue and the bondholder also does not become the owner of the assets of the company. The SPI raises the loan and then passes the cash on to the operating company, who repays

¹⁵² Ibid 80.
¹⁵³ Ibid 81.
the loan out of the cash flows of the company. The loan is secured by the assets of the borrower (the company), including contracts, licences, etc.\textsuperscript{154}

These transactions are ideal for businesses within stable and essential industries with fairly predictable income streams.

### 6.10.7 INTELLECTUAL PROPERTY SECURITISATION

These transactions are complex and potentially very risky, because the success of intellectual property depends much on popularity in the market at a specific moment. It is largely used for music royalty rights and is in essence a future flow transaction. It can be implemented by way of a secured loan or a true sale structure.\textsuperscript{155}

In a \textit{secured loan structure} the issuing SPI issues notes to provide a secured loan to an intellectual property SPI and all future royalties are then paid to last-mentioned, which uses the income to repay the loan. The intellectual property SPI cedes the intellectual property rights as security for the loan to the issuing SPI who pledges it again to the investors.

In a \textit{true sale structure} the issuing SPI purchases the intellectual property from the intellectual property SPI which results in the issuing SPI having exclusive licence to the rights and the right to receive all future income directly for its investors.\textsuperscript{156}

### 6.10.8 LIFE ASSURANCE SECURITISATION

Life assurers live in the reality that they have upfront costs, such as commissions, which make it sometimes difficult to adhere to statutory reserve requirements. The embedded value of the life assurer from a balance sheet perspective is the adjusted net asset value plus the present value of future policies. New policies, therefore, increase the need for extra immediate cash (against future premium income). For these reasons it makes sense for assurers to securitise their embedded values with the purpose of addressing their current liquidity needs. The future profits on their

\textsuperscript{154} Smith \textit{Implication of Basel II} 91-92. These structures are mainly used in the United Kingdom, where they utilize their insolvency legislation to protect the cash flows from the potential insolvency of the borrower (the business).

\textsuperscript{155} \textit{Ibid} 94.

\textsuperscript{156} \textit{Ibid} 94-95.
underlying book of business are usually adequate security to provide for such capital market financing by way of securitisation. 157

6.10.9 ASSET-BACKED COMMERCIAL PAPER CONDUITS

The asset-backed commercial paper conduit (ABCP) is one of the most important types of securitisation techniques. It is not really an asset-class, but a vehicle that can finance any type of underlying asset. It usually purchases bonds, trade receivables and home loans, and it funds itself through the issuance of short-term commercial paper. The sponsor of the conduit often funds the mismatch between long-term assets and short-term liabilities by way of a liquidity facility. 158

An ABCP 159 programme includes a SPI (the conduit) “that issues commercial paper and uses the proceeds of such issuance to obtain interests in various types of assets, either through asset purchase or secured lending transactions”. 160 Commercial paper is usually short-term debt on which the face value at maturity is payable. ABCP conduits issue commercial paper as their main liability and investors effectively provide liquidity to the conduit and receive compensation by way of a higher interest rate if the maturity date is extended. The conduits are reliant on credit enhancement for protection against losses and liquidity facilities to enable them to repay maturing commercial paper timely. 161

Most types of financial assets can be securitised as asset-backed commercial papers, which fund the acquisition of the assets by way of the issuance of short-term commercial paper. These conduits need a lot of liquidity to cover the difference between the long- and short-term liabilities.

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157 Ibid 98.
158 Ibid 289.
159 Asset-backed commercial paper is a short-term security that lasts between 1 and 180 days and is usually issued by a financial institution, backed by physical assets such as trade receivables, commercial loans or bonds. Smith submits on 112 that “(a)sset-backed commercial paper is an asset-class which, strictly speaking, is more of a securitization technique than an asset class itself”.
160 Smith Implication of Basel II 98. Assets often financed by way of ABCP conduits are trade receivables, consumer debt receivables, vehicle loans and equipment loans or leases, but may include asset-backed securities, corporate bonds and government bonds.
161 Ibid 98-100. Credit enhancement is a feature in securitisation transactions that absorbs some of the credit losses. See 6.9.5 above for more detailed discussion on this feature. Liquidity facilities enable an SPI to make timely payments of principal debt and interest to investors, notwithstanding market conditions or timing differences in the receipt of cash from the asset pool.
Other securitisation asset classes in which SPIs are utilised include structured covered bonds, future flow securitisation, trade receivables securitisation, inventory securitisation, non-performing loans securitisation, and collateralised debt obligations securitisation.162

6.10.10 DIVIDEND-INCOME PORTFOLIOS

Shareholders’ compensation is twofold, consisting of dividends and capital gains (or losses). To determine the overall profitability of an investment in shares, both the change in the value of the share (share price) and the value of the dividends received, must be taken into account. To this one must add the return received on the reinvestment of the dividends. Many investors prefer shares with a strong dividend-income potential. SPIs can be used for dividend income securitised portfolios.

6.10.11 DERIVATIVES

Instruments in financial markets are often widely classified as either “cash” or “derivatives”. While “cash” refers to a transaction in an underlying instrument (or commodity) for immediate delivery, “derivative” refers to a longer dated settlement on the difference between a pre-agreed price and the real market price at maturity.163 Partnoy subdivides derivatives into futures, options, swaps, structured notes, special-purpose vehicles and exotica. These instruments are used for hedging, speculation and arbitrage.164

In the debate on the value of derivatives, one school argues that derivatives are necessary to allow corporations, governments and financial companies to reduce and hedge exposures to fluctuations in interest rates, and to capture arbitrage opportunities and thus reduce financial costs. Another argues that the inherent risk

162 Ibid 57-100 for these asset classes and detailed discussions thereof.

163 Van Zyl et al 12. Van Zyl et al 378 define a derivative as “a financial instrument which embodies different terms, rights or obligations to those prevailing in the underlying, cash or physical market to which the instrument relates”. See 5.6 for reference to derivatives.

164 Partnoy 216-223. Exotic derivatives are highly speculative instruments taking leveraged positions based on a very narrow view of specific financial instruments or indices.
of derivatives makes it more of a gambling instrument than an investment instrument
and may damage the financial system and lead to systemic market collapses.\textsuperscript{165}

Derivatives usually have a different settlement date than that of the underlying
instrument and this aspect of timing is one of the core principles of the derivative as
instrument. The underlying instrument may be in the form of a share, the price of a
commodity, an interest rate for a specific period, etc. They may even carry other
derivative instruments as their underlying instruments (like options on futures). It is a
supplementary market – existing next to the underlying market where the other
instruments are traded.\textsuperscript{166}

Traditional securitisation is often referred to as “cash flow securitisation”, while credit
derivatives act as the building blocks of the process of synthetic securitisation. Credit
derivatives are also used to reallocate credit risk between counter-parties.\textsuperscript{167}

6.10.12 BONDS

Bonds are debt securities issued by a private company, the government or a semi-
government institution. Investors effectively lend money to the issuer who in
exchange for which they receive a promise to repay the loan (the principal) on a
specific maturity date. The issuer makes additional periodic interest payments (the
coupon). Bonds may be traded in the secondary market and can also be purchased
through collective investment schemes.\textsuperscript{168}

A bond can be defined as “a formal contract to repay borrowed money at a future
date with interest paid at fixed intervals”.\textsuperscript{169} Bonds are fairly certain, as the investor
knows the price, the yield to maturity, the coupon, the redemption amount and the

\textsuperscript{165} Ibid 213-214. See also Yeoh “Derivatives: Regulatory Reforms and New Rules” 2010 31(12)

\textsuperscript{166} Van Zyl et al 382. See Mminele in general.

\textsuperscript{167} See Smith Implication of Basel II 113-117 for detailed discussion on credit derivatives. See Van
Zyl et al 376-388 on derivatives. In 2009 the monthly turnover in derivative instruments in South
Africa fluctuated between R4 billion and R7.6 billion. See 6.5 and 6.6 respectively for
discussion on traditional and synthetic securitisation transactions respectively.

\textsuperscript{168} See Profile’s Unit Trusts and Collective Investments (March 2010) 100-101.

\textsuperscript{169} Foord Time in the Markets 20.
maturity date. The only uncertain aspect is whether the issuer will indeed comply with his duty in time. This is the default risk the investor is taking.\textsuperscript{170}

6.11 PASS THROUGH AND PAY THROUGH STRUCTURES

The manner in which the owners of the pools of assets share in the cash flows from the assets, are referred to as the payment structures, which may be in the form of pass-through, pay-through or bond structures.\textsuperscript{171} The pass-through structure passes through all of the principal and interest payments of assets to the investors, which make them passive tax vehicles, while the pay-through structure allow for reinvestment of cash flows and the purchase of additional assets. Both structures can be in the form of a SPI.\textsuperscript{172}

6.12 REPACKAGING

The repackaging process is when a bank sells assets to a multi-issuance, off-balance sheet, insolvency-remote vehicle in a tax friendly jurisdiction.\textsuperscript{173} The assets are beyond reach of the bank’s creditors and the bank is under no obligation to repurchase the assets. The bank’s customers are insulated from the bank’s credit risk, as the assets are not on the bank’s balance sheet. The multi-issuance vehicle (MIE) issues notes that only refer to a specific underlying collateral item and the noteholder has no claim to any other asset held. In repackaging cases SPIs are used and the MIE is more competitive, because of better funding options. The investor has no exposure to the bank’s risks and can sometimes even select the specific collateral item.\textsuperscript{174}

In terms of the Regulations the “repackager” is defined as follows:

“an institution that, whether at the commencement or during the life of a traditional or a synthetic securitization scheme, acquires and subsequently —

a) transfers the assets; or

\textsuperscript{170} See Van Zyl et al 310.
\textsuperscript{171} Karoly 12. The bond structure is an extension of the pay-through, whereby the SPI reinvest the cash flows until the payment date.
\textsuperscript{172} Tavakoli 2.
\textsuperscript{173} In the USA the Cayman Islands, Delaware, New York State, Luxembourg, the Netherlands, Ireland, Jersey, Guernsey and Gibraltar are some of the most common jurisdictions for SPIs. In the South African context it does not have to comply with the above requirements.
\textsuperscript{174} Tavakoli 3.
b) transfers the risk relating to assets, consisting of national Government securities or qualifying items of third parties via its balance sheet in terms of a traditional or a synthetic securitisation scheme: provided that an institution that, whether at the commencement or during the life of the traditional or the synthetic securitisation scheme, acquires and subsequently transfers the assets or the risk relating to assets, consisting of assets other than national Government securities or qualifying items of third parties via its balance sheet in terms of the said traditional or synthetic securitisation scheme, shall for purposes of this Schedule be regarded as an originator."

6.13 PROTECTED CELL COMPANIES AND TRUSTS

The protected cell company or cell trust is a special corporate body which combines several cells within a single legal vehicle. Each cell has its own assets and liabilities and functions independently, but under the umbrella of the cell-corporation or trust. Creditors of the individual cells have no recourse against the other cells within the group. The major motivation for this type of structure is the substantial savings that can be accomplished.

These structures were developed to assist insurance companies in spreading their risks. Although the individual cells are not autonomous legal entities the creditors cannot move through the walls of one cell to the available assets or equity locked-up in another cell. This method of ring-fencing separate risks within a single corporation is used in collective investment schemes and even as SPIs in securitisation transactions by packaging in the form of bonds, pass-through securities, or collateralised mortgage obligations. These structures are unfortunately also misused by banks, insurance companies and investors, not only for tax arbitrage purposes, but also as complex impermissible tax-avoidance schemes.

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175 GN R2, dated 01-01-2008. See the definition of “originator” and the discussion on the role of the originator elsewhere in this Chapter.
176 Alternative terms for “protective cell companies and similar legal structures include “incorporated cell companies”, “segregated account companies” (in Bermuda), “segregated portfolios” (in Cayman Islands) and protected premium accounts (in St. Vincent). See Oguttu “Curbing Tax Avoidance – Investments in Offshore “Protected Cell Companies and Cell Trusts”: The American and British Approach – What is South Africa’s View?” 2011 South African Mercantile Law Journal 16-44 20. In Chapter 8 the application of these structures in Mauritius and Malta will be discussed.
178 Also referred to as “captive insurance”.
179 Oguttu 21. See Chapter 7 for more on the trust as securitisation vehicle.
180 ibid 22-44 for discussion on the efforts by governments to prevent tax avoidance by way of these structures.
Although both companies and trusts are utilised as legal vehicles to create protected cells or segregated portfolios, trusts are largely used either as SPIs or in a unit trust form, with other cell structures usually in the form of companies. Oguttu\textsuperscript{181} submits that offshore unit trusts are often used in South Africa to defer capital gains tax liabilities, but admits that this loophole has most probably been effectively closed.

6.14 THE FUTURE OF SECURITISATION

It can be expected that the hunger for securitisation transactions has been curbed, at least temporarily, by the Basel II Accord. The major international meltdown of 2008 took place before the full impact of the new stricter regulations could be experienced. Although the Accord was introduced in 2004, its implementation only started in 2006 and in some countries only in 2008 or even later.

Smith\textsuperscript{182} identifies the following potential outcomes of the Basel II Accord on the securitisation industry:

(1) it should reduce the incidence of regulatory capital arbitrage as there would be fewer opportunities for achieving regulatory capital relief by way of securitisation;

(2) as various asset classes will be affected differently by the regulations, there may still be scope in some asset classes for regulatory capital relief;

(3) in addition to its envisaged effect on bank capital management, Basel II will also have an impact on the economics of certain types of securitisation structures;

(4) new securitisation structures and techniques are likely to be developed to mitigate the impact of Basel II;

(5) Basel II may result in greater participation in the securitisation industry by other types of participants, such as hedge funds.

As Smith correctly points out, securitisation has recently become more of a funding mechanism than a capital management tool, as it allows banks access to new

\textsuperscript{181} Ibid 42-43.

\textsuperscript{182} Smith Implications of Basel II 294-295.
Chapter Six: Securitisation

For this very reason it is submitted that securitisation shall continue to be used by credit institutions in one form or another.

The devastating effects of the latest financial crisis and the current global recession have prompted the Basel Committee to evaluate the possible shortcomings of Basel II, like an apparent inadequate and pro-cyclical capital requirement of 4%; the potential conflicts of interest amongst rating agencies; and, the allegations that Basel II has actually incentivised securitisation schemes, as financial institutions used them to reduce their asset risk-weighing, which resulted in reduced capital requirements, growing risk profiles and increased leverage.

In September 2010 the Basel Committee released their proposals for the capital requirements under Basel III. The overall aim of Basel III is to improve financial stability. It is clear that the capital requirements will be increased and a counter-cyclical capital buffer, as well as a leverage ratio, may be introduced. The rationales of Basel III can be summarised as follows: to raise the quality, quantity consistency and transparency of the capital base; to strengthen risk coverage; to introduce a leverage ratio; to promote the build-up of capital buffers in good times; to adopt an expected loss-provisioning model; and to set a global minimum liquidity standard for internationally active banks.

It is foreseen that most of these new regulations will be gradually implemented between 2013 and 2019. In the latest annual report of the South African Bank Supervision Department it is stated, in reference to these proposals that the Department will, on an ongoing basis review and amend “the regulatory framework in accordance with the latest internationally agreed regulatory, supervisory and market best practices and standards”.

Only time will tell what the effect of these requirements would be on securitisation as financing instrument.

183 Ibid 295.
185 http://www.dnbgov.com/pdf/DNBBaselIII.PDF (accessed 23-06-2011). It has been announced by the Minister of Finance that the leverage and liquidity ratios will become mandatory requirements in South Africa by 2018.
6.15 CONCLUDING REMARKS

In this Chapter has the concept of securitisation, as well as its application in South Africa, been discussed. The parties to these transactions, the legal structuring and key features thereof, and the different asset classes involved, have been explained. Some of the specific structures used in securitisation schemes have been referred to, where after the future of the securitisation as financial vehicle has been evaluated.

Schwarcz\textsuperscript{187} makes out a strong case in favour of securitisation, irrespective of the many negative results caused by some transactions during the past decade. While Enron used special-purpose vehicles purely to manipulate company statements, securitisation is usually applied by \textit{bona fide} companies to obtain cheaper financing, without the intention of creating false impressions of their financial position. He submits that the process of securitisation is efficient and fair, as it not only contributes to lower financing cost, but also provides liquidity for companies that battle to obtain affordable financing in the capital markets.\textsuperscript{188}

It is submitted that the pooling of assets in the form of securitisation has become such an integral part of the modern financial environment that it will only be replaced if another process, which offers similar advantages to the markets, can be developed.

The South African securitisation process is well-regulated, as has been indicated, and is largely in line with the Basel Accords. The regulatory initiatives have not, however, necessarily taken into account the potential limitations of the legal vehicles historically applied to structure some financial instruments.

In the next Chapter the focus will thus be on the application of the trust as a financial instrument vehicle. One of the areas in which the trust is utilised as legal entity is that of securitisation, with its most important role as that of special-purpose institution. The role of the trust as collective investment scheme vehicle, as securitisation instrument, and as entity of arbitrage, will be discussed. Relevant legislation affecting the trust, and its impact thereon, as well as the use of trusts offshore, will be included.

\textsuperscript{187} Schwarcz “Securitization Post-Enron” 2003 \textit{Cardozo Law Review} 34.

\textsuperscript{188} 34.
In last instance the purposes, contents and impact of the Basel Accords on the financial instrument milieu will be explored in Chapter 7.
CHAPTER SEVEN

THE TRUST AS FINANCIAL INSTRUMENT VEHICLE

7.1 INTRODUCTION

Irrespective of the fact that the true nature of the trust is to a large extent still in dispute, the trust remains a flexible and user-friendly institution in the financial environment. The trust became notable for its role as investment vehicle for unit trusts and participation bonds. In this Chapter the various roles of the trust in the financial arena will be scrutinised.

Honoré describes the unit trust as

“an arrangement created by a trust deed whereby certain assets, the “underlying securities, are held by the trustee on trust for the beneficiaries, who are the holders of unit certificates,”

and a participation bond as

“a mortgage bond over immovable property, registered in the name of a nominee company”.

The CISCA became effective on 3 March 2003 and unified the linked-product environment, including unit trusts and participation bonds. It repealed the Unit Trust Control Act of 1981 and the Participation Bonds Act of 1981 and brought all open-ended investment products under the same blanket. In terms of a collective investment scheme, funds from various investors are pooled together to achieve the critical mass needed for proper portfolio diversification and cost-effective structuring, with each individual investor retaining a right in his allocated share of the underlying assets locked up in the pool.

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1  619 and 639.

2  See 5.5 for a discussion on collective investment schemes and 7.7.1 for a discussion on the CISCA.
Chapter Seven: Trust as Finance Instrument

In terms of section 1 of both the Financial Services Board Act 97 of 1990 and the SSA, all collective investment schemes qualify as financial institutions. In terms of the South African Reserve Bank Act there is effectively no difference between a “financial instrument” and a “security”, as defined in the Security Services Act. It is submitted that all securities should be regarded as financial instruments and vice versa.3

The widest definition of the term “financial institution” is to be found in the Financial Services Board Act and includes the following:

“(i) any pension fund organisation registered in terms of the Pension Funds Act, 1956 (Act No. 24 of 1956), or any person referred to in section 13B of that Act administering the investments of such a pension fund or the disposition of benefits provided for in the rules of such a pension fund;

(ii) any friendly society registered in terms of the Friendly Societies Act, 1956 (Act No. 25 of 1956), or any person in charge of the management of the affairs of such a society;

(iii) a collective investment scheme as defined in section 1 of the Collective Investment Schemes Control Act, 2002, a manager, trustee, custodian or nominee company registered or approved in terms of that Act, and an authorised agent of such a manager;

(iv) any “exchange”, “authorised user”, “stock -broker”, “settling party”, “clearing house”, “central securities depository”, “participant” or “nominee” as defined in section 1 of the Securities Services Act, 2004;

(v) any “long-term insurer” as defined in section 1(1) of the Long-term Insurance Act, 1998 (Act No. 52 of 1998), and any “short-term insurer” as defined in section 1(1) of the Short-term Insurance Act 1998 (Act No. 53 of 1998);

(vi) any “independent intermediary” or representative as defined in section 1(1) of the Short-term Insurance Act, 1998, or in regulation 3.1 of the Regulations under the Long-term Insurance Act, 1998;

(vii) any “Lloyd’s underwriter” as defined in section 1(1) of the Short-term Insurance Act, 1998, and referred to in section 56 of that Act;

(viii) any person rendering or who is to render services contemplated in section 23A(1) of the Insurance Act, 1943;

(ix) any authorised financial services provider” or “representative” as defined in section 1(1) of the Financial Advisory and Intermediary Services Act, 2001;

(x) a bank as defined in section 1(1) of the Banks Act, 1990 (Act No. 94 of 1990), a mutual bank as defined in section 1(1) of the Mutual Banks Act, 1993 (Act No.

3 See 5.3. The Financial Markets Bill will repeal the SSA and replace the definition of “financial institution” with a new definition that will only include pension funds, friendly societies, collective investment schemes, insurers and banks. It unfortunately does not refer to the definition in the Financial Services Board Act.
Chapter Seven: Trust as Finance Instrument

124 of 1993), or a co-operative bank as defined in section 1(1) of the Co-operative Banks Act, 2007 (Act No. 40 of 2007), which deals with trust property as a regular feature of its business; or

(xi) any other person who or which deals with trust property as a regular feature of his, her or its business, but who is not registered, licensed, recognised, approved or otherwise authorised to deal so in terms of any Act, other than the Companies Act, 1973 (Act No. 61 of 1973), the Close Corporations Act, 1984 (Act No. 69 of 1984), and the Trust Property Control Act, 1988 (Act No. 57 of 1988)."

Many of these institutions, like pension funds, friendly societies, unit trusts, and participatory bonds function in the form of a trust. The Securitisation Regulations specifically stipulates that special-purpose institutions may be in the form of either a company or a trust. The trust can, therefore, be used in many instances as the special legal instrument or entity to either manage the financial instrument or security, or part thereof, or as the special-purpose entity in which the interest is housed.

During the past three decades has the trust been positioned as a major legal instrument in the business and investment environment. It is submitted that the international future of the trust will be in its application in the commercial milieu. European jurisdictions like Italy, Luxembourg, Switzerland and Monaco, have started developing a more vibrant trust law and some even ratified the 1986 Hague Convention on the Law applicable to Trusts and their Recognition. The original interest may have been as an estate planning tool, but once usurped in the legal system, its application will expand to the business world. Commercial trusts have become more and more important in most international domains with developed financial infrastructures. The result is that trusts are today found in Central and South American states, Japan, China, Taiwan and South Korea. The introduction of the trust to Asian jurisdictions was largely motivated by its positioning as foreign investment destinations, and in the processes of raising capital for public and commercial development initiatives. The emphasis in many of these jurisdictions has been on the trust’s flexible, tax- and cost-efficient characteristics, as well as its

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4 See the definition in s 1 of GN 2 in GG 30628 published on 01-01-2008.
5 Japan introduced the trust in 1922 and China only in 2001.
application in the provisioning of security for commercial loans, with the insertion of a juristic entity between the owner and the management.\(^6\)

The Japanese have largely focused on the trust as an investment vehicle, with individuals and corporations pooling their assets in investment portfolios. The investors are protected from any potential insolvency of the trustee, while the assets are effectively managed in a flexible, conduit-type, legal vehicle.

It was submitted by Lusina Ho\(^7\) that

\[\text{"(t)he purpose of the new Trust Law (in China) is to provide a legal instrument for the professional management of assets. The implications for China’s fast-expanding financial sector are bound to be far reaching. The new Law has already been applied in sophisticated financial transactions such as asset securitisation and the capital trust."} \]

The trust was introduced to China with the clear intention to facilitate the expansion of its financial sector and not for estate planning or some other personal purpose.

Trusts often fulfil a central role as one of the legal entities in the structuring of financial instruments – either as a collective investment vehicle or as a special-purpose vehicle. Many investment and risk funds held on behalf of third parties, such as unit trust funds, structured finance vehicles, retirement funds and medical aid funds, are held in a trust form. In this context the trust has become a major tool in the business and financial world and billions of rands are invested through structures involving trusts in one form or another, either as a mere holder of units or as a special-purpose vehicle or entity.

### 7.2 Trusts as Collective Investment Scheme Vehicles

#### 7.2.1 The Collective Investment Scheme

For many years the most common application of the trust as investment vehicle was in the form of the unit trust. Unit trusts originated in 1931 as reaction to the 1929 Wall Street crash and the survival of mutual funds. It can be described as a collective investment constituted under a trust deed. It is open-ended in that the underlying value of the assets is always represented by the number of units. In the

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\(^7\) Waters 4 refers to Ho Trust Law in China (2003).
Chapter Seven: Trust as Finance Instrument

United States trusts traditionally are used for pension schemes, mutual funds (which are similar to unit trusts), real estate investment funds, and for oil and gas royalty funds.\(^8\)

Each unit trust fund has a specific investment objective which determines the managers investment mandate. The trust manager makes a profit from the difference between the purchase price of the unit and the sale price. The parties to the trust deed are the management company and the trustee. The investors are issued with certificates by the company, representing the units.\(^9\)

Unit trusts were regulated in South Africa by way of the Unit Trust Control Act of 1981. One of the frustrations of unit trust investments in the South African context was the fact that no beneficiary nominations may take place on them, as it is regarded as an illegal *pactum successorium*. Last-mentioned is an agreement relating to the succession of an asset or benefit which postpones the devolution of personal rights until the death of the owner. It prohibits the owner of the asset to bequeathing such property to a third party in terms of his will or otherwise.\(^10\)

The CISCA repealed the aforementioned Act in March 2003 and replaced the unit trust concept with collective investments. A CIS can be described as “a trust based scheme that comprises a pool of assets that is managed by a collective investment scheme manager”.\(^11\)

All collective investment schemes (including a manager, trustee, custodian or nominee company) are “financial institutions” in terms of section 1 of the Financial Services Board Act 97 of 1990.\(^12\) Collective investments include open-ended

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10. See *McAlpine v McAlpine* 1997 1 SA 736 (A). Compare *Van Aardt v Van Aardt* 342/05 (2006) ZAECHC 37 (10-08-2006) (unreported) in appeal against the judgment of Plasket J in *Van Aardt v Van Aardt and Others* 062/2005 ECLD (21-07-2005). See also *Jubelius v Griesel NO en Andere* 1988 2 SA 610 (C) for the application of the relevant test as applied in *McAlpine* para [4]. The minority judgment by Nienaber J in McAlpine seemed to support the thinking that unit trust investments should be treated in a similar way as life assurance policies, on which beneficiaries may be nominated by the owner. Compare Keetse “Is our law on beneficiary nominations and *pacta successoria* outdated?” 2004(3) *Insurance and Tax* 3-8.
12. Earlier in this Chapter the definition has been quoted *verbatim*. The Financial Markets Bill will repeal the Securities Services Act and replace the definition of “financial institution”. It will apparently not affect the definition in the Financial Services Board Act.
investment companies “in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio” and are, therefore, much more than merely unit trusts.  

The parties to a CIS may include the following:

(a) Each participant in participation bonds has a proportional stake (participatory interest or unit) in the specific collective investment scheme in participation bonds.

(b) The trust is the financial instrument used to manage and administer the investment on behalf of the investors. This scheme enables individuals to invest in a cost-effective way on the stock exchange and in the money markets.

(c) The portfolio manager, armed with a specific portfolio mandate, uses the pool of money to invest in a diversified portfolio of investments on the stock exchange, in international equities, bonds, derivatives and other financial instruments.

(d) The scheme manager acts as the bridge between the investors and the portfolio manager and handles the administration and marketing of the collective investments.

(e) The trustee (or custodian) is independent and acts as the caretaker of all cash and securities in a specific collective investment scheme. He also ensures that the scheme is managed in accordance with the trust deed and the Act.

(f) The mortgagor is, in terms of participation bonds, the party who utilizes the money for loans against mortgage bonds over immovable property as security for repayment.

Honoré summarizes the different phenomena in the trust arena as follows:

“In the ordinary trust the trustee administers the property while the beneficiary enjoys it. The business trust exploits this form in that the beneficiaries often provide the capital for the business which is carried on by the trustee and in return receives a

13 See the definition of “collective investment scheme” in s 1 of the CISCA.
share of the profits. In the unit trust (read the collective investment scheme) the business administration is carried on by a third person, the manager or management company.”

In *Fedbond v Investec Employee Benefits* the court confirmed that a participant can only claim repayment of its investment in a collective investment scheme from the mortgagor and not from the manager. The relationship, however, is tripartite in nature. Although the manager is not a debtor to the participant, the agreement between them provides obligations for both the manager and the participant.

The TPCA does not, in terms of section 113 of the CISCA, apply in respect of a collective investment scheme. Any trust that is, therefore, formed in terms of the aforementioned Act will not be administered in terms of the TPCA.

The trust has the potential to fulfil a variety of roles in collective investment schemes. Section 1 defines a CIS as follows:

“(A) scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which –

(a) two or more investors contribute money or other assets to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and

(b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed, but not a collective investment scheme authorised by any other Act.”

From the definition it is clear that most collective investment schemes can be in any form, which implies that it can be in the form of a trust, a company, a close corporation, a partnership, or an association of persons. A CIS that is structured as

14 619.
15 *Fedbond Participation Mortgage Bond Managers (Pty) Ltd v Investec Employee Benefits Ltd* 2010 4 All SA 467 (SCA) paras [23] and [24]. Confirming *Syfrets Participation Bond Managers Ltd v Commissioner, South African Revenue Services* 2001 2 SA 359 (SCA). In a minority judgment Harms DP held that there is indeed a debtor-creditor relationship between the manager and the participant para [41].
16 The CISCA and the TPCA unfortunately do not clearly indicate its exclusive roles. The ideal situation would have been legislation that clearly states the different types of trusts and their administration.
Chapter Seven: Trust as Finance Instrument

an open-ended investment company, however, cannot be a trust as it has to be in the form of a company incorporated or registered under the Companies Act.\textsuperscript{17}

A “deed” is defined as follows:

“(T)he agreement between a manager and a trustee or custodian, or the document of incorporation whereby a collective investment scheme is established and in terms of which it is administered, and includes the deed of a management company which immediately prior to the commencement of this Act was a management company in terms of any law repealed by this Act.”\textsuperscript{18}

It is thus clear that any reference to “deed” in CISCA includes a trust deed as a deed is either an agreement or a document of incorporation. It may, therefore be represented by any agreement, including a trust instrument. The agreement between a manager and a trustee (or custodian) may be in any form. It is, however, not limited to trusts, partnerships, associations and agencies, but also includes close corporations and companies. The reference to the “deed of a management company” refers to a manager as defined in the Unit Trust Act 54 of 1981, section 3(1), which could only be a company incorporated in terms of the Companies Act. In terms of the CISCA can any person who is authorised in terms of the Act to administer a collective investment scheme, act as a manager.\textsuperscript{19}

It is submitted that the trust instrument, setting out the terms of the legal relationship between the trustee and the unit holders, should at least contain the following: the powers and duties of the trustee and the manager, where applicable; the investment objective and policy of the unit trust; the issue and transfer of units; the rights of the unit holders; the appointment of advisors to the unit trust; the appointment, removal or retirement of the trustee and manager; the fees of the trustee and manager; the valuation of units; reporting; distribution; and, termination and winding-up of the unit trust.\textsuperscript{20}

\textsuperscript{17} S 1 of the CISCA defines an “open-ended investment company” as follows: “a company with an authorised share capital, which is structured in such a manner that it provides for the issuing of different classes of shares to investors, each class of share representing a separate portfolio with a distinct investment policy”. The term “company” refers to an entity incorporated or registered in terms of the Companies Act.

\textsuperscript{18} S 1 of the CISCA. See also s 97 and 98 for certain matters which must be provided for in the deeds of collective investment schemes.

\textsuperscript{19} Subs 41(2) stipulates that only a company may be authorised as manager.

\textsuperscript{20} See also http://www.nabarro.com/Downloads/Unit_trust_an_overview.pdf (accessed 05-04-2012).
7.2.2 THE TRUST AS INSTITUTION AND TRUSTEE

The trustee or custodian must ensure that the sale or repurchase of the participatory interests in a CIS is performed correctly and at the correct price. The trustee or custodian represents the manager and complies with and enforces the instructions of the manager. It protects the rights of the investors and enforces some internal control systems. All irregularities in terms of the scheme must be reported and financial reporting must be monitored.21

In terms of section 69 only a company or an institution, “incorporated under a special Act”, may act as a trustee or as a custodian. Close corporations are specifically excluded in terms of the Act. The now repealed Unit Trust Act had a similar stipulation and it is unclear what institution the legislator had in mind. The dictionary meaning of “special” includes “distinguished”; “uncommon”; “designed for a particular purpose”; and, “peculiar to one person or thing”.22

Although a trust in South African law is not incorporated in the legal sense of the word, it can only be operational if the trustees have either been authorised by the Master of the High Court in terms of the TPCA or the trust has been approved by the Registrar of Collective Investment Schemes in terms of the CISCA. The fact that the legislator specifically excludes close corporations referred to in the Close Corporations Act indicates that the legislator foresaw that a close corporation may have been regarded as an “institution incorporated under a special Act.” If the Close Corporations Act was regarded as a “special Act”, there is no logical reason why the TPCA and the CISCA cannot be regarded as special Acts.

There may be other explanations as to why the close corporation has expressly been excluded and not the trust. At least two motivations can be offered for this specific exclusion. The first is the fact that there is no separation between ownership and management or control in the close corporation, and secondly, when both these acts had been enacted, only natural persons could become members of close corporations.

21 See Wille et al 67-69.
In light of the interpretive presumption against useless legislative stipulations it must be accepted that the legislator had a purpose with its provision for institutions. It is, therefore, submitted that a trust qualifies as an institution in terms of section 69 and may, therefore, become and act as a trustee or a custodian for a CIS.

In terms of section 68(1) the manager must appoint either a trustee or a custodian for its scheme, depending on the structure of the specific scheme. Only persons registered in terms of section 69 shall qualify as trustee or as custodian.

7.2.3 THE TRUST AS MANAGING AGENT

In terms of section 1 of the CISCA any person who is authorised in terms of the Act to administer a CIS, can act as a manager. The manager must avoid conflict with investors and must, therefore, disclose its interests. It manages the risks the scheme is exposed to, and acts as watchdog in the best interest of the investors.\(^{23}\) Only a private or public company may be authorised as a manager with the purpose of administering a CIS.\(^{24}\)

The manager may authorise an agent to fulfil the administering activities. The Act does not prescribe the incorporated form of the agent and it is, therefore, submitted that a trust may act as the agent of the manager.

7.2.4 THE TRUST AS A MEMBER OF THE PUBLIC

“Members of the public” is defined in section 1 of the CISCA to include –

\begin{itemize}
  \item \textbf{(a)} members of any section of the public, whether selected as clients, members, shareholders, employees or ex-employees of the person issuing an invitation to acquire a participatory interest in a portfolio; and
  \item \textbf{(b)} a financial institution regulated by any law,
\end{itemize}

but excludes persons confined to a restricted circle of individuals with a common interest who receive the invitation in circumstances which can properly be regarded as a domestic or private business venture between those persons and the person issuing the invitation.”

It is submitted that a trust cannot qualify as a member of the public for the purposes of the Act in as far as the specific trust is “confined to a restricted circle of individuals

\(^{23}\) See Wille \textit{et al} 65.

\(^{24}\) See subss 41(1) and (2), read with sub 2(1) of CISCA. The manager may also be involved in other businesses than the administration of a collective investment scheme, if the investors are not likely to be prejudiced. (s 86)
with a common interest,” as most trusts involved in such a transaction would qualify as a business venture for these purposes.

The term “financial institution” is not defined in the CISCA, but includes, in terms of section 1 of the Financial Services Board Act 97 of 1990, pension fund organisations, friendly societies, collective investment schemes, exchanges, long-term insurers, independent intermediaries, authorised financial services providers, banks, and any person dealing with trust property as a regular feature of his business, without being so registered, licensed, recognised, approved or authorised in terms of the Companies Act, the Close Corporations Act or the TPCA.

A number of these entities may function in the form of a trust, including any collective investment scheme, or any other trust, even if it is not a CIS, but it is authorised in terms of the CISCA.

7.2.5 THE TRUST AS AN ASSOCIATION

Section 1 of the CISCA describes an “association” in terms of section 26. It is submitted that it should have been section 25, which refers to “an association of persons carrying on the business of a collective investment scheme”. The persons that organise themselves as an association must, for licensing purposes, comply within a number of prerequisites, like representation, financial adequacy, independence, etc., without any limitation as to the legal form in which they operate. It is submitted that an association of collective investment schemes may be structured in the form of a trust.

7.2.6 THE TRUST AS AN INVESTOR

Investors are the holders of participatory interests in portfolios. The registrar may determine the composition of portfolios (section 46), which may include security portfolios, property portfolios, participation bond portfolios, or declared scheme portfolios, and these different schemes may even be converted from time to time.25 It is submitted that there is no impediment in the Act against a trust being an investor in a CIS.

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25 See subs 76(1) and s 84, dealing with the right of investors in case of a conversion.
In terms of Part XI, “Conversion of Collective Investment Schemes”, a collective investment scheme includes “one or more portfolios under such scheme and may, depending on the structure of the scheme, include a manager.” Section 76 defines a “conversion” as “a conversion of a collective investment scheme to any other format of a collective investment scheme permissible under this Act.”

The focus is here on one or more portfolios under a specific scheme. The term “portfolio” refers to a group of assets. There are no prescriptions regarding a scheme in the form of a company that is converted to a trust, but when a scheme in the form of a trust is converted into a company, it must comply with sections 81 and 82.

### 7.2.7 THE TRUST AND PARTICIPATION BONDS

A CIS in participation bonds is an ordinary CIS with the difference being that the portfolio consists mainly of assets in the form of participation bonds. A participation bond is defined in the CISCA, section 52, as follows:

“(A) mortgage bond over immovable property –

(a) which is described as a participation bond and is registered as such in the name of a nominee company and is included in a collective investment scheme in participation bonds; and

(b) which is a first mortgage bond or which ranks equally with another first participation bond and has the same mortgagor.”

It is submitted that a trust may be used as a legal vehicle for a CIS in participation bonds, as nominee-company, as participant, and as mortgagor. These different capacities in securitisation transactions refer to its position as issuer special-purpose institution, issuer owner special-purpose institution, and as security and security special-purpose institution owner, which will be discussed in more detail hereunder.

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26 “Participatory interest” includes an interest in a participation bond and is defined in s 1 as “any interest, undivided share or share whether called a participatory interest, unit or by any other name, and whether the value of such interest, unit, undivided share or share remains constant or varies from time to time, which may be acquired by an investor in a portfolio.”

27 A “nominee company” holds property in trust for third parties and enters into an agreement with the manager regarding the management and control of the nominee (s 52).

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7.3 THE TRUST AS SECURITISATION INSTRUMENT

According to Gorton the SPI is normally a trust, because it allows for repeat transfers of new receivables, whenever the originator so chooses.\(^2\) Locke, however, submits that the trust SPI is used in the United Kingdom and the United States, but not as often as the corporation, as it cannot provide the accounting, tax and insolvency benefits that a corporation SPI could.\(^3\) The writer then further explains that the SPI in a trust form is largely used in non-taxable grantor trust pass-through transactions, pay-through transactions, and in master trust transactions.\(^4\)

So-called “trust preferred securities” (TRUP’s) are often popular because of their tax advantages. They are considered debt instruments for tax purposes, allowing institutions to deduct the interest paid on them. They are also treated as equity for regulatory capital purposes and sometimes even by the credit rating agencies.\(^5\)

In terms the 2008 Securitisation Regulations, a special-purpose institution can be in the form of either a company or a trust.\(^6\) Compared to companies, trusts can provide certain benefits. Trust income may be distributed and taxed at potentially lower rates in the hands of the beneficiaries, the compliance requirements of trusts are less cumbersome than that of companies, and trustees may experience more limited liability than that of company directors.\(^7\)

It is submitted that the compliance factor has increased the applicability of the trust as legal entity after the introduction of the 2008 Companies Act. The intricacies of the new Act will be discussed in more detail in 7.6.2.

Smith explains the typical South African security structure as follows: \(^8\)

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\(^2\) Gorton & Souleles 14.

\(^3\) Locke 37.

\(^4\) See 6.10 for discussion on pay-through and pass-through transactions.


\(^6\) See the definition in s 1 of GN 2 in GG 30628 published on 01-01-2008.

\(^7\) See Itzikowitz & Malan 188-189 and the reference to Secretary for Inland Revenue v Rosen 1971 1 SA 172 (A). See also Wunsh 561.

\(^8\) See the diagram in Smith Implication of Basel II 303.
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The security special-purpose institution (A), beneficially owned by a security SPI owner trust (B), holds the security for the benefit of the investors (C) and secured transaction creditors (D), and (A) issues guarantees to (C) and (D) for the obligations of the issuer SPI (E), who is beneficially owned by the issuer SPI owner trust (F), with (F) issuing a suretyship in favour of (A) and pledges all its shares in (E) to (A), and (E) issues a security cession of its right and title in the assets, as well as an indemnity, in favour of (A).

As indicated by the following diagram the important role of trusts in the securitisation structure is obvious.

ILLUSTRATION 6: ROLE OF TRUSTS IN THE SECURITISATION PROCESS
7.3.1 THE TRUST AS ISSUER SPI

The issuer SPI acts as purchaser of the assets to be securitised. It is created with the sole purpose of acquiring and holding the assets, while issuing securities backed by the assets to fund the purchase price. The issuer should not fulfil any other roles and must refrain from any other obligations that may incur liabilities or risks. Its insolvency remoteness must be protected at all times and its isolation from other risks must instil confidence in its investors.

The issuer usually does not employ individuals and appoints third parties to manage its affairs. It is submitted that a trust is the ideal legal entity to employ as issuer.

7.3.2 THE TRUST AS ISSUER SPI OWNER

As beneficial shareholder, the issuer SPI owner trust owns all the shares in the issuer and stands surety to the security SPI for the performance of the issuer, with its obligations towards the secured creditors. The issuer SPI owner trust pledges its shares in the issuer as security for the suretyship.

7.3.3 THE TRUST AS SECURITY SPI

The security SPI trust is established to hold and realise security, subject to the priority of payments, for the benefit of secured creditors, including investors. The trustee acting on behalf of the security SPI must have a priority interest in the assets supporting the securitisation. The trustee further oversees the performance of the servicer as far as the debt collection is concerned. This role is crucial as the investor relies on the income generated from the asset pool as it has no recourse to the originator. If the trustee is not satisfied with the performance of the transaction it must declare it in default and take legal action to protect the interests of the investors.

7.3.4 THE TRUST AS SECURITY SPI OWNER

The security SPI owner trust is established solely to own, as beneficial shareholder, all the shares in the capital of the security SPI.
7.3.5 THE TRUST AS SPI

As has been indicated above, the trust can be employed successfully as a special-purpose institution in a number of roles within the securitisation structure. A SPI trust is created by way of a formal trust deed. A deed drafted with the purpose to create a SPI for a securitisation process should adhere to all the general requirements of a legitimate trust, although it is not registered with the Master of the High Court. 36

We submit that the essential elements of a valid trust are as follows:

(a) the founder must have an intention to create a trust;
(b) the office of trustee must exist;
(c) the trust property must be identifiable; 37
(d) the trust must have a lawful object. 38

It is submitted that the appointment of the trustee by the Master of the High Court, or some other body, is not necessary for the trust to come into being. It is adequate for an individual to accept the fiduciary position in relation to the object or the beneficiary, for a valid trust to exist. The office of a trustee remains an essential element for the trust to function as a trust. When a trust is without a trustee for any period of time, the trust will not disappear, but it will at the same time also not operate as a trust as there is no one to give effect to its very object. The question is, therefore, not whether there is an individual in office, but whether the office does exist. 39

The intention to create a trust must be clearly couched in some form or another, and must create a legal obligation regarding a subject and be to the benefit of an object,

36 See Chapter 2 for a detailed discussion on the requirements for a valid trust and the contents of a trust deed.
37 This is the "subject" requirement. In Conze v Masterbond Participation Bond Managers 1996 3 SA 786 (C) it was clear that, if no property is located in the trustee, only a trust in the wide sense can result. See also Deedat v The Master 1995 2 SA 377 (A).
38 This object may be to benefit one or more parties or it may be impersonal. In Peterson and Another NNO v Claassen 2006 5 SA 191 (C) 197B Bozalek J states that there is “a material difference between the object of a trust and the purpose thereof.” According to Pace & Van der Westhuizen 35 if “the person or class for whose benefit the trust is intended is not named or determinable, the trust fails for want of a certain object”.
39 See Nel and Others v Metequity Ltd (2006) SCA 140 (RSA); 2007 3 SA 34 (SCA); 2007 2 All SA 602 (SCA), and Peterson and Another NNO v Claassen 2006 5 SA 191 (C).
even if it is impersonal. The agreement between the parties to a trust does not have to be in writing. The TPCA, however, has bearing only on a trust of which the arrangement between the parties “is by virtue of a trust instrument”. A “trust instrument” is described in section 1 as “a written agreement or a testamentary writing or a court order”.

The CISCA does not explicitly require a written trust document, but does imply that. In the definition of a CIS, reference is made to the “deed”, which is defined as an agreement between a manager and a trustee or custodian (section 1). Although a written document is not specified, section 97 requires the deed to set out the requirements for the administration of the portfolio. It is, therefore, clear that only a written document will qualify as a deed for any trust to be employed as a CIS instrument or as a SPI.40

In South Africa a trust deed, and specifically a discretionary business trust deed, is usually drafted in the form of a contract.41 The legal effect is usually that the trustee assumes formal ownership of the assets of the discretionary trust and of the duty to utilize these assets to the benefit of the beneficiaries, as prescribed by the terms of the deed.42

The identity of the beneficiaries and the trust property, as well as the object of the trust, must be clear and unequivocal. A discretionary trust deed should clearly state that the trustees have an unencumbered discretion as to how, when and to which of the beneficiaries to distribute the income and the capital of the trust estate.

Similar to any other contract it is ideal to cover important management and discretionary aspects, over and above the essentials, such as the duties and powers of the trustees, the vesting of rights, security, meetings and decision-making processes, tax, application of income and capital, termination of the trust, record-

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40 “Deed” is defined in Webster’s Reference Library Concise English Dictionary (2005) 84 Geddes & Grosset as “a legal document recording a transaction”.

41 The definition of “trust” in the TPCA also confirms the establishment of inter vivos trusts by way of agreement. Hyland & Smith 17 refer to the trust deed as the “constitutive charter” of the trust.

42 See Crookes NO and Another v Watson and Others 1956 1 SA 277 (A).
keeping requirements, liabilities, amendments to the deed, limitations, compensation, testamentary dispositions, etc. 43

A deed in terms of the CISCA is in the form of an agreement between a manager and a trustee or custodian and sets out the requirements for the administration of the portfolio, which consists of a group of assets in which members of the public are invited to invest.

It is submitted that, although trust deeds in terms of the CISCA have to comply with the essential requirements of trusts, the Registrar of Collective Investment Schemes does not necessarily compel the parties to comply. Many approved deeds do not include the minimum essentials. Some deeds lack any reference to the object or the obligations of the trustees. Without any obligations the intention is usually also difficult to determine.

It is submitted that each deed registered in terms of the CISCA must clearly indicate the intention by the parties to create a trust, must identify the portfolio as subject, the fact that the public or other investors can participate in the scheme as objects of the trust, and the fact that the trustee agrees to accept delivery of and shall hold in safe custody the assets of the portfolio.

7.4 CONTENTS OF COLLECTIVE INVESTMENT SCHEME TRUSTS

As participation in a CIS only is possible by way of purchasing units in the scheme, the investor must conclude a contract with the product provider. This contract is subject to the trust deed regulating the scheme and the prescriptions of CISCA. 44

The CISCA subdivides the different collective investment schemes in those for securities, property and participation bonds. The Financial Services Board provides some standard trust deeds on its website, which include a deed for schemes in exchange-traded funds. 45 All the deeds are in the form of a contract between the scheme manager and the trustees. 46

44 See Wille et al 131. 
45 See http://fsb.co.za. An exchange-traded fund (EFT) is an investment fund traded on a stock exchange, holding assets like shares, commodities or bonds, usually tracking an index. They offer public investors an undivided interest in a pool of securities, like unit trusts, but can be traded like shares in listed companies. Where an EFT in South Africa is structured as an open-
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The deeds are replaced from time to time and supplemental deeds are sometimes added to existing deeds, which are usually implemented to provide for separate portfolios. The purpose of the deed is to establish a CIS as intended by the Act.

The contents of the trust instrument for a CIS in Securities, published by the Financial Standard Board as a standard deed on its website, will be evaluated to determine whether it does comply with the requirements of a valid trust. 47

The Preamble to the deed reads as follows:

“A. The manager and the trustee/custodian have agreed to establish a collective investment scheme to be known as the XYZ Unit Trust Scheme under the Collective Investment Schemes Control Act and to create thereunder, by means of supplemental deed, one or more separate portfolios.

B. The manager intends to make available to members of the public for investment participatory interests in one or more portfolios.

C. To protect and secure the interests of investors in a portfolio –
   (i) the manager undertakes to invest money or other assets on behalf of investors in one or more portfolios of the collective investment scheme under the supervision and control on the trustee/custodian; and
   (ii) the trustee/custodian agrees to accept delivery of and to hold in safe custody the assets of the portfolio.”

From the preamble to is it clear that the deed is a contract between the manager and the trustee, in terms of which the manager may create portfolios and deposit the underlying assets of these portfolios with the trustee, who in turn shall take custody thereof. Together they will establish and administer the scheme thereafter.

The deed commences with a list of definitions (Part I), which includes terms such as “classes of participatory interests”, “market value”, “participatory interest in issue”, “pricing date”, “service charge”, and, “valuation point.”

Part II deals with the details of the particular investment scheme. The object of the scheme is defined as follows:

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46 A standard deed for a Collective Investment Scheme in Securities is attached to this study as Annexure A.

47 See Annexure A.
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“To establish one or more separate portfolios in which investors can obtain participatory interests in diversified assets of local or foreign origin.”

To achieve the object the manager may create and issue an unlimited number of participatory interests or classes of interests in a portfolio; or establish a variety of portfolios, which may consist of different classes of participatory interests. The aim is to provide investors with a variety of investment opportunities.

It is submitted that this definition does not qualify as a proper objective for a trust as the principal objective of a trust should always be in the interest of the beneficiaries of the trust. The investment policy of the manager is prescribed as being aimed at investing at fair prices in the underlying assets, in order to achieve the objectives of the scheme. The deed may make provision that fixed property may either be held through shares in fixed-property companies or may directly be held by the trust. In this context it is stated that the primary objective is to afford investors growth in income and capital. It is submitted that this objective shall qualify as adequate to establish a trust.48

Part III deals with the appointment, remuneration, and powers of the manager, as well as particular duties of the manager and its retirement, substitution or liquidation. Part IV deals with the appointment, remuneration and powers of the trustee or custodian, as well as aspects relating to legal proceedings, registration and retention of assets, securities, removal of trustee and others. In Part V the number of portfolios in the particular scheme is defined, as well as the right of the trustee to reject certain assets. Part VI makes provision for the creation, sale, repurchase and cancellation of a participatory interest, Part VII for the issuing of participatory interest certificates, and Part VIII for receipts and distributions. Part IX regulates the register of investors and Part X financial matters.

Section 66 stipulates that all investors are bound by the trust deed “as if such investor or person had been a party to the deed”. Although investors do not consent to the main deed, their consent must be obtained, in terms of section 67, for any amendment thereto. The procedures to be followed for such approval are prescribed. Investors also have a right, in terms of section 68, to inspect the trust deed and to receive copies thereof.

48 See below for more on the object of the trust. Compare also 2.12.4 on the object of the trust.
The deed may prohibit particular types of investments and transactions and should prescribe the realisation and reinvestment of assets. The main function of the manager is to administer the scheme in terms of the deed, and to carry into effect the objectives and investment policy of the scheme. As the manager is a company, its powers will be determined by the memorandum of incorporation of the company and relevant prescriptions of the Companies Act.

In the case of a CIS in Property the manager is endowed with wide powers regarding the development of fixed property held by the trustees or held by fixed-property companies in which the trustees hold shares, subject to certain approvals by the trustees. Specific provisions applying to all fixed-property companies of which securities are included in a portfolio of the schemes are usually incorporated into the deed. The deed may further prescribe the requirements regarding immovable property being held directly by the scheme.

It is the manager’s task to create and issue participatory interests in the portfolios in a particular scheme, to make right issues regarding such interests and repurchase interests in accordance with the Companies Act. The trustee, appointed by the manager, must exercise all the powers necessary to protect the interests of the investors in terms of the deed and the CISCA. The trustees hold the underlying assets in the portfolio on behalf of the investors.

The underlying assets are utilised to create a portfolio, and participatory interests in the portfolio are exchanged for cash. The participatory interests of a portfolio may be consolidated or subdivided, provided that the existing investors are not prejudiced in any way. The manager must keep a register of investors in respect of each portfolio to enable him to identify the holder of each participatory interest with sufficient accuracy.

The investor’s rights against the trustee or manager are limited to those specifically conferred upon the investor by the CISCA or by the deed. Payments to the investors are also limited to funds held or controlled by the trustees for that purpose, as prescribed in the deed. The deed also prescribes the manner in which payment to investors may take place, and usually provides for supplemental deeds to be added to the master deed.
In Chapter 2 it was submitted that the essential elements of a valid trust are as follows:49

(a) the founder must have an intention to create a trust;
(b) the office for someone charged with a legal duty (obligation) must exist (i.e. trustee);
(c) the trust property must be identifiable with reasonable certainty (subject);
(d) the trust must have a lawful object. (The object will automatically include a beneficiary, even if it is impersonal)

When the above collective investment scheme deed is evaluated, I come to the conclusion that it does qualify as a trust deed. Either the manager alone, or the manager and the trustee collectively, has the intention to create a trust. The manager and the trustee are charged with certain obligations regarding the portfolio, which qualifies as subject of the trust. The trust is created in the interest of the investors, who qualify as the beneficiaries of the trust.

It is submitted that the intention, the obligation and the subject matter as requirements are adhered to in all standard CIS deeds, because they are inherently part of a collective investment scheme. The one requirement to establish a trust which may be omitted from CIS deeds, however, is the correct object. CIS deeds often state that the objective of the scheme is to establish portfolios in which investors can obtain participatory interests. It is indeed an integral part of any CIS scheme. It is submitted that such an assertion would merely qualify as the purpose of the trust and not as the object of the trust.

In Peterson v Claassen, Bozalek J stated that “(w)hilst it is correct that one of the essentials for the creation of a valid trust is that the trust object must be lawful, it does not follow, however, in my view, that a trust is void if it is created with a

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49 See 2.11.
fraudulent, illegal or immoral purpose. It is submitted that there is a material difference between the object of a trust and the purpose thereof”.50

To qualify as a trust, therefore, the parties must express as objective the benefit of a third party or another impersonal objective. It is clear from the rules of the scheme that it must be administered and managed by the manager and the trustees to the benefit of the investors. It may thus be argued that, even if the object is not correctly addressed in the deed, it may still constitute a trust. It is submitted, however, that the intention to benefit some identifiable individual or individuals or groups of individuals should be clearly expressed by the parties to the trust to ensure that a valid trust is created.

7.5 THE TRUST AND OTHER SECURITIES

7.5.1 BONDS, SHARES, DEBENTURES AND DERIVATIVES

Bonds are instruments promising the bondholder payment of interest and repayment of the capital investment over a certain period of time. The bondholder becomes a creditor of the party issuing the bond. The bondholder may trade this debt of his as it is in the form of a financial instrument, like a debenture. The bond issuer must pay the interest at pre-determined intervals and must repay the principal debt on the bond-maturity date. The bondholder is a priority creditor and must receive its interest before the shareholders can receive dividends. At insolvency the bondholders shall also be treated preferentially. Debt is thus a safer option than equity.51

The risk for the investor in bonds is thus directly linked to the quality of the issuer. Bonds in South Africa are largely issued by the central government and are in the form of fixed rate bonds, zero-coupon bonds, inflation-linked bonds, variable rate bonds and foreign currency bonds. Many municipalities and parastatals are also issuing bonds, sometimes with the purpose of funding specific projects.52

50 Peterson and Another NNO v Claassen 2006 5 SA 191 (C) 197B. According to Pace & Van der Westhuizen 35, if “the person or class for whose benefit the trust is intended is not named or determinable, the trust fails for want of a certain object”.

51 Melicher & Norton 172-173. See also Van Zyl et al 272, 322, and 274-283. Compare further Wille et al 95. See 5.6.

52 Van Zyl et al 287-296 & 310.
Debentures are long-term private sector debt instruments, such as bonds. They are issued by private or public companies, but without being secured by any specific assets of the issuing company. They are actually claims against a company, issued by the company, with the purpose of meeting the company’s capital requirements.53 The debenture-holder is, as a creditor of the company, entitled to interest and repayment of the capital.

Shares represent ownership of the assets of listed companies and are traded on the stock exchange. As co-owners of a company, the shareholders are entitled to share in the profits and gains of the company.54 For the investor it is much safer to invest in the shares of a listed company than that of a private company, because of the high levels of compliance and the general tradability of the share. Shareholders generally share in the after-tax profits of the company by way of declared dividends.

Derivatives are financial instruments which refer to different terms, rights or obligations – all relating to the underlying instrument.55 They usually appear in the form of futures, forwards, swaps, options or warrants. The underlying instrument may be a share, the price of a specific metal, or a specific rate of interest. They derive their value from the “behaviour” of the underlying instruments, whether being a stock, an index, a bond, or a currency.56

Bonds and debentures are thus both debt instruments and are not packaged in a separate legal vehicle. Shares represent rights in a certain company and derivatives are claims linked to the performance of a certain instrument. None of these securities are collective investment schemes and none of them needs a separate legal entity as vehicle. Other securities, like notes and index instruments, do not use legal entities either. Trusts, therefore, do not fulfil any role in the packaging or management of these securities.

Money market instruments are excluded from the definition of “securities”, although they are administered as if they were “securities”.57 The money market trade in short-term financial claims and assets, and both companies and individuals can park

53 See Locke 215.
54 See 5.6 of this thesis.
55 Van Zyl et al (eds) 378. See s 1 of the SSA for a definition of derivatives.
56 See 5.6.
57 They are regarded as securities for the purposes of Chapter IV of the SSA.
excess cash in the money market. The money market itself is not a financial instrument. It only utilises financial instruments, which are then traded in the market itself. Money markets, therefore, also do not utilise legal entities, such as trusts.

### 7.5.2 RETIREMENT FUNDS

Retirement funds can be described as “non-profit institutions that collect, invest and administer monies contributed to them by individuals and companies”. In reality they are nothing but regulated savings pools.

The legislative definition for pension fund organisations refers to

- “any association of persons established with the object of providing annuities or lump sum payments for members”, or
- “any business carries on under a scheme or arrangement established with the object of providing annuities or lump sum payments for persons”, or
- “any association of persons or business carries on under a scheme or arrangement established with the object of receiving, administering, investing and paying benefits”.

The Act does not prescribe the legal form this association of persons, or this business carried on under a scheme or arrangement, must comply with. A pension fund may, therefore, be structured as a trust. A pension fund can be structured in the form of a collective investment scheme, but does not necessarily have to comply with the definition thereof. Pension fund organisations are financial institutions in terms of the Financial Services Board Act, which draws a distinction between pension funds and collective investment schemes.

It is submitted that the trust concept is ideally suited for pension funds. As there is a clear separation between ownership and enjoyment of the assets the funds are isolated from the insolvency of the employer, the trustees, and the beneficiaries. As the solvency position of the fund is also regulated by legislation, it is a very safe type of investment.

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58 Van Zyl et al 210-211. Banks are the most prominent players in the money market. See 5.7.
59 Ibid 171.
60 S 1 of the Pension Funds Act 24 of 1956 (as amended).
61 See the Prudential Investment Guidelines and the Financial Services Board circular PF No. 130 titled “Good Governance of Retirement Funds”.

360
The trustee also manages the employer-sponsored fund independently from the employer as far as strategy is concerned and may even require additional contributions from the employer under certain circumstances. The employer may act as founder of the trust and conclude the trust agreement with the trustees, to the benefit of the beneficiaries.62

7.5.3 HEDGE FUNDS

Hedge funds have not been defined in the SSA or in the CISCA, neither is it referred to in the Financial Markets Bill.63 It has been defined as “a privately organized investment vehicle that manages a concentrated portfolio of public securities and derivative instruments on public securities that can invest both long and short, and can apply leverage.”64 Their investment strategies are often very narrow, which leads to concentrated portfolios. They often apply unlimited leverage, while largely using derivative instruments. These investments cannot be sold in the open market and their liquidity is, therefore, regarded as being very limited.

Another definition for hedge funds, which focuses more on the risk aspect thereof, is “a portfolio which uses any strategy or takes any position which could result in the portfolio incurring losses greater that its aggregate market value at any point in time, and which strategies or positions include, but are not limited to leverage or net short positions.”65

The perception that hedge funds are totally unregulated is not correct as investment managers must still register, in terms of the Financial Advisory and Intermediary Services (FAIS) Act 37 of 2002, as fund managers with the Financial Services Board (FSB).66 National Treasury and the FSB have recently released a proposed framework for the future regulation of hedge funds in South Africa, which may house

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62 See Van Zyl et al 175-179.
63 The term is also absent from relevant legislation in the US, like the Securities Act, the Security Exchange Act, the Investment Company Act, the Investment Advisors Act, the Commodity Exchange Act and the Bank Holdings Company Act.
64 Fabozzi 606. See also Van Zyl et al 200-203. The South African hedge fund industry is small, estimated at approximately R31 billion.
66 The Board (FSB) has introduced hedge fund regulation and licensing requirements, codes of conduct and fit and proper conditions, by way of the Financial Advisory and Intermediary Services (FAIS) division. See also Kopke “A Fine Balance to Avoid Overregulation of Hedge Funds” 2012(6) De Rebus 42-43.
these funds within the CISCA, as declared schemes in accordance with section 63. Within these proposals restricted hedge funds will be limited to private arrangements amongst qualified investors, while retail hedge funds will be marketed to the general public.67

Hedge funds are generally structured as limited liability partnerships, with the objective to consistently achieve above average returns. The limited partners, who are also the investors, appoint an investment manager, who is called a general partner. The partnership does not have any liability and the manager (or general partner) has extensive powers to manage the investments.

It is submitted that hedge funds can be created in the form of trusts. One or more investors can act as founders, with all the investors as beneficiaries and the general manager acting as trustee. The trust will, therefore, be formed by way of a contract between the founders and the manager, to the benefit of the investors as beneficiaries. At least one investor will have to bind himself contractually to the subject matter.

The major differences between the CIS in securities (unit trusts) and hedge funds are as follows:

(a) unit trusts may not invest more than 5% of their assets in one security, while hedge funds invest according to the investment strategy of the fund;
(b) unit trusts are available to the general public, while hedge funds are offered to specific potential partners;
(c) unit trusts are traded on a daily basis, while hedge funds are illiquid;
(d) unit trusts can have an unlimited number of investors, while hedge funds consist of a pool of limited private partners.68

The limited partnership concept of the hedge fund, and the fact that the public is not invited or allowed to invest in the scheme, disqualifies it as a CIS – which situation

68 Van Zyl et al 202.
may be changed soon, as indicated above. Whether trusts will ever be used for the housing of hedge funds will have to be seen.

7.5.4 INVESTMENT TRUSTS IN FINANCIAL STRUCTURING

Investment trusts receive money from investors in exchange for shares, which are issued by the trust itself. The capital is then pooled and invested by the trustees. It may be invested in the shares of other companies or in property or other investment forms. Investment trusts can be in the form of public or private trusts.

Public investment trusts are listed and traded on the stock exchange as Equity Investment Instruments and the general public has access to the shares. The share price does not necessarily reflect the true value of the portfolio as it often trades at a discount. Investors receive after-cost dividends from their investment.69 It is submitted that public investment trusts do qualify as collective investment schemes and must, therefore, adhere to the requirements of CISCA.

The CIS in securities (the so-called unit trust) differs from the public investment trust in the following ways:70

(a) the unit trust is open-ended and can continue to issue new units, which keep the price in line with the underlying value, while the investment trust is closed-ended, with a fixed number of shares being issued;

(b) the unit trust price depends on the value of the underlying securities and is determined according to the trust deed, while the share price in the investment trust is determined by supply and demand;

(c) the unit trust may not be invested by more than 5% in any one security, while the investment trust may be invested according to the investment strategy of the trust;

(d) unit trusts are not listed on an exchange, while public investment trusts are listed.

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69 Ibid 200.
70 Ibid 202.
One or more individuals can form a private investment trust, with the purpose of holding shares in private or public companies, or to purchase land for development or a property portfolio. These trusts may be vesting or non-vesting and only private individuals, or private legal entities, may take up a shareholding or rights to the assets in such a trust.71 As members of the public are not invited or permitted to invest in such a trust, it will not qualify as a CIS. Such a trust may, however, qualify as a public property syndication scheme, in which event the investor must be informed as such.72

7.6 THE TRUST AS ARBITRAGE VEHICLE

The meaning and impact of regulatory arbitrage, as well as the role of securitisation as vehicle for arbitrage, have been discussed in some detail in Chapter 5. The question is now whether it is justifiable to argue that the trust as financial vehicle is also used for the purposes of arbitrage.

Fleischer regards regulatory arbitrage as a method of financial “gamesmanship”, with the “game” being the process by which parties take advantage of any gap between the economic potential or opportunity of a deal, and the regulatory environment in which the transaction takes place. The secret is to ensure that the restructuring or relocation of the transaction makes it economically more viable, without a detrimental effect to its effectiveness or legality.73

As cost is one of the driving motivations for arbitrage, financial institutions may be tempted to believe that they can make an acceptable profit without any associated costs. Frachot makes it clear that there are “no free lunches” and that the level of arbitrage may bring with it a similar level of risk.74 It is alleged that most fees earned in the modern banking industry can be linked to the exploitation of arbitrage opportunities, which are most often the result of loopholes in certain legal, financial and accounting models.75

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71 See 4.3.2 for the practical application of the private investment trust.
73 Fleischer 227.
74 Frachot 124 submits that there is a “straight corollary” between the advantage and the risk.
75 Ibid 126.
Chapter Seven: Trust as Finance Instrument

The inherent risks of regulatory arbitrage as business model must not be underestimated. The lack of real economic value in such arrangements, apart from the apparent immediate rewards, has proved to be detrimental to some banks in the recent past. It is generally accepted that securitisation through special-purpose institutions are often more cost-effective than direct borrowing because of the reduction in monitoring costs. The insolvency-remote special-purpose institution separates its source of payment of its securities from the issuer’s other risks, which negates the need for active monitoring. Coupled with the leverage potential and the often favourable tax and accounting treatment of special-purpose institutions, make these instruments ideal for arbitrage purposes.76

Securitisation is often used as a regulatory arbitrage tool and that became further apparent after the first Basel Accord was introduced. Trusts fulfil an important role in many securitisation transactions and can, therefore, be regarded as a tool of arbitrage in securitisation.

In many financial centres and tax-neutral jurisdictions trusts are used by non-residents to structure their offshore asset bases and investments. These structures function as vehicles of regulatory arbitrage – either for protection against creditors or for tax purposes. Trusts have often been suspected as being tax-avoidance tools by regulators and have thus lead to punitive measures. In South Africa trusts have to pay tax at a higher rate than any other legal entity. There is no rationale in this – except as a measure to discourage taxpayers to utilise trusts for arbitrage purposes.

7.7 RELEVANT LEGISLATION AND THE ROLE OF TRUSTS

A number of Acts dealing with financial instruments, financial institutions and financial markets do have a bearing on trusts and trustees. These will be discussed in this section.

7.7.1 COLLECTIVE INVESTMENT SCHEMES CONTROL ACT 45 OF 2002

This Act commenced on 3 March 2003 and replaced the Unit Trusts Control Act and the Participation Bonds Act. Its purpose is to regulate and control the establishment

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76 Partnoy 222. See also Acharya & Schnabl 144-145.
and administration of collective investment schemes, which is a much wider concept than only unit trusts and participation bonds.\footnote{This Act will be referred to as CISCA.}

Collective investment schemes include all schemes in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, by way of shares, units or another participatory interest, while they share the risks and the benefits in proportion to their participatory interest. Any arrangement in which several beneficiaries contribute capital to a fund in return for transferable certificates, may be in the form of a trust,\footnote{See Honiball & Olivier 304.} and is regulated by CISCA.

The scheme is established by way of a deed and administered in terms of this deed, which may be packaged in the form of a number of entities, of which the trust is one. A CIS itself may be formed and operated in a trust, and a trust may also fulfil the role of trustee or custodian in a scheme. The deed is defined as

\begin{quote}
“the agreement between a manager and a trustee or custodian, or the document of incorporation, whereby a collective investment scheme is established and in terms of which it is administered”,
\end{quote}

and is the central defining document in terms of which the scheme is established. It sets out the operating rules of the fund, the types of investments the fund may make, the underlying charges, and the rules of repurchasing participatory interests.\footnote{S 1 of CISCA.}

These deeds are registered with the Registrar of Collective Investment Schemes and not with the Master of the High Court. The term “trust instrument” is defined in the TPCA as “a written agreement . . . according to which a trust was created”.\footnote{This Act will be referred to as TPCA.} A trust deed in terms of which a collective investment scheme is established, therefore qualifies as a trust instrument. All property in this trust, like shares or units, which must be administered in terms of the trust deed, qualifies as trust property. Collective investment schemes would thus have been regulated by the TPCA, had it not been for section 113 of CISCA specifically stipulating that the TPCA does not apply in respect of schemes administered in terms of CISCA.\footnote{See s 113 of the TPCA.} Although the TPCA
does not apply, the structure still has to comply with the common-law requirements of a trust.

CISCA does prescribe the matters which must be provided for in the trust deed as well as the exemption from and suspension of certain provision from the deed. Specific matters are prescribed for collective investment schemes in securities and for those in property. These include the investment policy; the valuation of the underlying assets in the portfolio (including non-listed assets); the calculation of selling and repurchase prices, as well as of distributions; the limits terms and conditions under which script may be lent and which the manager may borrow money on behalf of the portfolio; the charges to be levied; the necessary notices to investors and the procedure of amending the deed.82 An authorised agent appointed by a manager of a CIS, as well as a nominee company approved by the registrar, may both also be in the form of a trust.

The deed must compel the manager to repurchase all participatory interests offered to it. This is one of the attractive attributes of the CIS. The deed must define the workings of repurchasing, like the repurchase notices by investors and the valuation points to be applied to each repurchase. The asset manager and the scheme manager may belong to the same financial group or the scheme manager may appoint an outside asset management company. The asset manager is a key player as the investor relies on his/her abilities to achieve the required results with his/her investment decisions.83

The collective investment schemes vehicles which may all make use of trusts as their operative vehicle include a variety of schemes, like foreign collective investment schemes, unit trusts, participatory bonds, other participatory interests in schemes, index instruments, certain securities, money market instruments, derivative instruments, special-purpose institutions, and securitisation schemes.84 The Act places an obligation on the scheme managers to administer the schemes honestly, fairly and with “skill, care and diligence”, as the manager is in a fiduciary relationship

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82 See s 97 read with Schedules 1 and 2. An association licence may also be applied for by an association in the form of a trust. See s 25 read with Schedule 4.
83 The linked service providers act like warehouses and are financial institutions which package, distribute and administer a broad range of collective investment instruments by way of single entry points.
84 See the definition of “securities” in s 1 of the SSA.
towards the investors and must act in their best interests. Managers are burdened with a variety of duties, similar to those of trustees, such as the separation of assets, the avoidance of conflicts of interests, full disclosure, and the dispensing of adequate information to the investors.

The following illustration indicates the intricate relationships between the different parties to the CIS.

ILLUSTRATION 7: PARTIES TO THE COLLECTIVE INVESTMENT SCHEME

85 It is submitted that the scheme managers must also comply with the Financial Institutions (Protection of Funds) Act 28 of 2001, as they are in a fiduciary position, although they are not trustees in the formal sense of the word.

86 See Profile’s Unit Trusts and Collective Investments September 2011 69.
7.7.2 COMPANIES ACT 71 OF 2008

This Act commenced on 1 May 2011 and replaced Companies Act 61 of 1973 and made amendments to the Close Corporations Act 69 of 1984. The primary purpose of this Act was to provide for a consistent and harmonious business regime in South Africa in future, by way of regulating the incorporation, registration, organisation and management of companies responsibly.\(^\text{87}\)

Although this Act does not deal with trusts per se it does have some bearing on the trust concept. The fact that the term “juristic person” in section 1 includes a trust, makes it imperative to determine the impact of this Act on trusts in general and whether it has any effect on the trust as a vehicle for financial instruments.\(^\text{88}\)

In terms of section 3 a company will qualify as a subsidiary of a trust when the trustees of that trust are directly or indirectly able to exercise a majority of the general voting rights associated with the shares of that company, or to elect or appoint the majority of the directors. A private company or a close corporation of which the shares or membership interest respectively is held by a trust will, therefore, be regarded as a subsidiary of that trust, as the trustees of the trust will exercise control over the company and will elect the directors.\(^\text{89}\)

Section 40(5)(b)(ii) makes provision for certain shares to be held in trust for a third party, subject to specific performance by aforementioned. Subsections (6) and (7) stipulate specific rules regarding such shares and the manner and conditions under which they may be transferred to the subscribing party as and when they have become negotiable or upon fulfilment of all the prescribed obligations.

Section 43 makes provision for security documents to be in the form of a trust deed. Security documents include documents by which debt instruments are offered and the terms and conditions regarding the offer may be drafted in the form of a trust deed. The trust may act as holder of the debt instrument, subject to not having any interest in, or relationship with, the company that might conflict with its fiduciary duties.\(^\text{90}\) The trust deed may not exempt the trustee from, or indemnify him against,

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\(^{87}\) See s 7 for the details regarding the purposes of the Act.
\(^{88}\) The term “person” in the Act also includes “juristic person”.
\(^{89}\) See also the meaning of “holding company” in relation to a subsidiary, in s 1.
\(^{90}\) S 43(5).
his liability for breach of trust or failure to exercise the required degree of care and
diligence.\(^{91}\)

A trust may hold office as company secretary, subject to the requirements of sections
84(5), 86 and 87, and may be utilised to establish an employee share scheme as
provided for in section 95(c).\(^{92}\)

There is an overlap between companies and trusts as far as their application as
investment vehicles are concerned. In terms of the CISCA a collective investment
scheme can be either in the form of a trust or a company. Investment trusts,
however, are not trusts, but listed holding companies that invest in other companies
listed on a stock exchange and, therefore, fall under the Companies Act and not the
CISCA.

**7.7.3 SECURITIES SERVICES ACT 36 OF 2004**

This Act commenced on 1 February 2005 and consolidated the laws relating to the
regulation and control of exchanges and securities.\(^{93}\) It deals with all securities and
also to a limited extent with financial institutions.\(^{94}\)

As has been indicated in 7.7.1, many securities, like foreign collective investment
schemes, unit trusts, participatory bonds, other participatory interests in schemes,
index instruments, certain securities, money markets instruments, derivative
instruments, special-purpose institutions, and securitisation schemes, may be
established in the form of a trust.

Many financial institutions, like pension funds, friendly societies and collective
investment schemes may be organised in trust form.\(^{95}\) Also self-regulatory

\(^{91}\) *Ibid* (7).

\(^{92}\) See ss 97 for the standards for qualifying employee share schemes. See 4.3.6.

\(^{93}\) It replaced the Stock Exchanges Control Act, the Financial Markets Control Act, the Insider
Trading Act and the Custody and Administration of Securities Act.

\(^{94}\) “Financial institutions” include pension funds, friendly societies, collective investment schemes,
insurers, insurance intermediaries, and banks (s 1). See the Financial Services Board Act for a
more complete definition of “financial institutions”.

\(^{95}\) Banks may be only in the form of public companies. In general terms a long-term or short-term
insurance company shall only be registered if it is a public company – see subs 9(3)(a) of both
the Long-term Insurance Act and the Short-term Insurance Act.
organisations, like exchanges and central securities depositories may be operated in that form.96

This Act may shortly be replaced by the Financial Markets Act, which is currently in Bill form and will be discussed in more detail in 7.7.13. In the policy framework to the proposed new legislation it was stipulated that the reform of the financial sector regulatory system must be guided by fifteen governing principles.97 These are discussed in more detail in 9.2.9.1.

7.7.4 CO-OPERATIVES ACT 14 OF 2005

The motivation for this Act was to implement international co-operative principles and to enable co-operatives in the process to acquire legal status separate from their members. The principle purpose is described in section 2 as the promotion of the development of sustainable co-operatives, thereby increasing the number and variety of economic enterprises operating in the formal sector.

A co-operative is, according to section 1, an autonomous association of persons united voluntarily to meet their common economic and social needs and aspirations by way of an enterprise operated on co-operative principles. The members may receive shares in the co-operative, and each member has one vote in all meetings of a primary co-operative, which may be formed by a minimum of five natural persons.

The Act stipulates in some detail the provisions to be included in the constitution of a co-operative. The constitution may provide for a board of directors to be appointed and for the board to delegate some powers to a director, committee or manager.98 Although the Act does not provide specifically for a trust to be used in the formation of a co-operative, there should be no reason why this cannot be done. The trust deed needs to include the prescribed provisions and the trustees can be appointed in the same way as a board of directors. A trust that is registered as a co-operative will be incorporated as a legal person as prescribed in section 8.

96 See s 1, read with ss 8 and 30 of the Securities Services Act.
98 See s 14.
A co-operative can also be registered as a co-operative bank, as defined in the Co-operative Banks Act 40 of 2007, which is discussed in 7.7.9.

7.7.5 THE NATIONAL PAYMENT SYSTEM ACT 78 OF 1998

The purpose of this Act is to provide for the management, administration, operation, regulation and supervision of payment, clearing and settlement systems in South Africa. Financial instruments issued or traded in a financial system require funds to flow from one counterparty to another. When different banks are involved in a specific transaction, an inter-bank system is necessary. This flow-of-funds process is affected by the national payment system, which is a department of the South African Reserve Bank.

The designated clearing system participant, settlement system participant and settlement system operator are all defined as “persons”, specified in the applicable prescribed notices.

Section 1 specifically includes a trust in the definition of “person” for the purposes of this Act. A trust can thus be used as instrument to fulfil a variety of roles in the national payment system, such as designated clearing system participant, designated settlement system operator, designated settlement system participant, payment clearing house operator, settlement system operator, system operator, or Reserve Bank settlement system participant.

There is also no apparent reason why a trust cannot operate as a payment system management body, which is established with the object of organising, managing and regulating the participation of its members in the payment system. Trusts can, therefore, be utilised in a number of different roles in the national payment system.

7.7.6 FINANCIAL INSTITUTIONS (PROTECTION OF FUNDS) Act 28 OF 2001

This Act replaced the Financial Institutions (Investment of Funds) Act 39 of 1984 and has as its purpose the provision for, and consolidation of, the laws relating to the

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100 Van Zyl 218. The South African Reserve Bank Act 90 of 1989 prescribes the specific role of the Bank in the payment, clearing and settlement systems – see s 10(c).
101 See Lawack-Davids 2008(3) Obiter 453-471 for discussion on the framework of the National Payment System as detailed in Act 78 of 1998.
investment, safe custody and the administration of funds and trust property by financial institutions.

This Act refers to the definition of “financial institution” in the Financial Services Board Act 97 of 1990 (as amended), and includes pension funds, friendly societies, collective investments, stock brokers, insurers, independent intermediaries, financial service providers, and banks and other persons who deal with trust property as a regular feature of their business, without being authorised in terms of certain Acts. Most financial institutions are in some way or another involved with trusts and/or trust property. Many institutions, like pension funds, trust companies and unit trusts companies, are structured in the form of trusts, and most of them deal with fiduciary funds as a regular feature of their business.

It is imperative, therefore, for trustees, when dealing with trust funds, to comply with the requirements of this Act. The trustees must only act in terms of the trust deed and conclude transactions falling within their express powers. If need be, the trust deed may be amended by the trustees, and sometimes the beneficiaries, to empower them before acting. The general provisions trustees must adhere to, in terms of sections 2 to 4 of Act 28 of 2001, are as follows:

(a) they must observe the utmost good faith and exercise the care and diligence required of trustees;

(b) they may not gain any improper advantage for themselves or any other person;

(c) must declare any financial interest in writing to its co-trustees;

(d) may not invest trust property in a manner otherwise than directed by the trust deed or other instrument or agreement.

(e) may not invest trust property, otherwise than in the name of the trust or the trustees for the time being, except if so directed or required by the trust deed.

Non-compliance with these provisions is a criminal offence, punishable with a fine, imprisonment, or financial compensation.

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102 The Acts referred to are the Companies Act, the Close Corporations Act and the TPCA.
This Act focuses on trust property and not necessarily on property held by a trust. The definition of “trust property” is much wider than that in the Trust Property Control Act and includes any property “invested, held, kept in safe custody, controlled, administered or alienated . . . for, or on behalf of . . . the principal”. All assets held in a trust in terms of a trust instrument would, therefore, also be affected by this Act.

7.7.7 MUTUAL BANKS ACT 124 OF 1993

This Act provides for the registration and supervision of the activities of juristic persons doing business as mutual banks. Members of mutual banks share in the interest payable, depending on the type of share in which they have invested. The fact that the share capital of mutual banks cannot be traded on the stock exchange, limited their applicability and popularity.

The Act does not specify what type of legal vehicle may be used to form a mutual bank. While banks are required to be public companies, mutual banks can be in the form of any juristic person, the members of which qualify as such by virtue of their being shareholders in that entity, and are entitled to participate in the control of the said legal entity.

It is submitted that a trust can be used to form a mutual bank, although the definition refers to a juristic person. The registration of a mutual bank grants the bank juristic personality, irrespective of the personality of the vehicle it is housed in. A mutual bank which is formed by shareholders in a trust shall, therefore, acquire legal personality by way of its registration. It is submitted that any reference to articles of association shall include a trust deed.

7.7.8 BANKS ACT 94 OF 1990

This Act provides for the regulation and supervision of the business of public companies taking deposits from the public. Banks are required to be public companies registered as such. The business of a bank includes, amongst others, the acceptance of deposits from the general public as a regular feature and the utilisation of money, or of the interest or other income earned on money, accepted by

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104 Van Zyl et al 106-107.
way of deposit.\textsuperscript{105} In the general processes by a bank of utilising money, it often grants funds to lenders or investors, or for financing purposes, through the medium of a trust or a nominee.

Most banks do have trust companies as subsidiaries, specialising in fiduciary and related services.\textsuperscript{106} Banks can also be in association with trusts for administrative purposes.\textsuperscript{107}

7.7.9 CO-OPERATIVE BANKS ACT 40 OF 2007

This Act is linked to the Co-operatives Act 14 of 2005, which have been discussed in 7.7.4. A co-operative bank is a co-operative that is registered as a bank in terms of this Act and whose members are of similar occupation or profession or employed by a common employer or within the same business district, or have common membership in an organisation or association, or reside within the same defined community or geographical area. The purpose is to enhance access to banking services to the unbanked communities.

As has been indicated in 7.7.4, a trust may be utilised to form a co-operative and thus a co-operative bank can also be in the form of a trust.

7.7.10 FINANCIAL SERVICES BOARD ACT 97 OF 1990

This Act provides for the establishment of a board to supervise compliance with laws regulating financial institutions. The term “financial institution” is not defined in the CISCA,\textsuperscript{108} but includes, in terms of section 1 of the Financial Services Board Act 97 of 1990 (as amended), pension fund organisations, friendly societies, collective investment schemes, exchanges, long-term insurers, independent intermediaries, authorised financial services providers, banks, and any person dealing with trust property as a regular feature of his business, without being so registered, licensed,

\textsuperscript{105} See s 1 for the definition of “the business of a bank”.
\textsuperscript{106} See subss 6(3)(e), 52(1)(d)(i) and 53(c).
\textsuperscript{107} See subs 37(7)(c)(ii).
\textsuperscript{108} “Financial institution” is also defined in s 1 of the SSA.
recognised, approved or authorised in terms of the Companies Act, the Close Corporations Act or the TPCA.\textsuperscript{109}

The main function of financial institutions is to render financial services to the public or to juristic persons. A number of these entities may function in the form of a trust, including any collective investment scheme, or any other trust, even if it is not a CISCA, but it is authorised in terms of the CISCA. Trusts operating as financial institutions will, therefore, be supervised by the FSB.

\section*{7.7.11 SOUTH AFRICAN RESERVE BANK ACT 90 OF 1989}

The purpose of this Act is the legislative consolidation of the monetary system in South Africa. The primary objective of the Reserve Bank is to protect the value of the local currency.

The definition of the term “financial instrument” in section 1 is outdated as it refers to securities as defined in the Stock Exchange Control Act and financial instruments as defined in the Financial Markets Control Act, both of which have been repealed by the SSA. The Minister still has the power in terms of subsection (d) to declare “any other instrument, right or benefit” to be a financial instrument with the purpose that the Bank can buy, sell or deal in such an instrument and to hold it in safe custody for third parties. The Bank may deal in financial instruments, issue its own interest-bearing securities for purposes of monetary policy, and deal in such securities.\textsuperscript{110}

The only relevance of this Act for trusts would be when the Bank deals with financial instruments or other securities which are structured in the form of a trust as legal vehicle.

\section*{7.7.12 INSOLVENCY ACT 24 OF 1936}

In 6.8.2 the aspect of insolvency-remoteness in securitisation transactions has been discussed. The importance of the protection of the securitisation parties against insolvency cannot be over-emphasised as this is one of the major advantages of these transactions. The assets of a special-purpose institution are not subject to any claim by an institution transferring assets in terms of a traditional securitisation

\textsuperscript{109} The reference to “trust property” is as per the definition in the Financial Institutions (Protection of Funds) Act 28 of 2001.

\textsuperscript{110} Subss 10(h) and (i).
scheme to the SPI, just because the transferring institution is insolvent.\textsuperscript{111} The insolvency-remoteness aspect is also closely linked to the true sale requirement in 6.8.4. Where only a secured loan has taken place with no true sale, the protection against insolvency will most probably also fail.

Certain dispositions by the seller may, in the event of the seller’s insolvency, run the risk of being of no effect. In terms of the Act, dispositions made without value (section 26), voidable preferences (section 29), undue preferences (section 30), collusive dispositions (section 31), and voidable sales of businesses (section 34), are all examples of situations under which a true sale has not taken place. A court may also set a disposition aside in terms of the actio pauliana if it is proved that it was made by the insolvent party with the intention of giving one creditor an unfair advantage over other creditors. Part of the rating agencies’ functions would be to ensure, by way of proper due diligence processes, that these risks do not exist.

The insolvency of an originator can, therefore, always hold a risk for a trust acting as SPI, although it should, at least theoretically, be protected. The whole transaction must be packaged correctly to safeguard the SPI adequately.\textsuperscript{112}

7.7.13 FINANCIAL ADVISORY AND INTERMEDIARY SERVICES ACT 37 OF 2002

This FAIS Act regulates the licensing and operating of financial intermediaries in order to manage the level of advice and service to individual and group investors. All financial service providers and financial service provider representatives must meet the fit and proper requirements in terms of knowledge and skills in order to be licensed to give financial and investment advice.\textsuperscript{113}

An authorised financial service provider may be registered as a legal entity, including a trust. Besides compliance with the Companies Act or the TPCA respectively, such a service provider must also continually meet the FAIS requirements. A compliance officer must be appointed where more than one key individual is involved, proper

\begin{footnotesize}
\begin{enumerate}
\item[111] Securitisation Notice in GG 30628 dated 01-01-2008.
\item[112] The insolvency process will in future be affected by the new business rescue procedure to facilitate the rehabilitation of companies that are financially distressed as laid down in Chapter 6 of the Companies Act 2008. The definition of “insolvency proceeding” in the Financial Markets Bill 2011 includes the business rescue procedure.
\item[113] See s 8 of the FAIS Act.
\end{enumerate}
\end{footnotesize}
records must be kept, accounting records must be maintained and annual financial statements prepared. The financial service provider may appoint authorised representatives and the service provider accepts responsibility for the activities of the representative within the scope of its duties.

Financial service providers will consider a number of aspects in determining whether a trust is the ideal vehicle to use for its operations. These factors will include aspects of liability, statutory requirements, shareholding or beneficial interest requirements, accounting requirements, tax considerations, etcetera.114

7.7.14 FINANCIAL MARKETS BILL OF 2011

The purpose of this Bill is to create legislation replacing the Securities Services Act of 2004, in alignment with international standards. After an extensive review process, during which no major new policy issues were identified, it was decided that the extent to which existing policy is reflected by way of the SSA, should be expanded. It was found to be more appropriate to replace the current Act than instituting a complex amendment bill.

It seems to be more of a consolidation and updating of the previous Act than creating new concepts. The Memorandum suggests that recent developments in the local and international financial markets, as well as the global financial crisis, have necessitated an analysis of the appropriateness and effectiveness of the current regulatory approach and framework.

In amending the current Act, it was suggested that the integrity of the regulatory framework of the financial markets must be maintained; the regulatory framework must continue to meet its objectives; the regulatory framework must be aligned with local and international developments and standards; and it must remain effective in mitigating potential impacts of any possible future financial crisis.115

“Intermediaries” have been removed from the definition of “financial institution”, and the terms “securities” now include both listed and unlisted securities. A very

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114 See 3.2 and 3.3 for the advantages and disadvantages of trusts as business vehicle.
115 The policy framework of the Financial Markets Bill 2011 will be discussed in more detail in Chapter 9 of this thesis.
comprehensive definition of the term “settle” has been included, and the concept of “insolvency proceeding” is explained in some detail.

As the concepts of “securities” and “financial institution” are similar to that of Act 36 of 2004, this Bill, if enacted in its current form, shall be applicable in a similar way as the SSA.\(^\text{116}\) The term “person” shall include a partnership and a trust.\(^\text{117}\) A self-regulatory organisation\(^\text{118}\) that is not a juristic person (e.g. a trust) is, from the date on which it is licensed by the registrar, a juristic person for the purposes of this Bill, and may convert to a public or private company with the approval of the registrar.\(^\text{119}\) In the event that the self-regulatory organisation (i.e. an exchange, a central securities depository, or an independent clearing house) is not a juristic person, the provisions of the Companies Act relating to the duties of directors, shall apply to each member of the controlling body (e.g. trustees) of the organisation.\(^\text{120}\)

For the purpose of control and shareholding, “associate” in relation to a juristic person includes any person in accordance with whose directions its governing body (e.g. board of trustees) acts, and in relation to any person it includes a trust controlled or administered by it.\(^\text{121}\) It is thus clear that this Bill has an affect on trusts used as legal entities in the financial markets.

### 7.7.15 FINANCIAL SERVICES LAWS GENERAL AMENDMENT BILL OF 2012

The object of this Bill is the stabilisation of the financial services sector by way of a holistic regulatory approach and effective supervisory structures.\(^\text{122}\) This is addressed, amongst others, by way of a closure of particular regulatory gaps and the

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\(^\text{117}\) See s 81 of the Bill.

\(^\text{118}\) See s 1 for the definition of a “self-regulatory organisation”.

\(^\text{119}\) Subss 63(1) and 64(1).

\(^\text{120}\) See Da Silva C “A First Step towards Centralised Financial Services Regulation” April 2012 *Financial & Advisory News* 12. Compare Financial Services Laws General Amendment Act 22 of 2008 which has not yet come into operation, but has been amended by the 2012 Bill.
Chapter Seven: Trust as Finance Instrument

provision of increased supervisory capabilities. Several of these proposed amendments which have a direct effect on trusts are referred to below.

Trustees would be personally liable for the compliance with and the payment of contributions in terms of section 13 of the Pension Fund Act 24 of 1956.123 Pension funds in the form of trusts would qualify for business rescue purposes as if it were a company.124 Any person that performs an activity regulated by the TPCA shall be regarded as a “financial institution” as defined in the Financial Services Board Act 97 of 1990,126 but no person shall be liable for any loss or damage due to any power, duty or function.126

A number of amendments to stipulations in the Financial Institutions (Protection of Funds) Act 28 of 2001 referring to “trust property”, have been introduced.127 Section 176 confirms the position that a key individual in terms of the Financial Advisory and Intermediary Act 37 of 2002 may be registered as a trust.128

7.7.16 CREDIT RATING SERVICES BILL OF 2011

The purposes of this Bill are to ensure responsible and accountable credit rating agencies; to protect the integrity, transparency and reliability of the credit rating process; to improve investor protection; to improve the fairness, efficiency and transparency of financial markets; and to reduce systemic risk.129 A “person” in terms of the Bill includes a trust and a “regulated person” is “a person that has been granted authority “to conduct business or activities”. Only a person incorporated under the Companies Act may, however, be registered as a credit rating agency.130 Although a trust can thus not be registered as such, it may be regarded as an associate in relation to any other person.131 It is submitted that this Bill will have little, if any, impact on trusts.

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123 See subs 15(8)(c) of the Bill.
124 See s 29 of the Bill.
125 See s 52 of the Bill.
126 See s 64 of the Bill.
127 See ss 154, 155 and 157 of the Bill. The definition of “trust property” in Act 28 of 2001 includes any asset held or administered on behalf of a third party.
128 In terms of s 8 of Act 37 of 2002.
129 S 2 of the Bill.
130 See s 1.
131 In terms of s 18.
7.8 THE USE OF OFFSHORE TRUSTS

The offshore trust has been touched on in 3.7, 4.7 and 4.8. It has been illustrated that offshore trusts are used in the packaging of financial instruments in a similar way as onshore trusts. Besides the usual estate planning and corporate structuring processes, is it common practice in many offshore financial centres to use trusts for specific financial instruments, like mutual or unit trust funds, other collective investment schemes, umbrella funds, fund of funds, pension funds, provident funds, employee service benefit or stock option plans, insurance entities, and as structured finance vehicles.132

In a jurisdiction like Guernsey nearly 1200 collective investment schemes are managed. The legal vehicles used for these instruments include companies, protected cell companies, incorporated cell companies, unit trusts and limited partnerships. All unit trusts are constituted by an instrument of trust, usually between the manager and the trustees and are subject to the Guernsey Trusts Law of 2007. It is not a separate legal entity but is based on the concept of a trustee with legal title to the assets, held for the benefit of the unit holders.133

The principal forms of collective investment schemes under management in Ireland are schemes constituted in the form of unit trusts, investment companies or limited partnerships. A unit trust scheme is defined as “any arrangement made for the purpose, or having the effect, of providing facilities for the participation by the public, as beneficiaries under a trust, in profits or income arising from the acquisition, holding, management or disposal of securities or any other property whatsoever.”134 They may be either close-ended or open-ended. A unit trust scheme must act through an approved Irish incorporated fund manager company, with a prescribed minimum level of resources. Unit trust funds can be utilised for fund of funds, feeder

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132 Ginsberg 511.
133 http://www.pfs.gg/Userfiles/file/Gsy_Collective_Invest_Sch_050511.pdf (accessed 19-09-2011). See also Ginsberg 339. The assets of Protected Cell Companies are segregated into cellular and non-cellular assets and held in individually created cells, or the core, respectively. In an Incorporated Cell Company is each individual cell an incorporated company with separate legal personality.
134 The Unit Trusts Act of 1990.
Chapter Seven: Trust as Finance Instrument

funds, venture or development capital schemes, money markets, property schemes, futures and options schemes, or closed-ended schemes.135

In the Isle of Man three main classes of collective investment schemes are permitted, namely authorised funds, recognised funds and restricted funds. Its trust law is based on English law and is regulated by a number of different pieces of legislation, like the Trustee Act of 1961 and the Trusts Act of 1995.136 Unit trusts are further regulated by the Financial Services Act of 2008 and the Collective Investment Schemes Act of 2008. Nominee holders of units in unit trusts must also hold a fiduciary licence. The company laws have the flexibility to allow for the creation of a wide range of special-purpose vehicles, which are well suited to trust needs. The term “investment business activities” in the Isle of Man include dealings in investments, managing investments, giving investment advice, or acting as manager or trustee of collective investment schemes.137

Offshore trusts have the potential of being misused as money laundering vehicles. Roper and Ware explains the three steps in money laundering as follows: placement, during which the cash proceeds of the illegal activity are physically disposed of; layering, which is the process of disassociating the proceeds from its source by way of complex financial transactions; and integration, which is the legitimising process by bringing the laundered funds into the main economy. As financial institutions are targeted in this process, all forms of potential vehicles for such criminal activity must be monitored and policed.

A number of international initiatives have been introduced – one of which is the Financial Action Task Force on Money Laundering, which was formed in 1989.138 This topic was recently again on the agenda at an international tax and crime

137 The Basel Committee on Banking Regulations and Supervisory Practices (1998); the UN Vienna Convention; the Financial Stability Forum; the Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime (1990); the EC Directive on Prevention of the Use of the Financial System for the Purposes of Money Laundering (1991); and the initiatives by the Organisation for Economic Co-operation and Development, are all occupied with the issue of anti-laundering initiatives.
conference, named the Oslo Dialogue. International tax related crimes and money laundering processes can threaten the economic stability of countries and deprive governments of revenues needed for future sustainable development.  

7.9  THE BASEL ACCORDS

Banks are exposed to major risk factors, like credit risk, interest rate risk, market risk, operational risk and solvency risk. These risks must all be managed to ensure that banks do not go insolvent. In a case where depositors become concerned about a bank’s health or cash flow position, they may withdraw large amounts of their deposit, which will result in liquidity problems for the institution. The risk of such systemic failures has always forced authorities to regulate the banking industry more stringently than other commercial activities.

To monitor, coordinate and regulate international banking, the Basel Committee on Banking Supervision was established in 1974. During the 1980s banks were lending extensively, and the external indebtedness of many countries was growing rapidly and unsustainably. This resulted in the potential insolvency of some major international banks.

In 1988 the Basel Committee issued a document (Basel I Capital Accord), stipulating minimum percentages of capital that all banks should hold. The general purposes were to strengthen the stability of the international banking system and to ensure consistency in the international banking environment, by decreasing competitive inequalities amongst banks. Various limitations in the technical aspects of the Accord, like its over-simplified calculations and classifications, have limited its applicability and practical implementation.

The Accord was implemented in the European Union by way of the Capital Requirements Directive (CRD), which was designed to ensure the financial

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139  March 2011.
141  Smith Implication of Basel II 112.
soundness of credit institutions (banks and building societies) and certain investment firms. The CRD came into force on 1 January 2007, with firms applying the advanced approaches from 1 January 2008.\(^{143}\)

Although most countries adopted Basel I and its minimum regulatory capital requirement of 8%, it did not successfully take into account certain financial instruments and portfolio management techniques. It resulted in more complicated financial products, and specifically securitisation structures allowed banks to circumvent the regulatory minimums in practical terms, by way of so-called legal engineering.\(^{144}\) This resulted in the introduction of the Basel II Capital Accord in 2007, based on the three pillars of minimum capital requirements, supervisory review processes and market discipline.\(^{145}\)

While Basel I introduced risk-weighing of assets, Basel II refined this further by placing emphasis on supervision and market discipline to control capital adequacy. The focus was, however, still on the solvency of individual institutions, and not on systemic risk or liquidity. Aforementioned became the Achilles heel of the financial world, allowing banks to hold lower levels of regulatory capital for assets securitised through special-purposes institutions. Some submit that efficient capital adequacy requirements should be balanced with discretion to provide enough flexibility for the regulator when the markets change.\(^{146}\)

Basel II introduced the so-called “three pillar” concept, with Pillar I setting out the minimum capital requirements required by firms to meet credit, market and operational risk profiles; Pillar 2 requiring from firms and supervisors to take a view on whether a firm should hold additional capital against risks not covered in Pillar I; and, Pillar 3 aiming at improving market discipline by requiring firms to publish certain details of their risks, capital and risk management. Smith submitted that Basel II had the potential of eliminating many of the regulatory arbitrage opportunities available after Basel I, by alignment of the capital with the actual risk exposures, and by

\(^{143}\) The CRD framework was revised by the introduction of Basel II.

\(^{144}\) See MacNeil & O’Brien 72-73. Techniques like the construction of preference shares with dividends which could be interrupted if the bank lands in trouble, and innovative floating rate notes, were some of the new instruments developed by researchers.


\(^{146}\) MacNeil & O’Brien 438 & 194.
increasing the capital requirements for securitisation exposures. He, therefore, predicted a major impact on the securitisation industry, although he still submitted that new securitisation techniques were likely to be developed to counteract the effects of Basel II.\textsuperscript{147} The intervention of Basel II, however, was too late to have prevented the financial crisis.

The Basel III paper, prompted by the 2008 international financial crisis, announced on 10 December 2010, introduced higher and better quality capital requirements, better risk coverage, as well as a leverage ratio and capital build-up measures for periods of financial stress. In future banks will also be required to hold capital conservation as well as a countercyclical buffer. The Basel III proposals have been described as “a long-term package of changes” to current practices.\textsuperscript{148} The Basel III requirements will be phased in between 2013 and 2015.\textsuperscript{149} The regulators hope that this intervention shall be adequate to address the shortcomings which led to the 2008 financial crisis.\textsuperscript{150} Many others believe that it will take much more to impact the underlying problems in the international financial environment. As long as the world economy is driven by systemic debt, the Basels may just be the soothing of a deadly disease.\textsuperscript{151}

According to an October 2010 report\textsuperscript{152} South African banking supervision is effective and it has contributed to a reduction in the impact that the global financial crisis had had on the financial sector. The Banking Supervision Department of the South African Reserve Bank was commended for its early adoption and implementation of the Basel II framework and its efforts to remain in line with international developments. South Africa has implemented Basel II effectively, in a joint effort by the Banking Supervision Department and the Financial Services Board.

\textsuperscript{147} Smith Implication of Basel II 293-294.
\textsuperscript{148} http://www.fsa.gov.uk/about/what/international/basel (accessed 02-02-2012).
\textsuperscript{149} The total transition period is expected to run until 2021.
\textsuperscript{151} See Edozien We are caught in a systemic debt trap 5-09-2011 Cape Times. See Moyo in general.
7.10 CONCLUDING REMARKS

In this Chapter the trust as finance instrument in South Africa has been investigated. It became clear that the trust positioned itself as a popular and effective entity in this environment. The trust concept offers some flexibility and variety which the corporation cannot offer. It is further apparent that the commercial and financial milieu has accepted the trust as a necessary legal tool. The impact and influence that trusts have in the development of the formal law is clear from the large number of legislative interventions referred to in this Chapter.

The developers of innovative financial instruments are not generally concerned with the legal nature and technical development of the vehicle they employ, but with the effectiveness thereof. It is, therefore, imperative for lawyers involved in the financial and trust fields to be aware of and sensitive to the application of the trust concept. Where necessary the trust regime should either be developed to better suit the needs of the financial world, or to protect its integrity.

In the next Chapter the international context of trusts and its application in the financial sphere, including the potential impact of The Hague Trust Convention, will be considered. A number of offshore jurisdictions will be investigated: two of the more traditional financial jurisdictions, namely the United States and the United Kingdom, as well as two so-called offshore financial centre jurisdictions, respectively Mauritius and Malta.

The development from common-law trusts to statutory trust-law regimes in the first two jurisdictions will be evaluated, while the connection between trust legislation and securities legislation in the cases of Mauritius and Malta will be discussed. These examples will ultimately be compared with and contextualised in the South African environment, and potential lessons will be submitted to be learned therefrom, identified and applied.
8.1 INTRODUCTION

The trust as business vehicle in general, and the role of the trust as financial instrument in particular, have been evaluated in the South African context in Chapters 4 and 7 respectively. In this Chapter the focus will be placed on the trust figure in an international context.

This will firstly be achieved by investigating the international trust-law regime and the application thereof in a number of jurisdictions. Its applicability, if any, to the commercial and financial milieu application of the trust will be included in this investigation.

Secondly, some jurisdictions practising trust law will be evaluated with particular emphasis on their commercial activities. Two major historical trust jurisdictions, one civil and one common law, and two smaller new-generation financial centres will be included in the study. The position of South Africa in the bigger Southern African Development Community (SADC) will also be touched on during the investigation.

When trusts are evaluated in an international context, the underlying differences between civil and common-law jurisdictions must always be considered. The intertwining of the financial and commercial environments of European countries during the last two decades has led to the compilation of the “Principles of Trust Law” in the late 1990s.\(^1\) This was another effort to lay down the core trust concepts, but with enough “leeway for such concepts to develop differently in countries with different legal, cultural and socio-economic heritages.”\(^2\) The Hague Convention on the Law Applicable to Trusts and on their Recognition fulfilled a central role in the compilation of these principles.

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Hansmann and Mattei\(^3\) submit that the essential role of the trust figure is to perform a “property law-like” function and not so much a “contract law-like” function. The trust further provides a level of flexibility in business structures that are not available in jurisdictions with liberal corporative alternatives. This has contributed to the recent convergence of trust, or at least trust-like figures, in the private and corporate law of some civil-law countries. They further submit that the primary focus of the academic world remains on the private trust as an “intra-family wealth transfer” device, while the role it fulfils in the capital markets is largely ignored.\(^4\)

From an international organisational law perspective the trust has numerous tangent-points with partnerships and companies and can contribute towards the better understanding of these legal organisations. Even the American limited liability company and the European civil-law foundation have close connections with the commercial and charitable trusts respectively.\(^5\)

Civil-law jurisdictions which are not familiar with the trust figure, like China, have introduced trust laws during the past decade. Although the fiduciary concept was foreign to them, the need to remain competitive in the international investment and commercial environment was enough for them to embrace the trust figure. Japanese banks are following suit and jurisdictions such as Italy and Luxembourg recently ratified the Hague Convention of the Law Applicable to Trusts and on their Recognition.\(^6\)

Ultimately it seems as if the real selling-point of the trust as business tool locally, as well as in the international context, is locked up in its flexibility. Ogutta\(^7\) submits that the offshore discretionary trust is, because of its flexibility, autonomy, and the principle of separation of its management, ownership and enjoyment of the trust property, the offshore discretionary trust is the ideal vehicle for tax avoidance

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3 Hansmann & Mattei 434.
4 Ibid 437.
5 Ibid 438. They specifically focus on the role of trusts in the law of contract and agency on the one hand, and commercial law on the other.
initiatives. The writer further refers to certain specific aspects of offshore trusts which may entice the founder to abuse it for tax avoidance purposes, for example the practice of a letter of wishes and the appointment of a protector. ⁸

8.2 INTERNATIONAL TRUST LAW

8.2.1 INTRODUCTION

International trust law fulfils roles in both the estate planning and business spheres. The trust figure is ideally positioned to order relationships between different sets of business people and in the process partition off certain assets for separate treatment by creditors. The aforementioned characteristic is also advantageous in the area of financial instruments. The added feature of flexibility in organisational structure can contribute to commercial life in both common-law jurisdictions, familiar with the trust figure, and civil-law jurisdictions.

The more recent development of trust law in Europe cannot be separated from the birth of the European Union and the intertwined commercial and personal environment.⁹ Specific European legal principles, such as the Roman concepts of *fiducia* and *fideicommissum*, the Italian *fondo patrimoniale* and the German *fiduziarische Treuhand*, are all examples of trust-like institutions within the European legal culture. In some Caribbean jurisdictions aspects such as forced heirship, creditor protection, settlor control and confidentiality are in the forefront.¹⁰ It remains imperative that developments are not so business-focused that they lead to so-called “blind” or “limping trusts”.¹¹

Hayton¹² submits that this can only be prevented by the development of “a common core content” in international trust law — or at least for a specific geographical area.

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⁸ Ogutta LLD thesis 325-328.
¹⁰ Countries such as Bermuda, British Virgin Islands, Bahamas, Jersey and Cayman Islands have introduced new legislation in the 1980s and 1990s to address the troubling issues.
¹¹ See para 3.5.1 for explanation of the “blind trust” concept.
¹² In “Principles of European Trust Law” some of the elements of the “common core content” were laid down. See “Principles, Definitions and Model Rules of European Private Law, Draft
In the context of the European Union recent attempts have been made to consolidate the law of trusts. In the Draft Common Frame of Reference (DCFR) drafted in 2009, the so-called “Book X on Trusts”, was an attempt to create a unified trust model for Europe. It was submitted by critics that the so-called DCFR trust is not the ideal solution for Europe as it was influenced too much by the English legal system and contained “ambiguities and inconsistencies”.\(^{13}\) It remains to be seen whether this initiative will bring the European Union jurisdictions any closer to unification as far as trust law is concerned.\(^{14}\)

In Japan the modern trust concept was introduced in 1922 by legislation and it had a close relationship with banking practices.\(^{15}\) The definition focused on the administration of assets in “accordance with some specific purpose” and not exclusively for the benefit of a third party (although that may be the specific purpose). In recent times it has become more acceptable that the trust property should be regarded as a separate entity. Trusts are used in Japan for a large variety of business purposes, amongst them general commercial activities, collective investments, and business management.\(^{16}\)

In Canada the application of the trust figure developed far beyond the estate planning milieu and it fulfils a major role in the huge pension funds market and to a lesser extent the mutual funds market. It is also applied as a means of holding security, for certain lending transactions and as holding or custodian trusts. Waters submits that, although the lack of legal limited liability when the trust acts as a


\[^{15}\] The Trust Act and the Trust Business Act were simultaneously introduced. The private law of Japan, in the form of the Civil Code of 1898, was based upon the German Civil Code of 1896.

substitute for the company form, made it an unpopular choice in Canada, it is often used in conjunction with the corporation.\(^{17}\)

The Hague Conference on Private International Law is an international organisation with its primary focus on the unification of private international law. It has adopted more than thirty conventions during the last six decades, which include topics such as succession to deceased estates, foreign public documents, testamentary dispositions, matrimonial property regimes, and trusts. Much of its focus is on the potential conflicts of law in the international context.

Waters states that not only the conflict of laws should be addressed, but the substance of the law in different national jurisdictions, too. He submits that what is needed is “principally (a) change of attitude . . . (as) the techniques of revision and modernisation by way of legislation, code, convention and treaty are known”.\(^{18}\)

\section*{8.2.2 THE HAGUE TRUSTS CONVENTION}

As trusts are usually only familiar to common-law jurisdictions, but are used internationally and across borders for commercial, financial and personal purposes, the international legal community had to step in. The Hague Convention on Trusts was concluded in July 1985.\(^{19}\) Its preamble states that the trust is considered as a unique legal institution and the convention desires to establish common provisions on the law applicable to trusts and their recognition. This Convention has since been ratified\(^{20}\) by Australia, Canada (in eight states), Italy, Malta, the Netherlands, the United Kingdom,\(^{21}\) Luxembourg, Liechtenstein, Jersey, Guernsey, Isle of Man, Switzerland, Hong Kong, San Marino and Monaco.\(^{22}\) South Africa did not participate

\begin{footnotesize}
\begin{enumerate}
\item Waters “The Use of the Trust in Canada Today” in \textit{Modern International Developments in Trust Law} 103-121. See also Waters “The Revision and Modernisation of Trustee Acts in Canada” in \textit{Modern Developments} 251-268.
\item Waters “The Revision” 272.
\item It was adopted at the Fifteenth Session of the Hague Conference on Private International Law in 1984.
\item The United States and France have signed the Convention, but have not ratified it as yet.
\item Ratification by the United Kingdom included a number of territories, such as Bermuda, British Virgin Islands, Falkland Islands, Gibraltar, Guernsey, and the Isle of Man. Jersey brought itself in line with its own legislation.
\item It has also been signed, but not adopted into national law, by Cyprus, France and the United States.
\end{enumerate}
\end{footnotesize}
in the development of this document as it took place during the time of its political isolation.

The signatories recognised the existence and validity of trusts with a written trust instrument. The Convention sets out the basic characteristics of a trust and the rules for determining its governing law. This was necessary in light of the fact that many states did not have a developed law of trusts, while others differed substantially.

The Convention defines a trust as “the legal relationship created, *inter vivos* or on death, by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose”. It further specifies the law applicable to trusts and which governs their recognition.²³

According to article 2 a trust has the following characteristics:²⁴

(a) the assets constitute a separate fund and are not a part of the trustee’s own estate;

(b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;

(c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

Article 2 clearly states that the reservation by the settlor of certain rights and powers and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust. The Convention model incorporates both the Anglo-American trust, where the trustees have legal ownership and the beneficiaries have equitable ownership, and the South African model, where

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²⁴ See art 2 of the Hague Convention of the Law Applicable to Trusts and on their Recognition. Although the Convention only applies to written voluntary express trusts, it does not prevent signatory states from applying the Convention to resulting, constructive, statutory or judicial trusts. The UK’s Recognition of Trusts Act of 1987 applies the Convention to all trusts. See Hansmann & Mattei 352.
the trustees have ownership and the beneficiary has only a personal or contingent right.\textsuperscript{25}

In terms of articles 3 and 5 the Convention applies only to trusts created voluntarily and evidenced in writing, and only in so far as the Convention provides. Article 18 states that the provisions of the Convention may be disregarded when its application would be manifestly incomparable with public policy.

The law applicable to a specific trust is, especially in commercial transactions, of the utmost importance as it governs the appointment, duties, powers and capacity of trustees, security requirements, the duration of the trust, the liabilities of the trustees, the distribution of income and capital, variation mechanisms and administrative requirements.

In terms of the Convention the settlor shall expressly or impliedly determine the law by which the trust is governed, and where no applicable law has been chosen, the trust shall be governed by the law it is most closely connected with, taking into consideration the place of administration, the \textit{situs} of the assets, the place of residence or business of the settlor, as well as the objects of the trust and where they are to be fulfilled.\textsuperscript{26} This rule simplifies the jurisdiction issue considerably.

The Convention does not introduce the trust concept into the domestic law of non-trust states, nor does it create common rules for trust states.\textsuperscript{27} It focuses on common conflicts of law principles for both trust states and non-trust states.\textsuperscript{28} This will occur where a matter has connections with the legal systems of more than one country. If, for instance, the settlor of a South African formed trust is domiciled in Mauritius and the trust has assets in Namibia and the United Kingdom, while the beneficiaries are domiciled in South Africa and Australia, a number of connecting factors are present. To complicate matters further, the trustees may be domiciled in South Africa and Botswana respectively.

\textsuperscript{26} Art 7.
\textsuperscript{27} Compare also in this regard the European Convention on the Law Applicable to Contractual Obligations of 1980, also referred to as the Rome Convention. See 8.3 for more on this Convention.
\textsuperscript{28} Hayton (1995) 942.
Once the trust in question has been established validly according to articles 6 and 7, recognition must take place, which entails that the trust must be given all those effects that the law governing the particular trust, attaches to it.\(^{29}\)

The applicable law shall govern the validity of the trust, as well as its effects and administration. It shall further govern the position of the trustees regarding appointment, resignation, removal, their rights and duties, and their powers of delegation and investment. It shall further regulate the duration of the trust, the accumulation of assets, the relationships between and the liabilities of the parties to the trust, its variation and termination, the distribution of assets, and the duty of the trustees to account for their administration.\(^{30}\)

As a court must, however, still evaluate all factors holistically, other aspects such as the distribution of assets, the specific purpose of the trust, the domicilium of the settlor or the beneficiaries, or the details of the deed or will, may all be taken into account. In terms of articles 9 and 10 different laws and legal forums may be applied to separate particular components of the trust.\(^{31}\)

In terms of Articles 9 and 10 respectively, a severable aspect of the trust may be governed by a different law, while the law applicable to the validity of the trust shall determine whether that law, or the law governing the severable aspect, may be replaced by another law.\(^{32}\)

A recognised trust implies that the trust property constitutes a separate fund, that the trustee may sue and be sued in his capacity as trustee, and that he may appear or act in this capacity before a notary or any person acting in an official capacity. Personal creditors of the trustee shall have no recourse against the trust assets, neither shall the assets form part of the trustee’s insolvent or deceased estate. The trust assets shall also be excluded from the matrimonial property of the trustee. If the trustee has mingled the trust assets with his own property or has alienated it in

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\(^{29}\) Art 11.

\(^{30}\) Art 8.

\(^{31}\) This is obviously not a desirable state of affairs, but the nomination of the settlor in this regard shall be honoured.

\(^{32}\) Art 17 defines “law” as the rules of law in force in a state other than its rules of conflict of laws.
breach of trust, it may be recovered. The position of third party holders under these circumstances shall remain subject to the rules of the applicable legal forum.  

When assets are registered by the trustee it must be done consistently with the law of the applicable jurisdiction or in such other way that the existence of the trust is disclosed. States do not, however, have to recognise a trust of which the significant elements are more closely connected with a state which does not have the institution of the trust or of this category of trust. Article 19 provides for jurisdictions to enforce their powers in fiscal matters, such as tax, irrespective of the applicability of the Convention.

The Convention is not reciprocal in nature and no territorial limit exists for matters within its scope. The Convention shall apply even if the applicable law is that of a non-contracting state, except if the contracting state has limited its application to contracting states. The Convention further applies to trusts irrespective of the date on which the trust came into being.

It is submitted that the Convention does not add much to trust law in well-developed trust jurisdictions, such as South Africa, but may be of value to non-trust states in ensuring legal certainty to the position of trustees and beneficiaries within their borders. A non-trust jurisdiction ratifying the Convention receives a means to give effect to the operation of trusts within its borders without necessarily adopting the trust figure officially into its legal dispensation. Implementation, however, may build confidence in commercial circles and stimulate the economy of both strong trust jurisdictions and civil-law countries. For the same reasons it may be of value

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33 Art 11.

34 Arts 12 and 13. Although a court is permitted to refuse to recognise a trust where all the elements are civilian except for the choice of a foreign trust law and foreign trustees, an Italian court approved a trust issue where all the elements were Italian, except for the choice of a foreign trust law, which were Jersey and Malta respectively. See Hayton (2007) 20. Compare also arts 15 and 16 on the application of the provisions of law. Art 14 states that the Convention shall not prevent the application of rules of law more favourable to the recognition of trusts.

35 Art 22.

36 Hayton (1995) 953. See Hayton (1995) 954 for list of states that have signed and/or ratified and implemented the Convention.
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for trust jurisdictions, such as South Africa, to consider also ratification of the Convention.37

8.2.3 COMMERCIAL APPLICATION

To appreciate the application of the trust in a commercial context, it is necessary to understand the core characteristics of the concept. A trust creates a relationship between parties, in the form of an obligation, with regard to specific assets, and in favour of beneficiaries. The aforementioned have personal rights as well as proprietary rights (although sometimes very limited) against the trustees.38

Certain minimum requirements must be adhered to for a valid trust to come into being. If not, it may be a sham and the proposed results will not be achieved.39 In the case of commercial transactions, a sham trust may lead to major detrimental results, as the main purpose of a separate commercial vehicle, be it a company or a trust, is the protection it offers.

Langbein40 submits that

“the characteristic trust asset has ceased to be ancestral land and has instead become a portfolio of marketable securities,”

as it has become

“primarily a management device for assembling and administering a portfolio of financial assets.”

The value of the trust as commercial vehicle lies in its essential elements, such as the fact that a segregated trust fund exists, the fiduciary and managerial nature of the office of trustee, and the flexibility of the trust instrument.

Hayton41 refers to a number of advantages that the trust offers to borrowers and lenders:

37 See 10.2.17.
38 The proprietary rights may differ between jurisdictions acknowledging the equity principle and those that do not.
39 Hayton submits that “trust fund” is a collective term, while “trust property” includes both the original trust asset (donation) and all assets added thereafter.
40 Langbein 2007(5) 1072.
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(a) the trustee monitors the trust’s financial condition and maintains confidentiality in the process;
(b) arbitrary legal action is unlikely;
(c) the trustees’ discretionary powers may prevent technical defaults;
(d) the powers of the trustee may simplify processes and minimise costs;
(e) a supplemental deed can be used to address new issues;
(f) the trustees can represent all bondholders collectively;
(g) independent professional trustees can be trusted to police the debts effectively;
(h) independent professional trustees shall ensure equality and prevent manipulation.

The lack of legal personality enables trusts, in general, to have fewer minimum required formalities and to be managed less expensively than companies. Many jurisdictions do, however, regulate trusts used for specific purposes, such as collective investment schemes and pension funds. Hayton\(^\text{42}\) submits that the personal liability associated with the lack of legal personality of the commercial trust may motivate the trustees to be more diligent in their task. In practice the trustees can still limit their liability by conducting the trading activities in a company, with the shareholding held in trust.\(^\text{43}\)

The fiduciary nature of the individual relationships between the parties involved in a trust has been under scrutiny in the past.\(^\text{44}\) Finn\(^\text{45}\) investigates, amongst other things, the manner in and the extent to which fiduciary principles should be applied to commercial relationships, as well as the role of fiduciary law in regulating the modern business enterprise. Because of the contractual freedom and capacity of

\(^{42}\) Hayton (1999) 160.
\(^{43}\) Compare O’ Hagan 91-92.
\(^{44}\) See 2.9 of this thesis for a discussion on the fiduciary relationship in commercial transactions in general and trusts in particular.
parties in commercial arrangements, the fiduciary element is, although present, always less apparent and courts are apprehensive in enforcing it.\textsuperscript{46}

In an international context trusts are applied for a variety of commercial purposes, such as the pooling of the assets of individual investors, pension schemes, unit trusts, mortgage syndications, capital investment purposes, property management, fiduciary banking and services, charitable purposes, shareholding, and many more.\textsuperscript{47} Schwarcz\textsuperscript{48} submits that

“trusts have come to dominate certain types of modern business and financial transactions”

and used mortgage, credit card, vehicle, and student debt, as examples.

Langbein\textsuperscript{49} states that

“most of the wealth that is held in trust in the United States is placed there incident to business deals and not in connection with gratuitous transfers”.

He further submits that the motivation for this is the fact that the trust figure supplies a “highly adaptable, contract-like regime of rights, of fiduciary duties, and of internal governance”.\textsuperscript{50}

Although the Basel Accords had no direct implications on the trust figure as such, supervisory rules may have an indirect impact on the legal entities used by financial institutions.\textsuperscript{51} The Convention on the Organisation for Economic Co-operation and Development promotes policies designed to achieve sustainable economic growth in a financially stable environment. The effectiveness and efficiency of the legal vehicles, including trusts, used by individuals and large corporations in a specific

\textsuperscript{46} Finn “Fiduciary Law” in McKendrick Commercial Aspects 14 submits that the following aspects are to be considered: the manner in which and the purpose for which rights, powers and duties have been allocated by the contract; the contract’s commercial and business setting; and the actions lawfully open to the parties under and notwithstanding the contract.

\textsuperscript{47} Waters 2007(1) Journal of International Trust and Corporate Planning 4-8. In terms of Regulation 15 of the Consumer Protection Act Regulations No. R.293, published in GG No. 34180, dated 01-04-2011, the concept of a “public property syndication scheme”, also in the form of a trust, was created.

\textsuperscript{48} Schwarcz 2003 Business Lawyer 559-585, 559.

\textsuperscript{49} Langbein 1997 Yale Law Journal 166.

\textsuperscript{50} Ibid 189.

\textsuperscript{51} See 7.9 for a discussion on the Basel Accords.
jurisdiction or internationally, are central to the economic growth and financial stability of these initiatives and ultimately of the specific country.  

Gopalan submits that transnational commercial law is the product of a variety of initiatives to harmonise different national laws encountered by business people contracting across borders, and cannot be divorced from the *lex mercatoria*. These endeavours include multilateral conventions, bilateral treaties, community legislation, model laws, the codification of customs, the promulgation of international trade terms, and model contracts and forms. While conventions and treaties may be binding after ratification, most other initiatives are largely soft law options.

The objective of the 2010 Unidroit Principles of International Commercial Contracts is to establish a “balanced set of rules designed for use throughout the world irrespective of the legal traditions and the economic and political conditions of the countries in which they are to be applied”. This document may in future have specific relevance for trusts in the future in so far as they are dealt with and treated as contracts.

### 8.3 OFFSHORE TRUSTS

Sharman submits that the exact meaning of the term “offshore” often lies “very much in the eyes of the beholder”. The stereotypical offshore jurisdiction was an exotic tropical island in the middle of nowhere, until countries such as the United Kingdom and the United States have recently been described as offshore centres. It was suggested that one way to identify and/or classify an offshore jurisdiction is to

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52 The Convention came into force on 30 September 1961 and was signed by 20 countries originally, with another fourteen countries subsequently becoming members of the Organisation. See [http://www.oecd.org](http://www.oecd.org).

53 See 4.6.9 on the business trust and the *lex mercatoria*.

54 Gopalan 812-813. The United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration is an example of a transnational model law which may be applicable to international commercial trusts.

55 Gopalan 812-813. The United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration is an example of a transnational model law which may be applicable to international commercial trusts.


58 See 4.6.9 on the business trust and the *lex mercatoria*.


*Ibid* 4. The International Monetary Fund included the UK in its 2007 report.
determine what it sells. Sharman\textsuperscript{60} identifies four products indicative of offshore jurisdictions, namely asset protection (control over assets, without all the legal liability); major disparities between the number of registered legal entities in a country relative to the number of residents; off-balance sheet borrowing opportunities; and the round-tripping of capital (domestic money acquiring offshore status).

The offshore trust has already been touched on in paragraphs 3.7, 4.7 and 7.8. It creates some opportunities for diversification in the fields of investment, business and generational transfer of assets. Uncertainty in and mistrust of the international financial markets, the variety of legal and tax regimes, international trade, currency fluctuations and political instability led to fear amongst investors, traders, countries, and individuals.

The offshore trust has become for many an extension of its local legal entities and many offshore jurisdictions have capitalised in the search for alternatives by individuals and companies. These vehicles help by creating much needed sources of income and employment in some smaller jurisdictions and attract additional capital to be invested in its capital or money markets. The basic ingredients of the offshore trust jurisdiction include a sound and adequate legal and judicial system, political and economic stability, good communication systems, and the absence of an over-regulated tax and exchange control system.\textsuperscript{61}

Offshore trusts often provide large corporations with expansion opportunities, without necessarily burdening it with substantial increases in operational expenses. Other factors such as currency restrictions, governmental and legislative constraints, uncompetitive tax consequences, custom and excise limitations, exchange controls, restrictive labour regimes, and compromised confidentiality, may influence businesses to consider offshore solutions.

The focus of offshore trusts is often placed on the wealthy individual needing special protection against creditors and tax regimes. The offshore business trust, however, fulfils a much wider purpose and has to be conducive for all parties involved. These

\textsuperscript{60} Ibid 5-9.
trusts should preferably form part of a larger offshore business structure. A business venture on the brink of breaking into foreign markets may be wise in spreading its risks by way of such an offshore structure. Although the onshore business structure will usually cross-subsidise the new markets for a period of time, the long term result should be a *de facto* separation of profits and risk.\(^6\)

In the borderless modern society in which we find ourselves, the offshore trust is much more than a tax evasion tool, and is rather part and parcel of intelligent business and personal financial planning. It is submitted that the current global environment of high-level state control, over-legalisation, currency and market manipulation, over-taxation, economic instability, and general internationalisation of laws and politics, forces individuals and businesses to think globally and to spread their risks and taxability over a number of jurisdictions, where and if possible.

The essence of any trust, as it is with the corporation, is to break the chain of legal ownership between the founder and his own wealth.\(^3\) The term “asset protection trust”, used by Mitkute and Tanega and many others, does not really reveal anything about the trusts they refer to, as all trusts are essentially asset protection vehicles. The foreign trust in general merely takes this scenario further by also removing the second estate from out of the legal and financial jurisdiction to which the founder or mother company is connected. The motivation may include tax, personal, professional or business risks, or the political, labour or economic uncertainty in the home jurisdiction.

The so-called offshore asset protection trust is often regarded as a scoundrel, but Ausness\(^4\) argues, correctly so as it is submitted, that these trusts serve a legitimate purpose. It is obvious that the transfer of the assets to the trust must be legal. Ausness\(^5\) further requires that the settlor should only retain a reversion right, and

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\(^6\) The manner in which the Organisation for Economic Co-operation and Development defines a tax haven as “a jurisdiction that actively makes itself available for the avoidance of tax that would normally be payable in the high tax countries”, is over-simplistic and does not take cognisance of the important role that offshore business structures fulfil in international business.

\(^3\) Ginsberg 43.


\(^5\) 150. Mauritius is one of the popular offshore asset protection trust hubs of the world.
that he should not have appointment powers, nor should he act as trustee or protector.

Mitkute and Tanega\textsuperscript{66} submit that the trusts of certain offshore financial centres, however, offer more protection than others, because of their specific offshore legislation. This protection offered by offshore jurisdictions may include legislation that allows the settlor (or founder) to protect himself against insolvency by way of a protective trust which places the assets outside of the reach of creditors;\textsuperscript{67} to retain effective control over the assets in the offshore trust – sometimes by way of a protector as part of the trust structure;\textsuperscript{68} by protecting certain voidable dispositions by way of excluding certain categories of creditors, introducing shortened time frames and increasing or shifting the balance of proof;\textsuperscript{69} and by enforcing the application of offshore law to the trust and sometimes even including defensive law mechanisms.\textsuperscript{70}

It has been claimed that as much as two-thirds of all liquid capital in the world is to be found in offshore jurisdictions, while one-third of the world capital is deposited or administered through trusts in general (including offshore trusts). International financial centres are havens, not only for financial service providers, individual investors and entrepreneurs from all over the world, but also for multinational companies, looking for safe places for assets, profits and savings. Some, however, claim that asset protection trusts are still the most common form of trusts offshore.\textsuperscript{71}

Ginsberg\textsuperscript{72} explains that tax havens not only address tax and exchange control issues, but are very relevant as far as flexible corporate structures (so-called

\begin{itemize}
\item Mitkute & Tanega 48.
\item \textit{Ibid} 49 with reference to subs 6(1) of the International Exempt Trust Act of 1997 of Dominica.
\item \textit{Ibid} 50 with reference to subs 13C of the International Trusts Act of 1984 of the Cook Islands.
\item \textit{Ibid} 50 with reference to a number of jurisdictions, like Barbados, Cayman Islands, Bahamas, Dominica and the Cook Islands.
\item \textit{Ibid} 50 with reference to s 8 of the Trusts (Choice of Governing Law) Act of 1989 of the Bahamas. Compare Burns & McConvill "An Unstoppable Force: The Offshore World in a Modern Global Economy" 2011(7) Hastings Business Law Journal 205-216 205 referring to the negative perceptions and remarks by some political leaders, such as Barack Obama and Gordon Brown, that as certain offshore jurisdictions take revenue from onshore economies, much needed for bailouts and nationalisation, "they are bad and needed to be stopped".
\item http://www.slogold.net/trusts.html (accessed 17-09-2011). See also Mitkute & Tanega 46-61. They define asset protection trusts as “trusts that are designed to shield the settlor’s assets from the claims of creditors”.
\item Ginsberg 6.
\end{itemize}
hybrids), combined partnerships and special corporate characteristics are concerned. The offshore financial centres are often far more innovative than traditional jurisdictions in dealing with practical business, legislative and administrative issues regarding corporate structures, investments, trusts, insurances, and banking. A variety of financial products in many offshore jurisdictions, some of them utilising trusts, have developed as a result of the development of the regulatory environment. This has contributed to an alternative global trading system in some low or zero tax offshore centres. International offshore banking, offshore investment products, and offshore mutual trusts, are all continually increasing in importance.\footnote{Ibid 69-79.}

Offshore joint venture initiatives usually make use of companies, as being listed on a recognised stock exchange provides access to additional funding. Offshore entities are often cost-effective and user-friendly and, because the offshore jurisdiction is sometimes located on a small island, contact with the regulators is simple, flexible and relationship-based. Offshore jurisdictions are also popular for special-purpose investment vehicles and securitisation transactions. The fact that the directors and shareholders of offshore companies are not available to the general public is attractive to many investors. This secrecy does not, however, affect the necessary compliance with international standards set for money-laundering and other criminal activities. Confidentiality in offshore financial centre jurisdictions is not necessarily based on efforts to support tax evasion, but rather based on privacy.\footnote{Burns & McConville 209-217.}

Many offshore financial centres are also parties to tax information exchange agreements and they go out of their way to build confidence amongst national and international regulators. Other motivational factors are the presence of territorial tax systems (such as to be found in Hong Kong and Singapore), the practicality of mutual funds (Cayman Islands and British Virgin Islands), and the political and economic stability in most offshore financial centres – especially for investments originating in or linked to developing countries.\footnote{Ibid 217-219.}

The \textit{de facto} jurisdiction where the management and control of a business takes place is central to any form of offshore commercial activity. The most likely
application of the offshore business trust is as the holder of the shares of one or more offshore companies – in the same or other jurisdictions. It is submitted that offshore trusts play a more important role as part of an effective global business structure than it does as a tax evasion tool.

The offshore financial centre is usually defined in light of the business model it professes, namely to develop a business environment “which is more flexible than orthodox infrastructure and which caters more specifically . . . to the needs of non-resident investors”. The offshore trust, which is often central to such an infrastructure, is a trust formed in terms of the laws and policies of an offshore financial centre "enacted specifically to meet the needs of non-resident settlors".

Duckworth submits that offshore trustees have become more sensitive to and more aware of the risks of sham trusts, while most jurisdictions have adopted trust tax avoidance measures. The writer argues that these tactics have caused the players in the offshore trust milieu to change significantly — from clients originating from major common-law countries, to clients from Latin America, Continental Europe, the Middle East and the Far East. Along with aforementioned, came new so-called legal and cultural “baggage”, such as forced heirship, control retention, unfamiliarity with the trust concept, a propensity for unorthodox investment and foreign currency, and a desire for extra protection and confidentiality. These issues shifted the focus from tax planning to trust planning, with tax a lesser aspect. Irrespective of these new requirements offshore centres have worked hard to develop both the law and the practical application thereof to meet all interested parties’ approval. This tension between market requirements and international policy considerations shall always be part of the offshore financial centre milieu.

The alternative for the offshore trust is the local trust which does business in the foreign jurisdiction. The Uniform Statutory Trust Entity Act of 2008 in the United States makes provision for the statutory trust operating in an offshore jurisdiction. It stipulates that such a trust will continue to have the law of its original jurisdiction of

76 Mitkute & Tanega 48.
77 Ibid.
78 Duckworth 883.
79 Ibid 899-900. See 900-940 for discussion on various techniques used by the new generation settlor to reserve more power over offshore trusts.
formation apply to its internal affairs and a number of other aspects, such as the
determination of a liability, and the enforceability of a debt or obligation.80 These can
be seen as defensive steps by a government dissatisfied with the perceived (or
actual) losses caused to the national fiscus by way of certain trust practices. To
what extent these perceptions are real, and the level of effectiveness of the
somewhat extreme interventions, must still be seen.

It is submitted that legal and economic arbitrage have become a central and much
needed business tool in the twenty-first century. All major countries, banks and
international corporations are using arbitrage in the form of hedging to protect
themselves against future political uncertainties, changes in currencies, and major
political, economic and social power shifts. Private businesses and individuals
cannot be expected to not follow suit. The aspects of regulatory competition and
regulatory arbitrage, however, will be discussed in more detail in paragraph 8.6
below.

The aspect of conflict of laws is very relevant in the offshore trust environment. In
many instances the parties to the contract may choose the governing law of the
specific contract, while in other instances a variety of factors may have an influence
on the result. Linked to the question on the governing law, is the aspect of
jurisdiction by the courts. A variety of factors, such as familiarity, convenience,
commercial orientation, stability, language, fairness, and others, may be considered
when parties elect a particular governing system. It would often make sense to
apply the same legal system as both governing law and as enforcing forum.81

All offshore trusts have at least one foreign element. The settlor’s and/or
beneficiaries’ domicile, residence or nationality may even be situated at different
places. The places of the trust assets, whether in the form of fixed property, cash or
investments, may be in different jurisdictions. Other aspects, such as the location of
the trustees, the protector and the trust managers may all be at different locations all
over the world. All these parties and assets may also change their locations during

80 See subs 901(a). See discussion in Rutledge & Habbart “The Uniform Trust Entity Act: A
81 Wood 505-512. The governing law usually governs aspects such as formal validity,
interpretation, performance, breaches, prescription and limitation. See Wood 513-514. See
Wood 520-535 for aspects of judicial jurisdiction.
the existence of the trust. Some trust instruments may also provide the settlor with
the power to change the chosen jurisdiction of the trust when needed.82

The combination of relevant jurisdictions linked to a specific trust may include both
centres with the trust concept and centres without it. Even within particular trust
jurisdictions major differences regarding internal rules on capacity, formalities,
perpetuity, alienability, illegality, duties, powers, protections, and marital rights, may
be present.83 The matter may be further complicated by different conflict-of-law rules
in the different applicable jurisdictions. The settlor shall be wise in determining the
relevant applicable jurisdiction and to ensure further that the conflict-of-law rules of
such chosen locality is certain and well-developed.84 Most often the proper law85 of
the trust is determined by the trust instrument and the offshore law should usually be
the best choice.86 The ideal situation would be where a trust is governed by only
one law, irrespective of the location of all the trust property, although that is not
always the case.87

In many member states of the European Union, conflict rules are in contracts
governed by the European Convention on the Law Applicable to Contractual
Obligations of 1980 (the Rome Convention), while in case of the United States, the
1971 Restatement on Conflicts of Laws are applicable. Some jurisdictions allow
contractual parties to determine their own law of choice, without any limitations.88

Jersey was the first offshore centre introducing conflict-of-law rules, followed by
Turkey, the Caicos Islands and the Caymans.89 A variety of different approaches
were followed by these jurisdictions. One example is the Cayman approach in which
the transfer of the property to the trustee is distinguished from the creation of the

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82 Duckworth 886-887.
83 Other aspects may include legal phenomena such as forced heirship, claw-back dispositions,
reserved interests, revocable interests, reserved powers of disposition, etc.
84 Duckworth 887. Many offshore centres do not have well-developed conflict-of-law systems.
85 Ibid 890 states that the proper law is usually a reference to the system of law with which the
contract is most closely connected.
86 Some jurisdictions, such as the Bahamas, have defensive jurisdictional legislation. See s 8 of
87 Duckworth 889.
88 Wood 512-513.
89 Duckworth 892.
trust obligations to be performed by the trustee, versus the Jersey approach where the notion that capacity is a matter for the settlor’s domicile, was applied. ⁹⁰

In the next section the trust laws of two major economic jurisdictions and two small offshore financial centre jurisdictions will be discussed.

## 8.4 TRADITIONAL JURISDICTIONS

The Anglo-American trust tradition is often used as the compass for trust law in general. In this concept the settlor has his property vested in a trustee, who holds an office with specific duties and powers. The trustee administers the trust and its assets, but the assets are separate from his own personal estate and not available to his personal creditors. The beneficiaries have a specific equitable interest in the trust property, without being owners thereof, and have the right to protect their interests. These trusts fall under both the law of obligations and property law, while the trust device is not part of the property law regime in most other jurisdictions. ⁹¹

### 8.4.1 UNITED STATES OF AMERICA

#### 8.4.1.1 COMMON-LAW TRUSTS

The American trust model originated from the “use” in feudal England and the English courts of equity. ⁹² “Express trusts” are largely used as estate planning devices, while “constructive” and “resulting” trusts are those created by operation of law. In their business forms most trusts are governed by specific legislation, such as employee or tax laws. ⁹³ As a result of uncertainty over the legal status and results of the common-law trust as a mode of business organisation in the United States, many states have enacted legislation to validate and strengthen the trust figure as a business entity. In the business environment the trust will always compete with sole proprietorships, partnerships, limited liability companies and other corporate forms of business organisation.

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⁹⁰ Ibid 892-899 for a detailed discussion on the Jersey interventions.
⁹¹ Hayton (1999) 1-2, 125.
⁹² See Chapter 2 for more on the historical development of these practices in England.
⁹³ Hayton (1999) 123. As the focus of this thesis is the business application of trusts, estate planning and administration aspects (the so-called “probate” procedures) will not be attended to.
The business trust as an unincorporated business organisation first became prominent in 1909, with the first Massachusetts trusts already starting around 1827.94 It successfully avoided some arbitrary restrictions in that particular state’s corporation laws. It became a very popular vehicle for asset management and by the 20th century other states had followed suit.95 Business trusts are often referred to as “Massachusetts trusts”, irrespective of the state in which it was formed, consisting essentially of an arrangement whereby property is conveyed to trustees. The aforementioned hold the assets and manage them for the benefit of third parties who have transferable certificates as evidence of their shares in the trust.

The trust figure is used in a variety of roles in the US financial instrument industry. One of the popular applications of the trust is as SPI, which is, for tax purposes, usually in the form of a trust under the states of Delaware or New York. Two SPIs are normally used: one acts as the wholly-owned, insolvency-remote, subsidiary of the originator, which holds the assets as true owner, but is consolidated as wholly-owned subsidiary for tax purposes with the originator — which results in not constituting a taxable event for the originator. The other SPI issues the debt (or the asset-backed security) and is independent of the originator, when it purchases the assets from the first SPI. The only reason for this two-pronged approach is that the transaction is both a true sale for accounting purposes and a financing transaction for tax purposes.96

It seems as if the main consideration in the United States, when the form and venue of an SPI has to be decided upon, is the tax consequences. Tavakoli states that the ideal is for the SPI to pay zero tax on payments flowing in and out.97 It may make the transaction unattractive when a structured finance vehicle attracts additional taxes, beyond what investors would normally experience. The SPI is mainly regulated by accounting legislation in the United States and it is required to be “demonstrably distinct from the sponsor, limited in its permitted activities by way of

95 Hansmann & Mattei 474-475.
96 Takavoli 2. The SPI is restricted from issuing debt beyond a certain limit. This type of structure would not be allowed in South Africa after implementation of the 2008 Regulations on structured finance. See Locke 273.
97 Takavoli 4. The goal is to have “zero tax leakage”. The SPV should ideally be “tax neutral”.

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the deed or other instrument, must not make any major decisions, and may only sell non-cash assets under certain circumstances.”98

The beneficiaries of common-law trusts in the United States usually have limited liability, similar to that of shareholders in private companies.99 The common law also required third parties, transacting with a trust, to ascertain whether and under what circumstances the trustees were empowered to transact on behalf of the trust.100

Langbein101 indicates how the trust figure, as primarily management vehicle for family wealth, has developed into a complex financial asset portfolio device, which may include shares, bonds, contracts, annuities, and interests in pooled investments. The business and trading trust has manifested in a large variety of forms, which have often been allocated to differentiate between their functions and not necessarily their nature.

The grantor trust is popular for pass-through asset-backed securities, in which case the principal payments on the receivables are passed directly through the grantor trust’s special-purpose vehicle to the holders of the pass-through certificates. The grantor trust is a type of fixed investment trust that is essentially ignored for tax purposes. The owners of the interest are taxed as if they were the direct owners of their respective shares of the trust assets. It is created by way of a contract between a depositor and an independent trustee. This contract usually provides for the appointment of a trustee who acts as fiduciary for the investors with respect to the receivables; the pooling of certain assets into the trust by the originator; the issuance by the trust of certificates of beneficial interest in the trust back to the originator; the appointment of the originator as the servicer of the assets; the designation of the trustee as the representative of the certificate holders; and the remedies of the trustee in the event of default.

The originator sells the pass-through certificate to investors through an investment bank. These certificates represent undivided ownership interests in the receivables pooled into the trust. The grantor trust structure functions as a conduit for outright

98  Gorton & Souleles 8. At least 10% of the fair value must be held by unrelated third parties.
sales of assets to investors. The trust itself is ignored for tax purposes, if the trustees do not have the power to purchase new assets or substituted assets or any other power to reinvest monies in the trust, and if the trust has only a single class of pass-through certificates.

Trusts are often used to create pay-through debt securities. This permits the issuer to restructure the cash flows of receivables and offers a range of investment securities to interested investors. These asset-backed securities are known in the mortgage-backed securities, marketed as collateralized mortgage obligations.\footnote{Tett 321 explains that collateralised debt obligations (CDO’s) are a form of asset-backed securities, which are created by bundling together a portfolio of fixed-income debt (such as bonds), using those assets to back the issuance of notes.} The pay-through security is often issued by an entity which is a corporation or an owner trust, and which acts as an SPI to purchase assets and then issue several tranches of varying maturity asset-backed securities. The interest is tax-deductible, which results in the SPI being able to minimise taxation. After these deductions, the income is taxed in the hands of the SPI.

Owner trusts have the advantage of avoiding an additional layer of income tax at the entity level, as all income or expense passes directly through to the trust owner for tax purposes. This will not be the case if it were a corporation. It is a business trust established in a manner similar to the grantor trust. The trust issues the debt securities of varying maturities. The owners are investors who have purchased the ownership of the assets from the originator. An owner trust that was structured to envisage the issue of multiple series of ownership certificates became known as a so-called master trust.

Master trusts consist of a collection of funds from individual investors that are pooled together, with the purpose of obtaining wholesale rates. A group of investors together in a master trust combine their assets for greater bargaining power.\footnote{See http://www.investopedia.com/terms/m/mastertrust.asp (accessed 26-01-2012).}

Other forms of commercial trusts that have developed include financial asset securitisation investment trusts, multi- and single seller conduits, and domestically domiciled corporations.
Real estate mortgage investment conduits\textsuperscript{104} were created by United States Congress in 1987, in order to enable issuers to issue multiclass and multiple maturity securities without tax-related, structural constraints. They enjoy flow-through tax treatment with no tax imposed in the vehicle. They can only be used for mortgage collateral. They can be in the form of a company or a trust.

These different trusts are actually nothing more than a variety of manifestations of the same thing and proof as evidence of the versatility of the trust structure and how it has developed in the financial instrument environment. Eventually they are all just trusts.

**8.4.1.2 STATUTORY TRUSTS**

As a statutory trust is usually a juridical entity, separate from its trustees and beneficial owners, it differs in essence from the common-law trust form. The existence of statutory trusts does not prohibit the continued use of common-law trusts for commercial purposes. The statutory trust form is often used for mutual funds, real estate transactions and as asset securitisation vehicle.

In 1988 the Delaware Business Trust Act was adopted, with the purpose of removing the uncertainties — such as limited liability for beneficiaries — that have restricted the use of the trust figure for business transactions.\textsuperscript{105} This resulted in the Delaware business trust statute being regarded as a “generic corporation statute”, as it creates an entity with definite corporate attributes, replacing the common-law trust in many instances.\textsuperscript{106}

Both the Massachusetts and Delaware trusts have flexibility as their foremost advantage. The codified Delaware trust adds other advantages, such as:\textsuperscript{107}

(a) more legal certainty;

\textsuperscript{104} Conduits are similar to structured investment vehicles (SIV’s) and are entities that fund themselves by the issuing of short-term debt and investing in assets such as commercial loans or bonds. They are normally closely connected to a bank without necessarily appearing on the bank’s balance statement.

\textsuperscript{105} The position of the trustee was sometimes regarded as that of agent towards the beneficiary, which resulted in a veil piercing of the trust. Courts in different states interpreted this aspect in different ways.

\textsuperscript{106} Hansmann & Mattei 476. Statutory trust acts were also introduced in a number of other states, such as Connecticut, Wyoming, Virginia, and others.

\textsuperscript{107} \url{http://www.securitization.net/knowledge/spv/del_bus_trust.asp} (accessed 13-07-2011).
(b) a separate legal entity, which is bankruptcy-remote;

(c) it may be converted into a company or limited partnership;

(d) the beneficiaries enjoy limited personal liability;

(e) it qualifies to be used as an asset securitisation investment trust and a real estate investment trust in terms of the relevant legislation.\(^{108}\)

By the second part of the 1990’s numerous states had enacted asset protection trust legislation.\(^{109}\) Most of these pieces of legislation are over-protective and allow extreme powers and protection to the parties to the trust, which may be detrimental to third parties contracting with the trust.\(^{110}\)

In 2000 the Uniform Trust Code was adopted, applying to both trusts for estate planning and those for commercial purposes.\(^{111}\) Langbein\(^{112}\) submits that the previous forms of uniform legislation that influenced this codification process, shared a common denominator, namely the facilitation of the use of financial assets as trust investments.

Statutory trusts have become increasingly popular while their status in many states was still uncertain and case law was sparse.\(^{113}\) In terms of risk sharing, management, duties and liabilities, and insolvency protection, it offered similar results as the limited partnership and the limited liability company.\(^{114}\) For these and

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\(^{108}\) In terms of a 1994 amendment to the Delaware Business Trust Act the Delaware trust has perpetual existence and may not be terminated by the dissolution, termination or insolvency of a beneficiary, except should the terms of the deed provide otherwise. See http://www.securitization.net/knowledge/spw/symonds1.asp (accessed 13-07-2011).

\(^{109}\) The first was Alaska, followed by Delaware, Missouri, Nevada, Oklahoma, Rhode Island and Utah. See Ausness 157.

\(^{110}\) See Ausness 158 for some examples of these powers.

\(^{111}\) This Code was produced by the Uniform Law Commission as the first national codification of the American law of trusts.

\(^{112}\) Langbein 2007(5) Alabama Law Review 1071. He refers to the “(f)ive rounds of uniform legislation, namely the Uniform Principal and Income Act of 1931 (as amended); the Uniform Trusts Act of 1937 and the Uniform Act for Simplification of Fiduciary Security Transfers of 1958; the Uniform Common Trust Fund Act of 1938; the Uniform Trustees’ Powers Act of 1964; and the Uniform Prudent Investor Act of 1994. These different pieces of legislation each addressed specific issues of trust law and were not general trust-law legislation. They were embraced by a variety of states, but never became part of all the jurisdictions, with some introducing similar non-uniform statutes.

\(^{113}\) Rutledge & Habbart 1057. They submit that the statutory trust always offered more flexibility, with less formalities, than the corporation.

\(^{114}\) Ibid 1058. They refer to the statutory trust as a “gap filler”.
other reasons the Uniform Statutory Trust Entity Act was enacted in 2009. This Act is, however, still not a codification of general business law principles applicable to common-law business trusts. Common-law business trusts continue to exist and the Uniform Trust Code is also still applicable.\footnote{The common-law trust is based on a fiduciary relationship. See the Restatement (Third) of Trusts no 2 of 2003. The Code is applicable to statutory trusts to the extent that it is not conflicting with the Uniform Act or the trust deed.} The Act has both validated the statutory trust form as business organisation and addressed some of the disparity and inadequacy in this field of law.\footnote{See the Prefatory Notes to the Uniform Statutory Trust Entity Act 1 \url{http://www.law.upenn.edu/bll/archives/ulta/2007april_redline.pdf} (accessed 23-01-2012).}

In formulating this legislation the drafting committee followed the Delaware model as it is the most commonly used statutory trust form in the United States.\footnote{The Connecticut legislation on statutory trusts was also considered.} The Act acknowledges the supplementary value of all forms of ordinary trust law, but also included many principles from standard corporate law.\footnote{Such as attachment of property, management by trustees, standards of conduct of trustees, interested transactions, and limited liability.} It was submitted that the corporate law model is a true reflection of the “nature of a statutory trust as \footnote{Prefatory Notes 2. The Act is to a certain extent a mixture of the common law as laid down in the Uniform Trust Code of 2000 and the Uniform Limited Partnership Act of 2001.}a juridical entity”. In this sense the fiduciary aspects and the position of the beneficiaries in the common-law trust have fallen by the wayside.\footnote{Subs 603(a) provides that a person may become a beneficial owner of a statutory trust without any consideration, although the focus of the Act is to regulate the trust as business organisation and not for effecting donative transfers.}

The Act further entrenches the perpetual existence of the statutory trust, except where the governing instrument determines otherwise. The trust shall not terminate merely because of the death, incapacity, termination, dissolution or bankruptcy of a beneficial owner or a trustee.\footnote{Subs 306(a). See Rutledge & Habbart 1069.}

The Uniform Act contained a number of innovative stipulations, such as specific rules that may not be overridden in the statutory trust deed;\footnote{S 103 stipulates that the governing instrument may address the management of the trust, as well as the rights, duties, obligations, and powers of the trustees, and that of the beneficial owners.} the applicability of the common trust law on a statutory trust; prohibitions against a statutory trust having a “predominantly donative purpose”; the practice of conversions and mergers; specific
requirements for the dissolution of the statutory trust; and guidance on the general relationship between common-law trusts and statutory trusts.

Most parts of the Act consist of default rules – applying only when the governing instrument (deed) fails to address or insufficiently addresses the issue in question. One good example of this is section 502, dealing with the powers of trustees, stipulating as follows:

“A trustee may exercise:

(1) powers conferred by the governing instrument;
(2) except as limited by the governing instrument, any other powers necessary or convenient to carry out the business and affairs of the statutory trust; and
(3) other powers conferred by this Act.”

The legislature did not attempt to create a *numerus clausus* of possible or desirable powers, but also ensured that a trustee is not limited to those powers granted by the trust instrument.

Certain legislation, such as the Investment Company Act of 1940, supersedes the Uniform Act with respect to statutory trusts that function as investment companies, whether registered or not. This indicates that the legislature accommodated the need to cater for specific applications of the statutory trust.

Section 504 protects third parties dealing with trustees of statutory trusts, whether assisting a trustee in good faith, or dealing with such a trustee for value, without knowledge that the trustee is exceeding his power.

Section 505 requires a trustee to “act in good faith and in a manner the trustee reasonably believes to be in the best interests of the statutory trust”, discharging his duties “with the care that a person in a similar position would reasonably believe appropriate under similar circumstances”. The fiduciary duties familiar to the common-law trust have thus been confirmed for the statutory trust, but the emphasis is on the corporate nature thereof. It is suggested that the trust fiduciary obligation

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123 Prefatory Notes 3. See s 103 in this regard.
124 The obligation of loyalty is similar to the objective standard laid down in the Model Business Corporation Act (2008).
exists in the context of a donative transfer, while the corporate law fiduciary obligation focuses on the legal entity more than the individuals.  

The position of beneficiaries in the statutory trust is similar to that of shareholders in companies. The beneficial interest is freely transferable and belongs to the beneficial owner in his personal capacity, while the trust property belongs to the trust only. As the nature of the statutory trust is not donative, the beneficial owner receives his benefit as a result of a personal contribution.  

Rutledge and Habbart submit that, although the Uniform Act is largely based on the Delaware and Connecticut statutory trust acts, it offers a better alternative than those acts, as it addresses specific rules which may be unfamiliar to some practitioners. They further submit that, if the Act is widely adopted by a number of states, it will bring "a degree of order to the current mix of state statutes and principles of common law that currently governs statutory trusts" in the United States.  

In March 2011 a draft discussion document on the harmonisation of the Uniform Statutory Trust Entity Act was published. In this process a number of business related Acts were evaluated. It is submitted that the United States always needed some federal unification by way of statute in light of the haphazard development of securitised trusts in the different states.

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126 See s 601.

127 There is provision for a donative element, but only in specific circumstances. See Rutledge & Habbart 1087 in this regard.

128 Rudledge & Habbart 1059.

129 Ibid 1103.

130 Such as the Business Organisations Act, the Model Entity Transactions Act, the Uniform Partnership Act, the Uniform Limited Liability Company Act and the Uniform Statutory Trust Entity Act.

131 See also Langbein Alabama Law Review 2007(5) 1073-1074.
8.4.2 UNITED KINGDOM

8.4.2.1 COMMON-LAW TRUSTS

The trust figure in English law developed out of the “use” in the seventeenth century and the common law and equity became two functionally distinct, but interconnected, principles.\textsuperscript{132} The trust principle is thus embedded in the common-law tradition of the United Kingdom, although some statutory interventions, which are discussed below, have taken place.

Hayton\textsuperscript{133} describes the English trust as “an equitable obligation, binding a person to deal with property over which he has control, for the benefit of persons . . . (who) may enforce the obligation”. The trust is thus, essentially, “a fiduciary relationship with respect to property”.\textsuperscript{134}

The English trust is an attractive commercial vehicle for at least three reasons:\textsuperscript{135}

(a) The beneficiaries have equitable ownership of the property held by the trustees, which place them in a strong position towards third parties if the trustee would wrongfully transfer legal ownership of trust assets.

(b) The settlor has very wide discretion regarding the powers and duties he wants to grant the trustees.

(c) The settlor does not have to comply with severe formalities of incorporation and regulation.

From these motivations it is clear why the English trust is being used for a variety of commercial purposes in the United Kingdom – a few of which will be discussed here. This phenomenon exists despite the fact that “the flexibility of equity was at one time regarded as an unwelcome trespasser” to commercial transactions.\textsuperscript{136}

\textsuperscript{132} Watt \textit{Trusts and Equity} (2006) 12.

\textsuperscript{133} (2007) 3.

\textsuperscript{134} Hayton (2007) 28.

\textsuperscript{135} \textit{Ibid}.

\textsuperscript{136} Watt 59 and the reference to Bramwell LJ in \textit{New Zealand and Australian Land Co v Watson} (1881) 7 QBD 374 stating at 382 “. . . I should be very sorry to see them (referring to trusts) introduced into commercial transactions . . .”
The application of the trust as the holder of security over the assets of a debtor for a number of creditors is very common. Loans can easily be syndicated and vested in a trustee to be held on trust for a variety of creditors. The fact that there is only one security holder simplifies the processes of realisation and administration of the debt. Individual syndicated creditors can also be replaced easily and changed as the security remains vested in the same trustee – although the underlying beneficiaries are amended.137

The English draw a distinction between express and resulting trusts. The first being where the settlor expressly intended to create the trust and the second type where no such express intention was present, but the trust “arise(s) as an automatic consequence of a transferor’s failure effectively to dispose of beneficial ownership in the asset purportedly transferred.”138

The so-called subordination trust is used to segregate assets for third parties. One creditor subordinates its debt to that of another creditor by agreeing not to be paid until the other creditor has been paid. As the junior debt becomes subordinate to the senior debt, the junior debt is payable, in terms of the trust deed, by the debtor to a trustee. The aforementioned first pays the senior debt before the residue, if any, is paid towards the junior debt. If the junior creditor becomes insolvent the payments will not be attachable by its creditors as it vested in the trustee. This method often forms part of securitisation transactions with the trust acting as special-purpose vehicle.139

The trading trust acts as alternative for the limited company when carrying on business on behalf of the beneficiaries. The trading trust can either be as a standard discretionary trust with one or more beneficiaries or for the benefit of the holders of transferable certificates, representing what Hayton140 refers to as “beneficial fractional interests” in the trust fund. He submits that trading trusts are not favourable business vehicles in England because of the risks for creditors. The

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137 See Hayton (2007) 29-30 for a variety of examples of the application of the trust as a commercial security device.
138 Watt 133-135. The “constructive” trust arises by operation of law, either “to vindicate the equitable entitlement of the new beneficial owner, or to restrain the unconscionability of the original owner.” See Watt 253.
139 Hayton (2007) 31-33. See the reference to sinking fund trusts for future applications.
trustees cannot claim limited liability, like in the case of limited companies, but the creditor has no guarantee that the trustee is actually in a financial position to satisfy the claim. He also submits that the trustees of trading trusts are often limited companies.

The trust as an asset protection mechanism is used by a lender when he retains his proprietary interest in loan monies until the transaction is fulfilled. This is done by transferring the loan money to a trust as security for the transaction. The lender is thus protected against the insolvency of the borrower and will receive the loan amount from the trustee if the transaction fails.  

Trusts are used for collective investment schemes, pension funds, trade union benefits, employee share-ownership schemes, benevolent funds, and for recreational facilities. The United Kingdom followed some of the United States’ traditions in the development of its application of the trust figure to securitise debt. Master trusts have been employed to create security over the originator’s trust interest, while running the risk of being a collective investment scheme. The aforementioned may have had adverse tax consequences. Some argue that the utilisation of master trusts for securitisation transactions in the UK have led to “artificial structuring” processes and should better be replaced with limited liability partnerships.

Irrespective of a number of statutory interventions in the United Kingdom, the English trust remains in essence a common-law figure.

8.4.2.2 STATUTORY LAW

The first significant legislation for trusts was in the form of the Trustee Act of 1925, which made provision, amongst other stipulations, for certain discretionary powers

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141 Watt 61. This transaction can also be structured as a so-called Quistclose Trust. See Watt 62 and the reference to Quistclose Investments Ltd [1970] AC 567, which is an example of how the courts deal with the relationship between the law of contract and trust (common law and equity).

142 Ibid 51-53.

143 See the reference to master trusts in the United States, earlier in this Chapter.


to, and maintenance obligations by, trustees. It also dealt with aspects about agencies, and the liability and discharge of trustees.\textsuperscript{146} By way of the Variation of Trusts Act of 1958 the legislator addressed specific issues, such as the variation of beneficial interests.\textsuperscript{147} The legislature further granted the courts an unlimited jurisdiction to sanction the variation of trusts, as a direct result of the \textit{Chapman} case.\textsuperscript{148}

The Hague Convention on the law Applicable to Trusts and on their Recognition was incorporated into English law by the Recognition of Trusts Act of 1987. The Perpetuities and Accumulations Act of 1964 applied a statutory rule against remoteness of vesting to dispositions, without abolishing the common-law rule in this regard.\textsuperscript{149} The Trusts of Land and Appointment of Trustees Act of 1996 provides for courts to sanction any transaction beneficial to settled land for the beneficiaries of the settlement, and for settlors of trusts of land to remove their trustees’ powers of sale.

The legislative interventions culminated with the Trustee Act of 2000, which addressed a number of issues, such as the duty of care of trustees, their remuneration, and their powers of investment. Although the key aim was to make best commercial practice available to settlors, trustees and beneficiaries, the Act was largely regarded as “a confirmation and justification of existing methods and trust management.”\textsuperscript{150} The Act focuses on the law relating to trustees and persons having the investment powers of trustees and does not in any real way legislate the common-law figure of the English trust.

The Act grants trustees unlimited powers of investment as if they were ordinary owners of the assets.\textsuperscript{151} These wide powers are tempered by a duty to set an investment policy, with a strategy of diversification and suitability, after consulting

\textsuperscript{146} Watt 299, 301, 382, 394.
\textsuperscript{147} The rule in \textit{Saunders v Vautier} (1841) 10 LJ Ch 354 was specifically addressed. See Watt 40, 300 in this regard. See also Watt 314 and further.
\textsuperscript{149} See Watt 211-213 for a discussion on the respective applicability of the statutory and common-law rules against remoteness of vesting.
\textsuperscript{151} Subs 3(1).
with skilled advisors, and may also be limited by the trust instrument. The Act further empowers trustees with the right of delegation – excluding that of distribution, trustee appointments, and sub-delegation. They may also appoint nominees, agents and custodians. The Act also allows a general right to reasonable remuneration for professional trustees, and imposes an objective standard of a general duty of care on trustees.

Getzler voices the following criticisms against the Act:

(a) the self-regulatory model for investment purposes, instead of stricter rules and enforcement mechanisms;

(b) the acceptance of the portfolio investment theory, which may open the door for large scale arbitrage in investment methods;

(c) the reliance on fiduciary duties, while no apparent competitive and transparent market for competence in trust management exists as yet.

The Act makes provision for pension schemes established under a trust, but exclude large parts of the legislation from applicability to these schemes. There are also references to authorised unit trust schemes and common investment schemes for charities.

Certain parts of existing legislation dealing with specific aspects relating to trusts are still in operation in the United Kingdom and shall continue to co-exist with the Trustee Act of 2000. These include the Trustee Act of 1925, the Trustee Investments Act of 1961 and the Trusts of Land and Appointment of Trustee Act of 1996. None of these pieces of legislation can be regarded as a general trust statute. The trust figure in the UK, therefore, remains a common-law figure, tempered with legislative interventions only as far as particular administrative aspects and certain modern applications of the trust is concerned.

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152 Subs 6(1)(b).
153 Part IV (ss 11 to 24).
154 Getzler 6-7.
155 Ibid 8-10.
156 S 36 excludes parts of the duty of care provisions and stipulations dealing with the appointment of custodians, agents and nominees.
157 Subs 37(2) defines an “authorised unit trust” as a “scheme in the case of which an order under s 78 of the Financial Services Act 1986 is in force.”
Collective investments in the UK are regulated by the Financial Services and Markets Act of 2000 (the FSM Act). Although collective investments may be constituted either as a corporation or a trust, last-mentioned was the traditional form, the principal advantage being that the unit holder is allowed to share in the gains derived from the holding of a portfolio of shares or other assets, without necessarily being involved in the management of the fund. Unit trusts are typically constituted by a trust instrument, setting out the terms of the legal relationship between the trustees and the unit holders.

The aforementioned Act regulates authorised unit trusts, open-ended investment companies, and other regulated and unregulated schemes. The provisions of the Act are not, however, applicable to investment structures incorporated in terms of the Companies Act. Life assurance schemes, partnerships and other schemes not providing for the pooling of assets and gains are not affected by the FSM Act and its regulations.

Unit trusts are collective investment schemes under which the property is held under trust for the participants, with the trustee holding the property and the manager acting as operator of the schemes. Aspects such as authorisation, certification, rules, scheme particulars, alteration, withdrawal and intervention are provided for in the said Act. The rules set out all aspects of the constitution, management and operation of the schemes. These will be included in the trust instrument. Certain clauses may not be included in the deed, as prescribed by section 253 and the authorisation of a scheme may be revoked under particular circumstances. The Act also recognises offshore investment schemes although some must satisfy the prescribed requirements as set out in the treasury regulations.

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159 There are more than 1,250 authorised unit trusts in UK with assets under management of over 400 billion pounds. See [http://www.atlantic-cable.com/Article/SCTrust/farrer.htm](http://www.atlantic-cable.com/Article/SCTrust/farrer.htm) (accessed 05-04-2012).


161 See subs 254(1).

162 See s 264 and Directive 85/611/EEC. Schemes managed in and authorised under the laws of certain designated offshore jurisdictions may also be promoted in the UK (s 270). Treasury will, however, always have the final say. S 272 also makes provision for individual recognition of offshore schemes.
Trustees, managers or operators of collective investment schemes may be investigated in terms of the FSM Act.\textsuperscript{163} Collective investment schemes are popular because of the advantages they offer to various categories of people. The assets are well-protected in terms of the legislation against \textit{mala fide} behaviour from trustees and other parties involved in a scheme. Many United Kingdom schemes are promoted across the European Union.\textsuperscript{164}

The common-law trust figure is thus remaining a popular legal entity for certain categories of collective investment schemes in the UK and is applied for much more than estate planning.

8.5 OFFSHORE FINANCIAL CENTRE JURISDICTIONS

8.5.1 INTRODUCTION

Offshore financial centres — often referred to as low-tax or tax-haven jurisdictions — have developed an unsavoury name as taxpayers often use them to employ unlawful tax-saving schemes. These schemes usually make use of company and/or trust structures. One such scheme is the so-called “protected cell-company” structure.\textsuperscript{165} A tax haven has been defined as “a jurisdiction that actively develops tax policies aimed primarily at diverting finances and other geographically mobile capital from high-tax to low-tax countries”.\textsuperscript{166} The more diplomatic working definition used by Sharman\textsuperscript{167} is “a jurisdiction that has designed its financial regime to offer international financial services to non-resident firms and individuals.”

The fundamental principle of offshore finance is the fact that taxpayers may receive “diametrically opposed but legally valid answers to the same (tax) question from different quarters”\textsuperscript{168}. These differences may include aspects of ownership, profit-making, and the handling of debt. The various indirect attempts by governments to minimise the negative impact that offshore finance has on internal financial stability

\textsuperscript{163} See s 284.
\textsuperscript{164} See in general for discussion on UK unit trust environment \url{http://www.atlantic-cable.com/Article/SCTrust/farrer.htm} (accessed 05-04-2012).
\textsuperscript{165} See Oguttu 2011 \textit{South African Mercantile Law Journal} 16-44 for detailed discussion on PCCs.
\textsuperscript{166} Oguttu 2011 \textit{South African Mercantile Law Journal} 17 with reference to the Organisation for Economic Cooperation and Development (OECD).
\textsuperscript{167} Sharman 1.
\textsuperscript{168} \textit{Ibid}. 

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had mixed results and may even have contributed to the 2008 financial crisis. Sharman\textsuperscript{169} submits that offshore finance can be understood only in light of offshore products and the methods used in offshore jurisdictions to “provide the calculated ambiguity”.

Despite major criticism of financial centres, the search for competitive advantage in the global market place requires from international financiers and entrepreneurs to be innovative. The international governance initiatives to the offshore world include transnational regulatory networks, the classification and labelling of jurisdictions, and the roll-out of regulatory programmes, such as anti-money laundering and prudential regulations.\textsuperscript{170}

It is submitted that Maurer\textsuperscript{171} is correct in stating that offshore finance is “essential” to the business world, as it “provide(s) for the mitigation of risk and around-the-clock movement of assets, as well as the efficient handling of foreign exchange between banks and corporations.” The opponents of offshore finance and offshore jurisdictions often over-emphasise the misuse of these centres, without acknowledging the important role they are playing in international trade.

At the very heart of offshore centres is the need for businesses to diversify their risk. As no jurisdiction is absolutely safe it is imperative for businesses, both large and small, to search for protection mechanisms. Major corporations are often at risk when they are situated in small jurisdictions, relative to the size of the corporation itself. It is submitted that offshore financial centres have a specific role to play in international finance and the continued economic development of the world.\textsuperscript{172}

Offshore centres are used for a variety of good business reasons, such as joint

\textsuperscript{169} 1-3. The “ambiguity” refers to is the fact that the same question will receive different answers in different legal and tax jurisdictions. Sharman suggests that an interdisciplinary view may give more insight into the complexity of and solutions for the so-called “calculated ambiguity” created in the world of offshore finance.

\textsuperscript{170} Sharman 10. Some of the institutions and networks referred to by Sharman include the Financial Action Task Force on money-laundering; the International Organization of Security Commissions; the International Association of Insurance Supervisors; the Basel Committee; the Organization for Economic Cooperation and Development; the Commonwealth; and the Financial Stability Forum. See also Maurer “Re-Regulatory Offshore Finance?” 2008 2(1) Geography Compass 155-175 155-156, who adds the International Monetary Fund; the European Union; and non-governmental organisations, such as Oxfam, Christian Aid and the Tax Justice Network.

\textsuperscript{171} 159.

\textsuperscript{172} Burns & McConvill 205-221.
ventures, costs, ease of use, access to regulators, financial markets and information, securitisation structures, territorial tax systems, and political and legal stability.\textsuperscript{173}

The aspect of conflict of laws in the offshore trust environment is of some importance as different jurisdictions deal with it in different ways. The applicable legal principles of the Hague Convention grant offshore jurisdictions the opportunity of a universal set of principles. General acceptance thereof by offshore jurisdictions may contribute to much needed legal certainty. Some may prefer to incorporate the Convention into their legislation, like Malta, and others may instead include similar provisions in their domestic trust legislation, similar to Mauritius.

\textbf{8.5.2 MAURITIUS}

The Republic of Mauritius is an island situated in the Indian Ocean about 2 400km from the south east coast of Africa. As it was colonised by both France and England before becoming independent in 1968, a hybrid legal system has developed. Its civil law is based on the French Napoleonic Code and its commercial law follows the English tradition.\textsuperscript{174}

Although Mauritius is an independent state, it is still a member of the Commonwealth and has preserved its right of appeal to the Privy Council. Mauritius has decided to combine traditional financial centre advantages, such as no capital gains tax, no withholding tax, no capital duty on issued capital, free repatriation, and high levels of confidentiality, with the advantages of being a treaty-based jurisdiction.\textsuperscript{175} Trust law existed in Mauritius since 1962 and has been codified by way of three previous Acts and consolidated in the form of the Trusts Act 14 of 2001.\textsuperscript{176}

\textsuperscript{173} Ibid 205-220.
\textsuperscript{174} See Fulton & Whaley “Gateway to Africa” 26-02-2010 The Lawyer 42 www.thelawyer.com (accessed 20-07-2011).
\textsuperscript{175} In 2010 it had tax treaties with 13 African countries with another 7 being negotiated, and has signed investment promotion and protection agreements (IPPAs) with 15 African countries. IPPAs include a number of commitments, such as free repatriation of investment capital, guarantees against expropriation, proper treatment of investors, compensation for losses in case of war, riots or armed conflict, and arrangements for settlement of disputes between investors and contracting states. See also Moller “Mauritius” 25-06-2007 The Lawyer 29 www.thelawyer.com (accessed 20-07-2011).
\textsuperscript{176} The previous trust legislation, namely the Trusts Act of 1989, the Trust Company Act 28 of 1989 and the Offshore Trusts Act of 1992 were all repealed by Act 14 of 2001. Related legislation includes the Trust Fund for Specialised Medical Care Act of 1992, the Trust Fund for
Mauritius commenced with offshore banking facilities in 1989 and has offered comprehensive offshore legislation since 1992. Its economy is not limited to offshore activities like that in some other locations, but rests on agriculture, manufacturing and tourism. It differentiated itself in many ways from most of its African neighbours in being innovative and opportunistic. Although Mauritius was the location for the creation of the Organisation for the Harmonisation of Business Law (OHBLA) in Africa in 1993, it was never signed by Mauritius.

8.5.2.1 TRUSTS ACT 2001

A trust exists where a trustee holds or has vested in him property of which he is not the owner in his own right, but with a fiduciary obligation to hold, use, deal or dispose of for the benefit of the beneficiary, or for a specific purpose.

Trusts are created by a disposition of property and must be in writing. It must include the name of the trustee, the intention of the settlor, the object, the beneficiaries, the property transferred and the duration of the trust. Unit trusts, constructive trusts, resulting trusts and trusts arising by operation of law or by judicial decision, do not have to comply with these requirements.

Inalienable property and certain leasehold interests may not be transferred or disposed of to a trust, and no immovable property in Mauritius may be transferred to a non-charitable purpose trust. Fixed property situated outside Mauritius may be disposed of to any trust. The government is protecting the land for its citizens as its position as offshore destination may cause non-citizens to purchase all the

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177 Ginsberg 501.

178 The French acronym, OHADA, is more known for the same organisation. The treaty currently has seventeen signatories – all of them in western part of Central and North Africa. See http://www.ohada.org (accessed 13-02-2012).

179 S 3.

180 S 6. Collective investment schemes, including unit trusts, mutual funds and investment trusts are created and administered in terms of the Mauritius Securities Act 2005. A constructive trust automatically comes into being when a trustee or other person derives profit from a breach of trust, or obtains property as a result of such breach. The trustee shall then be deemed to be a trustee of the profit or property for the beneficiary. See s 53.

181 S 7. Transfer or vesting of immovable property situated in Mauritius to a trust with non-citizen beneficiaries, can only take place with permission from the Prime Minister (s 22).
valuable land and inflate prices to such an extent that the locals will not be able to survive.

The beneficiaries must be identifiable, or at least ascertainable, and their interests are transferable.\(^{182}\) The trust may also be declared as or known as a protective or a spendthrift trust.\(^{183}\) In terms of the Act discretionary, fixed, charitable trusts, and non-charitable purpose trusts may be formed.

The voluntary office of protector of a trust fulfils an important function and the trust deed may give that person the powers to remove or appoint trustees; to determine the law of the trust; to change the administration and to withhold consent for certain actions by the trustees. The protector is independent of the trustees and is not liable towards the beneficiaries or the trustees.\(^{184}\) The office of protector makes it possible for a non-citizen settlor to dictate certain administrative aspects of the life of the trust, even without being a trustee himself. The identity of the protector may be kept confidential to ensure anonymity.

Where a custodian trustee is appointed the trust property shall vest in that trustee only with exclusion of the other trustees. The function of the custodian is to hold and invest the assets according to the instructions of the managing trustee, and third parties dealing with aforementioned may not enquire about the involvement or not of the managing trustee. Only a firm, partnership or body corporate may act as custodian trustee.\(^{185}\) The managing trustee is not vested with that trust property which is vested in a custodian trustee. Where a managing trustee is nominated and certain powers reserved for him, no other trustee shall be liable for any actions regarding such reserved function.\(^{186}\)

Both the settlor and any beneficiary may hand a letter of wishes to the trustees with regard to the exercise of the functions of the trustees, and the trustees may have regard to such letter in exercising their functions, but shall not be accountable in any

\(^{182}\) Ss 14 and 17. In terms of s 19 a trust may also be created for a purpose, without any specific beneficiary. S 21 requires from all “purpose trusts” to appoint an enforcer whose duty is the enforcement of the terms and purposes of the trust.
\(^{183}\) S 18. This type of trust provides special protection to a beneficiary in case of a determining event, such as sequestration.
\(^{184}\) S 24. The settlor, a trustee, or a beneficiary, may be nominated as protector.
\(^{185}\) S 25.
\(^{186}\) S 26.
way for failing or refusing to have regard to such wishes. A letter of wishes shall not impose a fiduciary duty or obligation on a trustee.\textsuperscript{187} Although this Act does not refer to the discretionary nature of the trustees’ position, this provision protects the independence of the trustees and does not allow the settlor and beneficiaries to dictate to them. It is submitted that it will protect beneficiaries and settlors from their creditors arguing that the trust assets are vested in them because of their indirect control over the assets.

Trustees must be licensed by the Financial Services Commission to offer trusteeship services.\textsuperscript{188} The trust property does not form part of the personal estates of the trustees or the protector.\textsuperscript{189}

The trust deed does not become a public document and may be kept confidential by the trustees. The trust term is 99 years, except for non-charitable purpose trusts it is 25 years.\textsuperscript{190} The duty of the trustees is to preserve and enhance the trust assets and they shall usually be endowed with full powers of investment. Although trust information is confidential a trustee must provide information on request from a court, the settlor, the enforcer, and the protector; as well as from a beneficiary where the terms of the trust so authorise. A court shall only make an order contradictory to this confidentiality provision where the information is required for the purpose of an enquiry or trial into the trafficking of narcotics or dangerous drugs, or economic crime or money laundering. This provision is without prejudice to the obligations of Mauritius under an international treaty, convention or agreement.\textsuperscript{191}

Trustees must disclose their interests in other trusts when transactions between the trusts are entered into.\textsuperscript{192} Trustees are protected only against third party claims in as far as they have disclosed their position as trustees. If the trustee fails to inform

\textsuperscript{187} S 27.
\textsuperscript{188} The number, appointment, resignation and removal of trustees are regulated in terms of ss 28-31. S 34 also provides for a body corporate to act as a trustee.
\textsuperscript{189} S 32.
\textsuperscript{190} A charitable trust may be of perpetual duration.
\textsuperscript{191} S 33. Where on application by a person having an interest in the trust, the court is satisfied that the disclosure is \textit{bona fide} required for the purpose of any civil proceedings, the court may order the disclosure of information.
\textsuperscript{192} S 35. S 37 deals with the fiduciary duty of the trustee in detail. S 38-40 deal with the trustees’ duty relating to the trust property, their duty to act together and their duty to act impartially. Ss 50-52 deal with breach of trust by a trustee.
the third party he shall incur personal liability, but shall be indemnified by the trust if he has not acted in breach of trust. A bona fide purchaser or a third party advancing money to a trustee may treat the trustee as owner of the trust property and has no right to enquire about the details of the trust.\footnote{S 36.} This is yet another protection clause to ensure confidentiality of the contents and affairs of a trust.

Chapter VI (sections 41 to 49) deals with the general powers of the trustees in detail.

Mauritius is not a party to the Hague Convention on the Law Applicable to Trusts and on their Recognition, and a foreign trust whose proper law is a law other than Mauritian law is governed by that other proper law. A “foreign trust” is simply defined as a trust “the proper law of which is not that of the host”\footnote{S 2 of the Trust Act 14 of 2001 (Mauritius).} Foreign trusts are thus governed by and interpreted in accordance with the terms of the trust instrument and its proper law. Such a trust shall not be enforceable in Mauritius to the extent that it purports to commit an offence, is immoral or contrary to public policy, or purports to apply directly to immovable property situated in Mauritius.\footnote{S 60.} The proper law of a trust shall be the law indicated in the deed or intended by the settlor, and if unknown, the law with which the trust has its closest connection\footnote{The closest connection will be determined by way of the following factors, namely the place of administration designated by the settlor, the situs of the assets, the place of residence or business of the trustee, and the objects of the trust and the places where they are to be fulfilled (subs 61(2)).} when created, and if above-mentioned legal systems do not provide for trusts, then the law of Mauritius.

Mauritius provides for the protector to determine the proper law of the trust.\footnote{Subs 24(3)(b).} The foreign trust is governed by the terms of the trust and its proper law, with a foreign trust not being enforceable in Mauritius under specific circumstances.\footnote{Subss 60(1) and (2).} Section 61 stipulates that the proper law of the trust shall be the law determined by the trust instrument or that intended by the settlor, in the absence of which it will be the law
with which it has the closest connection at creation — alternatively the law of Mauritius.\textsuperscript{199}

Trusts in Mauritius are overseen by the Courts or Judges in Chambers and both trustees and other parties who have an interest in a trust matter may approach a Court or a Judge in Chambers for a declaration or order.\textsuperscript{200} A court may, on application by certain interested parties, approve an amendment of the powers of management or administration of the trustees.\textsuperscript{201} There is no provision for an amendment of the beneficiaries of the trust. The amendment will be drafted by the trustees or another interested party and submitted to the court for approval.

\textbf{8.5.2.2 SECURITIES ACT 2005}

This Act was promulgated to ensure a fair, efficient and transparent securities market and to strike a balance between the protection of investors and the interests of the market itself.\textsuperscript{202} Mauritius is on a growth path as far as its financial sector is concerned and wants to position itself correctly in the international market with the setting of appropriate regulatory and supervisory standards. The Act is administered by the Financial Services Commission and has as main objective the promotion of confident and informed participation of investors and consumers in an efficient local securities market.

Other objectives include the protection of investors against unfair practices; the fostering of a fair and efficient securities market; cooperation with other agencies to reduce systemic risk; the regulation of the disclosure of information; the regulation of the operation of securities exchanges; the prevention of criminal behaviour in the financial sector; cooperation with domestic and international regulatory and enforcement bodies; and the collection and dissemination of data, information and research on the security industry.\textsuperscript{203}

\textsuperscript{199} In ascertaining the law with which the trust has the closest connection the following factors will be considered: the place of administration, the \textit{situs} of the assets, the place of residence or business of the settlor, and the objects of the trust and the places where they are to be fulfilled.

\textsuperscript{200} See ss 62-65.

\textsuperscript{201} See ss 66 and 67.

\textsuperscript{202} This Act repealed the Stock Exchange Act of 1988 and the Unit Trust Act of 1989.

\textsuperscript{203} See s 6.
Operational licences to security exchanges, depositories, clearing facilities and securities trading systems are issued by the Financial Services Commission. The Act created two classes of market intermediaries, namely investment dealers and investment advisors. The dealers act as intermediaries and traders in the execution of securities transactions. The advisors advise, guide and recommend securities transactions to clients, while also managing portfolios of securities under discretionary or non-discretionary mandates.

The Act has adopted the international term of “collective investment scheme” for all arrangements that operate on the basis of pooling of funds from investors, with the object of investment in portfolios of securities and non-financial assets. These will include unit trusts, mutual funds and investment trusts, which may be structured in such legal forms as may be approved by the Commission. It is envisaged that many schemes will make use of the trust form as the definition of collective investment scheme means “a scheme constituted as company, a trust, or any other legal entity prescribed or approved of by the Commission”. Local schemes must be authorised by the Commission, while foreign schemes only have to be recognised by the Commission before they may be distributed in Mauritius.

All schemes are managed by a collective investment scheme manager, independent from the custodian, and on whom a number of fiduciary duties are imposed. A trust company, as subsidiary of a bank, may be appointed as a custodian, irrespective of whether the trust was set up in terms of the repealed Unit Trust Act of 1989, the Trusts Act of 2001 or this Act.

The Act granted managers of unit trust schemes five years to apply for licenses as investment managers of collective investment schemes, and existing investment institutions, unit trust schemes and authorised mutual funds also five years to apply as collective investment schemes. As section 6 of the Trusts Act of 2001 specifically excludes unit trusts, mutual funds and investment funds, collective investment schemes in the form of trusts do not have to comply with that Act.

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204 S 9.
205 S 2. “Unit trust” is defined as “a trust authorised under this Act as a collective investment scheme”.
206 Subss 100(1) and (3).
207 S 160.
8.5.2.3 MAURITIUS AS OFFSHORE JURISDICTION

Mauritius positioned itself as an important investment jurisdiction because of its relationship with India and China. The aforementioned is attractive through its “flexible and conducive regime for offshore business and the tax planning opportunities” which can be obtained. The fact that Mauritius has signed numerous double taxation treaties over the last decade, amongst them India, is a motivating factor for business empires.

The financial industry is regulated by the Financial Services Commission which covers all aspects of securities, insurance and international business. Global business activities are regulated in terms of the Financial Services Development Act of 2001, and make provision for initiatives ranging from aircraft financing and leasing, asset management, funds management, communication, insurance, logistics, shipping and trading (GBL 1 entities), to consultancy, information technology, passive investment holding, and special-purpose vehicle transactions (GBL 2 entities).

Mauritius also introduced anti-money laundering legislation in 2003 to create high standards of integrity and to prevent the exploitation of its financial services industry by unscrupulous operators. Mauritius has developed into one of the jurisdictions of choice for Indian manufacturers to raise international capital on the institutional markets, for debt and equity investment into China, and for special-purpose vehicles to provide debt finance to Singapore.

Moller submits that South African companies use Mauritius for group treasury operations, trade finance, international holding companies and cell captive insurance vehicles. It is submitted that Mauritius has developed a good reputation for the regulation and over-sight of its offshore sector. The over-all environment is viewed

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208 Moller 29.
210 Moller 29.
211 Mauritius is known for its collaboration with other jurisdictions to prevent round-tripping, money-laundering and tax evasion.
as fair and sufficiently regulated in international circles. Mauritius has also been excluded from the list of states with harmful taxation practices, compiled by the Organization for Economic Co-operation and Development (OECD).

Mauritius is a member state of both the Southern African Development Community (SADC) and the Common Market for Eastern and Southern Africa States (Comesa), which was established as an organisation of free independent states, agreeing to co-operate in developing their natural and human resources. Its main focus is to form a large economic and trading unit that can assist in barriers facing some individual states, by, amongst other measures, the introduction of common external tariff structures with third parties. Both initiatives regard “regional integration as a means of achieving industrialisation by freeing trade and jointly securing economies of scale and efficiency gains.”

Mauritius has further positioned itself as an attractive host for head office companies. One of the major contributors for this is its attractive special tax dispensation which is one of the best in the world for holding companies. Legwaila is of the opinion that the Mauritian holding-company regime “is clearly publicised with an unambiguous and transparent intention of attracting investors.”

8.5.3 MALTA

When Malta joined the European Union in 2004 it positioned itself as an international financial service centre which will serve Europe, in competition with jurisdictions such as Ireland and Luxembourg. It started aligning its financial services laws with

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213 In the United States case of Lawrence v Goldberg a bankruptcy court determined that the corpus of an offshore asset protection trust located in Mauritius was part of the debtor's bankrupt estate. The court ordered him to turn over the trust property to the bankruptcy trustee. The attempt by the settlor to hide behind Mauritius's offshore identity was unsuccessful.

214 Snieska, Gaidelys & Guzavicius “Factors Impacting Offshore Company Activities after the EU Enlargement” 2006(1) Engineering Economics 40.

215 See 8.6 below for more on this organisation.

216 Comesa was established in 1993, when it replaced the Preferential Trade Area for Eastern and Southern Africa (PTA) of 1981. It currently has 22 member states.


European Union laws a number of years before inclusion. It immediately entered the fields of structured finance and custodianships, with low capitalisation requirements.

As neither British trust law, nor the legal notion of “equity” in relation to trusts, were ever really absorbed into Maltese law, the Government had to issue new trust legislation to position itself as a financial hub. The first Trusts Act was introduced in 1988, aimed at attracting offshore structures, and in 1994 the Recognition of Trusts Act was enacted. The aforementioned incorporated the Hague Convention on the Recognition of Trusts into Maltese law, in a bid to boost financial services in Malta.

In 2004 the Trusts (Amendment) Act was enacted, renaming the Trusts Act the Trusts and Trustees Act, introducing a detailed regulatory framework for trustee and fiduciary activities.

### 8.5.3.1 TRUSTS AND TRUSTEES ACT 35 OF 1989

A trust exists where a trustee holds property under an obligation to deal with it for the benefit of beneficiaries or for a charitable purpose. The trustee acts as owner or as vested party in relation to the property, which constitutes a separate fund, distinct from the trustee’s personal assets.\(^{220}\) The trust may be formed in any manner, including unilaterally,\(^ {221}\) by oral declaration, by a written instrument, by operation of law, or by way of a judicial decision.\(^ {222}\) A trust in Malta is thus not necessarily formed by way of a contractual agreement, except unit trusts, which are created by written instrument only.\(^ {223}\)

A trust is governed by its proper law, which is determined in terms of the Act.\(^ {224}\) Malta is a party to the Hague Convention on the Law Applicable to Trusts and on their Recognition.\(^ {225}\) The proper law may be the law of Malta as chosen, or in terms

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\(^{220}\) Subss 3(1) and (2).

\(^{221}\) In terms of subs 7(3) is a unilateral declaration of trust “a declaration in writing made by a trustee stating that it is the trustee of the trust, containing all the terms of the trust as well as the names or the information enabling the identification of all the beneficiaries.”

\(^{222}\) Subss 7(1) and (2).

\(^{223}\) Subs 7(4).

\(^{224}\) S 5.

\(^{225}\) The Convention was incorporated into the Act as per Schedule.
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of article 7 of the Convention. If the chosen law is foreign or determined in terms of the Convention, it shall be governed accordingly.\textsuperscript{226}

Both Maltese and Mauritian legislation simply define a “foreign trust” as a trust the proper law of which is not that of the host (Malta and Mauritius respectively), with a “Maltese trust” being defined as a trust whose proper law is the law of Malta.\textsuperscript{227}

Malta has incorporated the Hague Convention into its legislation, which provides as follows: The first line of determination is the expressed or implied law chosen by the settlor, failing which, the trust shall be governed by the law with which it is most closely connected.\textsuperscript{228} The factors to be considered in determining the closest connection are similar to those provided for in the Mauritian legislation.\textsuperscript{229} The proper law of the trust shall govern its validity, its construction, its effects, and the administration of the trust, although certain administrative aspects may be governed by a different law.\textsuperscript{230}

A beneficiary has a personal entitlement, referred to as a beneficial interest, in or to the trust property.\textsuperscript{231}

The maximum lifetime of a trust is one hundred years, except for charitable purpose trusts, unit trusts and retirement scheme trusts.\textsuperscript{232} A unit trust is a trust established for investment purposes in which the beneficiaries (investors) partake in any profits or income arising from the acquisition, holding, management or disposal of property, and which is a collective investment scheme, as defined in the Investment Services Act.\textsuperscript{233}

The Maltese trust makes provision for both “private” and “professional” trustees – both regulated by the Malta Financial Services Authority.\textsuperscript{234} Private trustees are

\begin{footnotes}
\item[226] Ss 6, 6A and 6B deal in detail with all proper law aspects.
\item[227] S 2 of the Trust Act 14 of 2001 (Mauritius) and the Trusts and Trustees Act 35 of 1988 (Malta) respectively.
\item[228] Arts 6 and 7 of the Convention on the Law Applicable to Trusts and on their Recognition.
\item[229] See footnote 252.
\item[230] Arts 8, 9 and 10.
\item[231] Subs 9(1).
\item[232] S 12.
\item[233] S 2.
\item[234] The Authority was established by s 3 of the Malta Financial Services Authority Act 34 of 1988. Its overall function is to regulate, monitor and supervise all forms of financial services in Malta.
\end{footnotes}
friends and family, who may not be compensated for their duties and may only act as trustees on a limited number of trusts. 235 Professional trustees are formally authorised by the Authority and, in the case of trust companies, must comply with a number of prescriptions. 236 A trust may make use of a protector, who may appoint and remove trustees and require from a trustee to obtain his discretion. 237

No general rule of confidentiality is laid down by the Act, but section 29 stipulates in detail the specific situations in which trustees have a duty to give information regarding the affairs of the trust to certain parties. 238 In case of a trust holding property in relation to commercial transactions, the duties of the trustees relating to the provision of information may be determined by the terms of the trust, in which case the section 29 provisions shall not apply. 239 The trust can be used in Malta to structure employee share ownership plans as alternative to a collective investment scheme. 240 The definition of “commercial transaction” includes securities, securitisation of assets, collective investment schemes, employee benefit and retirement schemes, syndicated loan agreements, insurance policies, and multi-ownership and property structures. Trusts can, therefore, be used for a large number of different business purposes and the legislator granted the commercial trust specific advantages. 241

Where a trustee fails to inform a third party that is acting as a trustee, the trustee shall be personally liable to the third party. 242 Third parties are entitled to rely on declarations made by a trustee regarding the proper fulfilment of his powers and duties, and they do not have to enquire about his good faith. 243 This is an important

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235 See s 43A. The appointment, resignation, removal, and the duties and powers of trustees, are dealt with in detail in ss 18-24.
236 See s 43.
237 S 24A.
238 See also the Professional Secrecy Act of 1994 in this regard, placing a duty of strict confidentiality on all professionals and state officials.
239 Subs 29(12). Subs 43A(7) does stipulate that a trust deed filed with a depository notary shall be confidential.
241 S 1. Subss 6(6) and 21(7) allow specific derogations for commercial transactions.
242 Subs 32(2). S 33 makes provision for constructive trusts.
243 S 40.
mechanism to protect third parties against dishonest or unscrupulous trustees and creates confidence and faith in the trust as a reliable commercial vehicle. The trustee will be liable if he issues false information.244

A person receiving property upon trust or who acts as trustee and receives remuneration or does so on a regular or habitual basis, or holds himself out to be a trustee, must be authorised by the Malta Financial Services Authority, except, amongst others, persons acting under a license issued in terms of the Banking Act, the Investment Services Act, or the Insurance Business Act, or who operate a central securities depository in terms of the Financial Markets Act, or in terms of the Special Funds (Regulation) Act as trustee to retirement schemes, or who act as trustees of a unit trust which is a collective investment scheme.245

Trusts with only non-resident beneficiaries can still not be taxed in Malta.

8.5.3.2 SECURITISATION ACT 5 OF 2006

A securitisation vehicle in Malta may be in the form of a company, a commercial partnership, a trust created by a written instrument, or any other legal structure which the competent authority may permit. If a trust is used, its objects and purposes shall be limited to such matters that are necessary for securitisation transactions, and the trust instrument shall state expressly that it is a vehicle established subject to the provisions of this Act.246

Securitisation vehicles do not have to be licensed in terms of the Investment Services Act or the Financial Institutions Act and shall not be considered to be collective investment schemes.247 The originator may be any third party and in any form, including a trust, and any assets held by the originator or any other third party

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244 Subs 40(6).
245 Subss 43(1), (6) and (7).
246 S 3. S 4 provides for more than one vehicle to be used for a single transaction. Subs 4(2) prohibits the use of a securitisation vehicle for trade or any other purpose.
247 Ss 5 and 6. The competent authority may designate by notice that certain categories of securitisation vehicles shall be collective investment vehicle. The vehicle must give notice in terms of s 18 about its intention to enter into a securitisation transaction. A public securitisation vehicle must apply for a licence to make a public offering (s 19).
on behalf of the securitisation vehicle shall be considered as being held on trust for the benefit of the securitisation vehicle.  

The transfer of the securitisation assets from the originator to the securitisation vehicle may take place by way of any method of transferring, including a declaration of trust. Unless expressly stated, the debtor shall have no right or claim against the securitisation vehicle in connection with any obligation relating to the securitisation assets. The debtor shall only have rights under the assigned contract against the originator. There is no limitation to the types of risks that may be securitised. The securitisation vehicle may assume risks by acquiring assets, guaranteeing or assuming obligations, entering into derivative contracts or by committing itself in any other way.

The parties to the transaction may choose any law to govern their contract.

8.5.3.3 MALTA AS OFFSHORE JURISDICTION

In 1994 Malta abolished its offshore tax haven status and started taxing international financial services providers at standard corporate tax rates. Non-resident companies, however, did still qualify for specific tax advantages. In repositioning itself as an offshore financial centre to a reputable international onshore centre, the Maltese legislator had to address the abolishment of certain rules of confidentiality and the accommodation of nominees, as well as historical taxation practices.

Although the European Union has no official policy regarding offshore jurisdictions amongst its members, it does require from new member-states to limit some of its activities. One of the major internal problems experienced within the EU are the difference in taxes between the Union and the offshore centres. Malta has not been

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248 S 8.
249 S 9.
250 Subs 10(5). The assignment of the assets is valid and effective if the assignment identifies certain features of the class of receivables being subject to the assignment (subs 11(1)).
251 S 15.
252 S 17.
included in the list compiled by the OECD, identifying states with harmful taxation practices.\textsuperscript{254}

The high levels of education and training in the financial services sector offered by Malta, positions it “in the premier league of small finance centres”. Its stability and good international reputation gives investors confidence in doing business in Malta.\textsuperscript{255}

8.6 SOUTH AFRICA IN THE COMPARATIVE CONTEXT

8.6.1 INTRODUCTION

The United States developed its trust law in the very specific legislative context of a multiplicity of independent legal jurisdictions, operational within a federal system. It was always sensible to unify the different manifestations with consolidated legislation to protect the trust as viable legal option.

The United Kingdom had the privilege of a long and interesting common-law trust figure development, which was supported by some verifying legislation over nearly a century. It is submitted that the legislation did not infringe the common-law nature and pattern of the figure. In both these jurisdictions, the trust first originated as an estate planning tool, then as a business entity and ultimately as a legal vehicle in the financial instrument environment.

Trust law in both Malta and Mauritius was legislatively imported into the respective jurisdictions with the specific purpose of developing them as offshore financial centres. They had the advantage of the Hague Convention and the Malta legislator did indeed make use of that by ratifying the Convention and legislating the ratification.\textsuperscript{256}

South African trust law has developed largely independently of the legislator. The TPCA is the only trust-focused legislation and mainly deals with regulating the control of property in the hands of the trustees; their authorisation and appointment; the levels of care, diligence and skill required from trustees; the variation of trust

\textsuperscript{254} Snieska \textit{et al} 38, 40.

\textsuperscript{255} Teterov & Reuvid (eds) \textit{Doing Business with Malta} (2005) 167.

\textsuperscript{256} See 8.5.3.1.
deeds; and the custody of trust documents. The legislation did not address or interfere with the nature and natural development of the trust in any significant way.

8.6.2 UNITED STATES

It is submitted that there are lessons to be learnt from the four abovementioned jurisdictions. The United States model has unfortunately developed in a fragmented way with a number of states following a variety of detail, some of which culminated in the Delaware model for business trusts. The default mechanisms followed by the new Uniform Statutory Trust Entity Act of 2009 may hold some lessons for South Africa. The positive contributions of the US story are two-fold: firstly, they set the international trend as far as the application of the trust as special-purpose vehicle in financial transaction modelling is concerned, and secondly, they developed an academic and philosophical framework for the trust as corporative vehicle. The high levels of their activity in the banking and financial environment was thus complemented by the enquiring and empirical nature of writers such as John Langbein, Steven Schwarcz, Robert Sitkoff and others, who acknowledged the valuable contribution of the trust figure to the business and financial field.

8.6.3 UNITED KINGDOM

The United Kingdom retained its position as a common-law trust destination despite some aspects being legislated. This position largely reflects the position of the trust figure in South Africa. It may be prudent for the local legislator to take cognisance of the fact that the UK incorporated the Hague Convention into its domestic law. The Trustee Act of 2000 is in purpose not far removed from the local TPCA. Many will support the idea of the South African legislator reviewing the TPCA after thirty years in ensuring that it keeps track with modern developments. It is submitted, however, that such process should not include any statutory interventions over and above that of an administrative and practical nature. The true nature of the trust figure should remain common law. In this sense the UK model of minimum interference with the common-law figure is to be preferred.

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257 See 4.6.6.
258 See Chapter 9 for an evaluation hereof.
259 See Chapter 9 for a discussion of this aspect.
8.6.4 MAURITIUS

Mauritius has no common-law history of trusts because of its hybrid origins – a combination of French and English law. As its commercial law originated largely from English sources, the trust figure as business and financial vehicle fitted naturally. Trusts are, however, statutory creations as they are erected in terms of the Trusts Act, except for those that arise by operation of law or by judicial decision, such as unit trusts. To protect Mauritius’s limited land against affluent foreigners, certain limitations to the placing of fixed property in trusts had to be created.

The office of protector brought the trust figure in line with that of most financial centre jurisdictions and it is submitted that South Africa may have to consider that development if it plans on positioning itself in that space. The practice of custodian trusteeship may not be as pertinent. It is submitted that it is also not necessary to legislate the use of letters of wishes as was done in Mauritius, as these instruments are not enforceable and do not interfere with the discretion of the trustees. The confidentiality of the trust deed is not an unfamiliar principle in the South African context, where the general public also do not have access to it. The Master will only divulge trust information on request from someone with an interest therein. Other local legislation, such as the Consumer Protection Act, or a legal principle such as public interest, shall be adequate in particular circumstances to overrule the confidentiality aspect. It is submitted that it is not necessary to regulate it by statute as the legal principles are clear.

The Mauritian trust is limited to 99 or 25 years respectively. The rationale behind such limitation for the lengthy period of 99 years is unknown, but it may be part of the protection of property rights in some small or vulnerable jurisdictions. In many financial centre jurisdictions, and in most African countries, including Mozambique, Kenya, Uganda, Malawi and Rwanda, foreigners may not purchase land outright. They may only register leaseholds, for periods usually ranging between 25 and 99 years, depending on the country or region. These periods appear rather

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260 See recommendations in Chapter 9.
261 The Protection of Personal Information Bill of 2009 may, when enacted, have an influence on the publication of trust information.
262 Author has personal experience of this legal tradition and had discussions with practising lawyers in these jurisdictions on their land customs.
arbitrarily, without any specific scientific or economic motivation. It is submitted that it is not necessary for South Africa to limit the perpetual nature of its trust figure, as the nature of trusts, and what they are used for, will often determine its own justifiable period of existence. There is no apparent reason why a trust, holding assets, should be forced to terminate merely because it is in existence for a specific period of time.

It is submitted that the bulk of the provisions of the Trusts Act consists of principles generally present in South African discretionary trusts. An interesting element, however, is the inclusion of the Turquand rule, which may be advantageous in the commercial environment. It was suggested earlier that this principle has already been usurped into local trust law.\(^{263}\) The fact that Mauritius has not ratified the Hague Convention should not deter South Africa from seriously considering it.\(^{264}\)

### 8.6.5 MALTA

Malta has never adopted the British common-law trust and only introduced the figure by way of legislation in 1988, closely followed by incorporation of the Hague Convention in 1994. It is submitted that South Africa should consider following suit as far as the Convention is concerned. The Trusts (Amendment) Act of 2004 created a detailed framework for trustees and fiduciary activities in Malta. An interesting aspect is the fact that a discretionary trust is not necessarily created by way of contract. The beneficial interest of the beneficiary is framed in the form of a personal entitlement, which principle will not work in South Africa, where any "entitlement" can only become a possibility after some part of the capital or income had been previously distributed. It is submitted that the aspect of vesting has developed satisfactorily in South Africa and should not be interfered with by the legislator.

The limitation of the lifetime of trusts to 100 years is not an advisable route to follow, as has been indicated above.

The differentiation between private and professional trustees has also developed in South Africa – albeit in a different, less formal, manner. The concept of an

\(^{263}\) See para 4.6.4.

\(^{264}\) See Chapter 9 for a more detailed discussion on this recommendation.
independent trustee was developed by the courts during the last decade, although professional and corporate trustees, often in the form of trust companies, have been known for more than a century. It is submitted that the development of this aspect in South Africa is satisfactory and should be allowed to take its natural course.\textsuperscript{265} The enforcement thereof has occurred in a natural manner by way of a circular from the Chief Master of the High Court.

The formal introduction of the role of protector may add value to the South African trust, although it is submitted that, as there is no prohibition thereof, it may develop naturally. There are indeed some trust deeds that historically included a protector, although usually for no apparent reason. If the South African trust should be utilised as a financial centre instrument, such application is possible.

The aspect of confidentiality, as mentioned earlier, is addressed adequately by way of the general and statutory principles of South African law.

An interesting aspect of the Maltese legislation is the concept of a “commercial transaction”, which includes securities, securitisation of assets, collective investment schemes, employee benefit and retirement schemes, syndicated loan agreements, insurance policies, and multi-ownership and property structures.\textsuperscript{266} It was necessary for the legislator to specify that trusts may be utilised for these kinds of transactions. When a commercial transaction includes the appointment of a trustee to hold property, the trust is not only bound by the provisions of the trust deed, but the contents of the trust instrument supersede the statute.\textsuperscript{267}

The Maltese also included the Turquand principle in their trust legislation, as referred to above. The regulation of persons receiving property upon trust or who act as trustees and receive remuneration, or do so on a regular or habitual basis, or hold

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\textsuperscript{265} Trust companies are self-regulated in South Africa with the major exponent the Fiduciary Institute of South Africa (FISA). Companies and individuals may also join international associations such as the Society for Trust and Estate Practitioners (STEP). Regulation 910, issued in terms of s 30 of the Attorneys, Notaries and Conveyancers Admission Act 23 of 1934, required from all trust companies to be licensed in terms of the Licences Act 44 of 1962. Since the repeal of last-mentioned Act no new licenses could be issued. The SA Law Commission has recommended in Discussion Paper 110, Project 134 (Administration of Estates), published for comment in October 2005, that regulation 910 should be repealed.

\textsuperscript{266} S 1.

\textsuperscript{267} See subss 6(6) and 21(7).
themselves out to be trustees, must be admired. It is submitted that South Africa should, either by legislative intervention, or by way of soft law, follow suit.\textsuperscript{268}

It is submitted that South Africa has developed a strong common-law trust figure which can compete with any of the aforementioned jurisdictions. It has proved to be sustainable as an estate planning, business and financial instrument. It is submitted that this vehicle can be instrumental in South Africa’s quest to become an important financial destination and even an offshore jurisdiction.

At the moment South Africa is positioning itself as the gateway for the rest of the world to invest in Africa, and more specifically, Southern Africa.\textsuperscript{269} To make South Africa attractive enough to be regarded as such an entry point, sound regulatory and administrative systems are required.\textsuperscript{270} It strives for “closer collaboration and economic integration” in the SADC region.\textsuperscript{271}

Legwaila indicates how Mauritius has successfully positioned itself as an attractive investment option in other African states. The placement of headquarter companies in offshore jurisdictions is an international phenomenon, which can be contributed to a number of reasons, one of which is a favourable tax dispensation.\textsuperscript{272}

It is submitted that South Africa should position itself in the global context as an attractive host jurisdiction for business activities, such as headquarter company domain, call centre paradise, investment jurisdiction of choice, and as economic gateway into Africa and other developing economies.\textsuperscript{273}

\textsuperscript{268} See the recommendations in Chapter 9.

\textsuperscript{269} South Africa acceded to the SADC Treaty on 29 August 1994, which was approved by the Senate and National Assembly in September 1994.

\textsuperscript{270} See Legwaila 2011 SA Mercantile Law Journal 1. Writer refers to the 2010 Budget Review by National Treasury and submits that “relief from exchange control and taxation for various types of headquarter companies located in South Africa will be considered”. See also Legwaila 2001 (1) Obiter 126-142.


\textsuperscript{272} Legwaila Obiter 141.

\textsuperscript{273} See Su Yin & Walsh “Analyzing the Factors Contributing to the Establishment of Thailand as a Hub for Regional Operating Headquaters” 2011(6) Journal of Economic and Behavioral Studies 275-287 for discussion on establishment of a headquarter regime and comparative analysis between Thailand, Malaysia, Singapore and Hong Kong.
8.7 CONCLUDING REMARKS

In this Chapter the development of international trust law, as well as that in some specific jurisdictions, has been evaluated. Internationally there are a variety of trust manifestations, with most common-law and hybrid jurisdictions having a long history of trust law, while civil-law jurisdictions either do not know the figure at all or have a trust-like alternative. Most major economic jurisdictions in the world, however, offer trusts as an option, even if it had historically been a foreign concept, like in the case of China.

The Hague Trusts Convention is the most important international treatise on trust law and has been adopted by a number of trust and non-trust jurisdictions. It seems as if there is a general consensus amongst offshore financial centres that trusts do fulfil an important role in the financial and investment world. This is supported by the fact that many non-trust locations have taken steps to introduce statutory trusts as business and financial vehicles into their jurisdictions. For the trust to fulfil its role in international finance, it does not necessarily mean that it must be treated exactly the same everywhere. Although there may be variations in the way it manifests, similarly to companies, some principles should be universal. Business people, investors, fund managers, etc., should, however, be able to expect a minimum level of legal certainty when dealing with trusts – irrespective of where in the world the particular trust is formed or regulated.

It is submitted that the South African trust has developed satisfactorily and can compete as an effective business tool with both a traditionally strong common-law jurisdiction, such as the UK, and with modern offshore jurisdictions, such as Mauritius and Malta. Although South Africa has a well-developed trust-law regime, it is submitted that certain aspects should be addressed to assure that it can maintain itself in the international environment of business and finance.274

The importance of a trusted and defensible regulatory model for trusts will be discussed in the next Chapter. The applicability of the King Reports, the Tiebout Regulatory Model, the potential effects of the IOSCO and Unidroit principles, as well as the Uniform Ohada Act, Southern African Development Community Law and the

274 See Chapter 10 for conclusions, submissions and recommendations.
Basel Accords, will be evaluated. Other aspects to be considered include the *lex mercatoria*, future legislative interventions, and the value of the European Law Book X on Trusts.

In the search for a potential regulatory strategy for trust law in South Africa specific regulatory models will be considered, such as the Tiebout Model, the Enlightened Shareholders Value Model, and the Twin Peaks Regulatory and Supervisory Model.
CHAPTER NINE

INTERNATIONAL REGULATORY PRACTICES

9.1 INTRODUCTION

In the previous Chapter it was submitted that, although the current trust-law regime in South Africa can be regarded as sound and satisfactory from a regulatory perspective, some aspects have to be addressed to make it competitive in an international financial and business context. In this Chapter the current local, regional and international regulatory environment within which such interventions will take place will be investigated.

Regulators — which include central or regional governments, ministers, heads of departments, and other delegated functionaries — have a variety of regulatory options to choose from when the need for intervention emerges. Some of these are so-called hard options, such as parliamentary legislation or ministerial or board regulations, while others are softer legal instruments, such as directives, guidelines, guidance notes, position papers, practice notes or circulars.

It is submitted, however, that all forms of intervention, whether hard or soft, should comply with particular principles. In this Chapter some regulatory standards will be investigated and the potential value of some models of regulatory dispersion¹ will be evaluated.² Regulatory races to the bottom are of specific interest as far as jurisdictional havens and regulatory off-shoring in international commerce are concerned. The connection between regulatory dispersion and regulatory arbitrage will be included in this investigation.

Ultimately, these aspects shall all be evaluated in the South African trust context and to what extent the trust concept can be developed in the best interests of the local and international commercial environment and specifically as legal entity for commercial, investment and financial instrument purposes.

¹ Also called “regulatory differentiation”.
² See 9.3.
The importance of regulatory differentiation to both local and offshore structures must be appreciated. The so-called “offshore asset protection trusts” have contributed to some of the negative perceptions about the use of trusts in offshore financial centres. The primary purpose of these trusts is allegedly to shield assets from potential creditors. Business planning and structuring in general includes asset protection strategies such as asset isolation and risk diversification. It does not make sense to single out certain devices used to insulate entities or individuals against creditors, while others are left untouched. The asset protection trust can be used as a model for the entire trust milieu as a number of requirements have been adopted, such as the legality of the trust, the founder’s personal limitations as beneficiary and trustee, as well as other devices (i.e. trust protector clauses, anti-duress clauses and a non-binding letter of intent or letter of wishes).5

Offshore legislation is often shaped to assist foreign trust founders in placing their assets beyond the reach of their future creditors. The popularity of this tendency has led to some United States jurisdictions adopting similar tactics and to become the legal environment of choice for trust and other fiduciary services. These initiatives cause serious regulatory competition amongst different jurisdictions competing for the same markets. In theory this competitive process should result in more effective and affordable service at a lower cost base. The client should, therefore, be, in a better position — theoretically at least.

In the world of regulatory capital arbitrage the lesson learned was that stricter regulatory terms may actually lead to a “perverse result” in that banks may actually keep riskier assets within each category instead of lowering their risks as envisaged by the regulators. The theory behind regulatory capital arbitrage is that, when regulatory capital exceeds economic capital for a specific asset, less leverage is available for the particular asset, which will affect the margin and will motivate

3 Ausness 148 defines an asset protection trust as “a self-settled spendthrift trust which is created in order to protect the settlor’s property from the claims of creditors”. A spendthrift trust prohibits a beneficiary from transferring its interest to a third party and protects the trust property from the creditors of the beneficiary until the asset vests in the beneficiary. Courts in the US have treated offshore asset protection trusts in a very negative manner over a period of time. See Ausness 159-162.

4 Ibid 186.

5 Ibid 156, 172-175. These methods often result in a tension between the protection of the settlor and that of his creditors.

6 Calem & Follain 199.
investors to amend their asset allocation. By way of clever regulatory interventions the opportunities for arbitrage thus can be limited and even totally obliterated — that is in theory at least.

Offshore jurisdictions have caused many negative perceptions in certain sections of the financial and governmental world. Profits and sometimes even economic survival in an extremely competitive global reality, have forced many smaller nations into positioning themselves as offshore destinations. In the competitive environment of high finance regulatory differentiation, and specifically tax differentiation, have become one of the survival tactics for many offshore jurisdictions. One of the more positive reforms during the last decade was sound trust legislation, as can be seen in both Mauritius and Malta.

It is submitted that offshore financial structuring is here to stay and that sensible international regulatory intervention, such as the Basel Accords for global banking and finance, may be needed to temper the negativity towards offshore destinations and bring the reform needed by this industry. The Hague Convention is a step in the right direction as far as trusts are concerned. The next stop should be taxation. It is suggested that offshore jurisdictions should in the meantime take a “bottom up” approach and not wait for “top down” measures from international regulatory bodies. Malta is an example of a country that did exactly that to protect its base.

South Africa should decide exactly what role it wants to fulfil as financial destination as it cannot be everything to everyone. If it does enter the offshore financial environment, it is suggested that it should differentiate itself by way of an excellent regulatory framework.

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7 Ibid 200. Basel II would even the playing fields and will thus limit the opportunities for regulatory arbitrage.

8 See ibid 218, who submit that Basel II should ultimately have the desired effect. Calomiris & Mason 27, submit that the application of regulatory arbitrage in credit card securitisation was rather a matter of “efficient contracting” than of “an undesirable means of reaping safety net subsidies.”

9 See Partnoy 256 for an example of this approach in the derivatives market.

10 Book X on Trusts for European Law is also a positive step in guiding the development of trusts in an orderly fashion.


Chapter Nine: Regulatory Environment for Trusts

9.2 REGULATORY STANDARDS

It is prudent to investigate the current regulatory environment within which South Africa operates as well as existing international regulatory and self-regulatory standards which may in general contribute to the development of a sound philosophical and pragmatic legal basis for future interventions. In this process local and international standards that have crystallised during the last decade will be evaluated.

9.2.1 KING REPORTS

The King Committee on Corporate Governance in South Africa was formed in 1992 and was instructed to consider the state of corporate governance locally, in line with international best practices. The 1994-report marked the institutionalism of corporate governance in South Africa and recommended minimum standards of conduct for boards and directors of listed companies. The King I report advocated an integrated approach to good governance, including stakeholder interests and good financial, social, ethical and environmental practices.¹¹

The second report was published in 2002 and contained a Code of Corporate Practices and Conduct for listed companies, banks, financial and insurance entities, and particular public sector enterprises. The report identified seven characteristics of good governance, namely universally recognised and accepted forms of discipline, transparency as far as outsiders are concerned, independent mechanisms of conflict prevention and management, accepted mechanisms of accountability, responsible mechanisms of corrective action towards stakeholders, fairness in the balancing of competing interests, and awareness and positive responses to social responsibility. This so-called “triple bottom line” approach is based on the principle that it is good business practice to encourage companies to be good corporate citizens — balancing social, environmental and economic interests.

The third King report was issued in 2009 and was influenced by the Companies Act 2008 and some international governance trends and practices since the release of the previous report. King III applies to all entities regardless of the manner or form of incorporation or establishment. The principles in this report focus on good

governance in general and each entity has to consider the practical application thereof, although it may be mandated by way of statute, regulation or a soft law approach. King III deals with a variety of issues, such as ethical leadership, corporate citizenship, boards and directors, audit committees, the governance of risk, the governance of information technology, compliance with laws, rules, codes and standards, internal auditing, governance of stakeholder relationships, and integrated reporting and disclosure.

This report encourages companies to achieve a healthy balance between the various stakeholders – in the best interests of the company. The shareholder is thus not the only stakeholder of importance any longer. This latest King report is further based on an “apply or explain” approach, which enables entities to operate for the purposes for which they were intended, without being bound to follow standards which are, by their very nature, inflexible.

The principles of the King Code are not legally binding, except, to some extent, in the case of listed companies. It is submitted that business trusts are included in the “all entities” the King report refers to and that trustees should take note of the contents of the reports and the applicability of these self-regulatory principles. The future development of the business trust in South Africa should, therefore, be aligned to the direction given by King. It does seem as if the King Reports may have influenced the 2008 Companies Act in an indirect manner.

9.2.2 BASEL ACCORDS

The Basel Accords and the affect thereof in the South African context were discussed in Chapter 7. In this part the applicability of the Accords as far as regulatory intervention in trust law is concerned shall be evaluated. Basel I largely dealt with minimum regulatory capital requirements, while Basel II focused on the three pillars of capital requirements, supervisory review and market discipline. Basel III extended this process to better risk coverage interventions, such as leverage coverage and capital build-up measures.\footnote{See para 7.9.}

It is submitted that the supervisory review process introduced by Basel II may be of practical value to regulators in general. This review process includes risk
management techniques in monitoring and managing risks, such as strong risk management methods, the application of internal limits, and the improvement of internal controls.\footnote{The Basel Committee on Banking Supervision Consultative Document, called the New Basel Capital Accord, January 2001 paras 587 and 590.} The four key principles of supervisory review identified in the banking domain have been that of proper assessment and strategy;\footnote{Paras 594 – 611.} evaluation and monitoring;\footnote{Paras 612 – 622.} expectation that parties will operate outside the set parameters;\footnote{Paras 623 – 625.} and early intervention.\footnote{Paras 626 – 627.}

It was further stressed that supervision is not an exact science and discretion shall, therefore, remain an integral part thereof. For this reason the supervisory role should be fulfilled in a highly transparent and accountable manner. Regulatory requirements and factors taken into consideration should be publicly available.\footnote{Para 628.}

It is submitted that the aspects highlighted in this part of the Basel II document have some relevance to the manner in which any regulatory function is structured and applied.

The main aim of Basel III was to improve financial stability. As the main objectives were to raise the quality of the capital base, strengthen the risk coverage, introduce a leverage ratio and measures to promote capital buffers, and to set global minimum liquidity standards, this Accord did not add any value to regulatory processes in general.\footnote{Barfield (ed) 11.}

The Accords were very focussed and dealt with financial stability issues only, and could, therefore, not contribute much to national regulatory initiatives. They did, however, become important role-players in all forms of intervention in the banking, financial and fiscal domains. Because of the international nature of the Accords and South Africa’s commitment as part of the world economy, the local legislator shall in future continue to be influenced thereby.

\footnotetext[13]{The Basel Committee on Banking Supervision Consultative Document, called the New Basel Capital Accord, January 2001 paras 587 and 590.}
\footnotetext[14]{Paras 594 – 611.}
\footnotetext[15]{Paras 612 – 622.}
\footnotetext[16]{Paras 623 – 625.}
\footnotetext[17]{Paras 626 – 627.}
\footnotetext[18]{Para 628.}
\footnotetext[19]{Barfield (ed) 11.}
9.2.3 INTERNATIONAL ORGANISATION OF SECURITY COMMISSIONS

The International Organisation of Securities Commissions’ (IOSCO) policy documents are aimed at improving and enhancing regulatory standards in international securities markets.\(^{20}\) The South African financial services sector and the securities market sector were found to be largely compliant with the IOSCO Principles.\(^{21}\) The object of these assessments is to determine and address any regulatory gaps by way of sound regulatory interventions, the supervision of the financial sector, and to ensure transparent, accountable and stable financial markets.

The IOSCO Principles have been summarised in Chapter 6 and consist of principles relating to the regulator, principles of self-regulation, the enforcement of securities regulation, cooperation in regulation, principles for issuers, principles for collective investment schemes, the principles for market intermediaries, and principles for the secondary market.\(^{22}\)

Trusts have a role to fulfil in the financial sector, as has been indicated before, and the development of the trust concept should, therefore, take cognisance of all developments, both nationally and internationally, in the financial markets. The implementation of the IOSCO Principles and the potential effect thereof on legal entities should thus be considered when trusts are developed in South Africa. Any legislation or other regulatory steps should include a holistic evaluation of the effect these may have on legal entities, including trusts.

9.2.4 UNIFORM OHADA ACT ON CONTRACT LAW

The Organisation pour l’Harmonisation en Afrique du Droit des Affaires (OHADA: Organisation for the Harmonisation of Business Law in Africa) has initiated several uniform acts, of which the Uniform OHADA Act on Contract Law is but one.\(^{23}\) The OHADA was formed in 1993 with the object of creating a simple, modern, harmonised business law system for its members, which will enable access to higher levels of economic activity. The parties thereto want to ensure a safe legal environment which will contribute to enhanced investment opportunities. The current members are Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comores, Congo, Ivory Coast, Gabon, Guinea, Guinea-Bissau, Equatorial Guinea, Mali, Niger, Senegal and Togo.

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20 The IOSCO Principles consist of 38 principles of securities regulation. Other instruments include recommendations and objectives.
21 The recommendations of the Financial Sector Assessment Programme (FSAP) were instituted by the International Monetary Fund and the World Bank.
22 See 6.4.
23 OHADA was formed in 1993 with the object of creating a simple, modern, harmonised business law system for its members, which will enable access to higher levels of economic activity. The parties thereto want to ensure a safe legal environment which will contribute to enhanced investment opportunities. The current members are Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comores, Congo, Ivory Coast, Gabon, Guinea, Guinea-Bissau, Equatorial Guinea, Mali, Niger, Senegal and Togo.
aforementioned was decided upon by the Council of Ministers in 2001, followed by a
decision to request the International Institute for the Unification of Private Law
(Unidroit) to assist in the process. The two guiding principles were firstly to follow the
well-established Unidroit model and secondly to take into account the uniquely
African features. The last-mentioned apparently referred to a “range of de facto
circumstances and to the sociological setting in the different countries that may affect
the choice of the most appropriate legal rules”.24

One of the major questions in this process was whether contract law should be
formalistic or non-formalistic, especially in light of the generally high illiteracy rate in
many of the OHADA jurisdictions.25 This and a number of important Unidroit
principles were followed with the drafting of the OHADA Act. Strong emphasis was
placed on good faith, as well as the renegotiation of contract in the event of changes
in circumstances. The last-mentioned principle was met with some opposition as it
might aggravate instability and be misused by mala fide parties.26 The right to
terminate a contract because of a fundamental failure by another party to perform as
agreed was also included.

A principle that has direct applicability to trusts is the non-inclusion of a “cause” and
“consideration” notion. The Act does thus not exclude the binding force of a
gratuitous contract; neither does it prevent individual jurisdictions from applying
different principles in this regard. By not including “cause” and “consideration” as a
principle, both civil-law and common-law traditions were actually accommodated.27

It is submitted that the very nature of Ohada, and the fact that its focus is on the
balancing of a variety of legal and sociological cultures, does not add much value to
the development of individual aspects in a monolithic legal culture. In that sense

24 See Fontaine “OHADA Uniform Act on Contract Law – Explanatory Notes to the Preliminary
Draft” September 2004 http://www.unidroit.org/english/legalcooperation/OHADA/%20 (accessed
15-05-2012) par 16. See also Date-Bah “The Preliminary Draft OHADA Uniform Act on
Contract Law as Seen by a Common Law Lawyer” 1-6 http://www.unidroit.org/english/
25 In case of the Unidroit Principles formalism for contracts was rejected, while the Vienna
Convention on Contracts for the International Sale of Goods endorsed the principle, but allowed
signatories to exclude the non-formalistic approach in their individual jurisdictions.
26 Fontaine para 40.
27 Para 22.
Ohada is not offering much for South Africa to learn from, although it may be of some value in the development of a Southern African trust-law regime.

It is submitted that it may be of more importance to consider aspects of the modern international commercial and legal culture, as expressed in the *lex mercatoria* and elsewhere, in the development of our trust law, than any unique African pattern.

### 9.2.5 UNIDROIT PRINCIPLES

The International Institute for the Unification of Private Law (UNIDROIT) is an international independent intergovernmental organisation, actively involved in the preparation of international instruments in the form of conventions, uniform laws, legal principles, etc., focusing on international commercial and private law.28

The Unidroit Principles of International Commercial Contracts29 proposed a tailor-made contract law for the international business community, which are closely related to the Vienna Convention on Contracts for the International Sale of Goods of 1980 as well as the Principles of European Contract Law. The Unidroit Principles are not a binding international instrument, but merely a model for the use of regulators, contract parties, national courts and arbitrators.30 The objective was to establish an international set of rules for use “irrespective of the legal traditions and the economic or political conditions of the countries in which they are to be applied”.31

The Principles have not only been adopted by judges and arbitrators, but also by commercial law scholars and law academies. They have proved themselves to be practical and academics have added value in a wide variety of jurisdictions.32 The Principles have been described as “neither common law nor civilian but a genuine

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29 The first set of Principles was published in 1994 and the second in 2004.


32 Date-Bah 2.
international synthesis of the contract law principles of the major legal systems in the world”.33

A number of articles in the Unidroit Principles have direct applicability to trusts in the South African context and are often included in local trust instruments, such as:

- no particular form required, and modification or termination only in terms of the agreement or by a later agreement;34
- consensus, and the duty of confidentiality;35
- common intention of parties for interpretation;36
- a contract for an indefinite period may be terminated by either party by giving reasonable notice in advance, parties may confer rights on a third party, subject to certain conditions or limitations, a beneficiary must be identifiable but need not be in existence at time of agreement, and the liability of the beneficiary may be limited or excluded;37
- the rights conferred upon the beneficiary may be revoked or modified until it was accepted by the beneficiary;38
- the beneficiary may renounce a right conferred on it;39
- suspensive or resolutive conditions may be included;40 and,
- assignment of rights may take place.41

It was stated that the Principles “represent a constructive methodology to unify or harmonise the international commercial law”.42 It is submitted that the Unidroit Principles can add value to the development of the contents of trust instruments for commercial purposes in South Africa. In light of the international nature of contracts

33 Ibid 3-4.
34 See arts 1.2 & 1.3.
35 See arts 2.1.13 & 2.1.16.
36 See art 4.1.
37 See art 5.2.3.
38 Arts 5.1.8, 5.2.1, 5.2.2, 5.2.3, and 5.2.5.
39 Art 5.2.6.
40 Arts 5.3.1 & 5.3.2.
41 Art 9.
and trusts it is advisable for South Africa to consider international developments in contract law when any interventions by way of legislation are initiated.\footnote{Oosthuizen, Rights, Duties and Remedies under the United Nations Convention on Contracts for the International Sale of Goods – An Investigation of the CISG’s Compatibility with South African Law. Dissertation Rhodes University (2008) for discussion on the compatibility of an international convention with SA law. The same principles can be considered to determine the compatibility of the Unidroit Principles.}

\section*{9.2.6 SOUTHERN AFRICAN DEVELOPMENT COMMUNITY LAW}

The Southern African Development Community (SADC) is a regional economic community consisting of 15 Southern African member states, and can be described as “an organisation that strives for regional integration to promote economic growth, peace and security in the southern African region.” Besides the reduction of trade barriers, it strives for sound political values amongst its fifteen member states, building social and cultural ties, alleviating poverty and enhancing the standards of living amongst the more than 250 million people in the region.\footnote{http://www.southafrica.info/africa/sadc.htm#ixzz1lm4udsNF (accessed 08-02-2012). SADC started as Frontline States with the objective of political liberation for Southern Africa. It was first called the Southern African Development Coordination Conference (SADCC), which was formed in Lusaka, Zambia in 1980 with the adoption of the Lusaka Declaration. The focus moved from political liberation to economic liberation and culminated in the SADC Treaty and Declaration of 1992. The current member states are: Angola, Botswana, Democratic Republic of the Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.}

No formally developed SADC legal system exists, although a body of principles, rules and institutions has been developed with the purpose of achieving regional integration.\footnote{Zongwe DP “An Introduction to the Law of the Southern African Development Community” February 2011 Hauser Global Law School Program, New York University School of Law http://www.nyulawglobal.org/Globalex/Southern_African_Development_Community.htm (accessed 18-05-2012).} SADC law is instituted and administered by a set of functionaries, with the Secretariat executing SADC policies and the Tribunal providing a forum for the settlement of disputes on the interpretation and application of the SADC Treaty, protocols and other legal instruments.\footnote{Other institutions include the Summit of Head of State; the Organ on Politics, Defence and Security; the Council of Ministers; the Integrated Committee of Ministers; the Standing Committee of Officials; and SADC national committees.} The main areas of SADC law are trade, investment, agriculture, infrastructure, services, national resources and security. Member states are supposed to coordinate and harmonise national policies and laws with that of the SADC. Although the Treaty and the protocols to the Treaty are regarded as the primary sources of SADC law, non-binding soft-law instruments,
such as model laws and memoranda of understanding, are also an integral part thereof.\textsuperscript{47} The launch of the SADC law journal as a general reference for SADC law in 2011 was a major step towards the realisation and establishment of SADC law.\textsuperscript{48}

Investment in the SADC is of the utmost importance and cannot be separated from the impact of international business transactions, in which different legal structures fulfil a significant role.\textsuperscript{49} The integration and harmonisation of finance and investment mechanisms, coupled with sound macro-economic, fiscal and monetary policies in the region, are necessary for the effective penetration of the international business markets.\textsuperscript{50} Member states have to co-ordinate their investment regimes to create an attractive investment climate within the SADC. One of the instruments used is the Investment Annex which includes promotional, protective and regulatory interventions.\textsuperscript{51} Another initiative was the Committee on Central Bank Governors, as a specialised body in SADC to promote and achieve closer co-operation among central banks within the Community. The 15 central bank governors deal with the development of financial institutions and markets, co-operation regarding international and regional financial relations, and monetary, investment and foreign exchange policies.\textsuperscript{52}

It is submitted that the importance of sound and certain regulatory mechanisms for legal entities is of the utmost importance in a region that wants to achieve objects of the nature of the SADC. The Community may have to evaluate the different corporative and non-corporative legal structures in the region’s jurisdictions and embark on an initiative to move towards some common denominators in enhancing itself further as an investor-friendly region. It is submitted that the trust can, as in many individual jurisdictions, fulfil part of this role.

\textsuperscript{47} See Zongwe 2.1. Compare art 6(5) of the Treaty. The Regional Indicative Strategic Development Plan forms the framework for the regional integration of the SADC.

\textsuperscript{48} http://www.sadclawjournal.org/.

\textsuperscript{49} The SADC was the largest African regional beneficiary of foreign direct investment in 2009.

\textsuperscript{50} Zongwe 5.2. The Finance Protocol focuses on investment, taxation, central banking and regional capital and financial markets.

\textsuperscript{51} Ibid 5.2.2 for more on the Investment Annex. Four mechanisms were institutionalised, namely policy-making, oversight, policy implementation and dispute settlement.

\textsuperscript{52} See http://www.sadcbankers.org/Pages/default.aspx (accessed 28-10-2012).
9.2.7 **LEX MERCATORIA**

The concept of the *lex mercatoria* and its applicability in business trust law has been discussed in 4.6.9. The Unidroit Principles discussed in 9.2.5 are by some regarded as a type of formalisation of the so-called new *lex mercatoria*.\(^{53}\) It is significant that it is stated in the preamble to the Principles that they “may be applied when the parties have agreed that their contract be governed by “general principles of law”, the “*lex mercatoria*” or the like”. In this sense it seems as if the compilers of the Principles have indeed regarded it as such a formalisation process.\(^{54}\)

The two basic approaches adopted in the determination of the *lex mercatoria* have been its general identification and codification versus the identification of a particular rule on an *ad hoc* basis.\(^{55}\) Irrespective of the different schools of thought regarding the justification and applicability of the *lex mercatoria* or not, does it seem so as to fulfil a particular role in international commercial law. The significant number of recent arbitral awards wherein reference was made to the Unidroit Principles, may be evidence of the need for some universal set of basic principles in the international business environment.\(^{56}\)

As the exact contents of the *lex mercatoria* are still somewhat vague and uncertain, the Unidroit Principles have brought some legal certainty and clarity which may be the stabilising factor needed to establish the *lex* properly. It is submitted that the discussion of the Unidroit Principles in 9.2.5 and the conclusion reached is adequate support for the opinion that the *lex mercatoria* as general body of law, and the Unidroit Principles in particular as manifestation thereof, may add value to the future development of the trust as business entity in South Africa.

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envisaged that SAM will become operative in January 2015. More than ten discussion documents have been approved for public comment by the FSB SAM Steering Committee. These documents may have a significant influence on the design of the applicable secondary legislation.

The aim is to establish a risk-based supervisory regime for the prudential regulation of the insurance industry, which shall include both primary and secondary legislative interventions. The developmental process included quantitative impact studies and model approval processes. Although SAM has no direct relevance to the development of trusts as such, the methodology used during the solvency assessment and management process, can contribute towards the development of other regulatory processes. The question remains therefore what the lessons are to be learned from this extensive process.

9.2.9 RECENT LEGISLATIVE INTERVENTIONS – BILLS

9.2.9.1 FINANCIAL MARKETS BILL OF 2011

This Bill replaces the Securities Services Act 36 of 2004, which primarily focused on the regulation of securities exchanges, central securities depositories and clearing houses. Certain developments in the local and international financial markets have compelled the assessment of the current regulatory approach. It is imperative to maintain the integrity of the regulatory framework and to ensure that it meets all objectives, while being aligned with international developments and standards.

National Treasury’s proposed reforms to the financial sector regulatory system in South Africa must be guided by certain principles. These principles must be evaluated in light of the particular policy objectives, regulatory effectiveness and standards of international best practices. Some of the most appropriate principles will be discussed briefly.

57 This date has recently been changed from 1 January 2014, which is still the implementation date for the European counterpart. The two regimes will run parallel from 1 January 2014. For more details on SAM see www.fsb.co.za/insurance/SAM/DiscussionDocument/Dis (accessed on 20-05-2012). See further ftp://ftp.fsb.co.za/public/insurance/SAM/SAM_2012_Update.pdf for the latest report, dated March 2012 on the development of SAM.

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Principle 2 specifies that a transparent approach is necessary for regulation and supervision purposes and principle 3 specifies that the quality of supervision must be sufficiently intense, intrusive and effective. Principle 4 requires that policy and legislation must be set by government and the legislature, which shall provide the operational framework for regulators. In terms of principle 5a, regulators should operate objectively with integrity and operational independence, without losing accountability. Principle 6 stipulates the need for regulations to be of universal applicability and comprehensive in scope in order to reduce regulatory arbitrage opportunities. Principle 7 stresses the importance of regulatory coordination based on effective consultation, while principle 11 provides for strong market conduct oversight, complementing prudential regulation.

It is submitted that these principles can add value to the determination of an effective regulatory model for trusts in South Africa, as it touches on some of the crucial issues in the current trust-law dispensation. Aspects such as transparency, supervision and objectivity are also present in some of the regulatory models discussed in paragraph 9.3. The Twin Peaks model in paragraph 9.3.4 includes strong supervisory and consultative elements, while the proposed Integrated Stakeholders Model in paragraph 9.3.5 also includes aspects such as discretionary supervision, inclusivity and the need for a holistic approach.

9.2.9.2 CREDIT RATING SERVICES BILL OF 2011

This Bill aims to ensure responsible and accountable credit rating agencies locally, while protecting the independence and integrity of the local credit rating process. These steps shall improve investor protection and the general integrity of the local financial markets, while it reduces systemic risk.59

Some elements contained in the memorandum on the objects of the Bill may be of value in the search for sound regulatory processes. Credit rating agencies have been criticised for their role in the global financial crisis, such as their failure to detect the worsening financial market conditions and to adapt their ratings accordingly; their failure to understand some new risk products; and their high ratings of some

59 See para 7.7.16 for the purposes of the Bill as stipulated in s 2.
securitisation transactions. The G20 consequently proposed a proper regulatory oversight regime.

This resulted in the International Organisation of Securities Commissions (IOSCO) determining in June 2010 that credit rating agencies should be subject to adequate levels of oversight, and those used for regulatory purposes should be subject to registration and ongoing supervision. 60

9.2.9.3 FINANCIAL SERVICES LAWS GENERAL AMENDMENT BILL 2012

The primary objective of this Bill is the development of a sound and well-regulated financial services industry in a stable financial environment. The Bill has an impact on all statutes administered by the Financial Services Board, such as those dealing with pension funds, insurance, collective investments and the provision of financial services.

The Bill addresses certain shortcomings in South Africa’s adherence to international standards of financial regulation, aligns the financial sector with the new Companies Act and eliminates overlaps with some other legislation.61 A further aim of the Bill is to give the Minister of Finance the necessary powers to deal with systemic risks to the financial system and the Reserve Bank to intervene in the event of a banking crisis.

As this is an amendment Bill no obvious regulatory philosophy or process was followed. It is submitted that this Bill does not add any value in an investigation into the development of a sound regulatory model for trusts.

9.2.10 BOOK X ON TRUST LAW

The Draft Common Frame of Reference with Model Rules for European Private Law has included Book X on Trusts, which is a compilation of proposed trust regulations in an attempt to consolidate trust law in Europe.62 Chapter 1 deals with the

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60 See “Memorandum to the Objects of the Credit Rating Services Bill, 2011”, attached as annexure to the Bill.
62 See Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference (2009), which includes contracts, unjustified enrichment, ownership of goods, trusts and proprietary security right in movable assets.
fundamental provisions regarding trusts, including the parties to the trust. Chapter 2 contains the constitution of trusts and Chapter 3 deals with all issues regarding the trust fund. Chapter 4 stipulates ideal trust terms and Chapter 5 the decision-making and powers of the trustees. Chapter 6 deals with the obligations of trustees, while Chapter 7 covers remedies for non-performance. Chapters 8 to 10 deal with a variety of aspects, such as the change of trustees, the termination and variation of trust instruments, and relations to third parties.

Book X is a fairly complete set of trust rules and was written to accommodate the trust principles in a variety of jurisdictions. South Africa does not need such a document for its internal trust order, as our trust law has developed these principles already. It may, however, be a valuable model to consider if ever a concerted effort is launched to unite Southern Africa in its quest to become an offshore financial jurisdiction.

9.3 REGULATORY MODELS

9.3.1 INTRODUCTION

It is submitted that the current South African regulatory philosophy is in the process of aligning itself with international norms and standards. During the last decade, the public has been confronted with a huge number of legislative interventions, some of which were radical and new in thinking. Many of these statutes or regulations were the natural results of the process of constitutional evolution the jurisdiction found itself in since the introduction of a very progressive human rights-based Constitution in 1994.

It is submitted that the sum total of the King reports and South Africa’s exposure to the Basel Accords have contributed to a new philosophical approach in the development of regulatory standards. This influence can be observed in the Companies Act of 2008, the Solvency Assessment and Management programme, and in the Financial Markets Bill of 2011. It may, however, be ideal for South Africa to develop a comprehensive regulatory model, instead of the current, somewhat haphazard, approach. The aforementioned has unfortunately led to some very badly
drafted, sometimes even unconstitutional, legislation during the past decade. Poor legislative drafting can result in unconstitutional acts, legislation that is merely ineptly written, with mistakes, ambiguities and poor grammar, or may consist of legislation which may have dire consequences. An attempt to address these issues has been the subjecting of new legislation to the Regulatory Impact Assessment system. It has unfortunately not been very successful up to date.

9.3.2 ENLIGHTENED SHAREHOLDERS VALUE MODEL

The three basic models of corporate philosophy are the pure profit based shareholders model, where the sole purpose of the company is to promote and protect the interests of the shareholders; the pluralist model, requiring a balance between the interests of all the stakeholders; and the enlightened shareholders value model, emphasising the shareholders’ interest, but with an overall consideration of all other stakeholders – including employees, suppliers, creditors, the environment and the larger community.

Stein submits that last-mentioned model has officially been introduced into South African law by the new 2008 Companies Act, replacing the pure profit model of the old Act. The enlightened shareholders value model includes other values, such as transparency in dealing and accountability for all actions — principles also highlighted by the King reports. The philosophy followed includes the belief that companies are more than only business structures, but actually social and economic.

63 The National Credit Act 34 of 2005 is an example of poorly drafted legislation and was recently exposed as such in Sabelo v Standard Bank of SA Ltd (7-06-2012) (CC). The regulatory burden in general is affecting the economy negatively. See Lawack-Davids “Mind the Gap – Increasing Compliance – Burden and Regulatory Misalignment” 2011(3) Obiter 712-720 for a discussion on some of the regulatory challenges in the financial services industry.


65 See SBP Alert 5-6.


institutions, and should, therefore, take social and environmental imperatives into consideration when pursuing economic objectives.\textsuperscript{68}

The legislator restrained itself from over-controlling and rather encouraged self-regulatory mechanisms — albeit with strengthening the position of stakeholders with significant new rights and remedies.

It is submitted that the trustees of business trusts should take cognisance of the apparent introduction of the enlightened shareholder value model to the South African commercial environment. It is further submitted, however, that this model does not address the future role of the regulating and supervisory authorities adequately.

9.3.3 TIEBOUT MODEL

Charles Tiebout made the theory of regulatory competition popular by suggesting that inter-jurisdictional competition should lead to efficient legislation.\textsuperscript{69} Tiebout’s theory was based on the individual attractiveness of local authorities for residents. He developed a model of regulatory competition based on the premise that well-informed citizens will prefer to live in a community that provides the services that are closest to their personal preferences.\textsuperscript{70}

This proposition is based on the theory that people make major decisions based on their individual preferences. The result is that local authorities will provide citizens with what they want to ensure that they remain in the area or that new citizens move to the area. This will ultimately create a healthy level of competition which will result in better services, although it may cost more.\textsuperscript{71} This principle can be used in many


\textsuperscript{69} Mitkute & Tanega 51. See also 8.7.


\textsuperscript{71} See Mitkute & Tanega 51. Barlin calls it regulatory differentiation.
other environments, such as banking, consumer products, legal systems, corporative law and even trust law.

Although the Tiebout model has often attracted criticism and it was submitted that higher levels of satisfaction shall not necessarily always equate to higher levels of efficiency, many do believe that it provides at least a justifiable starting point. It is thus generally accepted that “competition amongst jurisdictions should yield efficient legislation”.72

Barlin73 submits that in industries where movement to offshore regulatory solutions are common and easily achievable, the result was often a dispersion of services rather than an upwards (or downwards) conversion.

Most scholars, however, will admit that globalised economic exchange in the competitive modern world will cause some pressure to form either side. Regulatory decisions are often compelled by economic considerations, which in turn will lead to regulatory arbitrage by companies and individuals in international commerce.74 One of the results may be the self-positioning by some states as niche markets for specific clients, which tendency does not necessarily amend the overall regulatory pattern.75

It is submitted that the different economic and legal models available and the highly competitive nature of the modern day international economic reality, will cause businesses and individuals to shop around. Most trade and economic models are dependent upon currency and market differentiations. The fact that the world has become integrated as far as movement and technology are concerned makes it less important where the manufacturing, consumption or management of goods or services take place.

Mitkute and Tanega76 identified three limitations to the Tiebout model when applied to offshore trusts. The first they referred to was the need for the client (the settlor/

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72 Mitkute & Tanega 51.
73 Barlin 1.
74 See 5.9 for discussion on regulatory arbitrage.
75 See Barlin 2 who submits that the long-term result may rather be an upward than a downward trend in regulatory habits. The writer submits that this pattern is seen in financial and shipping regulation.
76 Mitkute & Tanega 52.
founder or investor) to have *adequate information* to compare the legal rules of its home jurisdiction with that of any competing offshore jurisdictions. The second aspect was the grade of *mobility* the client had actually to be able to move to different jurisdictions – which might be influenced by costs, locality, language, rates of exchange, weather patterns, and personal circumstances. In the third instance there might be *external factors* that affect jurisdictional change. These might include legislation, regulatory restrictions, neighbouring jurisdictions, internal customs, etc.

It is admitted that the first two do not present major obstacles in the way of offshore trusts, as legal, tax and financial information about the different jurisdictions are readily available and mobility is usually not of much importance as business people generally do not have to relocate to the jurisdictions of their offshore trusts.

Transport and communication sources should usually also not create any logistical challenges, although cost may be a factor to consider. It is suggested, however, that cross-border externalities, based on the regulatory policies of offshore jurisdictions, are often problematic. Mitkute and Tanega\(^\text{77}\) submit that these issues may increase the cost of borrowing to counteract the inherent risks. The offshore trust legislator, however, does not usually factor externalities into its asset protection legislation, which may result in less efficient legislation.\(^\text{78}\) It has been argued that this problem might be addressed by means of conflict of law rules that prescribe the law of the founder’s home jurisdiction as the applicable law for disputes regarding the offshore trust.\(^\text{79}\)

In the final instance there is also the ever-present underlying risk that the so-called “race to the bottom” may result in weaker, and thus less effective, legislation. The opposite of that trend is what Barlin\(^\text{80}\) refers to as “the upwards harmonization of regulatory standards”.

If is submitted that if the Tiebout model is projected to the business trust in South Africa, the lack of adequate information and a number of external factors may indeed

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\(^\text{77}\) 51.

\(^\text{78}\) See Mitkute & Tanega 52-56 for discussion on the application of English Law to some questions regarding asset protection trusts in offshore jurisdictions, especially as far as conflict of laws and the applicability of UK jurisdiction in disputes are concerned.

\(^\text{79}\) Ibid 56. Conflict of law rules are discussed in 8.8.

\(^\text{80}\) Barlin 1. Some writers are proponents of a race to the middle.
inhibit the application of the model. Irrespective of these proposed limitations, the theory may still add value in the development process of a more suitable model for trusts, while guarding against the potential risk of weak, ineffective regulatory standards. The ideal will be the achievement of an “upwards harmonization”, as proposed by Barlin.\textsuperscript{81}

It is submitted that the ideal process of regulatory intervention for trust law should be based on an intention to create a sustainable and harmonised international environment which discourages role players to seek for arbitrage opportunities. Aforementioned can only be achieved if a healthy balance is struck between regulatory and economic capital in real terms\textsuperscript{82}, as well as a more standardised tax regime. The business milieu will always be dominated by the economic realities and major disparities will thus logically result in arbitrage seekers if tax and other regulators ignore the customer.

It is submitted that the simple principle laid down in the Tiebout theory is not adequate to ensure the best possible regulatory environment under all circumstances. The very basic proposition that regulatory competition shall yield efficient legislation has to be modified in the quest for modern regulatory interventions that will satisfy both the local and international requirements of an integrated legal world. Other phenomena, such as niche markets, cross-border externalities, and high levels of mobility, may make a simplistic theory even more undesirable.

\section*{9.3.4 TWIN PEAKS MODEL}

The so-called Twin Peaks model of regulatory and supervisory control has been developed in the United Kingdom as a direct result of the international financial crisis. It was stated that the basis of this model is the “presumption that regulators cannot rely on the judgment of the firms they supervise, and must take their own view

\begin{flushleft}
\textsuperscript{81} Barlin 1. As indicated before do some proponents rather prefer a so-called “race to the middle”. Compare Calem & Follain 199-200 a.f.
\textsuperscript{82} See Calem & Follain 200 in this regard.
\end{flushleft}
formed from their own analysis”. Where inconsistencies are found, the regulator must intervene.83

Twin Peaks allows for two independent groups of supervisors covering prudential and conduct issues. Each supervisory arm can make its own, separate, set of regulatory judgments against different objectives, while coordinating internally to maximise the exchange of information. It can be described as an independent, but coordinated, regulation. It is less reliant on legalistic rules and more focused on supervisory discretion.84 It can be summarised as judgment-led supervision, based on two legs, namely a sound institutional structure within a macro-prudential regulatory environment.

It is submitted that the Twin Peaks regulatory and supervisory model was unfortunately developed in the context of a systemic crisis in a very specific domain, namely the banking and investment sector. The fact that the model does include some valuable principles does not necessarily make it a workable model for the regulatory and supervision environment in general.

There are rumours that South Africa is considering adopting the Tiebout Model of regulatory and supervisory control. A specific challenge to consider in the South African context, however, is the lack of strong institutional and management structures — which are indispensable requirements for the successful implementation of the Twin Peaks model.

This model was developed in the United Kingdom, where a sound institutional structure exists within a well-developed regulatory environment. It is submitted that the elements of this regulatory and supervisory model should rather be incorporated into a broader regulatory model suited for the South African administrative and political reality. It is submitted that the Integrated Stakeholders Model is more appropriate for the local circumstances.


84 “UK Regulatory Restructuring and the Financial Services Bill".
9.3.5 INTEGRATED STAKEHOLDERS MODEL

It is submitted that, regardless of Tiebout’s premise, regulatory standards do increase in any event, irrespective of the existence of regulatory competition or not, as there is a continuous upwards harmonisation of standards internationally due to the development of the world we live in. It is correct that regulatory competition will contribute to the need for change. The initiatives by some jurisdictions, such as the states of Delaware, Alaska and New Hampshire, to compete with traditional offshore jurisdictions in attracting foreign trust settlors, by way of asset protection enhancing legislation, proves the point. Their aim to become jurisdictions of choice for trusts and fiduciary services will indeed result in some form of reaction by the traditional offshore jurisdictions to protect their base.85

It is submitted that regulatory models must be robust and practical and a number of relevant factors must be considered to develop a national model that is not only competitive, but also internationally compliant. Many of the practical as well as philosophical approaches by the advisory and regulatory organs discussed in paragraph 9.2 above can contribute in the development of a sound regulatory model.

The Enlightened Shareholders Value Model, emphasising the shareholders’ interest, but with an overall consideration of all other stakeholders, finds major favour internationally and adds value when regulatory models are investigated. Regulators should become more aware of, and sensitive towards, the needs of all parties that may be affected by their planned interventions.

The Tiebout model accepts that competition amongst jurisdictions should ultimately yield efficient legislation. It was indicated, however, that competition may sometimes rather result in a dispersion of services instead of an upwards conversion thereof. In light of the economic considerations, the Tiebout philosophy may attract regulatory arbitrage and should it not be advocated as an effective and efficient regulatory and supervisory model. It is submitted that competition is only one of a number of factors to consider when regulatory models are evaluated.

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85 Mitkute & Tanega 50. They accept the presumption that jurisdictions are affected by similar factors as business entities or initiatives.
Chapter Nine: Regulatory Environment for Trusts

The Twin Peaks concept is based on coordinated independence in the regulatory environment, with its focus not only on legality, but also on due process and proportionality. It is envisaged to negate the underlying subjective aspects of culture, focus and philosophy in the regulatory process. It does not, however, offer much guidance in terms of the fundamental legal and philosophical principles on which a model will be built. Twin Peaks is furthermore very much reliant on strong institutional support and a non-politicised, independent, regulatory environment.

It is submitted that the emphasis the IOSCO principles have placed on a holistic approach when developing regulatory standards, is indeed noteworthy and should be a factor to consider when a regulatory model is developed.

A valuable concept to be taken from the Unidroit principles is that a particular regulatory need shall determine the specific form of regulatory intervention to be applied. This entails that a national regulatory model should be flexible enough to allow for required outcomes in particular areas of regulation and supervision.

From the Solvency Assessment and Management programme it became clear that sound, quantitative, impact studies, as well as model approval processes, may contribute to better regulatory modulation and ultimately to better interventions.

It is submitted that the process followed in the formulation of the Financial Markets Bill has something to offer. It became clear that the developmental processes must be objective, effective, consultative, and applied with utmost integrity.

The King Reports also advocated an integrated and inclusive approach in which all stakeholders participate. Such an approach should contribute to a sound, stable, accountable and transparent regulatory model.

It is submitted that the ideal regulatory model is a combination of the above philosophies, with the emphasis on the integration of the interests of all stakeholders. The most important elements identified from the different models and initiatives are as follows:

- all stakeholders must be involved and considered in a holistic, integrated and inclusive process;
- adequate room must be left for self-regulatory mechanisms;
• regulatory and supervisory interventions must consider all economic objectives and the impact on competitiveness in general;
• a strong institutional structure as well as a macro-prudential perspective on regulation is necessary;
• supervisory role-players must be left with adequate discretionary powers; and
• regulatory interventions must address specific, quantitative needs.

The above can be modulated in the form of the Integrated Stakeholders Model for Regulatory and Supervisory Interventions (ISM), as follows: (See illustration 8.)

1. all stakeholders must be considered and involved in the regulatory and supervisory process;
2. all relevant economic objectives within an international competitive market, as well as possible economic consequences of such intervention, must be taken into account during the process;
3. all relevant legal objectives within a constitutional democracy within an international legal environment, as well as possible legal consequences of such intervention, must be taken into account during the process;
4. regulatory and supervisory bodies must be allowed to shape all interventions within a macro-prudential environment, without undue influence from political role players;
5. a holistic approach must be followed, with an empowered body, such as a regulatory assessment institute, continuously involved in the process;
6. a well-defined regulatory and supervisory model must be flexible enough to allow specific needs to be addressed effectively;
7. all interventions must allow continuous integration and inclusivity of all stakeholders and wider communities;
8. all interventions must allow for adequate discretionary supervisory application;
9. a strong institutional structure, based on a constitutional culture of service delivery, must be developed at all levels of government;
10. all regulatory interventions must encourage and empower stakeholders, both in the public and private domain, to take responsibility for the projected outcomes by way of self-regulatory mechanisms.
ILLUSTRATION 8: INTEGRATED STAKEHOLDERS REGULATORY MODEL

- Economic objectives
- All stakeholders
- Self-regulatory mechanisms
- Legal objectives
- Macro prudential regulation
- INTEGRATED STAKEHOLDERS REGULATORY & SUPERVISORY MODEL
- Discretionary supervision
- Strong institutional structure
- Holistic approach
- Specific needs
- Integrated & inclusive
9.4 REGULATORY INTERVENTIONS IN TRUST LAW

9.4.1 INTRODUCTION

In view of the above discussion the question now arises what regulatory intervention model shall be most appropriate in the South African trust-law environment. Regulatory interventions may take on different forms, such as national or provincial legislation, ministerial regulations, or soft law mechanisms, which may include self-regulatory processes and structures. The default position in a traditional common-law jurisdiction, such as South Africa, is to allow the law to develop naturally by way of the judiciary, with only minimum interference from the lawmakers.

It is submitted that the successful development of the trust as a legal concept in South Africa is an excellent example of what can be achieved when the legislature allows the law to run its natural course. It is submitted that the Trust Property Control Act was at the same time an example of a positive intervention by the legislative authority. All future initiatives by the aforementioned should, however, be done on the back of a proper regulatory model to ensure that the intervention achieves the desired results. Although the South African legal system has largely become a hybrid system, pure common-law manifestations, such as the trust, should be protected from major legislative interferences, as it may spoil the proverbial legal broth.

9.4.2 PRINCIPLES OF INTERVENTIONS

It is submitted that the principles locked up in the Integrated Stakeholder Model, as explained in paragraph 9.3.5 above, should be considered when regulatory interventions in trust law are drafted. In this process all contributors to the model should be utilised.

In terms of the Enlightened Shareholders Value Model, the interests of all stakeholders (not only that of shareholders) should be evaluated and accommodated to ensure that the resulting regulations bring about the required outcomes. The potential value of the trust concept to the economy in general must not be underestimated. The trust must be optimised in economic terms and allowed to fulfil its calling in both its traditional position and in new spheres of business. The legislature must be careful in not allowing negative sentiments, such as perceptions about its
misuse for tax purposes, to override good judgment when deciding on regulatory steps. It is proposed that trusts should be taxed ideally like companies to ensure a level playing field and to discourage any form of tax arbitrage.\(^{86}\)

The **Unidroit principles** contain a large number of aspects that may be relevant when specific legislation or regulations are compiled for trusts in SA. The modification of a contract or the termination thereof should be only in terms of the agreement itself or by way of a later agreement. The agreement should always be based on consensus amongst the participants thereto and the common intention of the respective parties should be considered when interpreted. A duty of confidentiality regarding the contents of the agreement may be created. Agreements for indefinite periods may be terminated by the parties under certain circumstances. Parties may also confer rights on third parties, subject to certain conditions or limitations. Beneficiaries must be identifiable, but need not be in existence at the time of the agreement and the liability of beneficiaries may be limited or excluded in the agreement. The rights conferred upon a beneficiary may be revoked or modified until they are accepted by the beneficiary and the beneficiary may also unilaterally renounce a right conferred on it. Agreements may include suspensive or resolutive conditions and assignment of rights may take place.

The principles used in the **Financial Markets Bill** introduced a number of interesting aspects, such as supervision, management and operational elements. It was submitted that the regulations, as well as the supervisory processes linked thereto, should be transparent. The supervision must further be qualitative, intense, intrusive and accountable. Management processes must be objective, effective and done with integrity. Operational independence is necessary and regulation must be universally applicable and comprehensive enough to prevent arbitrage. Proper oversight is also necessary to achieve prudent regulation. The effectiveness of the intervention must be tested against the specific objectives set for the legislation or regulations. All role players should be held accountable for their actions and the regulatory framework must be flexible, efficient and proportionate. In trust law these principles shall have an effect on the role of trustees as well the Master of the High Court in his/her supervisory role.

\(^{86}\) See Stein 8-10 for more on this model.
The Solvency Assessment and Management programme suggested that regulatory interventions should be prudential, and the methodology itself may contribute positively to the final regulatory intervention.

The IOSCO principles indicated that regulatory standards had to be continuously improved and enhanced and that sound regulatory interventions might include self-regulatory mechanisms. Supervisory mechanisms were necessary and all mechanisms had to ensure transparency, accountability and stability. In the final instance was it imperative to use a holistic approach to regulation.

The King Reports supported an integrated approach in which the interests of all stakeholders had to be considered. Such an approach to regulatory intervention should result in the development of sound practices, which were stable, transparent and accountable. In trust development competing interests must also had to be balanced to ensure a fair participation by all role players. The regulatory environment had to support and encourage good governance as well as proper risk and technological management. The aforementioned should include monitoring and the setting of internal limits and controls. Minimum standards of compliance must be set, which should provide for regular processes of auditing and financial reporting mechanisms.

The King Reports referred to a triple bottom line approach as being social, environmental and economic, but it is submitted that in the regulatory environment of trusts the approach should be social, legal and economic. The trust is a social instrument and plays an important role in the future financial planning of many families. The trust concept also has a pure economic value to it as has been indicated by the important role it fulfils in the business environment. In the final resort the trust is a legal phenomenon and is it a central piece in the legal entity puzzle of many jurisdictions, including South Africa.

The Basel Accords required that certain information should be readily available to public and proper assessment and strategic planning is necessary. It further emphasised aspects such as evaluation and monitoring. Basel also presupposed arbitrage and advocates an environment where discretion becomes an integral part of supervisory mechanisms.
Stein\textsuperscript{87} refers to the five “economic growth objectives” taken into account with the development of the new companies legislation, namely simplification, to promote competitiveness and development; flexibility, to promote innovation and investment; efficiency; transparency, to encourage high standards of corporate governance; and predictability. To this one can add the goal of harmonisation and compatibility with the best practices in international jurisdictions. These principles are as applicable to the development of trust law as they were to company law, particularly in light of the business trust.

It is submitted that Waters\textsuperscript{88} is correct when he says that the codification of the law of trusts in common-law countries are most probably not ideal. He states that although trustee legislation (versus trust legislation) should be enabling and supportive devices in these jurisdictions, the real development of common-law traditions should take place by the hands of lawyers, academics and judicial officers. The flexibility in the hands of judges allows the development of the law to reflect “modern issues and modern practice”.\textsuperscript{89}

Langbein\textsuperscript{90} submits that the flexibility of the trust has largely contributed to its applicability and popularity as an enterprise organisation. The trust and the company are competing for organising business activity. In the case of pension funds and unit trust funds the trust is usually the vehicle of first choice, while with the non-profitable organisation not much is to be chosen between the trust and the company. One of the main reasons for the apparent lack of interest in the development and applicability of the commercial trust is the fact that its application is largely in the hands of a small group of specialising individuals and institutions, such as banks and investment companies.\textsuperscript{91}

\textsuperscript{87} 3-4. In reference to the 2004 Policy Paper by the Department of Trade and Industry. The declared policy was to develop a “clear, facilitating, predictable and consistently enforced (company) law”.


\textsuperscript{89} Ibid 268.

\textsuperscript{90} In Hayton (ed) 191 he mentions a few examples of how the trust form has led to innovatory thinking in corporation law.

\textsuperscript{91} Ibid 194.
9.5 CONCLUSION

In this Chapter the current local, regional and international regulatory standards have been identified and evaluated in the context of some known regulatory models. It was submitted that the ideal regulatory model for trusts is a combination of the accepted philosophies, with the emphasis on the integration of the interests of all stakeholders.

It is submitted that a new regulatory model, which has been referred to as the Integrated Stakeholders Model for Regulatory and Supervisory Intervention, could be considered for South African trust law. This model is holistic, consultative, harmonising and inclusive in nature, and focuses on the particular need to be addressed as well as the particular purposes to achieve, with all relevant factors and the interests of all role players being taken into account. In developing this model, a number of other models have been integrated, one of which was the Twin Peaks model.

In the final Chapter of this thesis the conclusions and submissions will be stated, as well as recommendations for future regulatory interventions. The recommendations are made in the anticipation that the regulatory and supervisory authorities will follow the principles of the Integrated Stakeholder Regulatory model when identifying, determining, planning, strategizing and implementing any and all interventions.
CHAPTER TEN
CONCLUSIONS, SUBMISSIONS AND RECOMMENDATIONS

10.1 INTRODUCTION

The aim of this thesis was to evaluate the role and operation of the trust as a business vehicle, and more specifically as legal entity for financial instruments. In the first part the trust concept in general and the business trust in particular, have been discussed.

Chapter 1 dealt with the motivation for and purposes of the study, as well as the research methodology applied. The application of the trust as not only a vehicle of gratuity, but also as a business and financial instrument, has been stressed. It was submitted that the trust in this wider context has much to offer and justifies a proper evaluation.\(^1\) The question posed was whether the current South African legal framework for the application of the business trust is sound and adequately robust in light of the development of the international business and financial environment.\(^2\) It was submitted that the study shall commence with a historical analysis of the trust as legal concept, within a continuous desktop methodology. The comparative component was submitted to include international conventions and treaties, as well as some foreign jurisdictions, with some emphasis on the application of the trust within collective investment schemes and the securitisation process. All discovered information was to be evaluated on a continuous basis from a critical-analytical perspective.\(^3\)

The next Chapters were exclusively focused on the trust concept, with Chapter 2 focusing on the history, development and nature of the trust in South Africa, including the parties to the agreement and the contents of the trust instrument.\(^4\) A number of

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\(^1\) See 1.2.
\(^2\) See 1.5.
\(^3\) See 1.6.
\(^4\) See 2.2.
specific characteristics of the trust, such as the trust in the narrow and wide senses, the separation of enjoyment and control, the piercing of the trust veil, the fiduciary relationship and the legal personality of the trust have been included in this discussion.\textsuperscript{5}

In Chapter 3 the practical application of the \textit{inter vivos} trust as legal phenomenon, as well as its position in relation to other legal figures and specific manifestations of the trust concept, were considered.\textsuperscript{6} The close and sometimes interlinking relationship with a number of legal phenomena was illustrated, exposing the wide impact of trusts in the private and business milieu. The advantages and disadvantages of trusts were investigated and its position relative to the corporative structure was evaluated.\textsuperscript{7} The aspect of offshore trusts was also referred to.\textsuperscript{8}

Chapter 4 consisted of a study of the application of the business trust in general, and the manifestation of the trust as a business organisation in particular.\textsuperscript{9} This evaluation included the trading trust, the private investment trust, the collective and non-collective investment scheme trust, the pension fund trust, the employee and empowerment trust, the friendly society trust, the security trust, and the community trust. In this Chapter all relevant legislation, as well as a number of specific \textit{capita selecta} on the business trust, were evaluated, which included the effect of the conduit principle and the vesting of rights in the business trust.\textsuperscript{10} The applicability or not of specific concepts, such as the Turquand rule, judgment proofing and the circle of assent doctrine, were investigated. The applicability of the trust as broad-based black economic empowerment vehicle has also been covered.\textsuperscript{11} The practical relevance of the doctrines of conscionability and the \textit{lex mercatoria} on the trust concept, have also been evaluated.\textsuperscript{12} The offshore business trust and the role of the trust in international finance were also included.\textsuperscript{13}

\textsuperscript{5} See 2.5-2.10.
\textsuperscript{6} See 3.4 and 3.5.
\textsuperscript{7} See 3.2, 3.2 and 3.6.
\textsuperscript{8} See 3.7.
\textsuperscript{9} See 4.3 and 4.5.
\textsuperscript{10} See 4.6.
\textsuperscript{11} See 4.6.3.
\textsuperscript{12} See 4.6.8 and 4.6.9.
\textsuperscript{13} See 4.7 and 4.8.
In the second part of the theses the focus moved to the financial milieu in which the trust concept is applied – both locally and internationally.

In Chapter 5 the South African financial environment was investigated, which included the wider concept of financial instruments, the practice of structured financing and the phenomenon of regulatory arbitrage. The variety of financial instruments were analysed within the context of the role fulfilled by the trust in many of them.

Chapter 6 dealt with the concepts of both traditional and synthetic securitisation and its practice in South Africa. An attempt was made to demystify the securitisation process, including the parties to the process, the legal structuring of the transaction and the main features of such transaction. A number of other aspects, such as the different asset classes and particular securitisation structures, were discussed. The purpose of this Chapter was the familiarisation of the terrain in which the trust operates within a particular specialised field in the financial environment.

In Chapter 7 the application of the trust concept in the current financial milieu was discussed, with the focus on its application as collective investment scheme vehicle and its role in securitisation transactions in particular. Legislation relevant to the financial environment has been included in this discussion. The utilisation of the trust as vehicle in regulatory arbitrage schemes, as well as the utilisation of offshore trusts, has also been considered, with specific reference to the impact of the Basel Accords.

In Chapter 8 a comparative analysis of the trust concept in South Africa was undertaken. The influence and application of international trust law have been

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14 See 5.2.
15 See 5.8.
16 See 5.9.
17 See 5.4–5.7.
18 See 6.5 and 6.6.
19 See 6.7–6.9.
20 See 6.10.
21 See 7.2 and 7.3.
22 See 7.7.
23 See 7.6, 7.8 and 7.9.
evaluated,\(^24\) where after the role of the trust as legal concept in the United States and the United Kingdom, as well as in Mauritius and Malta, was critically-analytically compared.\(^25\) It was submitted that South Africa’s position and aspirations as part of the Southern African Development Corporation within its role in the broader international community were factors to be taken into consideration when the future of the trust was evaluated.\(^26\)

In Chapter 9 the current and developing regulatory environment has been discussed. The implications of the King reports on local regulatory interventions, as well as the impact of the Basel Accords and the IOSCO principles, were considered and new statutory initiatives by the South African legislator noted. The impact on the regulatory milieu of accords of an international nature, such as the Ohada Act on Contract Law, the Unidroit Principles, and the SADC law, has been evaluated.\(^27\) Some aspects of Book X on Trusts as European model law have also been introduced.\(^28\) An investigation of three known regulatory models, namely the Tiebout model, the enlightened shareholder value model, and the Twin Peaks model has taken place. Flowing from these examples, a regulatory and supervisory model for the development of trust law in South Africa was proposed. Combined with the Integrated Stakeholder Model some principles of intervention have been suggested.\(^29\)

In Chapter 10 the research process will culminate in specific conclusions, submissions and recommendations. These must, however, not be evaluated in isolation, but within the context of South Africa’s historical, political, and economic perspectives, and its position as part of the Southern African sub-region.\(^30\)

In light of the projected ambition of South Africa to position itself as a major jurisdictional player in the international financial environment, it is submitted that statutory and other interventions should be holistic and legally, ideologically and strategically sound and robust. A number of national and international regulatory

\(^{24}\) See 8.2.
\(^{25}\) See 8.4 and 8.5.
\(^{26}\) See 8.6.
\(^{27}\) See 9.2.
\(^{28}\) See 9.2.10.
\(^{29}\) See 9.3 and 9.4.2.
\(^{30}\) See 8.6.
initiatives have a direct or indirect effect on the milieu in which the trust operates as business and financial vehicle. Many interventions are not necessarily focused on the particular outcome, and the impact may, therefore, be more incidental than intentional.

It was submitted that a best practice as far as regulatory modelling is concerned should be identified and religiously applied if the optimum results are to be expected. Regulators and policymakers should model intervening methodologies in terms of the preferred regulatory programme and desired outcome, and not haphazardly. It is, therefore, suggested that the conclusions, submissions and recommendations proposed in this Chapter should be evaluated in the context of a particular regulatory strategy, as was suggested in Chapter 9.

It is further submitted that any regulatory intervention must be internationally compliant, robust, competitive and practical; and must be both qualitatively and quantitatively measurable, while it promotes objectivity, effectiveness and integrity, resulting in an accountable, transparent and stable legal and financial environment. It is submitted that the integrated stakeholder model can be used effectively in this process.

10.2 CONCLUSIONS, SUBMISSIONS AND RECOMMENDATIONS

In Chapter 4 the following two problems were identified:

Problem 1: Whether the business trust is a better form of business organisation than the partnership or the company.

The business trust fulfils a crucial role in the South African business milieu and should not be regarded as a competitor for the partnership or the company. Since the introduction of a limited future application of the close corporation, the continuance of the business trust was raised in importance as it provided another option for business people. The business trust can never replace the company, and that was never the intention. It does provide a legal vehicle that can be more removed from the business operator or the shareholder in a company and further

31 See 9.2 and 9.3 on regulatory standards and regulatory models.
32 See 9.3.5 and 9.5 on the proposed integrated stakeholder model.
33 See 9.5.
34 See 4.2.
provides for groups of people to hold interests collectively. It is also the vehicle of choice for particular collective investment schemes. Many of the other roles of the business trust, such as holder of private company shares or as employee or empowerment vehicle, cannot be done as effectively by way of the company. The business trust is thus a crucial legal entity in the totality of the South African business environment and its absence will leave a major void.

Problem 2: Whether existing trust law is adequate to govern business trusts.

The existing broader legal framework for South African trusts is adequate and sufficiently crystallised to accommodate the business trust successfully. One aspect that may need to be addressed by the legislator, if the judiciary does not address it shortly, is the formalisation of the legal persona of the trust. A number of other aspects should, however, be addressed by softer interventions to strengthen the trust milieu for the purposes of the business trust. These aspects will be discussed in what follows as conclusions, submissions and recommendations.

10.2.1 FUTURE OF TRUSTS

There are hundreds of thousands of registered trusts in South Africa. The vast majority of trusts are registered with the different provincial divisions of the Master of the High Court. As no central data base exists, the different offices of the Master have separate registration processes and reference number allocation. There is no name reservation or name protection process in place. The evaluation of the contents of trust instruments registered with the Master is superficial and a lack of proper management of trusts and trustees is the order of the day.

The fact that the trust is often treated as an orphan by law faculties, may contribute to a lack of lawyers and other legal professionals specialising in trust law. The trust has so many roles to fulfil: in private law, law of succession, commercial law, financial law, and financial instrument law. The effect of this split personality of the trust is not limited to South Africa. Sitkoff states that “the business trust is something of an

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35 The Master’s offices are situated at Bloemfontein, Cape Town, Grahamstown, Kimberley, Mmabatho, Pietermaritzburg, Pretoria, Umtata, Bisho, Thohoyandou, Johannesburg, Polokwane, Durban and Port Elizabeth. See http://www.justice.gov.za/master/m_main.htm.

36 See 2.3 for general discussion on the trust in South Africa.

37 Sitkoff 2005(1) University of Illinois Law Review 34.
orphan" in the United States legal academy, as those who study business law assume that it falls within the purview of the trust scholars and those who study trust law “ha(s) cast it aside as the province of the business law scholars”. This may lead to poor trust deeds and negligent administration by legal practitioners in general. The trust is thus its own worst enemy as its real value lies in its *sui generis* status.

It is recommended that law faculties at South African universities evaluate the content of their trust-law training and the exposure they grant their students to this important topic. The topic of testamentary trusts is justifiably covered thoroughly under the law of succession, and trusts in general should be incorporated into family and advanced family law. Inter vivos trusts should form an integral part of the curricula on law of contracts, business entities law, financial law, private international law, law of international trade, as well as insolvency law. It may be ideal for some law faculties to present trust law as a separate subject, covering all aspects of this field on a specialised level. Such a strategy shall not only elevate the field of trust law, but should result in the future development of a sounder and stronger trust-law dispensation in South Africa.

It is submitted that educational empowerment will contribute towards a stronger institutional structure and better discretionary, supervisory and self-regulatory outputs by regulators and other stakeholders alike. An integrated and inclusive process will be jeopardised if the larger stakeholder audience is not educationally empowered to participate in a meaningful way.

The trust has a crucial role to fulfil in South Africa as far as estate planning, asset protection, business structures, investment structures, employee protection, empowerment transactions, and pension fund structures are concerned. It further became indispensable for certain collective investment schemes, such as unit trusts, and as special-purpose vehicles in securitisation scheme transactions.

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38 Some of the most important cases affecting South African trust law during the past decade have been matters of divorce.

39 See 3.2.16, 3.2.17, and 4.3 for discussions on the different roles trusts fulfil both as private wealth-protector and as commercial vehicle.

40 See 4.3.3 and Ch 7 in general. The trust is employed in a number of roles within collective investment schemes and as securitisation instrument.
Trusts used as collective investment scheme vehicles are approved by the Registrar of Collective Investment Schemes. These trusts are not necessarily evaluated by the Registrar as trusts, but as collective investment schemes. It is submitted that the drafters of the TPCA did not envisage the application of trusts as investment vehicles, securities or securitisation entities. Some of these commercial applications were not even known in South Africa when the Act came into operation. The specific legislation in terms of which investment vehicles are formed, also does not address the issue of the legal vehicles to be utilised in any detail.

It is submitted that the trust concept has become a crucial part of the South African wealth, financial and economic systems, with assets worth billions of rands tied up in trusts and trust structures. The utilisation of trusts is so prevalent that any debate not acknowledging the important role of trusts in our community and economy is removed from reality. The question is not whether trusts have a future, but rather whether lawyers, financial advisors and government institutions will allow trusts to fulfil their different roles effectively and optimally – in the best interests of everyone.

It is submitted that the trust in South Africa is a particular legal concept which is in need of sound regulatory and supervisory practices. It is submitted that the proposed integrated stakeholder model does contain the necessary elements needed to address the specific needs of the South African trust effectively.

10.2.2 TRUST DEVELOPMENT

It is submitted that the legislator should not become involved in a general development of the trust concept in South Africa, but should allow the trust to follow its course of developing in a natural way as it has been doing for so long. Less regulation and better supervision and enforcement are, however, necessary in the trust-law environment. There is an international tendency amongst regulators to interfere and even over-regulate in fields previously regulated by professional and voluntary bodies, with the financial planning environment as a good example.41

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41 In a presentation by Gerhard Meyer at the 2012 Annual Financial Planning Institute Convention he stressed the fact that the regulators are more and more interfering with standards of ethics and principles in the professional arena. The latest regulatory innovation in the financial advisory environment is the Treating Customers Fairly (TCF) initiative, which follows closely on the heels of the previous Financial Intelligence Centre Act (FICA) and the Financial Advisory
Chapter Ten: Conclusions, Submissions and Recommendations

The responsibilities of the different stakeholders in the regulatory environment should be clear and parties should be operationally independent and accountable, with adequate powers, resources and the capacity to perform their respective functions. This will include the role fulfilled by the Master of the High Court and the Registrar of Collective Investment Schemes. The regulators should adopt clear and consistent regulatory processes and always observe the highest professional standards.

The dangers of over-regulation or overly involved legislators are well-known. It has been submitted that legislation has recently been passed without a careful qualitative and quantitative assessment of its conformity with the requirements of the Constitution, with “draftsmen serving the aims of politicians and ignoring the exigencies of the law”. Lawack-Davids submits that misaligned and over-burdening regulatory interventions can result in regulatory arbitrage and may ultimately “derail the very objectives intended by the legislation.” The writer proposes “an appropriate regulatory-assessment model”.

In this process stronger self-regulation, the setting of higher standards of practice within the fiduciary industry, and a higher quality of monitoring and supervision by the responsible governmental institutions, can go a long way to ensure more confidence in trusts. Banks in South Africa have become more diligent in their evaluation of trust instruments before allocating credit to trusts and are insisting on proper trust deeds, the appointment of independent trustees and the necessary powers for trustees to act. This is largely the result of specific decisions by the courts in the past decade. In South Africa this development came about in a natural way, without any interference by the legislative organs.


42 See 10.2.7, where it is submitted that the roles of the Master and the Registrar should be fulfilled by a new functionary, namely a Registrar of Trusts.

43 Derksen “Transformation of the Judicial System” 2012(7) De Rebus 60.


45 712. The writer sets the following as the goals of regulation: efficiency, effectiveness, transparency, clarity and equity.

46 See Foord 47.
In the United States, however, “unification” by way of so-called “statutorification” was needed.\(^{47}\) The modern trust asset is not only property, but more often a portfolio of marketable securities, and the modern trust has thus primarily become “a management device for assembling and administering a portfolio of financial assets”.\(^{48}\) Langbein\(^{49}\) is of the opinion that the transformation in the character and function of trusteeship required legislation in the United States. It is submitted, however, that the South African position is different as our trust concept was, fortunately, not clouded by a number of legislative attempts over a period of sixty years as in the United States,\(^{50}\) but was actually allowed to develop in a gradual, unforced manner.\(^{51}\)

The investment guru, Dave Foord,\(^{52}\) states that “too much regulation is worse, far worse, than no regulation at all. Without regulation the general public soon learns that “\textit{caveat emptor}” and word of mouth makes people cautious. With regulation, people are lulled into a false sense of security.” The ideal development process of trust law is by way of the judiciary, customs, and self-regulatory steps by practitioners.\(^{53}\) Some soft law interventions, such as practice notes or directives by the Master of the High Court and sometimes regulatory direction in the form of board notices by the Minister of Justice and Constitutional Development should be adequate.

Any formal regulatory interventions from ministerial level or higher should be done within the framework and with full cognisance of a well-developed regulatory model.

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\(^{47}\) See 8.4.1. Compare Langbein 2007(5) \textit{Alabama Law Review} 1069-1082. See the development of the Uniform Acts in the United States. These statutes have changed the nature of the United States trust concept dramatically. Their dominant purpose was the facilitation of financial assets as trust investments. See Langbein 2007(5) \textit{Alabama Law Review} 1071.

\(^{48}\) \textit{Ibid} 1072.

\(^{49}\) \textit{Ibid} 1073.

\(^{50}\) See the summary by Langbein 2007(5) \textit{Alabama Law Review} 1070 of the development of the Uniform Acts between 1930 and 1994, culminating in the Uniform Trust Code of 2000.

\(^{51}\) See 8.6.

\(^{52}\) Foord 46.

\(^{53}\) Gerhard Meyer in his presentation titled “Possible Future Scenarios for the Financial Planning Profession” poses certain solutions for professionals to meet higher requirements voluntarily, such as linking their value proposition to holistic services; building compliance within their businesses; creating businesses with strong corporate identities; cooperating with other professionals; and living by principles and not by rules.
It was submitted that an integrated stakeholder model should be developed for trust-law interventions.\footnote{See 9.4.4 and 9.5.2.}

**10.2.3 LEGAL PERSONALITY**

The trust concept has developed in South Africa to the point where it is more than just a useful legal entity, although without legal personality, by way of common-law processes only, and with minimum interference by the legislator.\footnote{See 2.10.} This development allowed the trust to position itself as a flexible and dynamic legal vehicle that finds application in a wide variety of fields as has been indicated before.\footnote{See Chs 3 and 4.}

The lack of legal personality by the trust is, however, often regarded as a limiting characteristic.\footnote{See 2.10 for discussion on the legal personality of the trust.} The legislator has addressed this by granting the trust legal personality for the purposes of particular legislation.\footnote{See 2.10 and 3.2.3 for examples.} It is submitted that this aspect cannot easily be addressed by the judiciary as it will require a departure from the common-law principles.

One may be tempted to propose that the legislator should consider settling this issue as it can be regarded as a justifiable intervention to bring the trust concept in line with its application in a modern, developed, financial and legal reality. Such radical departure from the legal tradition, however, will change the very nature of the trust in a drastic way, as assets will then no longer vest in the trustees, but in the entity itself. Although this may make the concept more understandable for the general public and trust operators alike, it is submitted that such an intervention may cause more harm than good.

It is submitted that the current process of including the trust as legal or juristic person in new pieces of legislation for the purposes of that specific legislation only, is to be preferred and encouraged as it allows the trust to continue in its development as business entity, without an attempt to equalise it forcefully with the company. Its differences are indeed its strength and that is where its value lies.
Chapter Ten: Conclusions, Submissions and Recommendations

It is submitted that addressing a specific issue, such as the legal personality of the trust, is consistent with the requirement included in the integrated stakeholder model that regulatory interventions should address particular needs and refrain from interference of a general nature.

10.2.4 CONTENTS OF TRUST DEEDS

Specific minimum requirements for the trust instrument of a business trust should be determined by a future Registrar of Trusts by way of practice notes.59 The trust deeds for all new business trusts should preferably be evaluated in terms of a check list and the Registrar should have the authority to refuse registration where these minimum requirements are not met. This check list must not be limited to the current JM21 requirements of the Master,60 which are rather superficial, but should go to the heart of the contents of the deed itself.61

The general principles of the law of contract must be adhered to and the trust deed must actually form a trust and not a mere donation or some other result. Consensus should be central to the trust agreement and the common intention of the respective parties should be considered when interpreted. Although the parties should have a general duty of confidentiality regarding the contents of the agreement, particular directions regarding the disclosure of information is necessary, whether to trustees, beneficiaries, creditors, or other parties who can indicate a definite interest.

The terms of the agreement should be determined by the trust deed, even if it is placed within the discretion of the trustees. The trust deed should provide for instances where particular duties or rights are conferred upon third parties, subject to certain conditions or limitations. The nature of beneficiaries, as well as their rights and liabilities, must be clearly described.

59 See 10.2.7 for the submissions regarding a Registrar of Trusts.
60 The JM21 requirements include basic information such as the details of the beneficiaries and the trustees, the past experience of the trustees, the banking, address and accounting officer particulars, and certain statements about the assets of the trust for jurisdictional purposes.
61 The principles laid down in Book X on Trusts for European Law can be used in determining such a checklist. See 9.2.10.
Provision should be made for both discretionary and non-discretionary or so-called vesting trusts. Agreements may include suspensive or resolutive conditions, or a combination thereof.\textsuperscript{62} An assignment of rights may also take place. Trust deeds should provide for a minimum standard of financial reporting, such as annual management statements.\textsuperscript{63} Aspects such as the duties and liabilities of trustees, as well the object of the trust, and the amendment of the deed and the termination of the trust itself, must be addressed. The European law Book X on Trusts may be a helpful source in the development of some soft law interventions. It was submitted that although South African trust law did develop most of the principles contained in Book X, aforementioned document may be a helpful source in the context of a Southern African trust-law initiative.\textsuperscript{64}

Where trusts are used for collective investment schemes, the following aspects should be covered in the trust deed:

- the powers and duties of the trustee and the manager, where applicable;
- the investment objective and policy of the unit trust; the issue and transfer of units;
- the rights of the unit holders and the appointment of advisors to the unit trust;
- the appointment, removal or retirement of the trustee and manager;
- the fees of the trustee and manager and the valuation of units;
- reporting, distribution, termination and winding-up of the unit trust;\textsuperscript{65} and
- the procedure to be followed when amendments to the deed are necessary.

The one deficiency identified in standard CIS trust deeds was the confusion between the \textit{object} and the \textit{purpose} of the trust. As has been highlighted, CIS trust deeds often refer to the object of the scheme as the establishment of particular investment portfolios. It was submitted that this is the purpose of the scheme, while the object of the trust should always be the benefit of a third party or another impersonal

\textsuperscript{62} “Resolutive” in this context refers to the ability to dissolve or terminate.

\textsuperscript{63} Some trusts must undergo an independent review or financial audit if so required by a particular Act. See 3.2.6 for the accounting requirements on trusts.

\textsuperscript{64} See 9.2.10. See Annexure B for the contents of Book X.

\textsuperscript{65} See also \url{http://www.nabarro.com/Downloads/Unit_trust_an_overview.pdf} (accessed 05-04-2012).
objective. Although the rules of the CIS often clearly indicate that it must be administered and managed by the manager and the trustees to the benefit of the investors, it is submitted that the intention should be clearly expressed by the parties to the trust to ensure that a valid trust is indeed created.

The amendment or variation clause in trust deeds is of the utmost importance. The fact that a trust deed is generally regarded as a contract between the donor and the trustees creates the legal conundrum that a variation after the death of the donor can be perceived as being a unilateral action by one of the parties to a contract. Variation clauses are often lacking in clarity and even logic and the standard amendment clause in South Africa often prohibits any changes to the destination of capital or income. In light of the fact that trusts may continue for decades and sometimes even generations, well thought through variation clauses are of the utmost importance.

10.2.5 LEGAL PRINCIPLES

Some particular legal principles, such as the Turquand rule, the piercing of the corporate veil and the doctrine of unconscionability, are as relevant to the trust as it is to the company. It may be wise to include these principles in modern trust deeds.

In terms of the Turquand rule a third party who negotiates in good faith with a legal entity, may accept that the individual representing such entity has the necessary authority to bind the organisation. The courts did confirmed the application of the Turquand rule on actions by trustees under certain circumstances, but not without some opposition. The current legal situation in this regard is, however, still

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66 See 7.4.
67 See 2.4.
68 See 2.12.1.
69 For a well-developed proposed variation clause see Stafford LL.M dissertation Rhodes University (2010).
70 See 4.6.4 for a discussion on the application of the Turquand rule.
71 See 2.8 for discussion on the piercing of the veil doctrine.
72 See 4.6.8 for a discussion on the conscionability theory.
73 See Man Truck & Bus (SA) Ltd v Victor 2001 2 SA 562 (NC) 569 and Vrystaat Mielies (Pty)Ltd v Nieuwoudt 2003 2 SA 262 (O).
somewhat uncertain. The Supreme Court of Appeal held in *Land Bank v Parker*\(^74\) that the *Turquand* rule “may well in suitable cases have a useful role to play in securing the position of outsiders who deal in good faith with trusts”.

It was submitted that it is in the interest of contracting third parties and to ensure legal certainty, that the rule is applied to trusts.\(^75\) It is further submitted that the doctrine has effectively been extended by the courts to trusts and that it is in the general interest of the business environment that the rule be applied to trusts in a similar way as to companies.\(^76\)

It was submitted that, although it is difficult for third parties to determine the contents of trust deeds and reliable records of trustee minutes, and it is true that the application of the *Turquand* rule on trusts will place a heavy burden on co-trustees, it shall have some positive consequences on the way trusts are managed. It may motivate trustees to become actively involved in the management of their trusts, discourage the use of “dummy”\(^77\) trustees, motivate trustees and beneficiaries to have reliable trustees appointed, and instil confidence when third parties are dealing with trusts in the business environment. The conclusion is that the *Turquand* rule has been fully absorbed into trust law in South Africa.\(^78\)

The veneer is pierced where a trust becomes a “mere smokescreen which is being used to achieve other (ulterior) motives”.\(^79\) The legal existence of the juristic person is thus ignored for the purposes of “adjudicating the rights and liabilities of the parties to the particular dispute.” For other purposes the separate legal existence of the company is not infringed upon.\(^80\)

A piercing of the trust veil will take place when the ownership (enjoyment) and the control of the assets of the trust vest in the same party to such an extent that the trust becomes the *alter ego* of that individual. Any attempt to differentiate between the two

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\(^74\) *Land & Agricultural Bank of SA v Parker* 2005 2 SA 77 (SCA) 85B-D, 86B, 90G.

\(^75\) See 4.6.4. Compare Matthews 34; Claassen 25.

\(^76\) See Davis *et al* (eds) 42.

\(^77\) Referring to individuals who accept appointments as trustees, but with no real intention of applying their minds independently to decisions by the board of trustees. In practice they become rubber stamps of the founder or other trustees.

\(^78\) See 4.6.4.

\(^79\) Hyland & Smith 10. See their discussion on 11-14 on *Jordaan v Jordaan* 2001 3 SA 288 (C) and *Badenhorst v Badenhorst* 2006 2 SA 255 (SCA). See 2.8.

\(^80\) Davis *et al* (eds) 21.
would become artificial and would have the potential to prejudice creditors and other third parties. In the United States it was decided that the piercing doctrine would become justifiable when someone exercised such control over the trust that it became a “mere instrumentality or alter ego of that individual”, and the person used that control to commit a wrongful action, which caused injury to a third party.\footnote{Vitiello & Kessler 1-3.}

It is submitted that the “piercing of the veil principle” has been successfully extended to South African trust law and that it is justifiable to apply the doctrine of piercing of the trust veil or veneer on the same basis as the piercing of the corporate veil.\footnote{Compare First Rand Limited v Britz [2011] ZAGPPHC 119 case no 54742/09 (20-07-2011) (unreported). See 2.8 for discussion on the doctrine.}

The doctrine of conscionability in contract law enables a court to decline to enforce a contract whose terms are seriously one-sided, overreaching, exploitative, or otherwise fundamentally unfair.\footnote{See 4.6.8.} To overcome the presumption that people usually contract in their own best interest, it must be proved that “either the negotiation process was tainted by duress or fraud or that the term sought to be enforced is in violation of public policy.”\footnote{Marrow 195.}

Although the concept of “unconscionability” had been known in South Africa for a long time, it never became a principle of general application, until the legislator took the first steps in this direction by including the doctrine first in the Consumer Protection Act in 2009 and then in the new Companies Act in 2011.\footnote{See the Consumer Protection Act 68 of 2009 and the Companies Act 71 of 2008.}

It is submitted that it will be advantageous to incorporate a test like the conscionability test into trust law to broaden the power of courts to interfere with the contents of both mortis causa and inter vivos trusts on procedural and substantial grounds of unfairness.\footnote{See 4.6.8 for discussion on the trust and conscionability.}

The test of conscionability has become a reality in the South African business milieu and trusts cannot be excluded therefrom. As trusts are often used as business vehicles and also qualify as juristic persons in terms of both the Consumer Protection...
Act as the Companies Act, they should offer the same protection to all affected parties as any other business form would offer.

It is submitted that as the doctrine of conscionability has now been established in South African law, it will become part of trust law. It should, however, be developed by the courts and preferably not by way of legislative intervention as it is in the best interest of the trust concept that its development takes place in a natural common-law manner.

10.2.6 FIDUCIARY POSITION OF TRUSTEES

The fiduciary nature of the function of trustees is in the process of being developed. The nature of a fiduciary relationship is one of trust and good faith. Watt submits that the fiduciary duty “is the defining duty of trusteeship”, with the two principle obligations being the trustee’s duty not to allow his interests to conflict with that of the trust, and not to make an unauthorised profit from his position of trust or from the trust property.

The separation of management and enjoyment is closely linked to the fiduciary nature of the role of trusteeship. The nature of the fiduciary relationship between the trustees and the beneficiary is one where the trustees may act only in the interest of the beneficiary at all times, in concurrence with the powers and duties conferred upon him by way of the trust deed. The two poles of the relationship are, therefore, the fiduciary rights of the beneficiary on the one hand and the fiduciary obligation of the trustee on the other – both derived from the trust deed.

It is submitted that the terms care, diligence and skill in section 9 of the Trust Property Control Act collectively express the meaning of the term fiduciary. When performing with care, diligence and skill, all actions must be taken in good faith, with a proper purpose and in the best interest of the company or trust.

It is further submitted that the legislated content of the fiduciary duty for companies, namely care, diligence, skill, good faith, proper purpose and best interest, can also

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87 See 2.9 for discussion on the fiduciary relationship within the trust concept.
88 343.
89 See Idensohn 148.
90 See 2.7 for discussion on the separation of enjoyment and control.
be applied when the fiduciary duty of the trustee is evaluated. Such an approach will go a long way in aligning the trust and the corporation – especially where the trust fulfils the role of business entity. Such an approach will support the competitiveness and the economic survival of the trust concept.

10.2.7 REGISTRAR OF TRUSTS

The lack of a designated Registrar of Trusts within the Department of Justice and Constitutional Development has resulted in a total lack of coordinated management and supervision of trust matters on a national level. The fact that some trusts are not registered and supervised by the Department, but by the Registrar of Collective Investment Schemes, further contributes to the lack of standardisation and proper control. An integral part of the appointment of a national Registrar of Trusts, linked to designated Trust Supervisors at each High Court in the country, must be a national data base for the registration of all trusts – including trusts used as financial instruments.

It is submitted that the management and control of trusts should be taken from the general functions of the Master of the High Court. It is proposed that the Department of Justice and Constitutional Development should create a central Trust Registrar with Deputy Registrars at each division of the High Court. Each Deputy Registrar should allocate and control trust reference numbers, with the particular High Court Division indicated as part of the reference number of the trust. All allocated reference numbers should be linked to a central data register. All trusts, including collective investment scheme trusts, should be registered and supervised by this Registrar.

It is submitted that the registration, evaluation, appointment of trustees, and amendments to trust deeds, should be managed and controlled by the Deputy Registrars at the separate Divisions of the High Court. The Registrar may require from trustees to do an annual return, similar to that done for companies, and should further allow trusts to remain dormant for a specific period of time. The officials

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91 Compare s 9 of the TPCA. See Stein 240-253 for more on the duties of directors.
92 See 2.13.5 for the role of the Registrar of Collective Investments.
93 See 1.2 for the challenges experienced in the current system.
94 See 2.13.4 for the role of the Master of the High Court.
dealing with trusts should have adequate training in all types of trusts, including business trusts, financial instruments, and other forms of commercial trusts. Trusts should receive similar treatment to private companies and close corporations, as most trusts are utilised for similar purposes.

To achieve transparency, all parties need to be accountable to the Registrar and all stakeholders should be allowed to participate appropriately and effectively. Trust information, and the contents of trust deeds should be available to all stakeholders. Trusts should be predictable and effective. The experience of legal and fiduciary practitioners is that the trust management and supervision system is often poor and unreliable. Communication from Master’s offices regarding trusts is often of a sub-standard and often legally unsound. Amendments to trust deeds and the appointment of trustees can take months to finalise and mistakes on letters of authority or endorsements are the order of the day. Trust files often get misplaced and are managed in a disorderly fashion. The different Master’s offices have different levels of infrastructure and quality of personnel, which lead to different levels of service. Some offices are known for poor service deliverance and practitioners will do everything to avoid working with them.

It is submitted that the difficulties experienced creates fertile ground for regulatory arbitrage. The aforementioned should be discouraged and appropriate enforcement mechanisms and sound regulatory interventions shall discourage arbitrage. The regulator should focus on a healthy balance between adequate disclosure for the sake of transparency and the risk of over-regulation. It is imperative that local regulatory interventions, preferably soft law interventions, are harmonised with international best practices as well as some foreign jurisdictions.

It is submitted that a strong institutional structure (coupled with prudential regulatory interventions) is a prerequisite for a sound legal and financial environment. This principle has been stressed in the Twin Peaks model and is also included in the proposed integrated stakeholder model.\footnote{See 9.3.4 and 9.3.5.}

10.2.8 OFFICE OF PROTECTOR
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It is submitted that the office of protector will bring the trust concept in line with that of most financial centre jurisdictions in the world, and that South Africa may have to consider that development if it plans on positioning itself in that space. The office of protector usually provides for an individual or body corporate which has the power to appoint or remove trustees or to consent to a trustee’s resignation.

The Mauritian Trusts Act 14 of 2001 makes provision for a protector that may act in an advisory capacity towards the trustees and who may remove and appoint trustees, as well as determine the proper law of the trust and may amend the administrative forum of the trust. Even the exercise of powers and discretions by the trustees may be subject to the protector’s consent. The fact that such appointee may be a settlor, a trustee or a beneficiary, whilst he is not automatically liable to the beneficiaries or the trustees for the bona fide exercise of his powers, is disturbing viewed from a South African legal context. As it may interfere with the discretionary nature of the trust it is submitted that this route should not be followed if the protector function is introduced in our law of trusts.

The Maltese model makes provision for a protector who may only appoint and remove trustees, and require the trustees to obtain his permission. This is more acceptable in our understanding and application of the discretionary trust. The Book X of European trust law also provides for a trust auxiliary which has the power only to appoint and remove trustees or to consent to the resignation of a trustee. The trust auxiliary does have to act in good faith and may not obtain unauthorised enrichment.

The office of protector is still created and regulated by the trust instrument and is not automatically incorporated into all trust deeds. The purpose is apparently the protection of founders from trustees they are not familiar or comfortable with. As

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96 See 8.5.2.1 and 8.5.3.1.
97 In Book X on Trusts it is called a “trust auxiliary” and not a “protector”. See Chapter 1 of Book X, s 203(4). See 9.2.10.
98 S 24.
99 See 8.5.2.1.
100 Trusts and Trustees Act 35 of 1988 (as amended) s 24.
101 See 8.5.3.1.
102 See Book X, Ch 6, s 301 as per Annexure B.
many offshore jurisdictions only allow locals as trustees, the founder can protect himself by way of the appointment of a protector to represent him and his interest.

It is submitted that the office of protector can be incorporated into trusts instruments by South African drafters where needed. It is not necessary to be regulated or incorporated by legislation. It may be of more value in cases where foreign founders create trusts in South Africa without them being appointed as trustees. Their interests may then be protected by way of the protector’s office.

It is submitted that this approach is holistic and consistent with the requirements of competitiveness and the achievement of particular economic objectives, as contained in the integrated stakeholder model.

**10.2.9 PROFESSIONAL TRUSTEES**

Persons who receive property upon trust or who act as trustees and receive remuneration, or who do so on a regular basis, or hold themselves out to be trustees, are regulated in many jurisdictions, but not in South Africa.\(^{103}\) The advent of independent trustees as a result of the *Parker* case has made the office of the professional trustees far more prevalent and needed.\(^{104}\) In the past independent trusteeships largely dealt with testamentary trusts for minors or persons with limited legal capabilities, but the compulsory appointment of independent trustees on all trusts created a new business and professional opportunity.

Although the Trust Property Control Act\(^ {105}\) only defines a trustee as “any person”, legal persons, such as trust companies, are regularly appointed as trustees. The Mauritian legislation\(^ {106}\) allows “a person” or “a body corporate” as trustee, while the Maltese law\(^ {107}\) makes provision for a “natural person” or a “juridical person” to act as trustee. The concept of corporate trustees, in the form of trust companies or other body corporates, is becoming more familiar in South Africa and is apparently the advent of the professional trustee – whether in the form of individuals or corporates.

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103 See 2.13.3 for general discussion on the office of trustee.

104 See *Land & Agricultural Bank of SA v Parker* 2005 2 SA 77 (SCA). See 2.7 for discussion on the rationale behind independent trusteeships, namely the separation of enjoyment and control.

105 Act 57 of 1988 s 1. The term trustee is also only used in the context of a "person" in Book X on European trust law.

106 Subss 23(1)(a) and (b) of Trust Act 14 of 2001. See 8.5.2.

107 Subs 18(2) of the Trusts and Trustees Act 35 of 1988 (as amended). See 8.5.3.
It is submitted that trusteeship is coming of age in South Africa and that it is a natural development that does not need any legislative intervention at this stage. Trust companies will have to position themselves for the role of offshore trusts. The role of independent corporate trusteeships is not common yet and few service providers are currently available. It may be necessary to consider minimum entry and compliance standards for independent trustees in future, particularly when acting on trusts for offshore parties.

The introduction of a directional policy document, setting minimum entry standards, as well as sound, non-evasive instruments in the supervision of trustees, should be seen as justifiable interventions, protecting the integrity of the profession, consistent with the principles of the integrated stakeholder regulatory model.

10.2.10 SOLVENCY AND LIQUIDITY

Companies must comply, in terms of the 2008 Companies Act, with solvency and liquidity tests in certain circumstances and before particular transactions may be entered into. Although this legislation has no bearing on trusts, the question may be asked whether any consideration should be given to trusts complying with similar requirements.

The principle of “solvency” tests whether the business’ assets are exceeded by its liabilities, while the test for “liquidity” determines if a company can ensure it has enough cash to pay its liabilities for the next year. Directors and senior managers must perform solvency and liquidity tests based on the financial records, while considering potential future eventualities, satisfying themselves that the company will be able to pay its debts and that liabilities fairly valued will not exceed assets fairly valued.

These tests must be performed before the provision of financial assistance to third parties for the acquisition of the company’s own shares; before loans or other financial assistance are given to related parties; before any dividends or other distributions are made to shareholders, and before merging with another company.

\[108\] S 4.
take place. Directors may be held personally liable if a company does go insolvent and it is established that the management should have foreseen it.

As solvency and liquidity tests are not enforced legislatively upon close corporations in the same manner, it is submitted that it is not necessary to enforce them on business trusts. It is submitted that the nature of trusts does, however, require the trustee, in complying with his fiduciary duty, to evaluate the solvency and liquidity position continually, amongst others, of the trust. In terms of the fiduciary duty, all acts and decisions of the trustees should be in the best interests of the beneficiaries. To comply with that duty, the trustees must determine whether the trust can actually afford a specific action, such as the granting of financial assistance or the distribution of income or capital.

10.2.11 CONFIDENTIALITY

It is submitted that the aspect of confidentiality of trust documents does not need regulating in South Africa. Although the parties to the trust deed should have a general duty of confidentiality regarding the contents of the agreement, particular directions regarding the disclosure of information are necessary, whether to trustees, beneficiaries, creditors, or other parties who can indicate a definite interest.

Book X on European trust law does not determine the existence of a general duty of confidentiality by trustees, but does implicate it by allowing the trustees to refuse information which is confidential to them in their capacity as trustees. The Mauritian legislature, however, has created an extensive duty to maintain confidentiality relating to the details of the trust property, all conduct relating to the trust administration, the exercise of powers and duties, as well as the reason for such action. A court may only order disclosure of such information in very specific circumstances.

In Malta the duty of confidentiality is implied and a trustee may furnish the following information without being in breach of its duty, namely: that the trust exists and its date of execution; the identity and address of the current trustees; that the trustees

109 “Distributions” for these purposes include the issue of capitalisation shares and share buy-backs.
110 See Ch 6, subs 106(3). See 9.2.10.
111 See subss 33(2) and (3) of Act 14 of 2001. See 8.5.2.
are duly authorised and empowered to carry out the particular transaction and has obtained all necessary consents; and, information on the revocability of the trust in question.\textsuperscript{112}

It is submitted that the contents of the Maltese legislation in this regard are very sound and practical and should be supported. It has been submitted in 10.2.4 that a Registrar of Trusts should issue some practice notes regarding the contents of trust deeds, which notes may include prescriptions regarding the inclusion of a confidentiality clause in all deeds, in which case the Maltese model is recommendable.\textsuperscript{113}

The current direction by the Department of Justice and Constitutional Development reads as follows: “You should please apply in writing to the Office where the Trust has been registered, providing reasons why this information is needed. The Master will then request the input of the Trustees and beneficiaries, after which he/she will exercise his discretion in providing you with the information / not. Should the Master refuse to provide you with this information, you will need to apply to the Information’s Officer of the Department of Justice.”\textsuperscript{114}

10.2.12 DURATION OF TRUSTS

The duration of trusts does not need to be regulated in South Africa. It has become practice in some jurisdictions to regulate it by way of legislation. It is submitted that the duration of trusts, as well as the particular method of termination, should be determined in the deed.\textsuperscript{115} Forced termination because of the expiration of a prescribed period of time, may have prejudicial results.

If, for example, the trustees of a trust hold fixed property for the benefit of minors when the trust comes to an end, such property must be registered in the names of these minors receiving the benefits. Trusts are often used with the purpose of protecting particular assets, which assets will become unprotected when the trust comes to an end, which may be prejudicial to the beneficiaries.

\textsuperscript{112} Subs 40(4) of Act 35 of 1988. See 8.5.3.
\textsuperscript{113} See Chief Masters Directive 2 of 2009 on access to information on trusts in light of s 18 of the TPCA, the Access to Information Act 2 of 2000 and the Promotion of Administrative Justice Act 3 of 2000.
\textsuperscript{115} See 3.2.5 on the termination of trusts.
In terms of the South African tax dispensation such a forced termination may be regarded as a capital gains event as ownership changes. If so, it may force the beneficiary to sell the asset to be able to pay the capital gains tax. This is often the result in cases of undesirable capital-gains events, such as the death of an individual.

10.2.13 FINANCIAL REPORTING

Trusts do not have to have minimum accountancy processes, such as compilations, independent reviews and audits. The trust instrument determines the accounting requirements. Irrespective of the set requirements, trustees should ensure that accurate financial records are kept and that the board of trustees approves of all expenses and distributions.

It is submitted, however, that trustees should at least have annual management statements compiled, including an income and balance statement to enable the trustees to evaluate the financial position of the trust and to satisfy themselves of the proper financial management thereof. It is ideal that business trusts do comply with certain minimum accounting standards to instil trust in the trust concept.

It is suggested that a responsible organisation, such as the South African Institute of Professional Accountants (SAIPA), should lay down standards of accountancy practices for business trusts. It is submitted that trust accounts should preferably not be regulated by way of legislation, except where the trust is registered as a non-profit or public benefit organisation. A strong institutional structure, coupled with macro-prudential regulatory interventions, such as self-regulatory mechanisms, should be adequate to ensure responsible financial reporting.

10.2.14 TAXATION OF TRUSTS

Targeting the tax dispensation of trusts will lead to undesirable business structures and tax arbitrage. The tax dispensation of trusts should ideally be equalised with that

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116 In case a trust is the shareholder of an owner-managed private company with a total public interest score of less than 100 points, such company (or close corporation) must be independently reviewed, although the trust does not have to be reviewed.
of companies, except in particular circumstances, such as with testamentary trusts for minors and special trusts for physically or mentally disabled persons.\textsuperscript{117}

The income of a trust and any capital gains made are taxed in the hands of the trustees at higher rates than those for individuals. Trusts also do not enjoy the rebates of individuals. In many respects trusts are now treated similarly to companies. Specific steps to equalise the taxation of trusts with that of corporates have contributed in establishing trusts as much more than tax planning instruments.

It is submitted that if trusts are neither favoured nor penalised by the tax authorities they will ultimately fulfil their ideal role as private and business vehicles. It is submitted that, if the integrated stakeholder regulatory model is followed, aspects such as competitiveness and economic considerations, coupled with a holistic, macro-prudential philosophy, will ensure that trusts are not unduly penalised for the wrong reasons by tax policy makers and regulators.

\textbf{10.2.15 BUSINESS TRUSTS}

Although no legal difference exists between a business trust and a non-business trust, it seems to be desirable to differentiate between the two forms.\textsuperscript{118} Even if the contents of the trust deeds are similar, the potential application thereof differs substantially in some instances. Sitkoff\textsuperscript{119} indicates that the current domination by the corporate structure “unfairly diminishes the historic role of the business trust”. To prove his submission that the common-law business trust was historically a significant competitor to the company as business organisation, he reveals that Rockefeller’s infamous Standard Oil Company originated as a trust and not as a company. He further submits that the business trust and the company are “mirror-image entities that respond to different investor needs”.\textsuperscript{120}

The potential commercial application of the trust adds value and gives options to business operators and developers. The King reports are applicable to all forms of

\textsuperscript{117} See 3.2.7 on trusts as tax planning instruments.

\textsuperscript{118} See 4.1.

\textsuperscript{119} Sitkoff 2005(1) University of Illinois Law Review 32. In the United States they even use the concept of anti-trust law instead of competition or monopoly law, which indicates the historical value of trusts in the business environment.

\textsuperscript{120} Sitkoff “Commercial Trusts as Business Organisations: Unraveling the Mystery” 2003 The Business Lawyer 585. In this analysis he compares aspects such as tax and creditor risks.
businesses and not only to those in the form of companies. The reality of the trust as
business entity and its wide application is not always acknowledged by the courts
and academic writers. Some submit that its future is in jeopardy and its survival is
not even justified. There is a general lack of understanding of the important role it
fulfils in practice.

The legislature should not interfere with any other legal aspects of trusts, as the
common-law trust has crystallised satisfactorily over the last century. Interventions
should be limited to the registration, management, supervision and operational
aspects thereof. The registration procedures must be simple and standardised and
costs should be kept low. Trusts should remain flexible legal vehicles, so as to
protect its role as part of the appropriate diversity of corporate structures.\textsuperscript{121} To
remain efficient legal vehicles, trust management should be simple, and the duties,
responsibilities and liabilities of the parties thereto, clarified.

Remedies need to be certain and the role of trusts as part of business combinations
should be clear. The value of the trust as commercial vehicle lies in its essential
elements, such as the fact that a segregated trust fund exists, the fiduciary and
managerial nature of the office of trustee, and the flexibility of the trust instrument.
The uniqueness of the trust must be protected. It is submitted that the very existence
of the trust concept in our legal system makes South Africa more attractive as a
business location than it would have been without the trust option.

10.2.16 THE HAGUE CONVENTION

The non-ratification and incorporation of the Hague Convention prevents South Africa
from reaping the potential rewards thereof.\textsuperscript{122} The main contributions incorporation
may make is instilling confidence in the South African trust-law and financial-
structuring regimes and ultimately in the business and investment sectors in general.

Gopalan\textsuperscript{123} submits that transnational commercial law is the product of a variety of
initiatives to harmonise different national laws encountered by business people
contracting across borders, and cannot be divorced from the \textit{lex mercatoria}.\textsuperscript{124}

\begin{flushright}
\textsuperscript{121} This became even more important since the abolishment of new close corporations.
\textsuperscript{122} See 8.2.2.
\textsuperscript{123} Gopalan 811.
\textsuperscript{124} See 4.6.9 on the business trust and the \textit{lex mercatoria}.
\end{flushright}
These endeavours include multilateral conventions, bilateral treaties, community legislation, model laws, codification of customs, the promulgation of international trade terms, and model contracts and forms. While conventions and treaties may be binding after ratification, most other initiatives are largely soft law options. It may be prudent for the local legislator to take cognisance of the fact that a major player such as the United Kingdom has incorporated the Hague Convention into its domestic law.

It is submitted that South Africa should become sensitive to the developments of international trust law as one of the building blocks in positioning itself as a serious contender in the offshore market. Incorporation of international instruments should, however, not be done in isolation and must ideally form part of a wider, overall engagement in the development of South Africa, and Southern Africa, as an offshore financial destination.

An incorporation of the Convention into South African law will address potential uncertainties, such as the applicable conflict of law rules, and instil confidence in South Africa as trust, investment and business destination. It is submitted that an overall strong environment for legal instruments is necessary to achieve the economic objectives set by government. As a chain is only as strong as its weakest link, the new company law regime will also be negatively affected if its supporting institutions are not brought on par.

**10.2.17 HEADQUARTER COMPANIES**

South Africa has the potential to establish itself as a headquarter jurisdiction for international companies. Mauritius is an example of an offshore financial centre that has positioned itself successfully as an attractive African investment option and a potential location for international companies. Botswana is following suit with “a

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125 Gopalan 812-813. The United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration is an example of a transnational model law which may applicable to international commercial trusts.

126 See 8.2.2 and 8.4.2.


128 See Legwaila 2011(1) Obiter 141 for discussion on headquarter company opportunities.
strategy to improve the ease of doing business in Botswana and to improve the country’s global competitiveness’.\textsuperscript{129}

If South Africa wishes to position itself in the global context as an attractive host jurisdiction for business activities, such as a headquarter company domain, call centre venue, investment jurisdiction of choice, and as economic gateway into Africa and other developing economies, it must ensure that the legal structures it offers are not only effective and efficient, but internationally competitive.\textsuperscript{130} It is submitted that the quality of the South African trust as business vehicle contributes to this. The value of trusts in the international business milieu cannot be illustrated better than by the fact that a major business jurisdiction like China has incorporated the trust concept into its legal system.\textsuperscript{131}

\textbf{10.2.18 INTERNATIONAL ROLE OF TRUSTS}

The development of a more streamlined approach to the harmonisation of international business and estate structures will install more confidence in the trust concept locally as well as internationally. The internationalisation of both businesses and individuals needs a more transparent and less diverse set of universal rules for estate planning, business structures and financial instruments.\textsuperscript{132}

For offshore trusts to become effective planning tools, adequate information to compare the legal implications of the home jurisdiction with that of competing offshore jurisdictions, as well as the grade of mobility of the client to move between jurisdictions, should be considered. Last-mentioned includes costs, locality, language, exchange rates and personal circumstances. External factors, such as

\textsuperscript{129} Creamer “Charm Offensive: Botswana cuts Taxes, gives Private Sector Scope” 6-12 July 2012 Mining Weekly 8. It is reported that the Minerals Minister, Dr Ponatshego Kedikilwe, is constantly encouraging investors to provide inputs on how well the government is performing in its mission to not only reduce red tape, but to ensure that bureaucracy must not impede the aims of government.

\textsuperscript{130} See Su Yin & Walsh 275-287 for discussion on establishment of a headquarter regime and comparative analysis between Thailand, Malaysia, Singapore and Hong Kong.


\textsuperscript{132} See 8.6. See Hauser 37-38.
legislation, regulatory restrictions, other influencing jurisdictions and internal customs, may further contribute to the complexity of the change of jurisdiction.\footnote{See Mitkute & Tanega 51-52.}

Legal, tax and financial information are, however, often readily available and should not prevent a smooth transition. Mobility also becomes less problematic as the world becomes smaller and more connected, which makes actual physical relocation unnecessary. Cross-border externalities, based on the regulatory policies of the offshore jurisdictions may, however, remain a challenge for as long as regulators focus on their jurisdictions in isolation instead of participating in the global evolvement of the financial and business reality.

It is submitted that conflict of law rules, which prescribe the law of the founder’s home jurisdiction as the applicable law for disputes regarding the offshore trust, may go a long way in addressing these issues.\footnote{See 8.6. Compare Mitkute & Tanega 56. Conflict of law rules are discussed in 8.8.} South Africa should decide exactly what role it wants to fulfil as financial destination. If it does enter the offshore financial environment, it is suggested that it should differentiate itself by way of an excellent regulatory framework, which should preferably form part of a minimum “common core content” for the Southern Africa geographical area.\footnote{See Hayton (ed) 17. In “Principles of European Trust Law” some of the elements of the “common core content” were laid down. The European Union made recent attempts to consolidate the law of trusts by way of the 2009 Draft Common Frame of Reference – the part that dealt specifically with trusts was called Book X.}

Offshore trusts often provide large corporations with expansion opportunities, without necessarily burdening it with substantial increases in operational expenses. Other factors, such as currency restrictions, governmental and legislative constraints, uncompetitive tax consequences, custom and excise limitations, exchange controls, restrictive labour regimes, and compromised confidentiality, may influence businesses to reconsider offshore solutions.

The trust concept has an important role to fulfil in the development of South Africa as a player in the international financial market and as a serious contender in the international business space. It is high time for government, the business world and the legal and accounting fraternity to embrace the trust as an important legal reality in
the South African business environment and treat it as alternative legal vehicle to the company.

South Africa has the potential to become an offshore financial jurisdiction of value.\textsuperscript{136} The basic ingredients of the offshore trust jurisdiction include a sound and adequate legal and judicial system, political and economic stability, good communication systems, and the absence of an over-regulated tax and exchange control system.\textsuperscript{137} South Africa has started relaxing its exchange control mechanisms, although its tax dispensation might still be regarded as overly strenuous. Other factors, such as currency restrictions, governmental and legislative constraints, uncompetitive tax consequences, custom and excise limitations, restrictive labour regimes, and compromised confidentiality, may influence businesses to reconsider particular offshore solutions. Indirect stimuli, such as the very high levels of crime in South Africa, the endemic levels of corruption amongst government and other public servant officials, and the frequent occurrence of serious labour-related uprisings, may further discourage investors.

Offshore financial centres are often far more innovative than traditional jurisdictions in dealing with practical business, and legislative and administrative, issues, affecting corporate structures, investments, trusts, insurances, and banking. If South Africa wants to be taken seriously as an offshore jurisdiction it will have to become innovative in its thinking. The inclination of regulatory development from a political perspective should be replaced by a strategic disposition with the focus on the long-term end result of becoming a truly international player.

Investors must be able to transact in a simple, flexible and relations-based legal and business environment. The system within which legal structures are registered, licences issued, tax registered, etc., must be effective and efficient with the minimum red-tape. In many respects South Africa is currently a well-regulated, poorly-implemented jurisdiction. Government officials and public servants often stand in the way of the effective and efficient role out of a first-world regulatory environment. One of the challenges is to deal with such a large public service in comparison to that of traditionally small offshore jurisdictions, such as Mauritius or Malta.

\textsuperscript{136} See 8.3.

\textsuperscript{137} Duckworth 884.
Offshore trusts often provide large corporations with expansion opportunities without necessarily burdening them with substantial increases in operational expenses. Ultimately, should offshore financial jurisdictions not regard themselves as tax- or exchange-control havens, but appreciate their potential as jurisdictions with much needed flexible corporate hybrid structures, which may include non-standards such as combined partnerships and other entities with special corporate characteristics, of which the trust is one.\(^{138}\)

### 10.2.19 OFFSHORE FINANCIAL AND BUSINESS JURISDICTION

If the political will is present to position South Africa as a continent leader in the international financial and trade milieu, the development of its legal entities should be a high priority. Companies have recently been addressed by way of new legislation. The important role of trusts in the international commercial environment should, however, not be underestimated. If the local trust law does not instil the same confidence as company law does, it may jeopardise the initiative. A reputable trust-law dispensation is indeed one of the building blocks of any offshore financial destination and has now become even more important in international trade, with China embracing trusts.

The establishment of South Africa as an offshore destination includes a potential status as headquarter jurisdiction for international companies, as destination for international investment fund structures, as cash investment port for high net worth individuals, as international trade facilitator, and as reliable business structure destination. Major inroads have been made as far as some of these are concerned, particularly as banking- and investment-structure destination, with the adherence to and incorporation of the Basel Accords and even draft legislation on credit ratings.

As has been indicated before, a global positioning as attractive host jurisdiction for major international business activities and legal jurisdiction of choice will require sound and reliable legal structures that are internationally competitive.\(^{139}\) There is no doubt that the trust as legal vehicle has a central role to fulfil in this conquest.

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\(^{138}\) Ginsberg 6.

\(^{139}\) See 10.2.18 and 10.2.19.
On a local level, aspects such as adequate legal, tax and financial information, the efficiency of trust management and supervision, the costs involved, transparency, the quality of independent trustees, confidentiality, language barriers, legislation, regulatory restrictions, internal customs, etc., must be satisfactorily addressed.

South Africa will have to depart from the current perception of a fairly well-regulated, but poorly administrated, jurisdiction, to an excellent, but not overly regulated, sound and flexible jurisdiction, where the administration and services are world-class, with the minimum red tape involved.

The other recommendations in this Chapter, such as the formation of a Registrar of Trusts, stronger educational inputs at university level, the incorporation of the Hague Convention, and sound soft law interventions, will all contribute to a sound and strong local trust-law regime that can face the challenges and needs of the international business environment successfully.

**10.2.20 REGIONAL COMPETITIVENESS**

What is true for South Africa is just as relevant for the Southern African region. If the region wants to position itself as a reliable player in the fields of international business and finance, the different role players will have to cooperate as a team. In light of the physical location of Southern Africa it should focus on its attributes, such being the gateway to Africa, its natural beauty, its space, and its protection against potential natural disasters.

Team Southern Africa should become much stronger than individual nations if it emphasises the total value that the region can offer, without any attempts by individual jurisdictions to have it all. In a regional context a model trust law, such as Book X on European Law, may strengthen the trust as a legal vehicle. South Africa and Mauritius are arguably the strongest current contenders as offshore financial centres in the region, and both have strong trust-law legislation in place. Other countries in the region, particularly those of English origin, should find it easy to adapt to such model laws.

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140 Compare 9.2.10.
It will be wise for jurisdictions in the region with the necessary potential and desire to become part of a regional offshore financial and business stronghold, to adapt and incorporate the Hague Convention as this will add to confidence in the trust law of the region. Botswana is an example of a regional player that makes no excuses for its ambition to position itself as an international business hub.

A combined and concerted regional effort will also prevent arbitrage opportunities, which may damage the region more than it contributes to its development. Trust-law regimes that complement one another will be only the start and must be followed by political and economic stability, sound legal systems, and complementary tax- and exchange-control policies.

Southern Africa as a region shall have to be innovative in its endeavours to create and communicate a competitive offshore financial region. Any inclination to manipulate such development from a political perspective should be replaced by a strategic disposition with the focus on the long-term end result of becoming a truly international financial and business pivot.

10.2.21 SOFT LAW INTERVENTIONS

Soft law interventions and initiatives can include directives, circulars, practice notes, guidelines and guidance notes by the Master of the High Court or a future Registrar of Trusts. Position papers can be compiled by academics or task teams, and the national Minister may make use of regulations and board notices. It is recommended that the involvement of the Minister should be limited to the minimum and should rather take place through guidelines by ministerial task teams than by way of regulatory interventions.

Action by the Master in reaction to the acclaimed Parker-case regarding the appointment of independent trustees is ample evidence that soft law options can be effective. Since the Chief Master has issued a directive in this regard, thousands of both new and old trusts have complied.

The natural legal development of the South African law on trusts has also proved to be an effective, although slow, process. It is recommended that the common law

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141 See fn 123 above.
142 See 9.2.6 for more on the SADC.
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should be allowed to continue on this road as this has led to a competitive trust-law regime. Legislative interventions by the national government should be limited to the bare minimum in cases of a common-law concept such as the trust. Soft law mechanisms are a way of nudging the development subtly in the desired direction without disturbing the natural common-law equilibrium.

Other forms of soft law may include model laws, restatements, and standard contract forms.\(^{143}\) Model laws are not common to South Africa and differ from uniform laws and conventions in that they are originally of an informative nature, providing a model for national legislatures to consider. Model laws are also flexible as far as acceptance is concerned in comparison to uniform laws and conventions.\(^{144}\) Book X on Trusts for European Law is a good example of a model law.\(^{145}\) Model laws are not recommended for the South African internal process, but may be considered in a Southern African context.

Standard contract forms are, according to Gopolan,\(^{146}\) easily adaptable and modifiable and have become popular in international commercial activity. It is submitted that a number of trust instrument examples have become fairly standard amongst South African legal practitioners. These are, however, not always a legal blessing, as many practitioners do not necessarily apply their minds to trust deeds when preparing them, but follow a “copy and paste” route.

The creation of an office of Registrar for Trusts should result in a more focussed management style than that of the Master’s office and hopefully a closer involvement in the actual development of the trust concept. During this process directives and other soft law interventions shall become more prevalent and strengthen the current trust regime.

It is submitted that soft law interventions can fulfil a major role in the development of an effective macro-prudential regulatory and supervisory framework, as more stakeholders, who are intensely involved in the practical designing of the interventions, can be involved in the process. Soft law interventions also encourage stronger

\(^{143}\) See Gopolan 817 for discussion on these soft law options.

\(^{144}\) See Gopolan 803 for a discussion on their flexibility.

\(^{145}\) See 9.2.10.

\(^{146}\) 817. Gopolan submits that certain soft law tools, such as model laws, have contributed tremendously to the harmonisation of legal practices.
discretionary inputs and the development of a sense of ownership and responsibility by stakeholders.

A model trust law for the Southern African region may release the potential to strengthen all partaking jurisdictions in their total offering of a sound and trustworthy offshore legal and financial framework for investors, investment scheme managers, business initiatives and other commercial applications. The ideal would be for the sub-region to position itself as the most reliable and successful financial location in Africa and in the developing world. The region does not currently suffer the same level of challenges of some other parts of Africa, such as serious internal conflicts, civil wars, unstable governments, and natural disasters. It is also not as dissension-and colonial-prone as others, because of its substantial natural resources, such as oil, nor is it as over-populated as some other developing countries.

The development of trust law in South Africa and the Southern African region is intricately interwoven with their economic and financial contexts. Law and finance are in many respects two sides of the same coin. Legal structures usually fulfil an integral role in the development and implementation of all financial instruments – also the dubious ones. In this process of development both the economic and legal realities must thus be considered.

Lord Keynes\textsuperscript{147} has warned that

\begin{quote}
"(w)hen enterprise becomes a mere bubble on a whirlpool of speculation, the consequences may be dire . . . when the capital development of a country becomes a by-product of the activities of a casino . . . the job (of capitalism) will be ill-done",\end{quote}

while the reality of the modern trust concept is just as confrontational when Langbein\textsuperscript{148} submits that

\begin{quote}
"(t)he characteristic trust asset has ceased to be ancestral land and has become instead a portfolio of marketable securities – primarily a management device for assembling and administering a portfolio of financial assets."
\end{quote}

The final word belongs to Benjamin Disraeli, Earl of Beaconsfield and Prime Minister of Great Britain, stating:\textsuperscript{149}

\begin{flushright}

\end{flushright}
"I repeat . . . all power is in a trust — that we are accountable for its exercise, that from the people and for the people, all springs, and all must exist."

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<td>AIRB</td>
<td>Advanced Internal Ratings Based</td>
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<tr>
<td>ASISA</td>
<td>Association of Investments and Savings South Africa</td>
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<tr>
<td>BESA</td>
<td>Bond Exchange of South Africa</td>
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<tr>
<td>BRICS</td>
<td>Brazilia, Russia, India, China and South Africa</td>
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<tr>
<td>CIS</td>
<td>Collective Investment Scheme</td>
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<td>CISCA</td>
<td>Collective Investment Schemes Control Act 45 of 2002</td>
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<td>COMESA</td>
<td>Common Market for Eastern and Southern Africa States</td>
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<td>CRD</td>
<td>Capital Requirements Directive</td>
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<td>EFT</td>
<td>Exchange-traded fund</td>
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<td>FAIS</td>
<td>Financial Advisory and Intermediary Services Act 37 of 2002</td>
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<td>Fannie Mae</td>
<td>Federal National Mortgage Association</td>
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<td>Fiduciary Institute of South Africa</td>
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<td>Freddie Mac</td>
<td>Federal Home Loan Mortgage Corporation</td>
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<td>Financial Sector Assessment Programme</td>
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<td>LISP’s</td>
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<td>Organisation for Economic Co-operation and Development</td>
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<td>Offshore financial centre</td>
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<td>Organisation for the Harmonisation of Business Law in Africa</td>
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<td>Over-the-counter derivative market</td>
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ANNEXURE A  STANDARD DEED FOR A COLLECTIVE INVESTMENT SCHEME IN SECURITIES

ANNEXURE B  BOOK X ON TRUSTS FOR EUROPEAN LAW

AS PER DRAFT COMMON FRAME OF REFERENCE
Amend Fin Year End (clause 65), Definitions of Accounting period, Distribution date, Ex-dividend date for your purpose; Note: clause 30.1.2 is only if Exit charge is applicable to whole scheme and all portfolios, otherwise, it must be addressed in portfolios’ supplemental deed. Performance fee must be added in the supplemental of the relevant portfolios by adding additional paragraphs to clause 50.

DEED

Made and entered into by and between

XYZ Unit Trust Management Company Limited
Registration number 2004/032413/06
(“the manager”)

and

ZZZ Limited
Registration number 1951/000009/06
(“the trustee”) / ("the custodian")

PREAMBLE

A. The manager and the trustee/custodian have agreed to establish a collective investment scheme to be known as the XYZ Unit Trust Scheme under the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002) and to create thereunder, by means of supplemental deed, one or more separate portfolios.
B. The manager intends, subject to the Act and this deed, to make available to members of the public for investment participatory interests in one or more portfolios.

C. To protect and secure the interests of investors in a portfolio -

(i) the manager undertakes to invest money or other assets on behalf of investors in one or more portfolios of the collective investment scheme under the supervision and control of the trustee/custodian; and

(ii) the trustee/custodian agrees to accept delivery of and to hold in safe custody the assets of a portfolio.

D. The parties have reached agreement on the following matters relating to the establishment and administration of the collective investment scheme and its portfolios:
PART 1: DEFINITIONS

1. Definitions

1.1 In this deed a word defined in the Act bears the meaning so assigned to it.

1.2 In this deed, unless inconsistent with the context -

“accounting period”, in relation to the first distribution in respect of a portfolio to be made in terms of this deed, means the period not exceeding 12 months commencing on the date of commencement of such portfolio as declared by the manager in consultation with the trustee/custodian and ending on the day immediately prior to the first day of xxx and xxx of each year, or such other day as may be determined by the manager in consultation with the trustee/custodian and, in relation to each subsequent distribution, means the period beginning with the last ex dividend date and ending on the day immediately prior to the next ex dividend date: Provided that after the first distribution in respect of that portfolio the financial year end of a portfolio must each year coincide with the day immediately before one of the ex dividend dates referred to above;

“certificate” means a certificate or statement issued to an investor pursuant to the provisions of this deed which serves as evidence of the title of the investor to the participatory interest referred to therein and properly acquired by the investor;
2.1.1 “classes of participatory interests” means a category of participatory interests within a portfolio which differs from another category of participatory interests within the same portfolio as a result of its specific characteristics and different titles represented by characters of the alphabet and further individually distinguished by a number (e.g. Class A, Class A1 Class B, etc.) and indicated on the certificates as such; Provided that when different classes of participatory interests are created in a portfolio –

(a) participatory interests that exist immediately prior to the implementation date that were created subject to specified maximum levels of charges as determined by the trust deed in terms of the Unit Trusts Control Act, 1947 (Act No. 18 of 1947), or the Unit Trusts Control Act, 1981 (Act No. 54 of 1981) (“the UTC Acts”), prior to the coming into effect of the Unit Trusts Control Amendment Act, 1998 (Act No. 12 of 1998) on 1 June 1998, shall be categorised as a specific class, titled “Class R” participatory interests; and

(b) participatory interests that exist immediately prior to the implementation date, that are subject to levels of charges as may be determined by the deed, shall be categorised as a specific class of participatory interests other than Class R participatory interests.”.

“distribution date”, in relation to a specific portfolio, means a date not later than the last business day of xxxx and xxxx of each year, or such other day or days as may be determined by the manager and the trustee/custodian by supplemental deed: Provided
that the first distribution date of each portfolio created under this deed may not be more than 12 months after the date of creation of such portfolio;

“electronic”, in relation to any document created under this deed, includes created, recorded, transmitted or stored in digital or other intangible form by electronic, magnetic, optical or any similar means;

“ex dividend date” means the first business day of xxx and xxx of each year or such other day or days as may be determined by the manager and the trustee/custodian and approved by the registrar;

“implementation date” in relation to the creation of additional participatory interests as different classes of participatory interests in a portfolio, means a date determined by the manager, after consultation with the trustee, on which additional participatory interests in different classes of participatory interests are issued for the first time, which date shall coincide with the beginning of an accounting period;

“in writing” includes any visible electronic form;

“manager’s charge”, in relation to a participatory interest in respect of different classes of participatory interests, means the charge(s) in that class of participatory interests contemplated in clause 30;

“market value” in respect of securities, means the value determined in terms of section 44 of the Act or in respect of a participatory interest, the repurchase price of that participatory interest;

“participatory interest in issue”, in relation to a portfolio, including a portfolio consisting of different classes of participatory interest, means
all participatory interests that have been created and entered in the register of that portfolio, including those held or deemed to be held by the manager;

“payment in lieu of income accruals” means the amount which the manager must pay into the income account of a particular class of participatory interests in the portfolio on the creation of new participatory interests for that class of participatory interests to acquire for the participatory interests so created, equal participation in the relative income which has accrued (including payments received in lieu of income accruals for the said class of participatory interests) from the last ex dividend date to the date on which the participatory interests are created for the class of participatory interests. Such amount shall be calculated by dividing the total number of participatory interests in issue in that class of participatory interests at the time at which the calculation is made into the total amount then standing to the credit of the relative income account of that class of participatory interests, and by multiplying the quotient by the number of new participatory interests created in that class of participatory interests at the time at which the calculation is made;

“permissible deductions” means any deduction in connection with the administration of a portfolio referred to in section 93 of the Act;

“pricing date” means the day on which the prices of participatory interests in the portfolio(s) are calculated and shall be daily, excluding weekends and public holidays.
“register” means the register of investors;

“scheme” means; XYZ Unit Trust Scheme

“service charge” means the periodical charge stipulated in the deed and as disclosed in all marketing material, to remunerate the manager for the administration of a portfolio or different classes of participatory interests in a portfolio;

“the Act” means the Collective Investment Schemes Control Act, 2002 (Act No 45 of 2002);

“valuation point” means the point in time on a pricing date at which the prices of participatory interests are calculated and shall be 15H00 daily. Provided that with the consent of the trustee, valuations may take place more frequently but not less frequently.".
PART II : THE SCHEME

2. The constitution and name of scheme

The manager and the trustee/custodian hereby establish the XYZ Unit Trust Scheme which may consist of various portfolios.

3. Object of scheme

The object of the scheme is to establish one or more separate portfolios in which investors can obtain participatory interests in diversified assets of local or foreign origin. In order to achieve this object the manager may, subject to the Act and this deed -

3.1 create and issue an unlimited number of participatory interests or classes of participatory interests in a portfolio established in terms of a supplemental deed to the deed; or

3.2 establish a variety of portfolios, including portfolios consisting of different classes of participatory interests, in order to provide investors with investment opportunities in diversified assets and to provide for different fees and charges.
PART III : THE MANAGER

4. Appointment of manager

Subject to the Act and this deed, XYZ Unit Trust Management Company Limited is the manager of the scheme.

5. Remuneration of manager

5.1 The manager is remunerated for its services and reimbursed for its expenses in performing its obligations under this deed.

5.2 The manager may at any time in its discretion waive or rebate its remuneration or reimbursement or any part thereof.

6. Powers of manager

Subject to the Act and this deed, the manager may in its absolute and uncontrolled discretion -

6.1 do all such things and enter into all such arrangements as are necessary for the administration of the scheme and to achieve the investment objectives of a portfolio of the scheme;

6.2 select, purchase, sell, exchange or change any of the assets of a portfolio;
6.3 in writing appoint persons to exercise powers and perform duties on its behalf and, in particular, appoint transfer secretaries, secretaries and agents; and

6.4 act on the advice or information obtained from professional advisers and others considered by it to be experts.

6.5 borrow money under section 96 of the Act subject to the following limits and conditions:

6.5.1 The manager must obtain the prior consent of the trustee/custodian to the borrowing;

6.5.2 the term of the loan may not exceed 61 days, provided that if insufficient liquidity continues thereafter the loan may be renewed with the consent of the trustee/custodian;

6.5.3 the loan may not bear a penalty for early settlement;

6.5.4 the loan must be serviced in sequence of priority out of –

6.5.4.1 inflows to the portfolio; and

6.5.4.2 realisation of assets;

6.5.5 the outstanding capital amount of the loan must be used when computing a portfolio’s net asset value price in terms of clause 27;

6.5.6 as security for the repayment of the loan the manager may -

6.5.6.1 cede a proportionate share of the assets of the portfolio to the lender on condition that ownership of the ceded assets will only be transferred to the lender if the manager is in default; or
6.5.6.2 grant an option to the lender to purchase a proportionate share of the assets, equal in value to the outstanding amount of the loan, at the end of the term of the loan;

6.5.7 the manager may only borrow funds if liquidity cannot reasonably be obtained without encumbering the assets of the portfolio;

6.5.8 the amount borrowed must be limited to an amount necessary to repurchase or cancel participatory interests;

6.5.9 the manager must disclose in its point of sale documents that an investor is required to sign, that the manager may borrow up to 10 per cent of the market value of the portfolio to bridge insufficient liquidity.

6.6 engage in scrip lending under section 85 of the Act subject to the following limits and conditions:

6.6.1 The scrip lending must be beneficial to all investors;

6.6.2 the manager may lend or offer to lend securities with a value not exceeding 50 per cent of the market value of all the securities included in a portfolio;

6.6.3 the securities that may be lent to one borrower are limited in accordance with the limits determined by the registrar for the inclusion of money market instruments in a portfolio;

6.6.4 collateral security for the securities loaned must have an aggregate value that exceeds the market value of the securities
loaned by not less than five per cent at all times and may only consist of –

6.6.4.1 cash; or
6.6.4.2 other securities or a combination of securities;

6.6.5 securities may not be lent for a period longer than 12 months;
6.6.6 securities may not be lent unless subject to a right of recall;
6.6.7 all fee income earned from securities lending, less necessary expenses, must be administered for the benefit of investors;
6.6.8 the manager must disclose in the quarterly and annual financial statements the securities that are lent, the value thereof and the composition and the nature of the collateral security held in respect of such loan;
6.6.9 the agreement of loan and the agreement relating to the security furnished by the borrower must be in writing and must at least provide for -

6.6.9.1 the period of notice of termination of the loan;
6.6.9.2 payments that may be made by the borrower to the portfolio in lieu of dividends accrued or paid in respect of the securities borrowed;
6.6.9.3 fees or charges payable by the borrower to the portfolio;
6.6.9.4 charges payable by the borrower to the portfolio to compensate investors for additional taxes in respect of taxable earnings in the form of payments by the borrower
to the manager in lieu of dividends accrued or paid on the
securities loaned;

6.6.9.5 reservation of the right of execution without court order
and immediate transfer to the manager of the ownership
of and all rights, including voting rights, attached to the
collateral security, if the borrower defaults or becomes
insolvent;

6.6.9.6 an undertaking by the borrower to deliver to the portfolio
securities equivalent to any rights in respect of the loaned
securities that may become exercisable before redelivery
of the loaned securities.

7. Voting rights on assets

7.1 Indemnity

On being furnished with such reasonable indemnity against
costs as the trustee/custodian may require, the
trustee/custodian may delegate to the manager or its nominee
the right to attend or to vote at a meeting of an issuer of assets
included in a portfolio, and to take part in or consent to any action of
an issuer of such assets. No investor shall have any right in
relation to any asset, to attend or to vote at such meeting or to take
part in or consent to any such action.

7.2 Proxies
The trustee/custodian must execute such proxies, powers of attorney or other documents as the manager may require in order to enable it or its representative or its nominee to attend or to vote at any such meeting and to take part in or consent to any such action.

7.3 Meaning of vote
In this clause “vote” includes not only a vote at a meeting of an issuer but also any decision of an issuer relating to any arrangement, scheme or resolution, or to any alteration in or abandonment of any rights attaching to any part of the assets, and the right to requisition or join in a requisition to convene any meeting or to give notice of any resolution or to circulate any statement.

8. Trustee/custodian to forward notice to manager

The trustee/custodian or its nominee must on receipt thereof forward to the manager any notice of a meeting of an issuer, a report, circular and all other documents received by it, or its nominee, from an issuer.

9. Manager to prepare documents

The manager must, at its own expense -

9.1 prepare all cheques, warrants, notices, accounts, summaries, declarations, offers or statements which the trustee/custodian under the provision of this deed is required to issue, serve or send, and
deposit the same with the trustee/custodian together with stamped and addressed envelopes, if so required, so as to afford the trustee/custodian sufficient time to examine, check and timeously dispatch such cheques and documents; and

9.2 prepare, sign and execute all certificates and all transfers of assets which, but for this provision, would fall to be prepared by the trustee/custodian, and deposit the same with the trustee/custodian for signature and execution.

10. Retirement and substitution or liquidation of manager

10.1 The manager may, with the written approval of the trustee/custodian and the registrar, in writing appoint any other company qualified to act as manager in terms of the Act, as manager in its stead, and may assign to such appointee all its rights and duties as manager under this deed. Such appointee must execute an instrument in a form as approved by the trustee/custodian and the registrar in terms of which it undertakes to fulfil all the obligations of the retiring manager. The retiring manager is then, upon payment to the trustee/custodian of all sums then due by it to the trustee/custodian (without prejudice to the rights of the trustee/custodian, investors or other persons, in respect of any act or omission prior to such retirement) absolved and released from all its duties and obligations under this deed. The new manager thereafter exercises all the powers, enjoys all the rights, and performs
all the duties and obligations of the manager under this deed, as if the new manager had originally been a party to this deed.

10.2 The retiring manager remains entitled to all participatory interests in respect of which no certificate or valid claim is outstanding at the date of retirement and may require the new manager to issue to it a certificate in respect of any such participatory interests and to enter its name in respect thereof in the register or otherwise record its ownership of such participatory interests. The retiring manager continues to enjoy all the rights of an investor in respect of all participatory interests held by it.

10.3 If the manager is liquidated, the trustee/custodian must take immediate steps for the appointment of a new manager.
PART IV : THE TRUSTEE/CUSTODIAN

11. Appointment and powers of trustee/custodian

Subject to the Act and this deed, Nedbank Limited is the trustee/custodian of the scheme. The trustee/custodian has all the powers necessary to protect the interests of investors in terms of the Act and this deed and has, save as otherwise provided in this deed, the powers necessary to perform its functions to achieve the objectives of the scheme and its portfolios.

12. Legal proceedings relating to a portfolio of the scheme

12.1 Legal proceedings relating to a portfolio of the scheme must be instituted by or against the trustee/custodian in its capacity as such, and the trustee/custodian may institute, prosecute, intervene in or defend any legal proceedings relating to or concerning a portfolio of the scheme or its affairs and, as a prerequisite to such action, may require the manager to indemnify it against all costs, expenses and liabilities thereby incurred.

12.2 The trustee/custodian is not liable to make any payment to any investor except out of any funds held by or paid to it for that purpose under the provisions of this deed.
13. **Remuneration of trustee/custodian**

13.1 In every accounting period, the manager must:

13.1.1 authorise payment to the trustee/custodian by way of remuneration for the trustee’s/custodian’s services, of such amount as may be agreed between them; and

13.1.2 reimburse the trustee/custodian for all its expenses incurred in connection with the scheme, other than expenses expressly required by this deed to be paid out of a portfolio, and other than expenses incurred by it as a result of its own negligent and unlawful conduct.

13.2 Such remuneration and reimbursement are in addition to any sums that the trustee/custodian may receive or retain under any other provision of this deed.

14. **Registration and retention of assets by trustee/custodian**

14.1 The assets of a portfolio must be registered either in the name of the trustee/custodian or with the written consent of the registrar in the name of a nominee company of the trustee/custodian. Any reference in this deed to the trustee/custodian in relation to the vesting, registration or holding in its name of assets, or to its rights, powers and obligations as the registered owner of the assets, is, unless inconsistent with the context, deemed also to be a reference to the said
nominee company. The trustee/custodian is liable for any act or omission of the nominee company in relation to any assets held in the name of the nominee company. Despite the foregoing, the trustee/custodian or its nominee company must take delivery of and retain in safe custody and under its own supervision and control the documents of title to the assets.

14.2 Subject to the provisions of this deed with regard to scrip lending and the borrowing of money by the manager, the assets must be held by the trustee/custodian or its nominee company in its name in trust for the investors and the trustee/custodian or its nominee company may not allow the whole or any part of such assets to be pledged or encumbered in any way.

15. Trustee/custodian not obliged to furnish security

The trustee/custodian is not obliged to furnish security to the Master of the High Court or to any other official for the due performance by it of any of its obligations in terms of this deed.

16. Trustee/custodian may deal in participatory interests and act as banker to the scheme

16.1 The trustee/custodian may –
16.1.1 purchase, hold, deal in or dispose of participatory interests for its own account or otherwise;

16.1.2 if the trustee/custodian is a bank, act as banker for the scheme;

16.1.3 enter into any financial, banking or other transaction with the manager or an investor, or with a concern any of whose shares or securities form part of the assets;

16.1.4 hold any security in any such concern.

16.2 The trustee/custodian is not accountable in any way to the manager or investors for any profits made or benefits derived by it from any of the matters referred to in clause 16.1.

17. **Trustee/custodian may accept signed request from manager**

Subject to section 72 of the Act, the trustee/custodian is not liable for anything done or omitted or suffered by it in good faith and in accordance with or pursuant to any written request, notice, direction, advice or other communication of the manager. The trustee/custodian may accept any document signed on behalf of the manager by a duly authorised person and directed by the manager to the trustee/custodian, as sufficient evidence of any request, notice, direction, advice or other communication from the manager to the trustee/custodian.
18. **Trustee/custodian may act on advice of competent person**

The trustee/custodian may act upon the advice, statements of or information obtained from lawyers, the manager, bankers, accountants, members of any exchange or other persons considered by the trustee/custodian to be experts in relation to the matters upon which they are consulted.

19. **Trustee/custodian and manager may interpret deed**

Subject to this deed and without prejudice to the right of any person to have recourse to the Courts, the trustee/custodian and the manager may resolve all questions of interpretation of the provisions of this deed.

20. **Removal of trustee/custodian**

20.1 Subject to the Act, the manager may with the written approval of the registrar -

20.1.1 pursuant to a ballot of investors in all portfolios (to which clause 67 applies); or

20.1.2 at the written request of not less than 50% of the investors excluding the manager, in all the portfolios,
holding not less than 50% in value of the total number of
participatory interests then in issue,
require the trustee/custodian by notice in writing to resign from office.

20.2 A trustee/custodian appointed in the place of a retiring
trustee/custodian must execute an instrument in a form approved by
the manager and the registrar in terms of which it undertakes to fulfil all
the obligations of the retiring trustee/custodian. The retiring
trustee/custodian is (without prejudice to the rights of the manager,
investors or other persons, in respect of any act or omission, liability,
negligence or dishonesty, prior to such retirement) absolved and
released from all further obligations under this deed. The new
trustee/custodian thereafter exercises all the powers, enjoys all the
rights, and is subject to all the duties and obligations of the
trustee/custodian under this deed, as fully as if such new
trustee/custodian had originally been a party to this deed.

20.3 A trustee/custodian is deemed to have resigned if its certificate of
registration is revoked or suspended under section 69(3) of the Act,
and the manager must in that event immediately appoint another
person qualified to act as trustee/custodian in terms of the Act.
PART V : PORTFOLIO

21. **Number of portfolios**

The scheme may consist of one or more portfolios, inclusive of portfolios consisting of different classes of participatory interests, established by supplemental deed.

22. **Trustee/custodian entitled to reject asset**

The trustee/custodian may refuse to accept as part of the assets of a portfolio, any asset which according to its judgment, infringes the terms of this deed or a supplemental deed or the Act and the manager must, in such an event, deposit with the trustee/custodian cash or assets of equal value which comply with the terms and objects of this deed.
23. **Initial or additional portfolio and offer of participatory interests**

The initial and each additional portfolio must each have a minimum market value as determined by the manager after consultation with the trustee and comprise assets or cash received or deemed to be received by the manager. The manager is responsible for the payment of all expenses (including permissible deductions) arising out of and relating to the formation of the initial and any additional portfolio. The participatory interests issued to the manager in respect of such assets or cash are deemed to be the first participatory interests in issue in a particular portfolio and must be issued at a minimum price determined by the manager. At the date on which the manager commences the sale of participatory interests to the public, the market value of each portfolio must be at least an amount as determined by the manager after consultation with the trustee. The first issue of participatory interests in a portfolio to the public is made in such a manner as the manager may decide. The said first issue may take the form of an offer by the manager of a specified number of participatory interests at a fixed price per class of participatory interests not exceeding the net asset value price per class of participatory interests on a previous date, which date shall not be more than 28 days before the closing of the offer.
24. **Creation, subdivision or consolidation of participatory interests**

24.1 The manager has the exclusive power to secure the creation and issue of participatory interests in a portfolio, including the creation and issue of different classes of participatory interests.

24.2 The manager may, with the consent of the trustee/custodian and the approval of the registrar, in writing, at any time effect any subdivision or consolidation of participatory interests in issue in any particular portfolio without prejudice to the rights and privileges of the then existing investors. For the purpose hereof the manager is obliged to send a written notice to all investors which must include the following minimum information:

24.2.1 Full particulars of the subdivision or consolidation including:

24.2.1.1 in the case of a subdivision, the number of additional participatory interests to which the investor is entitled and which have been entered in the register; or

24.2.1.2 in the case of a consolidation, the number of participatory interests to which the investor is entitled and which have been entered in the register.
24.3 The costs involved in the subdivision or consolidation of participatory interests must be borne by the manager which must within 21 days after the date on which the subdivision or consolidation takes place, issue additional certificates or certificates replacing existing certificates to investors or, if certificates are no longer issued, notify investors as contemplated in clause 24.2. If an investor tenders participatory interests to the manager for repurchase after the date of the subdivision or consolidation but before additional certificates are issued or existing certificates replaced, or investors are notified as aforesaid, a certificate issued before the subdivision or consolidation is deemed to represent the number of participatory interests to which the investor is entitled as a result of the subdivision or consolidation.

24.4 For purposes of the creation, sale, repurchase or cancellation of participatory interests, the valuation point, as defined, must be applied on each pricing date.

25. **Undivided interest in portfolio**

Each investor is, equally with every other investor, entitled to one undivided proportionate participation in a portfolio that does not have different classes of participatory interests. Every fraction of a participatory interest ranks *pari passu* proportionately with that particular interest.
26. **Minimum number of participatory interests that may be sold**

The minimum number of participatory interests that may be sold to an investor must be determined by the manager.

27. **Net asset value and sale price of participatory interest**

Unless participatory interests are offered at a fixed price pursuant to section 94(1)(b) of the Act, the manager must issue participatory interests in a class of participatory interests in a particular portfolio at the net asset value price per participatory interest in that particular class, which price is calculated on the date on which any participatory interest in that class is issued or the previous date, whichever is consistently applied, according to the formula –

\[
\frac{A + B}{C}
\]

Where:

A = the aggregate market value of the assets notionally allocated to a particular class of participatory interests in a portfolio, excluding the income accruals and payments referred to in B in respect of that class of participatory interests, on the last valuation point determined by the manager on the last pricing date, which valuation point may not be more than 24 hours, prior to or after such date, excluding weekends and public holidays;

B = the aggregate of all income accruals and payments received in lieu of income accruals from the creation of new participatory interests in respect of that class of participatory interests in the portfolio, during the relevant accounting period up to the said date, but excluding:
(i) any part of those income accruals and payments in lieu of income accruals, set aside at the last preceding distribution date for distribution, but not yet distributed; and

(ii) such further amount, out of those income accruals and payments in lieu of income accruals, as in the opinion of the manager represents a fair proportion, at the pricing date, of the permissible deductions for the relevant accounting period;

\[ C = \text{the total number of participatory interests in issue in a particular class of participatory interests in the portfolio on the pricing date.} \]

28. **Price at which manager may sell participatory interest owned by it for own account**

The manager may at any time for its own account sell any participatory interest owned or deemed to be owned by it and for the time being outstanding, at any price not exceeding the price at which a new participatory interest in a particular class in the relevant portfolio would at that time be issued in accordance with the provisions of clause 27, and the manager may retain for its own use and benefit all monies received by it in respect of such sale. Any commission, remuneration or other sum payable to an authorised agent of the manager in respect of the sale of any such participatory interest, must be paid by the manager.
29. Manager may sell participatory interest in exchange for asset

29.1 Subject to and in accordance with the following provisions, the manager may secure the creation and issue of, or sell a participatory interest in a particular portfolio by way of exchange for an asset upon such terms as the manager may think fit.

29.2 The value of the participatory interest so sold is calculated according to the purchase price at the time when such participatory interest was so sold.

29.3 Any permissible deductions relating to the acquisition of such asset must be paid out of the relevant portfolio.

29.4 The manager and the trustee/custodian must be satisfied that the exchange is not likely to prejudice existing investors.

30. Manager’s charge

30.1 Manager’s charge includes any or all of the following:

30.1.1 Upfront manager’s charge
In relation to a participatory interest, means that portion of the amount received from an investor which represents the manager’s charge in respect of expenditure incurred and administration performed by it in
connection with the creation, issue and selling of such participatory interest in that class of participatory interests which, subject to any notice referred to in clause 30.2,

(a) may be expressed as a percentage of the amount received from an investor; or

(b) may be calculated, as agreed with an investor in writing, in terms of clause 30.3 in accordance with a sliding scale; or

(c) may be a fixed amount per specific type of transaction, or

(d) or may be a combination of the above:

Provided that in respect of Class R participatory interests in a portfolio of which any charge was fixed at a maximum of 5 per cent prior to 1 June 1998, i.e. the date of coming into operation of section 7 of the Unit Trusts Control Amendment Act, 1998 (Act No. 12 of 1998), such charge shall remain so fixed unless the investors effected agreed to any change thereof in terms of section 98 of the Act. Where a Class R charge is less than five percent, any increase to the maximum charge will be of no force unless the manager has given not less than three months’ written notice to every investor.

30.1.2 Exit charges:
The manager may charge an exit fee. The exit fee will apply to all amounts withdrawn from the portfolio within 12 months from date of first investment in the portfolio. The exit fee will be calculated as percentage (excluding VAT) of all amounts so withdrawn.

30.2 The manager must give not less than three months’ written notice to investors of any increase in the manager’s charge or any change in the
method of calculation thereof that could result in an increase thereof or of the introduction of any new charge.

30.3 Nothing herein contained precludes the manager, in its discretion, to reduce or waive the manager’s charge or to pay commission in respect thereof. The scale of the manager’s charge applicable to varying sizes of investment, if any, must be determined and published by the manager in all relevant marketing material.

31. Variations in manager’s charge

Any reduction in the manager’s charge, if any, shall be passed on to investors in respect of the uncompleted portion of any contract for the sale of participatory interests. Any increase in that charge, if any, may not be applied to any contracts for the sale of participatory interests entered into at a date prior to the date on which such increase came into effect.

32. Conditions for sale of participatory interest

The manager may not sell or offer any participatory interest for sale except on the terms set out below:

32.1 Each purchase of participatory interests must be a completed transaction and ownership of the participatory interests passes to the
purchaser as soon as the manager has accepted an offer to sell participatory interests and the purchase price has been paid;  

32.2 the manager must immediately after each purchase transaction take steps to register the transfer of the participatory interests to the purchaser in the register of the portfolio; and  

32.3 the manager must issue a Purchase Note or a statement of account to a purchaser reflecting the sale of the relevant participatory interests: Provided that the purchaser may at any time demand a certificate referred to in clause 40 in respect of the participatory interests so purchased if the minimum number of participatory interests referred to in clause 26 is purchased.

33. **Manager to furnish trustee/custodian with information**

In order to enable the trustee/custodian to give effect to this deed, the manager must furnish to the trustee/custodian on request statements of all issues of participatory interests and of the prices at which they were issued, particulars of any assets which it intends or plans to purchase or sell for the account of the scheme, and any other information which the trustee/custodian may reasonably require.

34. **Manager to repurchase participatory interests**
34.1 It shall be incumbent on a manager to repurchase any number of participatory interests offered to it by an investor as determined in this deed.

34.2 For the purpose of clause 34.1 and subject to clause 34.3 the point in time by when offers to repurchase participatory interests must be received is 14H00 on each pricing date.

34.3 The time determined in terms of clause 34.2 may not be changed unless 30 days’ prior written notice has been given to investors.

34.4 A manager, when it receives a request for repurchase of participatory interests under circumstances prescribed by the registrar under section 114(3)(f) of the Act -

34.4.1 may, with the prior consent of the trustee of custodian; or

34.4.2 must, without delay when the trustee or custodian so requires,

suspend the basis of the repurchase of the relevant participatory interests, if the manager, trustee or custodian, as the case may be, is of the opinion that the circumstances referred to, warrant the suspension in the interests of investors.

34.5 The repurchase of such participatory interests shall be priced and settled in accordance with conditions prescribed by the registrar under section 114(3)(f) of the Act.

34.6 Save for the circumstances contemplated in clause 34.5 above, an investor shall not be entitled to any asset of the portfolio
35. **Notice to repurchase**

35.1 An investor who wishes to sell his or her participatory interests may, by notice in writing to the manager or its duly authorised agent, require the manager to repurchase all or any of such participatory interests.

35.2 No notice requiring the manager to repurchase a participatory interest is valid unless the investor delivers to the manager or its authorised agent, the certificate, if any, representing the participatory interests offered for repurchase or, at the option of the manager, produced such evidence of his or her title to the participatory interest to be sold as the manager may consider sufficient. The said notice must be accompanied by an instrument of transfer and such other necessary documents referred to in clauses 43 and 46 of this deed. If the repurchase price is not paid to the investor on delivery of the said documents to the manager, the investor must be issued with a receipt for such documents.

36. **Repurchase price**

Subject to clause 34, the repurchase price per participatory interest payable by the manager must be the amount determined in terms of
clause 27 at the time when the notice referred to in clause 35 was received by the manager.

37. **Date of payment of repurchase price**

Subject to clauses 34.4 and 34.5, payment in respect of an offer for the repurchase of a participatory interest must be made to the holder of such participatory interest within 14 days of the receipt of such offer.

38. **Balance certificate**

If the certificate delivered to the manager or its authorised agent comprises a larger number of participatory interests than that stated in the notice to the manager to sell or repurchase, a balance certificate must, subject to clause 40, be issued by the manager free of charge to the investor.
PART VII : PARTICIPATORY INTEREST CERTIFICATES

39. Certificate

When any participatory interest is created and sold, the manager must issue, and the trustee/custodian countersign, a certificate representing the said participatory interest in the name of the investor entitled thereto, if so requested by the said investor. The trustee/custodian may not countersign any certificate unless it has received from the manager payment for the participatory interests sold in the form of cash or assets in terms of the Act and this deed, together with all documents necessary to effect transfer of the participatory interests.

40. Form of certificate

A certificate must be in the form determined by the manager and the trustee. A certificate must, for each separate portfolio, contain at least the serial number of the certificate; the number of participatory interests and the class of participatory interest represented thereby; the full name and address of the investor; the name and address of the manager and the trustee; and the date on which the name of the investor has been entered in the register as the investor represented by the certificate.
41. **Signature of certificate**

Each certificate, if any, other than a statement, must be signed, either graphically or otherwise, by a duly authorised official on behalf of the manager and countersigned either graphically or otherwise by a duly authorised official on behalf of the trustee/custodian. No certificate may be issued or is valid until so signed.

42. **Issuing of certificate**

42.1 A certificate must be issued to the manager, should it require one, and to an investor, if requested, in respect of a participatory interest to which the manager or investor is entitled.

42.2 If the intention of the manager is to resell any repurchased participatory interest in the future it shall not be required to enter it’s name into the register.

43. **Number of participatory interests for which certificate is issued**

A certificate may represent any number or class of participatory interests determined by the manager.
44. **Exchange and consolidation of certificates**

Subject to this clause, an investor in a particular portfolio may exchange his or her certificate or certificates for one or more new certificates representing a like number of participatory interests in that portfolio. The manager may determine a charge for each such new certificate. Before any such exchange takes place the investor must surrender to the manager the certificate which is to be exchanged. Every new certificate must be in the same name as the surrendered certificate, which must be cancelled and particulars of the new certificate must be entered in the register of the relevant portfolio.

45. **Replacement of destroyed, mutilated or lost certificates**

45.1 If any certificate is worn out or defaced, the manager, on production of the certificate must cancel the same and issue a new certificate in place thereof. If any certificate is lost, stolen or destroyed, then on proof to the satisfaction of the manager of such loss, theft or destruction and on such indemnity (if any) as the manager may deem adequate being given, and on such terms as the manager may decide, a new certificate in lieu thereof must be given to the person entitled to such lost, stolen or destroyed certificate. An entry as to the issue of the new certificate and the indemnity (if any) must be made in the register.
45.2 In the case of loss, theft or destruction of a certificate, the person availing himself or herself of the provisions of clause 45.1 must pay to the manager all expenses incidental to the investigation of the evidence of the loss, theft or destruction and of the preparation of the said indemnity. In addition, any person to whom a new certificate is issued in terms of clause 45.1 shall pay a charge to the manager as the manager may determine for each new certificate so issued.
PART VIII: RECEIPTS AND DISTRIBUTIONS

46. Payment of receipts to trustee

46.1 The following receipts in cash must be deposited in a separate trust account for each or all portfolios with a bank, registered in terms of the Banks Act, 1990 (Act 94 of 1990), or the Mutual Banks Act, 1993 (Act 124 of 1993), being an account under the control and supervision of the trustee/custodian:

46.1.1 All monies which are received for investment as a result of the sale of participatory interests;

46.1.2 all dividends, interest or other income which accrue to the underlying assets; and

46.1.3 the proceeds of all capital profits, rights and bonus issues.

46.2 If any receipts are to be deposited with a foreign bank not approved under the Banks Act, 1990, it must be deposited with a bank, agreed upon between the manager and the trustee/custodian, and finally registered as a bank in terms of the laws of a foreign jurisdiction applying regulatory standards which are not less stringent than the equivalent standards in the Republic.

46.3 All assets received as a result of the sale of a participatory interest must be taken into account as an investment for the benefit of the
relevant portfolio and new participatory interests must be created in terms of this deed to represent such investment.

46.4 All income accruals received during an accounting period must be credited to an account called the “Income Account” in the books of account of the portfolio concerned and shall form part of such portfolio under the supervision and control of the trustee/custodian. If a portfolio receives any bonus, right or benefit in respect of any of the assets, whether in cash or scrip or by warrant, cheque, credit or otherwise, which is in the nature of income, the manager must convert such bonus, right or benefit into cash for the credit of the relative Income Account. Any other bonus, right or benefit must be treated as a capital gain and must be included in the relevant portfolio. No new participatory interests may be created out of income accruals or such capital gains.

46.5 All amounts received in lieu of income accruals from the creation and sale of participatory interests in a class of participatory interests in a portfolio during an accounting period must be credited to the income account of that class and must be available for distribution to investors in that class of participatory interests in the portfolio at the next ex dividend date.

46.6 All amounts received as income accruals in terms of clause 46.4 must be credited to the income account and must be available for distribution to the investors in that portfolio at the next ex dividend date.
47. Manager’s decision on nature of bonus conclusive

If any doubt arises as to whether any bonus, right or benefit referred to in clause 46.4 constitutes an income accrual or a capital gain, such question must be resolved by the manager after consulting the trustee/custodian and the auditors, and such resolution is conclusive.

48. Distribution of income

48.1 The manager must on each distribution date distribute to investors (including the manager in respect of any participatory interests to which it is entitled) registered in the register of a portfolio as at the commencement of business on the immediately preceding ex dividend date, pro rata to the number of participatory interests then held by such investors in a class of participatory interests in that portfolio, the amount verified by the trustee as available for distribution in each class in that portfolio as hereinafter provided in respect of the accounting period immediately prior to such ex dividend date.

48.2.1 On each ex dividend date, the amount required to effect a distribution must be set aside and may no longer be taken into account in determining the market value of the portfolio for the purpose of calculating the prices of participatory interests in all classes of participatory interests.

48.2.2 On each distribution date the said amount shall be transferred from the income account to the distribution account for a class of participatory interests, under the
supervision and control of the trustee, which must be distributed for the benefit of investors in that class of participatory interests.

48.2.3 The amount to be distributed in respect of each participatory interest must be rounded down to the nearest one hundredth of a cent, and the amount to be distributed to any one investor must be rounded down to the lower cent.

48.2.4 The aggregate balance remaining to the credit of the distribution account for a class of participatory interests on completion of the distribution, shall be carried forward and added to the amount available for distribution for that class of participatory interests in the next accounting period.

48.3 If an investor makes a written application to the manager to that effect, the distribution due to him or her must automatically be reinvested in participatory interests for his or her benefit.

49. Determination of amount available for distribution

In determining the amount available for distribution per class of participatory interest in a portfolio, the amount remaining after deducting all permissible deductions proportionately per class, excluding the manager’s service charge, must be allocated proportionately to each class of participatory interest. In each class the payments in lieu of income accruals received during that accounting period will be added to the amount so allocated plus any amount
carried forward per class of participatory interest less the manager's service charge per class and the balance must be distributed to investors.

50. Charges and method of calculation

50.1 The service charge in respect of classes of participatory interests shall consist of –

a monthly amount for the administration of the scheme in respect of a class of participatory interests of a portfolio, whether accrued daily or not, based on an annual percentage rate of the proportionate market value of the total assets of a portfolio (excluding per class of participatory interests income accruals and permissible deductions).

50.2 The manager may, subject to clause 50.1, change any charge of a class of participatory interests of a portfolio or change the method of calculation of such charge or introduce an additional charge: Provided that any such change or introduction of an additional charge that could result in an increase of charges for existing investors is of no force unless the manager has given not less than 3 months written notice to every investor and has affected the necessary amendments to this deed or such supplemental deed.

51. Payment of service charge
As soon as practicable after the end of each calendar month, the trustee/custodian must pay to the manager in respect of a class of participatory interests of a portfolio, proportionately from the Income Account, the service charge referred to in clause 50.1 for each day of the respective calendar month:

Provided that if there is a shortfall in the Income Account of a particular class of participatory interests –

51.1 participatory interests in that class of participatory interests may be issued to the manager; or

51.2 an amount in respect of that class of participatory interests proportionately deducted from the Capital Account may be paid to the manager,

equal in value to such shortfall.".
PART IX : REGISTER OF INVESTORS

52. Register of investors

A register of investors in respect of each portfolio must be kept by the manager and the manager may for this purpose appoint transfer secretaries acceptable to the trustee/custodian. The remuneration of the transfer secretaries must be paid by the manager out of its own funds and the manager is liable for any act or omission, dishonesty or negligence on the part of a transfer secretary, when acting as such.

53. Contents of register

The manager must enter in the register of each portfolio the name and address of each investor, the number of participatory interests held by each investor and the serial number of his or her certificate, if any, or account number; the date of entry and, if participatory interests are transferred, a sufficient reference to the name and address of the transferor. If new participatory interests are created, the manager must enter the number of such participatory interests in the register.
54. **Register is evidence**

The register is proof that a registered investor is the owner of the participatory interests registered in his or her name. The manager need not recognise any trust or other right affecting the ownership of a participatory interest or the rights incidental thereunto unless such trust or other right is recorded in a trust instrument as defined in the Trust Property Control Act, 1988 (Act No. 57 of 1988).

55. **Change of name or address**

If an investor wishes to register a change of name or address such investor must give notice thereof in writing to the manager who must change the register accordingly.

56. **Inspection of register**

The trustee/custodian may at all reasonable times during business hours inspect a register. Any other person may inspect the register during business hours on payment of a fee determined by the manager.
57. **Closing of register**

A register may be closed at such times and for such period as the manager may with the approval of the trustee/custodian determine:
Provided that it may not be closed for more than 14 consecutive days or more than 30 days in any period of twelve months.

58. **Death, insolvency or other disability of investor**

58.1 The manager may require such evidence of the death, insolvency or other disability of an investor as it may think fit.

58.2 On the death of any one of joint investors, the survivor(s) shall be the only person(s) recognised by the manager as having any title to or interest in the participatory interest in respect of which they are registered.

58.3 The executor or administrator of a deceased investor, or the trustee of an insolvent investor, or the curator of an investor under a legal disability (not being one of several investors) including the trustee/custodian in respect of this scheme (if appointed as executor, administrator, trustee or curator) shall be the only persons recognised by the manager as having any title to or interest in a participatory interest held by the deceased, insolvent or disabled investor.

58.4 Any person becoming entitled to a participatory interest in terms of clauses 58.2 or 58.3, upon producing such evidence as sustains the
capacity in which he or she seeks to act or of his or her title as the manager considers sufficient and on delivering of the relevant certificate (if any) to the manager for cancellation, may (subject to the rights of any joint investor) elect either to be registered himself or herself or to have some other person nominated by him or her to be registered as an investor and subject to clause 45 to have a new certificate issued in his or her name, or in the name of his or her nominee, as the case may be. If the person so becoming entitled elects to be registered himself or herself, he or she shall deliver or send to the manager a notice in writing in a form prescribed by the manager, signed by him or her, stating that he or she so elects. If he or she elects to have his or her nominee registered he or she must testify his or her election by executing in favor of his or her nominee, a transfer of such a participatory interest. All the provisions of this deed relating to the transfer of a participatory interest are applicable to any such notice of transfer as if the death, insolvency or other disability of the investor had not occurred and the notice of transfer were a notice of transfer executed by such investor.

58.5 A person entitled to a participatory interest in terms of clauses 58.2 or 58.3 may receive and may give a discharge for all monies payable in respect of such participatory interest: Provided that he or she may not receive notices of or take part in any ballot of investors until he or she has been registered as an investor.
58.6 The trustee/custodian may hold in trust any monies payable in respect of a participatory interest in respect of which any person is entitled to be registered, or a participatory interest in respect of which a person is entitled to transfer, until such person or his or her nominee has been registered as an investor.

59. **Participatory interest owned by manager**

The manager is deemed to hold participatory interests, and is treated for all purposes of this deed as an investor, during such times as there is no other person registered or entitled to be registered as an investor in respect of such participatory interests. All such participatory interests are deemed to be in issue. Nothing herein contained prevents the manager from becoming an investor.

60. **Transfer of participatory interest**

Every investor may transfer a participatory interest held by him or her by a written instrument in such form as the manager may approve: Provided that no transfer may be registered if the registration thereof would result in the transferor or the transferee becoming the holder of a lesser number of participatory interests than is prescribed by the manager. The instrument of transfer accompanied by such evidence as the manager may require to prove the title of the transferor or his or her
right to transfer the participatory interest (together with any necessary declarations or other documents) must be duly completed and executed by the transferor and (unless otherwise determined by the manager) by the transferee, and must be lodged with the manager, and within 14 days thereafter the manager must register the transferee referred to in such instrument of transfer as an investor and must, if required, issue to such transferee a new certificate representing the participatory interest so transferred. The transferor remains entitled to the participatory interest to be transferred until the name of the transferee is entered in the register in respect thereof. No transfer or purported transfer of a participatory interest, other than a transfer made in accordance with this clause, entitles the transferee to be registered in respect thereof nor may any notice of such transfer or purported transfer be entered in the register. The manager must retain all instruments of transfer.

61. Balance certificate

If only some of the participatory interests represented by any certificate are transferred, the transferor is, subject to the terms of this deed, entitled to a new certificate free of charge in respect of the balance of such participatory interests.
62. **Liability for transfer cost**

In all cases where the transfer of participatory interests between an investor and the manager is effected, the manager is liable for the payment of all costs necessarily incurred in connection with such transfer. In all other cases the costs so incurred are the liability of the persons concerned and not of the manager and the manager may charge a fee determined by the manager, for each transfer.

63. **Cancellation of participatory interest**

Only the manager may effect a reduction in a class of participatory interests of a portfolio by means of a cancellation of a participatory interest in that class of participatory interests in that class of participatory interest, subject to surrender of the appropriate certificate of a participatory interest to the manager and confirmation by the manager that the appropriate participatory interest has been struck from the register of investors. The manager must retain records, which may be inspected by the trustee at all reasonable times during business hours, of the number of participatory interests in a class of participatory interests so cancelled and the amount paid to the manager in respect thereof, which amount must be calculated in terms of clause 64. Before effecting a reduction, the manager must ensure that a portfolio includes (or will include upon completion of the sale of
assets which may have to be sold as a result of the cancellation of a participatory interest in a class of participatory interests) sufficient cash to pay the amount payable to the manager upon such reduction.

64. **Payment to manager for cancelled participatory interest**

If a manager cancels a participatory interest in a class of participatory interests, the manager is entitled to receive out of a portfolio in respect of that participatory interest cancelled, an amount determined in terms of clause 27 on the date of the notice to cancel. The said amount must be paid to the manager out of cash forming part of the portfolio concerned and against surrender to the trustee of the certificates to be cancelled or against delivery to the trustee of particulars of the participatory interest in that class of participatory interests to be cancelled in respect of which no certificate is outstanding. Upon such payment and surrender or delivery the participatory interest in question is cancelled.
PART X : FINANCIAL MATTERS

65. Financial year-end of manager and portfolio

The financial year-end of the manager and of each portfolio of the scheme is the end of xxx of each year.
66. Deed binding on all parties

This deed is binding on the trustee/custodian, the manager and an investor and any person claiming through them as if such investor or person had been a party to this deed.

67. Amendment of deed and balloting of investors

The consent of investors for an amendment of this deed must be obtained in the following manner:

67.1 Where such an amendment only affects one or more than one class of participatory interests in a portfolio, the investors, excluding the manager, holding no less than 25% in value of the total number of participatory interests then issued in that class of participatory interests or those classes of participatory interests of that portfolio, as the case may be, must respond in writing in a ballot conducted by the manager. The amendment must be consented to by investors holding a majority in value of the participatory interests held by the investors who have responded.

67.2 Where the amendment affects more than one or all the portfolios in the scheme, investors, excluding the manager, holding no less than 25 per
cent in value of the total number of participatory interests then issued in those portfolios affected, must respond in writing. The amendment must be consented to by investors holding a majority in value of the participatory interests held by the investors who have responded.

67.3 If investors holding less than 25 per cent in value of the total number of participatory interests then issued have responded in accordance with clauses 67.1 and 67.2, a second ballot must be conducted. In this ballot investors holding a majority in value of the participatory interests held by the investors who have responded, must consent to the amendment.

67.4 Every registered investor may vote in the case of a ballot in respect of each participatory interest held by him/or her: Provided that an investor or his or her duly authorised representative may exercise all his or her voting rights, but is not obliged to exercise all his or her votes or exercise all the votes he or she is entitled to in the same way.

67.5 When a ballot is necessary the manager must dispatch to every investor a ballot paper and a memorandum approved by the Registrar containing the reasons for the proposed amendment.

67.6 For the purposes of clauses 67.1, 67.2 and 67.3 only ballot papers which are received by the manager within thirty business days after dispatch to investors may be taken into account and be regarded as valid. Ballot papers must be counted by the auditors of the scheme and their finding, as conveyed in writing to the manager, is final and binding.
67.7 Where a registered investor is holding participatory interests as a nominee or person duly appointed to act on behalf of the beneficial owners of such participatory interests, the nominee or such person must obtain written instructions from such owners as to how to respond to the proposed amendment of this deed.

67.8 If, for the purposes of clause 67.7, some beneficial owners are in favour of the proposed amendment but others are against it, the nominee or such person must respond accordingly and for that purpose the nominee or such person may respond in favour of and against the proposed amendment.

67.9 The provisions of clauses 67.1, 67.2 and 67.3, which deal with the weighting of the response by an investor, also apply in the case of the responses by a nominee or such appointed person.

68. **Copies of deed and inspection thereof**

A copy of this deed must at all times during normal business hours be made available by the manager or the trustee/custodian at their respective head offices for the inspection by an investor or a prospective purchaser of a participatory interest. Any investor is entitled to receive from the manager a copy of this deed on production of his or her certificate or other acceptable evidence of his or her holding, upon request to the manager and on payment to the manager of such amount as the manager may require for each copy of the deed.
The manager must on request and at its expense supply to the trustee/custodian such copies of this deed as the trustee/custodian may require.

69. **Payment to investor**

Any monies payable under this deed to an investor must be paid by crossed cheque marked “not transferable” and made payable to or to the order of, and sent through the post to the registered address of such investor, or be paid or delivered in such other manner as the manager and the trustee/custodian consider, in the interests of the investor, to be safe and convenient, or in the case of joint investors may be made payable to or to the order of and sent through the post to the registered address of that one of the joint investors who is first named in the register, or otherwise as agreed, at his or her risk. If an investor or the joint investor who is first named in the register, gives a mandate in writing to the manager, in such form as the manager must approve, for payment to the bankers or other agent or nominee of the investor or joint investors, then the same must be sent through the post to the address given in such mandate, or otherwise be dealt with in accordance with such mandate. Payment as set out above is a good discharge to the manager and the trustee/custodian.
70. **Receipt by one of joint investors valid discharge**

The payment or posting to the joint investor who is first named in the register of any money payable to joint investors, or of a certificate, written notice or other document intended for joint investors, is deemed to be payment or posting to all such joint investors.

71. **Notices**

71.1 Any notice required to be served on an investor is deemed to have been duly given if sent by post to or delivered at his or her registered address and be deemed to have been served four days after the same was posted or delivered. In proving such service it shall be sufficient to prove that the envelope or wrapper containing the notice was posted. Any notice sent to an investor by means of a facsimile is deemed to have been served on the date of transmission. If so requested by an investor any notice may be sent electronically and is deemed to have been served on the same day it was sent.

71.2 Any notice or document sent by post to or delivered at the registered address of an investor is, notwithstanding that such investor is deceased, insolvent, or under any other legal disability, and whether or not the trustee/custodian or the manager has notice of his or her death, insolvency or other disability, deemed to have been duly served, and such service is deemed a sufficient service on all persons interested in
the participatory interests concerned, whether jointly with or as claiming through or under him or her.

71.3 The accidental omission to give notice to an investor, or the non-receipt of any notice by any investor, does not give rise to any claims by such investor against the scheme, the trustee/custodian or the manager, and does not invalidate any matter or thing done pursuant to or in terms of such notice.

71.4 Any notice between a manager and trustee/custodian shall be in writing.

72. Custody and disposal of documents

72.1 The manager may destroy or otherwise dispose of all instruments of transfer in its custody after the expiration of six years from the date of registration thereof and all certificates in its custody which have been cancelled at any time after the expiration of six years from the date of cancellation thereof and all registers, statements and other records and documents, other than this deed, relating to the scheme at any time after the expiration of six years from the termination of the scheme. The manager incurs no liability as a result of such destruction. Unless the contrary is proved, every instrument of transfer so destroyed is deemed to have been a valid and effective instrument, duly and properly registered, and every certificate so destroyed is deemed to have been a valid certificate, duly and properly cancelled.
72.2 This clause applies only to the destruction of a document in good faith and without notice of any claim or dispute, regardless of the parties thereto, to which the document might be relevant.

72.3 This clause does not apply to any document expressly excluded by the trustee/custodian by notice in writing to the manager.

73. **Electronic and telephonic transacting**

73.1 The manager and the trustee/custodian have agreed to allow for transacting via electronic and telephonic means, subject to clauses 73.2 and 73.3 and the consent of the investor.

73.2 If the investor consents to electronic or telephonic transacting, the investor must be fully apprised in the initial application form used for electronic and telephonic transacting and in all application forms posted on the manager’s website, of the conditions of electronic and telephonic transacting.

73.3 Such application forms must at least provide for –

73.3.1 the procedure to effect electronic or telephonic transacting and the costs involved;

73.3.2 the procedure for registration of an electronic or telephonic transaction;

73.3.3 the legal implications of such a transaction for the investor;

73.3.4 all disclaimers by the manager;
73.3.5 any limitation of liability afforded to the manager;
73.3.6 the security risks and risk of interception inherent to electronic and telephonic transacting;
73.3.7 related precautionary or security measures;
73.3.8 confirmation to investors that telephone calls are recorded and that such records shall be retained for a period of five years;
73.3.9 confirmation by the manager that its website complies with relevant legislative requirements applicable in the Republic;
73.3.10 a warning that taxation of other jurisdictions is not taken into account;
73.3.11 a warning that information contained on the website does not constitute advice.

73.4 The terms and conditions under which electronic or telephonic transacting will be done must be displayed on screen or verbally communicated, as the case may be.
74. **Signatures**

SIGNED AT ………………………………………. THIS ……………. DAY OF
……………………………………………….. 2005

AS WITNESSES:

1. ………………………

2. ………………………

For **XYZ Unit Trust Management Company Limited**

…………………………………………

Name: In his capacity as Managing Director who is duly authorized hereto.

SIGNED AT ………………………………………. THIS ……………. DAY OF
……………………………………………….. 2005

AS WITNESSES:

1. ………………………

2. ……………………… For **Nedbank Limited (the Trustee)**

…………………………………………

Name: In his capacity as Managing Director who is duly authorized
Chapter 1: 
Fundamental provisions 
Section 1: 
Scope and relation to other rules

X. – 1:101: Trusts to which this Book applies
(1) This Book applies to trusts created under Chapter 2 (Constitution of trusts).
(2) With appropriate modifications this Book also applies to trusts:
   (a) constituted by:
      (i) a declaration to that effect set out in an enactment; or
      (ii) a court order with prospective effect; or
   (b) arising by operation of law set out in an enactment relating to a matter not determined by these rules.
(3) In this Book, “court” includes a public officer or body, if authorised to act under the applicable national law, but does not include an arbitral tribunal.

X. – 1:102: Priority of the law of proprietary securities
In relation to trusts for security purposes, this Book is subject to the application of the rules in Book IX (Proprietary security in movable assets).

Section 2: 
Definition, special legal effects and parties

X. – 1:201: Definition of a trust
A trust is a legal relationship in which a trustee is obliged to administer or dispose of one or more assets (the trust fund) in accordance with the terms governing the relationship (trust terms) to benefit a beneficiary or advance public benefit purposes.
X. – 1:202: Special legal effects of a trust
(1) A trust takes effect in accordance with the rules in Chapter 10 (Relations to third parties) with the effect that the trust fund is to be regarded as a patrimony distinct from the personal patrimony of the trustee and any other patrimonies vested in or managed by the trustee.
(2) In particular (and except for some reason other than merely that the trust fund is vested in the trustee):
(a) the personal creditors of the trustee may not have recourse to the trust fund, whether by execution or by means of insolvency proceedings;
(b) the trust fund is not subject to rules allocating property rights on the basis of matrimonial or family relationships; and
(c) the trustee’s successors are not entitled to benefit from the trust fund on the trustee’s death.

X. – 1:203: Parties to a trust
(1) The truster is a person who constitutes or intends to constitute a trust by juridical act.
(2) The trustee is the person in whom the trust fund becomes or remains vested when the trust is created or subsequently on or after appointment and who has the obligation set out in X. – 1:201 (Definition of a trust).
(3) A beneficiary is a person who, according to the trust terms, has either a right to benefit or an eligibility for benefit from the trust fund.
(4) A trust auxiliary is a person who, according to the trust terms, has a power to appoint or remove a trustee or to consent to a trustee’s resignation.
(5) Except as otherwise provided for by this Book:
(a) a truster may also be a trustee or a beneficiary;
(b) a trustee may also be a beneficiary; and
(c) any of those parties to a trust may also be a trust auxiliary.
(6) In this Book a person’s “successor” is the heir or representative who under the law of succession becomes entitled to that person’s personal patrimony on that person’s death. Where the context permits, a reference to a party (or former party) to a trust is a reference to that person’s successor if that person has died.
X. – 1:204: Plurality of trustees
(1) Where there are several trustees, the trust is solidary.
(2) Where trust assets are vested in several trustees together, their co-ownership is joint.

X. – 1:205: Persons entitled to enforce performance of trustee’s obligations
(1) A beneficiary has a right to performance of the trustee’s obligations so far as they relate to that beneficiary’s right to benefit or eligibility for benefit.
(2) The persons who may enforce performance of the trustee’s obligations under a trust to advance public benefit purposes are:
   (a) any public officer or body having that function; and
   (b) any other person having sufficient interest in the performance of the obligations.
(3) A trustee may enforce performance of the obligations of a co-trustee.

X. – 1:206: Right to benefit and eligibility for benefit
(1) A person has a right to benefit if the trust terms require the trustee in given circumstances to dispose of all or part of the trust fund so as to confer a benefit on that person.
(2) A person has an eligibility for benefit if the trust terms permit the trustee in given circumstances to dispose of all or part of the trust fund so as to confer a benefit on that person, but whether or not that person is to obtain a benefit depends on an exercise of discretion by the trustee or another.
(3) A beneficiary’s eligibility for benefit becomes a right to benefit if the trustee gives the beneficiary notice of a decision to confer benefit on that beneficiary in accordance with the trust terms governing that eligibility.
(4) In this Book “benefit” does not include the exercise by a trustee of a right of recourse to the trust fund.
Section 3:
Modifications of and additions to general rules

X. – 1:301: Extended meaning of gratuitous
(1) In this Book “gratuitous” means done or provided without reward.
(2) A juridical act or a benefit is also regarded as gratuitous in this Book if, considering the value of the rights created by the juridical act or the benefit provided, the value of the reward is so trivial that fairness requires it to be disregarded.

X. – 1:302: Notice
(1) Where this Book requires notice to be given to a person, but it is not reasonably practical to do so, notice may be given instead to the court.
(2) Where there are several trustees, a requirement to give notice to the trustees is satisfied by giving notice to any one of them, but a notice relating to a change in trustees must be given to a trustee who will continue to be a trustee after the change takes effect.

X. – 1:303: Mandatory nature of rules
The rules of this Book are mandatory, except as otherwise provided.

Chapter 2:
Constitution of trusts
Section 1:
Basic rules on constitution by juridical act

X. – 2:101: Requirements for constitution
A trust is constituted in relation to a fund vested in the trustor, without any further requirement, if:
(a) the trustor declares an intention to constitute a trust in relation to that fund;
(b) the declaration satisfies the requirements set out in X. – 2:201 (Requirements for a declaration); and
(c) either X. – 2:102 (Constitution by transfer) or X. – 2:103 (Constitution without transfer) applies.
Chapter 2: Constitution of trusts

X. – 2:102: Constitution by transfer
(1) If the other requirements for constitution are satisfied, a trust is constituted when in implementation of the declaration the fund is transferred to a person who agrees to be a trustee or is identified in the declaration as a person who is or is to be a trustee.
(2) The rules on contracts for donation apply analogously to an agreement between truster and intended trustee for the transfer of the fund in the truster’s lifetime.
(3) Where the truster has made a binding unilateral undertaking to constitute a trust to a person who is intended to be a trustee of the fund, that person is a trustee of the right to performance of the obligation created by the undertaking, unless that right is rejected.

X. – 2:103: Constitution without transfer
(1) If the other requirements for constitution are satisfied, a trust is constituted by the declaration alone, without a transfer, if:
   (a) the declaration indicates that the truster is to be a sole trustee;
   (b) the declaration is testamentary and does not provide for a trustee; or
   (c) (i) the truster does all of the acts required of the truster to transfer the fund to the intended trustee,
       (ii) the intended trustee does not or cannot accept the fund, and
       (iii) the declaration does not provide otherwise.
(2) When a trust is constituted under paragraph (1), the truster becomes a trustee.

Section 2: Declaration

X. – 2:201: Requirements for a declaration
(1) The requirements referred to in Section 1 (Basic rules on constitution by juridical act) for a declaration of an intention to constitute a trust are that:
   (a) the declaration is made by the truster or a person who has authority to make it on the truster’s behalf; and
   (b) the declaration complies with any requirement as to form set out in X. – 2:203 (Formal requirements for declaration).
(2) No notice or publication of the declaration to any party is required.
X. – 2:202: Mode of declaration
(1) A person declares an intention to constitute a trust when that person by statements or conduct indicates an intention that the person in whom the fund is or is to be vested is to be legally bound as a trustee.
(2) In determining whether one or more statements contained in a testamentary or other instrument determining rights over an asset amount to a declaration of an intention to constitute a trust in relation to that asset, an interpretation of those statements which gives effect to their entirety is to be preferred.

X. – 2:203: Formal requirements for declaration
(1) Where the transfer of a fund requires the making of an instrument by the transferor, the declaration of an intention to constitute a trust is of no effect unless contained in the instrument of transfer or made in the same or an equivalent form.
(2) A declaration that the truster is to be the sole trustee is of no effect unless made in the same form as a unilateral undertaking to donate.
(3) Where the trust is to be created on the death of the maker of the declaration, the declaration is of no effect unless made by testamentary instrument.

X. – 2:204: Revocation or variation of declaration
(1) The maker of a declaration may revoke or vary the declaration or a term of the declaration at any time before the trust is constituted.
(2) A revocation or variation is of no effect unless it satisfies the formality requirements, if any, which applied to the declaration.
(3) However, a declaration or term set out in an instrument may be revoked by substantially destroying or defacing that instrument, so far as it relates to that declaration or term, if the applicable national rules permit a statement intended to have legal effect contained in such an instrument to be revoked by that means.

X. – 2:205: Effects when declaration does not satisfy requirements
If the fund is transferred to the intended trustee in implementation of a declaration which does not satisfy the requirements of X. – 2:201 (Requirements for a declaration), the transferee takes the fund on the terms of a trust to re-transfer the fund to the truster.
Section 3:  
Refusal of trust and rejection of right to benefit

X. – 2:301: Right of trustee to refuse the trust  
(1) If a person has become a trustee without agreeing to act when a trust is  
constituted, that person may refuse to act as a trustee by notice to:  
(a) the truster; or  
(b) any co-trustee who has full legal capacity and agrees to act as a  
trustee.  
(2) Refusal may take the form of either a rejection of all the rights which  
have vested or a disclaimer of the whole trust, but operates as both a  
rejection and a disclaimer.  
(3) A refusal may not be revoked.  
(4) Where a person reasonably incurs costs in order to refuse, that person  
has a right to be reimbursed by any co-trustees who accept the trust  
fund and agree to act or, if there are no such co-trustees, the truster.  
(5) Where a sole trustee refuses or there is no co-trustee who accepts the  
trust fund and agrees to act, the truster becomes a trustee of the fund in  
accordance with X. – 2:103 (Constitution without transfer) paragraph  
(1)(c), unless the declaration of the intention to constitute a trust pro-  
vides otherwise.  
(6) Subject to the previous paragraphs of this Article, the requirements for  
a refusal and its effects are determined by the application or analogous  
application of II. – 4:303 (Right or benefit may be rejected).

X. – 2:302: Rejection of right to benefit or eligibility for benefit  
A beneficiary’s right under II. – 4:303 (Right or benefit may be rejected) to  
reject a right to benefit or an eligibility for benefit is exercised by giving  
otice to the trustees.

Section 4:  
Additional rules for particular instances

X. – 2:401: Whether donation or trust  
(1) Where a person transfers an asset to another gratuitously and it is  
uncertain whether or to what extent the transferor intends to donate
the asset or to constitute a trust in respect of it for the benefit of the transferor, it is presumed that the transferor intends:
(a) to donate to the transferee, if this would be consistent with the relationship between the parties and past or concurrent dealings of the transferor;
(b) in any other case, that the transferee be a trustee for the benefit of the transferor.
(2) A presumption in paragraph (1) may be rebutted (and the alternative intention in paragraph (1) established) by showing that at the time of transfer the transferor did not or, as the case may be, did intend to dispose of the asset for the exclusive benefit of the transferee.
(3) Paragraphs (1) and (2) apply correspondingly where the transfer is to several transferees (including where the transfer is to the transferor and another).
(4) Where it is shown or presumed that the transferor intends to dispose of the fund for the benefit of a transferee only in part, or for the benefit of one transferee, but not a co–transferee, the transferor is to be regarded as intending to constitute a trust for the benefit of the transferee to that extent.

X. – 2:402: Priority of rules of succession law
Where the trust is to take effect on the truster’s death, the trust is subject to the prior application of those rules of succession law which determine:
(a) how the deceased’s estate is to be disposed of in satisfaction of the funeral costs and debts of the deceased; and
(b) (i) whether the truster was free to dispose of any part of the fund,
(ii) whether any person has a claim in respect of any part of the fund by reason of a family or other connection to the deceased, and
(iii) how such claims are to be satisfied.

X. – 2:403: Trust in respect of right to legacy pending transfer of legacy
Where a truster declares that a legatee is to be a trustee in relation to a legacy from the truster and that declaration satisfies the requirements set out in X. – 2:201 (Requirements for a declaration), but the legacy has not yet been transferred, the legatee is a trustee of the right against the truster’s successor which arises in respect of the legacy on the truster’s death.
Chapter 3:
Trust fund
Section 1:
Requirements for the initial trust fund

X. – 3:101: Trust fund
(1) Trust assets, whether or not of the same kind, form a single trust fund if they are vested in the same trustees and either:
   (a) the trust terms relating to the assets indicate that they form a single fund or require them to be administered together; or
   (b) separate trusts relating to the assets are merged in performance of the obligations under those trusts.
(2) Where trusts are constituted at the same time, on the same terms, and with the same trustees, the trust assets form a single trust fund unless the trust terms provide otherwise.
(3) In this Book “part of the trust fund” means a share of the trust fund, a specific asset or share of an asset in the fund, or a specific amount to be provided out of the fund.

X. – 3:102: Permissible trust assets
Trust assets may consist of proprietary or other rights, so far as these are transferable.

X. – 3:103: Ascertainability and segregation of the trust fund
(1) A trust is only created in relation to a fund in so far as, at the time the trust is to come into effect,
   (a) the fund is sufficiently defined in the trust terms or the assets forming the fund are otherwise ascertainable; and
   (b) the fund is segregated from other assets.
(2) A declaration of intention to create a trust in relation to an unsegregated fund is to be regarded, so far as the other terms of the declaration permit, as a declaration of an intention to create a trust of the entire mixture containing the fund on the terms that:
   (a) the trustee is obliged to segregate the intended trust fund; and
   (b) until the fund is segregated, the rights and obligations envisaged by the terms of the declaration apply in relation to a corresponding part of the mixture.
Section 2: Changes to the trust fund

X. – 3:201: Additions to the trust fund
(1) After a trust is created, an asset which is capable of being a trust asset becomes part of the trust fund if it is acquired by a trustee:
   (a) in performance of the obligations under the trust;
   (b) as an addition to or by making use of the trust fund;
   (c) by making use of information or an opportunity obtained in the capacity of trustee, if the use is not in accordance with the terms of the trust; or
   (d) when or after the trustee disposed of that asset otherwise than in accordance with the terms of the trust.
(2) Where there are several trustees, an asset may become part of the trust fund in accordance with this Article without being acquired by all of them.

X. – 3:202: Subtractions from the trust fund
(1) An asset ceases to be part of the trust fund when it ceases to be vested in a person who is under the obligation set out in X. – 1:201 (Definition of a trust).
(2) Where there are several trustees, an asset remains part of the trust fund so long as it is vested in at least one of the trustees in that capacity.

X. – 3:203: Mixing of the trust fund with other assets
(1) If trust assets are mixed with other assets vested in the trustee in such a way that the trust assets cease to be identifiable, a trust arises in respect of the mixture and VIII. – 5:202 (Commingling) applies analogously, as if each patrimony had a different owner, so as to determine the share of the mixture which is to be administered and disposed of in accordance with the original trust.
(2) If the other assets are the personal patrimony of the trustee, any diminution in the mixture is to be allocated to the trustee's personal share.
Chapter 4: Trust terms and invalidity

X. – 3:204: Loss or exhaustion of trust fund
(1) A trust ends when the trust fund has been completely disposed of in performance of the obligations under the trust or for any other reason there ceases to be a trust fund.
(2) Where the trustee is liable to reinstate the trust fund as a result of non-performance of obligations under the trust, the trust revives if the trust fund is reinstated.

Chapter 4:
Trust terms and invalidity
Section 1:
Trust terms

X. – 4:101: Interpretation
Without prejudice to the other rules on the interpretation of unilateral juridical acts, if the meaning of a trust term cannot otherwise be established, interpretations to be preferred are those which:
(a) give effect to the entirety of the words and expressions used;
(b) prevent reasonable conduct of a trustee from amounting to a non-performance;
(c) prevent or best reduce any incompleteness in provision for disposal of the trust fund; and
(d) confer on the truster a right to benefit or enlarge such right, if the trust is constituted gratuitously in the truster’s lifetime and the truster has or may have reserved such a right.

X. – 4:102: Incomplete disposal of the trust fund
(1) To the extent that the trust terms and the rules of this Book do not otherwise dispose of the trust fund in circumstances which have arisen, the trust fund is to be disposed of for the benefit of the truster.
(2) However, if the incomplete disposal of the trust fund arises because effect cannot be given to a trust for advancement of a public benefit purpose or because performance of the obligations under such a trust does not exhaust the trust fund, the trust fund is to be disposed of for the advancement of the public benefit purpose which most closely resembles the original purpose.
X. – 4:103: Ascertainability of beneficiaries
(1) A trust term which purports to confer a right to benefit is valid only if the beneficiary is sufficiently identified by the truster or is otherwise ascertainable at the time the benefit is due.
(2) A trust term which permits a trustee to benefit those members of a class of persons which the trustee or a third person selects is valid only if, at the time the selection is permitted, it can be determined with reasonable certainty whether any given person is a member of that class.
(3) A person may be a beneficiary notwithstanding that that person comes into existence only after the trust is created.

X. – 4:104: Ascertainability of right to benefit or eligibility for benefit
(1) A right to benefit or eligibility for benefit is valid only in so far as the benefit is sufficiently defined in the trust terms or is otherwise ascertainable at the time the benefit is due or to be conferred.
(2) If the benefit to be conferred is not ascertainable only because a third party cannot or does not make a choice, the trustees may make that choice unless the trust terms provide otherwise.

X. – 4:105: Trusts to pay creditors
A trust for the purpose of paying a debt, or for the benefit of a creditor as such, takes effect as a trust to benefit the debtor by a performance of the debtor’s obligation discharging the debtor.

Section 2: Invalidity

X. – 4:201: Avoidance by the truster
Without prejudice to other necessary adaptations, Book II Chapter 7 (Grounds of invalidity) is modified as follows in its application to trusts constituted gratuitously in the truster’s lifetime:
(a) the truster may avoid the trust or a trust term if the trust was constituted or the term included because of a mistake of fact or law, regardless of whether the requirements of II. – 7:201 (Mistake) paragraph (1)(b) are satisfied;
(b) a truster who was dependent on, or was the more vulnerable party in a relationship of trust with, a beneficiary may avoid the trust or a trust term in so far as it provides for benefit to that beneficiary unless that beneficiary proves that the beneficiary did not exploit the truster’s situation by taking an excessive benefit or grossly unfair advantage;

(c) the reasonable time for giving notice of avoidance (II. – 7:210 (Time)) does not commence so long as:
   (i) the truster exercises an exclusive right to benefit from the income; or
   (ii) the trust fund consists of one or more rights to benefit which are not yet due; and

(d) where sub-paragraph (c)(i) applies, acceptance of benefit is not to be regarded as an implied confirmation of the trust.

X. – 4:202: Protection of trustees and third parties after avoidance

(1) The trustee’s title to the trust fund is unaffected by avoidance.

(2) Unless the trustee knew or could reasonably be expected to know that the trust or trust term might be avoided:
   (a) a trustee is not liable in respect of any administration or disposition of the trust fund which was in accordance with the terms of the trust before the trust was avoided;
   (b) a trustee may invoke against the person entitled to benefit as a result of avoidance defences which the trustee could have invoked against the beneficiary who had a right to that benefit before avoidance; and
   (c) a trustee retains any right of recourse to the trust fund which arose before avoidance.

(3) Avoidance of the trust does not affect the rights of a third party who before avoidance acquired a beneficiary’s right to benefit, or a security right or other limited right in that right to benefit, if:
   (a) the third party neither knew nor had reason to know that the trust or trust term could be avoided; and
   (b) the disposition is not gratuitous.
X. – 4:203: Unenforceable trust purposes
(1) A trust which is for a purpose other than to benefit beneficiaries or to advance public benefit purposes takes effect as a trust for the trustor.
(2) The trustee has a revocable authority to dispose of the trust fund in accordance with the original trust for the advancement of the unenforceable purpose in so far as:
   (a) advancement of that purpose does not infringe a fundamental principle or mandatory rule and is not contrary to the public interest;
   (b) it can be determined with reasonable certainty whether any given disposal of the trust fund is or is not for its advancement; and
   (c) the disposal is not manifestly disproportionate to any likely benefit from that disposal.

Chapter 5:
Trustee decision-making and powers
Section 1:
Trustee decision-making

X. – 5:101: Trustee discretion
(1) Subject to the obligations of a trustee under this Book and exceptions provided for by other rules, the trustees are free to determine whether, when and how the exercise of their powers and discretions is best suited to performing their obligations under the trust.
(2) Except in so far as the trust terms or other rules provide otherwise, the trustees are not bound by, and are not to regard themselves as bound by, any directions or wishes of any of the parties to the trust or other persons.
(3) The trustees are not obliged to disclose the reasons for the exercise of their discretion unless the trust is for the advancement of a public benefit purpose or the trust terms provide otherwise.

X. – 5:102: Decision-making by several trustees
If there are several trustees, their powers and discretions are exercised by simple majority decision unless the trust terms or other rules of this Book provide otherwise.
Chapter 5: Trustee decision-making and powers

X. – 5:103: Conflict of interest in exercise of power or discretion
Unless the trust terms provide otherwise, a trustee may not participate in a decision to exercise or not to exercise a power or discretion if the effect of the decision is to confer, confirm, or enlarge a right to benefit or eligibility for benefit in favour of the trustee.

Section 2:
Powers of a trustee
Sub-section 1:
General rules

X. – 5:201: Powers in general
(1) Except where restricted by the trust terms or other rules of this Book, a trustee may do any act in performance of the obligations under the trust which:
   (a) an owner of the fund might lawfully do; or
   (b) a person might be authorised to do on behalf of another.

(2) Subject to restrictions or modifications in the trust terms, the other Articles of this Section provide for the powers of a trustee in particular cases.

X. – 5:202: Restriction in case of minimum number of trustees
(1) Where there are fewer trustees than a minimum required by the trust terms or these rules, the trustees may only exercise:
   (a) a power to appoint trustees;
   (b) the right to apply to court for assistance;
   (c) a right under X. – 6:201 (Right of reimbursement and indemnification out of the trust fund); and
   (d) any other right or power of a trustee to the extent that its exercise is:
      (i) expressly provided for in the circumstances by the trust terms;
      (ii) necessary for the preservation of the trust fund; or
      (iii) necessary for the satisfaction of trust debts whose performance is due or impending.

(2) If the trust is constituted by a transfer to at least two trustees the minimum number of trustees is two, unless the trust terms provide otherwise.
Sub-section 2: Particular powers of a trustee

X. – 5:203: Power to authorise agent
(1) The trustees may authorise an agent to act on behalf of the trustees and, subject to the restrictions set out in the following Articles of this Section, may entrust to another performance of obligations under the trust.
(2) Several trustees may authorise one of them to act on their behalf.
(3) However, personal performance by a trustee is required for decisions as to whether or how to exercise:
   (a) a discretion to confer benefit on a beneficiary or to choose a public benefit purpose to be advanced or its manner of advancement;
   (b) a power to change the trustees; or
   (c) a power to delegate performance of obligations under the trust.
(4) A person to whom performance of an obligation is entrusted has the same obligations as a trustee, so far as they relate to that performance.
(5) A trustee is obliged not to conclude, without good reason, a contract of mandate which is not in writing or which includes the following terms:
   (a) a term conferring an irrevocable mandate;
   (b) terms excluding the obligations of an agent set out in Book IV. D., Chapter 3, Section 1 (Main obligations of agent) or modifying them to the detriment of the principal;
   (c) a term permitting the agent to subcontract;
   (d) terms permitting a conflict of interest on the part of the agent;
   (e) a term excluding or restricting the agent’s liability to the principal for non-performance.
(6) The trustees are obliged to keep the performance of the agent under review and, if required in the circumstances, give a direction to the agent or terminate the mandate relationship.

X. – 5:204: Power to transfer title to person undertaking to be a trustee
(1) The trustees may transfer trust assets to a person who undertakes to be a trustee in relation to the assets and to dispose of them as the original trustees direct and in default of any such direction to transfer them back to the original trustees on demand.
(2) The recipient must be:
   (a) a person who gives such undertakings in the course of business;
   (b) a legal person controlled by the trustees; or
   (c) a legal person designated in an enactment as eligible to carry out
       such a trust obligation or satisfying requirements set out therein for
       this purpose
(3) X. – 5:203 (Power to authorise agent) paragraphs (5) and (6) apply correspondingly.

X. – 5:205: Power to transfer physical control to a storer
(1) The trustees may place trust assets and documents relating to those
    assets in the physical control of a person who undertakes to keep the
    trust assets safe and to deliver them back to the trustees on demand.
(2) X. – 5:204 (Power to transfer title to person undertaking to be a trus-
    tee) paragraphs (2) and (3) apply correspondingly.

X. – 5:206: Power to delegate
A trustee may entrust to another the performance of any of the trustee's
obligations under the trust and the exercise of any of the trustee’s powers,
including the exercise of a discretion, authority to dispose of trust assets
and the power to delegate, but remains responsible for performance in ac-
cordance with III. – 2:106 (Performance entrusted to another).

X. – 5:207: Power to select investments
In so far as the trustees are obliged to invest the trust fund, the trustees may
invest in any form of investment and determine the particular manner of
investment which is best suited to fulfil that obligation.

X. – 5:208: Power to submit trust accounts for audit
Where appropriate, a trustee may submit the trust accounts for an audit by
an independent and competent auditor.
Chapter 6:
Obligations and rights of trustees and trust auxiliaries
Section 1:
Obligations of a trustee
Sub-section 1:
General rules

X. – 6:101: General obligation of a trustee
(1) A trustee is obliged to administer the trust fund and exercise any power to dispose of the fund as a prudent manager of another’s affairs for the benefit of the beneficiaries or the advancement of the public benefit purposes, in accordance with the law and the trust terms.
(2) In particular, a trustee is obliged to act with the required care and skill, fairly and in good faith.
(3) Except in so far as the trust terms provide otherwise:
   (a) these obligations include the particular obligations set out in X. – 6:102 (Required care and skill) and the following sub-section; and
   (b) an administration or disposal of the trust fund is of benefit to a beneficiary only if it is for that person’s economic benefit.

X. – 6:102: Required care and skill
(1) A trustee is required to act with the care and skill which can be expected of a reasonably competent and careful person managing another’s affairs, having regard to whether the trustee has a right to remuneration.
(2) If the trustee is acting in the course of a profession, the trustee must act with the care and skill that is expected of a member of that profession.

Sub-section 2:
Particular obligations of a trustee

X. – 6:103: Obligations to segregate, safeguard and insure
(1) A trustee is obliged to keep the trust fund segregated from other patrimony and to keep the trust assets safe.
(2) In particular, a trustee may not invest in assets which are especially at risk of misappropriation unless particular care is taken for their safe-
keeping. Where the asset is a document embodying a right to a performance which is owed to whoever is the holder of the document, such care is taken if the document is placed in a storer’s safekeeping in accordance with X. – 5:205 (Power to transfer physical control to a storer).

(3) So far as it is possible and appropriate to do so, the trustee is obliged to insure the trust assets against loss.

X. – 6:104: Obligation to inform and report
(1) A trustee is obliged to inform a beneficiary who has a right to benefit of the existence of the trust and that beneficiary’s right.
(2) A trustee is obliged to make reasonable efforts to inform a beneficiary who has an eligibility for benefit of the existence of the trust and that beneficiary’s eligibility.
(3) In determining what efforts are reasonable for the purposes of paragraph (2), regard is to be had to:
   (a) whether the expense required is proportionate to the value of the benefit which might be conferred on that beneficiary;
   (b) whether the beneficiary is a member of a class whose members the trustee is required to benefit; and
   (c) the practicalities of identifying and communicating with the beneficiary.
(4) So far as appropriate, a trustee is obliged to make available information about the state and investment of the trust fund, trust debts, and dispositions of trust assets and their proceeds.

X. – 6:105: Obligation to keep trust accounts
A trustee is obliged to keep accounts in respect of the trust funds (trust accounts).

X. – 6:106: Obligation to permit inspection and copying of trust documents
(1) A trustee must permit a beneficiary or other person entitled to enforce performance of the obligations under the trust to inspect the trust documents and to make copies of them at that person’s own expense.
(2) Paragraph (1) does not apply to:
   (a) the opinions of a legal adviser relating to actual or contemplated legal proceedings by the trustees in that capacity against the per-
son seeking inspection; and evidence gathered for such proceedings;

(b) communications between the trustees and other beneficiaries and any other communications whose disclosure would result in a breach of confidence owed by the trustees in that capacity to another.

The trustees may refuse inspection and copying of trust documents so far as these relate to information which is confidential to the trustees in that capacity if the beneficiary does not provide adequate assurance that the confidentiality will be maintained.

Unless the trust is for the advancement of public benefit purposes, the trustees may also refuse inspection and copying of documents so far as the documents disclose the reasons for the trustees' decision to exercise or not to exercise a discretion, the deliberations of the trustees which preceded that decision, and material relevant to the deliberations.

The trust terms may enlarge the rights of inspection and copying which are provided for by this Article.

In this Book “trust documents” are:

(5) (a) any documents containing the trustor's declaration of intentions relating to the trust (whether or not intended to be binding) and any juridical act or court order varying the trust terms;

(6) (b) minutes of meetings of the trustees;

(c) records made and notices and other communications in writing received by a trustee in that capacity, including the opinions of a legal adviser engaged by a trustee at the trust fund's expense;

(d) any documents containing juridical acts concluded or made by the trustees;

(e) receipts for disposal of trust assets; and

(f) the trust accounts.

X. – 6:107: Obligation to invest

(1) A trustee is obliged to invest the trust fund, so far as available for investment, and in particular:

(a) to dispose of assets which ordinarily neither produce income nor increase in value and to invest the proceeds;
(b) to take professional advice on investment of the fund, if the trustees lack the expertise required for the efficient and prudent investment of funds of the size and nature of the trust fund;
(c) to make a spread of investments in which overall:
   (i) the risks of failure or loss of particular investments are diversified; and
   (ii) the expected gain significantly outweighs the potential failure or loss;
unless the trust fund is so small that a spread of investments is inappropriate; and
(d) to review at appropriate intervals the suitableness of retaining or changing the investments.

(2) A trustee is not obliged to invest assets:
   (a) which are imminently required for transfer to or use by a beneficiary or for satisfaction of a trust debt; or
   (b) whose investment would otherwise impede the trustees in carrying out their other obligations under this Book.

(3) The obligation to invest does not authorise a trustee to dispose of trust assets which according to the trust terms are to be retained by the trustees or transferred in kind to a beneficiary.

X. – 6:108: Obligation not to acquire trust assets or trust creditors’ rights
(1) A trustee is obliged not to purchase a trust asset or the right of a trust creditor against the trustees, whether personally or by means of an agent.
(2) A contract for the sale of a trust asset which is concluded as a result of non-performance of this obligation may be avoided by any other party to the trust or any person entitled to enforce performance of the obligations under the trust.
(3) The right to avoid is in addition to any remedy for non-performance.
(4) This Article applies with appropriate modifications to other contracts for the acquisition or use of a trust asset or a right corresponding to a trust debt.
X. – 6:109: Obligation not to obtain unauthorised enrichment or advantage
(1) A trustee is obliged not to make use of the trust fund, or information or an opportunity obtained in the capacity of trustee, to obtain an enrichment unless that use is authorised by the trust terms.
(2) A trustee may not set off a right to performance from a beneficiary, which is owed to the trustee in a personal capacity, against that beneficiary’s right to benefit.

X. – 6:110: Obligations regarding co-trustees
A trustee is obliged to:
(a) cooperate with co-trustees in performing the obligations under the trust; and
(b) take appropriate action if a trustee knows or has reason to suspect that:
   (i) a co-trustee has failed to perform any obligation under, or arising out of, the trust, or such non-performance is impending; and
   (ii) the non-performance is likely to result or have resulted in loss to the trust fund.

Section 2:
Rights of a trustee

X. – 6:201: Right to reimbursement and indemnification out of the trust fund
A trustee has a right to reimbursement or indemnification out of the trust fund in respect of expenditure and trust debts which the trustee incurs in performance of the obligations under the trust.

X. – 6:202: Right to remuneration out of the trust fund
(1) A trustee has a right to such remuneration out of the trust fund as is provided for by the trust terms.
(2) Unless this is inconsistent with the trust terms, a trustee who acts as a trustee in the course of a profession has a right to reasonable remuneration out of the trust fund for work done in performance of the obligations under the trust.
(3) Paragraph (2) does not apply if:
   (a) the trustee, in the capacity of beneficiary, is entitled to significant
       benefit from the trust fund; or
   (b) the trust was created as a result of a contract between the trustee
       and the truster; or
   (c) the trust is for the advancement of public benefit purposes.

X. – 6:203: Rights in respect of unauthorised acquisitions
(1) This Article applies where:
   (a) a trustee acquires an asset or other enrichment as a result of a non-
       performance of an obligation under the trust; and
   (b) the asset becomes part of the trust fund or the enrichment is added
       to the trust fund in performance of an obligation to disgorge.
(2) The trustee has a right to reimbursement or indemnification for any
    expenditure or obligation which it was necessary to incur to make the
    acquisition. If the trustee previously satisfied in full or in part a liability
    under X. – 7:201 (Liability of trustee to reinstate the trust fund), the
    trustee has a right to reimbursement from the trust fund to the extent
    that after the acquisition the trust fund is more than reinstated.
(3) The trustee also has a right to reasonable remuneration if:
    (a) the acquisition was made in good faith to increase the trust fund;
    and
    (b) the trustee would be entitled to remuneration under X. – 6:202
        (Right to remuneration out of the trust fund) paragraph (2)(b) if
        the acquisition had been in performance of an obligation under the
        trust.
(4) If the acquisition resulted from a non-performance of the obligation
    under X. – 6:109 (Obligation not to obtain unauthorised enrichment or
    advantage) to which a beneficiary validly consented, the trustee may
    waive the rights under paragraphs (2) and (3) and take over the con-
    senting beneficiary’s right to benefit from the acquisition.
(5) A trustee is not entitled under this Article to more than the value of the
    acquisition.
X. – 6:204: Corresponding rights against beneficiaries
(1) Where the right of a trustee under X. – 6:201 (Right to reimbursement and indemnification out of the trust fund) exceeds the trust fund, the trustee may recover the excess from the beneficiaries.
(2) The liability of a beneficiary under paragraph (1) is:
   (a) limited to the enrichment which that beneficiary has obtained in accordance with the trust terms; and
   (b) subject to the defence of disenrichment, VII. – 6:101 (Disenrichment) applying with appropriate adaptations.
(3) The right to recover under paragraph (1) ends six months after the right to reimbursement or indemnification has arisen.

X. – 6:205: Right to insure against personal liability at trust fund’s expense
(1) A trustee has a right to reimbursement or indemnification out of the trust fund in respect of expenditure or a debt which the trustee reasonably incurs to obtain insurance against liability under X. – 7:201 (Liability of trustee to reinstate the trust fund).
(2) Paragraph (1) does not apply in so far as:
   (a) the trustee has a right to remuneration for performing the obligations under the trust; or
   (b) the insurance is against liability arising out of a non-performance which is intentional or grossly negligent.

Section 3:
Obligations of a trust auxiliary

X. – 6:301: Obligations of a trust auxiliary
(1) A trust auxiliary is obliged to disclose the identity of the trustees if this information is known to the trust auxiliary and is not otherwise apparent.
(2) In deciding whether to exercise a power a trust auxiliary is obliged:
   (a) to act in good faith; and
   (b) not to obtain an enrichment which is not authorised by the trust terms.
Chapter 7: Remedies for non-performance
Section 1: Specific performance, judicial review and ancillary remedies

X. – 7:101: Specific performance
(1) The enforcement of specific performance of an obligation under the trust includes the prevention of a trustee from disposing of or otherwise dealing with a trust asset otherwise than in accordance with the terms of the trust.
(2) Specific performance cannot be enforced if performance requires a trustee to exercise a discretion.

X. – 7:102: Judicial review
(1) On the application of a party to the trust or a person entitled to enforce performance of an obligation under the trust, a court may review a decision of the trustees or a trust auxiliary whether or how to exercise a power or discretion conferred on them by the trust terms or this Book.
(2) A former trustee who has been removed by the trustees or a trust auxiliary without the trustee’s consent has a corresponding right to judicial review of that decision.
(3) A court may avoid a decision of the trustees or a trust auxiliary which is irrational or grossly unreasonable, motivated by irrelevant or improper considerations, or otherwise an abuse of power or outside the powers of the trustees or the trust auxiliary.

X. – 7:103: Further remedies
Other rules may provide for:
(a) accounts and inquiries concerning the trust fund and its administration and disposal, as directed by court order;
(b) payment or transfer into court of money or other assets in the trust fund;
(c) the appointment by court order of a receiver to administer a trust fund;
(d) the exercise of rights and powers of a trustee by a public officer or body, in particular in relation to trusts to advance public benefit purposes;
(e) suspension of the rights and powers of the trustees to administer and dispose of the fund;
in cases of actual or suspected non-performance of the obligations under the trust.
Section 2:
Reparation and disgorgement of unauthorised enrichment

X. – 7:201: Liability of trustee to reinstate the trust fund
(1) A trustee is liable to reinstate the trust fund in respect of loss caused to
the trust fund by non-performance of any obligation under, or arising
out of, the trust, if the non-performance:
(a) is not excused; and
(b) results from the trustee’s failure to exercise the required care and
skill.
(2) However, a person is liable under paragraph (1) only if that person
knew, or it was manifest, that that person was a trustee.
(3) A trustee is not liable merely because a co-trustee, an agent or other
person entrusted with performance, or an authorised recipient of trust
assets has caused loss to the trust fund.
(4) Paragraph (3) does not prejudice any liability of the trustee arising:
(a) under paragraph (1) out of the trustee’s own non-performance of
an obligation under the trust, in particular:
(i) an obligation to act with the required care and skill when
choosing to appoint or engage that person and agreeing the
terms of the engagement; or
(ii) the obligation to keep the performance of that person under
review and, if required in the circumstances, to take measures
to protect the trust fund; or
(b) out of delegation of performance (X. – 5:206 (Power to delegate));
(c) under VI. – 3:201 (Accountability for damage caused by employees
and representatives); or
(d) because the trustee induced, assisted or collaborated in that per-
son’s non-performance.
(5) III. – 3:702 (General measure of damages) applies with appropriate
adaptations to determine the measure of reinstatement.
(6) The following rights of a trustee are suspended until the trustee has
completely reinstated the trust fund:
(a) any right of recourse to the trust fund; and
(b) any right to benefit which the trustee has in the capacity of ben-
eficiary.
(7) This Article is subject to the trust terms.
Chapter 7: Remedies for non-performance

X. – 7:202: Liability of trustee to compensate a beneficiary
(1) A trustee who is liable under X. – 7:201 (Liability of trustee to reinstate the trust fund) is also obliged to compensate a beneficiary who, despite reinstatement of the trust fund, does not obtain a benefit to which that beneficiary was entitled or, if there had been no failure of performance, would have been entitled under the trust terms.
(2) The beneficiary has the same right to compensation as arises from non-performance of a contractual obligation.
(3) This Article is subject to the trust terms.

X. – 7:203: Disgorgement of unauthorised enrichment
Where a trustee obtains an enrichment as a result of non-performance of the obligation under X. – 6:109 (Obligation not to obtain unauthorised enrichment or advantage) and that enrichment does not become part of the trust fund under X. – 3:201 (Additions to the trust fund), the trustee is obliged to add the enrichment to the trust fund or, if that is not possible, to add its monetary value.

Section 3: Defences

X. – 7:301: Consent of beneficiary to non-performance
(1) A trustee has a defence to liability to the extent that reinstatement, compensation or disgorgement would benefit a beneficiary who validly consented to the non-performance.
(2) A beneficiary consents to a non-performance when that beneficiary agrees to conduct of the trustee which amounts to a non-performance and either:
   (a) the beneficiary knew that such conduct would amount to a non-performance; or
   (b) it was manifest that such conduct would amount to a non-performance.
(3) Paragraph (1) applies whether or not the non-performance enriched or disadvantaged the beneficiary who consented.
(4) Where a beneficiary participates in the non-performance in the capacity of trustee, paragraph (1) applies in relation to any co-trustees who are liable. A right of recourse between the solidary debtors as regards

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any residual liability to reinstate the trust fund or compensate a beneficiary is unaffected. 

(5) A consent is not valid if it results from a mistake which was caused by false information given by the trustee or the trustee’s non-performance of an obligation to inform.

X. – 7:302: Prescription
The general period of prescription for a right to performance of an obligation under a trust does not begin to run against a beneficiary until benefit to that beneficiary is due.

X. – 7:303 Protection of the trustee
(1) A trustee is discharged by performing to a person who, after reasonable inquiry, appears to be entitled to the benefit conferred.
(2) The right of the beneficiary who was entitled to the benefit against the recipient of the benefit arising under Book VII (Unjustified enrichment) is unaffected.

Section 4:
Solidary liability and forfeiture

X. – 7:401: Solidary liability
(1) Where several trustees are liable in respect of the same non-performance, their liability is solidary.
(2) As between the solidary debtors themselves, the shares of liability are in proportion to each debtor’s relative responsibility for the non-performance, having regard to each debtor’s skills and experience as a trustee.
(3) A debtor’s relative responsibility for a non-performance to which that debtor consented is not reduced merely because that debtor took no active part in bringing it about.

X. – 7:402: Forfeiture of collaborating beneficiary’s right to benefit
(1) Where a beneficiary collaborated in a trustee’s non-performance, a court may order on the application of that trustee or another beneficiary that the right to benefit of the beneficiary who collaborated be forfeited.
(2) The right to benefit of a beneficiary who validly consented to the non-performance, but did not collaborate in it, may be forfeited only to the extent that the beneficiary has been enriched by the non-performance. 

(3) To the extent that a beneficiary's right to benefit is forfeited under this Article, benefit which is otherwise due to that beneficiary is to be applied so as to satisfy the trustee's liability until either the liability is extinguished or the right to benefit is exhausted.

Chapter 8: 
Change of trustees or trust auxiliary 
Section 1: 
General rules on change of trustees

X. – 8:101: Powers to change trustees in general
(1) After the creation of a trust, a person may be appointed a trustee and a trustee may resign or be removed:
(a) in accordance with a power:
   (i) under the trust terms or
   (ii) conferred on the trustees by this Section; or
(b) by court order under this Section.
(2) The exercise of a power within paragraph (1)(a) is of no effect unless it is in writing. The same applies to a binding direction to trustees regarding the exercise of such a power.
(3) An exercise of a power under the trust terms by a person who is not also a continuing trustee does not take effect until notice is given to the continuing trustees.
(4) The resignation or removal of a sole trustee is effective only if a substitute trustee is appointed at the same time.

X. – 8:102: Powers to change trustees conferred on trustees
(1) The powers conferred by this Section on trustees may only be exercised:
(a) by unanimous decision; and
(b) if in the circumstances a trust auxiliary does not have a corresponding power or the trust auxiliary cannot or does not exercise such a power within a reasonable period after a request to do so by the trustees.
(2) Subject to paragraph (1), the trustees are obliged to exercise their powers under this Section in accordance with any joint direction by the
beneficiaries if the beneficiaries have a joint right to terminate the trust in respect of the whole fund. 

(3) The trust terms may modify or exclude the powers conferred by this Section on trustees.

Section 2: 
Appointment of trustees

X. – 8:201: General restrictions on appointments
(1) An appointment of a person as trustee is of no effect if:
   (a) it is manifest that the co-trustees would have power to remove that person, if appointed, on grounds of that person’s inability, refusal to act, or unsuitability;
   (b) the person appointed does not agree to act as trustee; or
   (c) the appointment exceeds a maximum number of trustees provided for by the trust terms.
(2) A provision in the trust terms that there is to be only one trustee takes effect as a maximum of two.

X. – 8:202: Appointment by trust auxiliary or trustees
(1) The trustees may appoint one or more additional trustees.
(2) The continuing trustees may appoint a substitute trustee for a person who has ceased to be a trustee.
(3) Unless the trust terms provide otherwise, a self-appointment by a trust auxiliary is of no effect.

X. – 8:203: Appointment by court order
On the application of any party to the trust or any person entitled to enforce performance of an obligation under the trust, a court may appoint:
(a) a substitute trustee for a person who has ceased to be a trustee, or
(b) one or more additional trustees,
   if in the circumstances:
   (i) no one else is able and willing to exercise a power to appoint; and
   (ii) the appointment is likely to promote the efficient and prudent administration and disposal of the trust fund in accordance with the trust terms.
Section 3:
Resignation of trustees

X. – 8:301: Resignation with consent of trust auxiliary or co-trustees
(1) A trust auxiliary who may appoint a substitute trustee in the event of the trustee’s resignation may consent to a resignation.
(2) A trust auxiliary may consent to a resignation without the consent of the continuing trustees only if a substitute trustee is appointed at the same time.
(3) The continuing trustees may consent to a resignation.
(4) A trustee may only resign with the consent of a trust auxiliary or co-trustees if after resignation there will be at least two continuing trustees or a special trustee.
(5) Special trustees, for the purposes of this Book, are:
   (a) any public officer or body having the function of acting as a trustee; and
   (b) any legal persons designated as such in an enactment or satisfying requirements set out in an enactment for this purpose.

X. – 8:302: Resignation with approval of court
A court may approve the resignation of a trustee who cannot otherwise resign if it is fair to release the trustee from obligations under the trust, having regard in particular to whether after resignation an efficient and prudent administration and disposal of the trust fund in accordance with the trust terms can be secured.

Section 4:
Removal of trustees

X. – 8:401: Removal by trust auxiliary or co-trustees
(1) Where a court might remove a trustee on grounds of inability, refusal to act, or unsuitability, the continuing trustees may remove that trustee.
(2) The removal of a trustee by a trust auxiliary or the trustees does not take effect until notice of the removal is given to the trustee who is to be removed.
X. – 8:402: Removal by court order
(1) On the application of any party to the trust, a court may remove a trustee without that trustee’s consent and regardless of the trust terms if it is inappropriate for the trustee to remain a trustee, in particular on grounds of the trustee’s:
(a) inability;
(b) actual or anticipated material non-performance of any obligation under, or arising out of, the trust;
(c) unsuitability;
(d) permanent or recurrent fundamental disagreement with co-trustees on a matter requiring a unanimous decision of the trustees; or
(e) other interests which substantially conflict with performance of the obligations under, or arising out of, the trust.

Section 5:
Effect of change of trustees

X. – 8:501: Effect on trustees’ obligations and rights
(1) A person who is appointed a trustee becomes bound by the trust and acquires the corresponding rights and powers. Subject to the following paragraphs of this Article, a trustee who resigns or is removed is released from the trust and loses those rights and powers.
(2) The obligation to cooperate with co-trustees does not end until the expiry of a reasonable period after resignation or removal.
(3) A former trustee’s right of recourse to the trust fund takes effect as a right against the continuing trustees. A right to reimbursement, indemnification or remuneration by a beneficiary is unaffected.
(4) A former trustee remains bound by:
(a) the obligation in X. – 6:109 (Obligation not to obtain unauthorised enrichment or advantage);
(b) trust debts; and
(c) obligations arising from non-performance.

X. – 8:502: Vesting and divesting of trust assets
(1) Title to a trust asset vests in a person on appointment as a trustee, without a court order to that effect, if that title is:
(a) capable of transfer by agreement between a transferor and a transferee without the necessity for any further act of transfer or formality; or
(b) regarded under the applicable national law as vested in the trustees as a body.

(2) The vesting of an asset in a person who is appointed a trustee does not divest any continuing trustees.

(3) A person who resigns or is removed as a trustee is divested correspondingly.

X. – 8:503: Transmission of trust documents
A continuing or substitute trustee is entitled to the delivery up of trust documents in the possession of a former trustee. The person in possession has the right to make and retain copies at that person’s own expense.

X. – 8:504: Effect of death or dissolution of trustee
(1) Where one of several trustees dies or a corporate trustee is dissolved, the trust fund remains vested in the continuing trustees. This applies to the exclusion of any person succeeding to a deceased or dissolved trustee’s other patrimony.

(2) Where a sole trustee dies, the deceased trustee’s successors become trustees and accordingly:
(a) the trustee’s successors become subject to the trust and acquire the corresponding rights and powers;
(b) the trustee’s successors become liable for trust debts incurred by the deceased trustee to the extent of the deceased trustee’s estate; and
(c) the trust fund vests in the trustee’s successors, but the trustee’s successors may only exercise the powers set out in X. – 5:202 (Restriction in case of minimum number of trustees) paragraph (1), regardless of the number of successors.

(3) A trustee’s testamentary disposition of the trust fund is of no effect, but the trust terms may confer a testamentary power to appoint a trustee.

(4) Obligations arising from non-performance devolve on the deceased trustee’s successor.
Section 6:
Death or dissolution of trust auxiliary

X. – 8:601: Effect of death or dissolution of trust auxiliary
A power of a trust auxiliary ends when the trust auxiliary dies or is dissolved, but the trust terms may permit a testamentary exercise of the power.

Chapter 9:
Termination and variation of trusts and transfer of rights to benefit
Section 1:
Termination
Sub-section 1:
General rules on termination

X. – 9:101: Modes of termination
A trust in respect of a fund or part of a fund may be terminated:
(a) by a truster or beneficiaries in accordance with a right provided for by the trust terms;
(b) by a truster in accordance with X. – 9:103 (Right of truster to terminate a gratuitous trust);
(c) by a beneficiary in accordance with X. – 9:104 (Right of beneficiaries to terminate);
(d) by a trustee under X. – 9:108 (Termination by trustee);
(e) by merger of rights and obligations under X. – 9:109 (Merger of right and obligation).

X. – 9:102: Effect of termination on trustee’s liabilities
(1) To the extent that the trust is terminated the trustee is discharged.
(2) Unless the parties concerned agree otherwise, termination of the trust does not release a trustee from liability:
   (a) to a beneficiary arising out of the trustee’s non-performance of any obligation under, or arising out of, the trust; or
   (b) to a trust creditor.
Sub-section 2: Termination by truster or beneficiaries

X. – 9:103: Right of truster to terminate a gratuitous trust
(1) Except as provided for by paragraphs (2) and (3), a truster has no implied right to terminate a trust or a trust term merely because the trust was constituted gratuitously, irrespective of whether:
(a) the trust was constituted without a transfer by the truster;
(b) the truster reserved a right to benefit during the truster’s lifetime.
(2) A truster may terminate a gratuitously constituted trust, or a term of such a trust, which is for the benefit of a person who does not yet exist.
(3) A truster may terminate a gratuitously constituted trust for the benefit of another to the same extent that the truster might have revoked a donation to that beneficiary if the benefit had been conferred by way of donation.

X. – 9:104: Right of beneficiaries to terminate
(1) A beneficiary of full legal capacity may terminate the trust in respect of a fund or part of the fund which is for that beneficiary’s exclusive benefit.
(2) If each is of full legal capacity, several beneficiaries have a corresponding joint right to terminate the trust in respect of a fund or part of the fund which is for the exclusive benefit of those beneficiaries.
(3) A trust may not be terminated in respect of part of the fund if this would adversely affect the trust in respect of the rest of the fund for the benefit of other beneficiaries or for the advancement of public benefit purposes.

X. – 9:105: Meaning of “exclusive benefit”
(1) A fund or part of a fund is to be regarded as for a beneficiary’s exclusive benefit if all of that capital and all of the future income from that capital can only be disposed of in accordance with the trust terms for the benefit of that beneficiary or that beneficiary’s estate.
(2) For the purposes of paragraph (1) the possibility that the beneficiary might give a consent, or might fail to exercise a right adverse to that beneficiary’s own benefit, is to be disregarded.
X. – 9:106: Notice of termination and its effects

(1) A truster or beneficiary exercises a right to terminate by giving notice in writing to the trustees.

(2) A trust or part of a trust which is terminated by the truster takes effect from that time as a trust for the benefit of the truster.

(3) Where a beneficiary, exercising a right to terminate, instructs the trustee to transfer to someone other than the beneficiary, notice of termination vests in that person the right to benefit from the fund or part of the fund which is to be transferred.

(4) Unless the transfer is impossible or unlawful, the trustee is obliged to transfer the fund or part of the fund in accordance with the notice of termination and without delay. The obligation to transfer supersedes the obligation to administer and dispose of the fund or part in accordance with the trust terms.

(5) If a transfer is impossible because it would require the grant of an undivided share in an asset for which undivided shares are not allowed, the trustee is obliged:
   (a) to divide the asset and transfer the divided share, so far as this is possible and reasonable; and otherwise
   (b) to sell the asset, if this is possible, and transfer the corresponding share of the proceeds.

(5) The trust is terminated when and to the extent that the required transfer is made.

X. – 9:107: Trustee’s right to withhold

(1) A trustee may withhold such part of the fund which is to be transferred as is needed to satisfy:
   (a) trust debts;
   (b) the trustee’s accrued rights of recourse to the fund; and
   (c) the costs of transfer and of any required division or sale of an asset, so far as those debts, rights and costs are allocated to the part of the fund which is to be transferred.

(2) The right to withhold ends if the person exercising the right to terminate pays compensation for the debts, rights and costs allocated to the part of the fund which is to be transferred.
Sub-section 3:
Other modes of termination

X. – 9:108: Termination by trustee
(1) Where a beneficiary has a right to terminate a trust under X. – 9:104 (Right of beneficiaries to terminate) paragraph (1), a trustee may give a notice to that beneficiary requiring that beneficiary to exercise that right within a period of reasonable length fixed by the notice. If the beneficiary fails to do so within that period, the trustee may terminate the trust by a transfer to that beneficiary. The beneficiary is obliged to accept the transfer.
(2) A trustee may also terminate the trust by payment of money or transfer of other assets of the trust fund into court where other rules so provide.

X. – 9:109: Merger of right and obligation
(1) A trust ends when the sole trustee is also the sole beneficiary and the trust fund is for that beneficiary’s exclusive benefit.
(2) Where there are several trustees, paragraph (1) applies correspondingly only if they have a joint right to benefit.
(3) If a trust subsists in relation to the beneficiary’s right to benefit or the right to benefit is encumbered with a security right or other limited right, the trustee remains bound by that trust or encumbrance.

Section 2:
Variation

X. – 9:201: Variation by truster or beneficiary
(1) The trust terms may be varied by a truster or beneficiary in accordance with:
   (a) a right provided for by the trust terms;
   (b) the right provided for by paragraph (2).
(2) A truster or beneficiary who has a right to terminate a trust has a corresponding right to vary the trust terms so far as they relate to the fund or part of the fund in respect of which the trust might be terminated.
(3) The exercise by several beneficiaries of a joint right to vary the trust terms requires their agreement to that effect.
(4) A variation which is to take effect from the death of the person exercising the right to vary is of no effect unless it is made by testamentary instrument.

(5) A variation does not take effect until notice in writing is given to the trustees.

X. – 9:202: Variation by court order of administrative trust terms
(1) On the application of any party to the trust or any person entitled to enforce performance of obligations under the trust, a court may vary a trust term relating to the administration of the trust fund if the variation is likely to promote a more efficient and prudent administration of the fund.

(2) A variation under paragraph (1) may not significantly affect the operation of the trust terms governing its disposal unless the court also has power to vary those terms under one of the following Articles.

X. – 9:203: Variation by court order of trusts for beneficiaries
(1) On the application of any party to the trust or any person who would benefit if the term to be varied were removed, a court may vary a trust term which confers a right to benefit or eligibility for benefit on a person who:
   (a) does not yet exist; or
   (b) does not presently conform to a description, such as membership of a class, on which the right depends.

(2) The same applies where the trust term confers a right to benefit or eligibility for benefit at a remote time in the future or which is conditional on the occurrence of an improbable event.

X. – 9:204: Variation by court order of trusts for public benefit purposes
(1) On the application of any party to the trust or any person entitled to enforce performance of obligations under the trust, a court may vary a trust term which provides for the advancement of a public benefit purpose if, as a result of a change of circumstances, the advancement of the particular purpose provided for by the trust term cannot be regarded as a suitable and effective use of resources.

(2) A variation under paragraph (2) must be in favour of such general or particular public benefit purposes as the truster would probably have
chosen if the truster had constituted the trust after the change in circumstances.

Section 3:
Transfer of right to benefit

X. – 9:301: Transfer by juridical act of right to benefit
(1) Subject to the other paragraphs of this Article, the transfer by juridical act of a right to benefit is governed by Book III Chapter 5 Section 1 (Assignment of rights).
(2) A gratuitous transfer is of no effect unless it is made in writing.
(3) A transfer which is to take effect on the death of the transferor takes effect only in accordance with the applicable law of succession.

Chapter 10:
Relations to third parties
Section 1:
General provisions on creditors

X.–10:101: Basic rule on creditors
(1) A person to whom a trustee owes a trust debt (a trust creditor) may satisfy that person’s right out of the trust fund (in accordance with X. – 10:202 (Rights of trust creditors in relation to the trust fund)), but other creditors may not except in so far as these rules provide otherwise.
(2) Paragraph (1) does not affect any right of a creditor of a party to a trust to invoke a right of that party relating to the trust fund.

X.–10:102: Definition of trust debt
(1) An obligation is a trust debt if it is incurred by the trustee:
(a) as the owner for the time being of a trust asset;
(b) for the purposes of, and in accordance with the terms of, the trust;
(c) in the capacity of trustee and by a contract or other juridical act which is not gratuitous, unless the creditor knew or could reasonably be expected to know that the obligation was not incurred in accordance with the terms of the trust;
(d) as a result of an act or omission in the administration or disposition of the trust fund or the performance of a trust debt; or
(e) otherwise materially in connection with the trust patrimony.

(2) The obligations of trustees to reimburse, indemnify or remunerate a former trustee or an intended trustee who has exercised a right of refusal are also trust debts.

(3) Other obligations of a trustee are not trust debts.

Section 2:
Trust creditors

X.—10:201: Rights of trust creditors against the trustee
(1) A trustee is personally liable to satisfy trust debts.
(2) Unless the trustee and the trust creditor agree otherwise:
(a) liability is not limited to the value of the trust fund at the time the trust creditor’s right to performance is enforced; and
(b) subject to the rules on change of trustees, liability does not end if the trust fund ceases to be vested in the trustee.
(3) A party to a contract is not to be treated as agreeing to exclude or limit liability merely because the other party discloses that that other party is concluding the contract in the capacity of trustee.

X.—10:202: Rights of trust creditors in relation to the trust fund
A trust creditor may satisfy a right out of the trust fund:
(a) to enforce performance of a trustee’s personal liability under X. — 10:201 (Rights of trust creditors against the trustee); or
(b) in the exercise of a security right in trust assets.

X.—10:203: Protection of the truster and beneficiaries
A truster or beneficiary is not in that capacity liable to a trust creditor.
Section 3:
Trust debtors

X.–10:301: Right to enforce performance of trust debtor’s obligation
(1) Where a trustee has a right to performance and that right is a trust asset, the right to enforce performance of the obligation of the debtor (the trust debtor) accrues to the trustee.
(2) Paragraph (1) does not affect:
(a) a beneficiary’s right to performance by the trustee of obligations under the trust in respect of the right against the trust debtor; or
(b) procedural rules which allow a beneficiary to be a party to legal proceedings against the trust debtor to which the trustee is also a party.

X.–10:302: Set-off
A trustee’s right against a trust debtor may only be set off against:
(a) a right corresponding to a trust debt; or
(b) a beneficiary’s right to benefit out of the trust fund.

X.–10:303: Discharge of trust debtor
The discharge of a trust debtor by a trustee is of no effect if:
(a) the discharge is not in performance of the trustee’s obligations under the trust; and
(b) (i) the discharge is gratuitous; or
   (ii) the debtor knows or has reason to know that the discharge is not in performance of the trustee’s obligations under the trust.

Section 4:
Acquirers of trust assets and rights encumbering trust assets

X.–10:401: Liability of donees and bad faith acquirers
(1) Where a trustee transfers a trust asset to another and the transfer is not in accordance with the terms of the trust, the transferee takes the asset subject to the trust if:
(a) the transfer is gratuitous; or
(b) the transferee knows or could reasonably be expected to know that
the transfer is by a trustee and is not in accordance with the terms
of the trust.

A transferee on whom a trust is imposed under paragraph (1) has a
(2) corresponding right to a return of any benefit conferred in exchange.
The trust imposed under paragraph (1) is extinguished if:
(3) (a) benefit which was provided by the transferee in exchange is dis-
posed of in performance of an obligation under the trust; or
(b) the trustee or a third party satisfies an obligation to reinstate the
trust fund.

A transferee can reasonably be expected to know a matter if:
(4) (a) it would have been apparent from a reasonably careful investiga-
tion; and
(b) having regard to the nature and value of the asset, the nature and
costs of such investigation, and commercial practice, it is fair and
reasonable to expect a transferee in the circumstances to make that
investigation.

This Article applies correspondingly where a trustee creates a security
right or other limited right in a trust asset in favour of another.

(5)

Section 5:
Other rules on liability and protection of third parties

X.—10:501: Liability for inducing or assisting misapplication
of the trust fund

(1) Non–contractual liability arising out of damage caused to another by
virtue of VI. – 2:211 (Loss upon inducement of non-performance of
obligation) is modified as provided for by paragraph (2).

(2) A person who intentionally induces a trustee's non-performance of an
obligation under the trust, or intentionally assists such non-perform-
ance, is solidarily liable with that trustee, if the trustee is liable to re-
instatethe trust fund.
X.–10:502: Protection of third parties dealing with trustees
(1) A contract which a trustee concludes as a result of a non-performance of an obligation under the trust with a person who is not a party to a trust is not void or avoidable for that reason.
(2) In favour of a person who is not a party to the trust and as against a trustee, a person who has no knowledge of the true facts may rely on the apparent effect of a trust document and the truth of a statement contained in it.