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THE REGULATION OF UNIT TRUSTS AND TRUSTEES' POWERS TO INVEST IN THEM

As a trustee of a private trust, the range of investment options available today must seem particularly daunting, especially since beneficiaries themselves have greater access to financial information and are consequently better informed. Trustees may be tempted to simply buy into a unit trust. Some things, however, stand in the way. First, a trustee may be constrained to invest only in authorised unit trusts by section 7 and the First Schedule of the Trustees Act.[1] Even if not, the trustee must still be concerned whether an investment in such funds satisfies the duties of care and skill required of trustees. What does it mean to purchase a unit trust? In particular, is the regulation of such funds sound, and are there problems with delegating the private trustee's investment decision to the trustee or manager of a unit trust?

I. THE PROMOTION OF FUND MANAGEMENT

IN January 1998, the Report of the Sub-Committee on Finance and Banking of the Committee on Singapore's Competitiveness (the 'Report') listed 55 areas in which deregulation could help the development of Singapore's financial sector. The latter currently makes up 11% of the GDP and was the fastest growing sector at 12% per annum from 1986 to 1993 (compared to an average of 9.1% for all other sectors). From 1993 to 1996, however, it was the laggard *vis-à-vis* these other sectors at 7.2% (combined average 8.7%). Amongst the areas covered by the Report were: fund management, treasury/risk management, equities, general debt issuance, corporate finance and venture capital, insurance and reinsurance, and cross-border electronic banking. This paper is concerned with the fund management sector, in general, and the regulation of unit trusts in particular.

The Report recommended that public sector funds (including Singapore's foreign reserves) should be allocated to private sector fund managers on an expedited basis. The Government Investment Corporation of Singapore and the Monetary Authority of Singapore ('MAS') has since agreed to

[1] Cap 337, 1985 Rev Ed. Section 86 of the Act requires that new unit trusts be approved by the Ministry of Law before they receive authorised unit trust status.

distribute $25 billion and $10 billion respectively.[2] There is little doubt that size matters. In the United States, it is estimated that funds have to raise between US$50-100 million fairly rapidly to be viable.[3] In contrast, Singapore funds have struggled recently to raise $15-20 million. Without size, there is the lack of soft dollars to pay for investment research, now regulated in the United States by section 28 of the Securities Exchange Act 1934 (the 'Exchange Act'),[4] which enhances the competitive advantage of a fund. Economies of scale also allow for lower management and distribution fees.[5]

In June 1996, an estimated US$3.2 trillion was invested in mutual funds in the United States.[6] This industry finds its genesis in large long-term trusts managed by professional trustees and money management firms in Boston. Boston's natural advantages included the sophistication of its investing public and pool of professional trustees and fund managers. According to one commentator, the coming together of the Boston trustee and the dynastic trust resulted in the prudent investor rule that will be examined in detail later.[7] By contrast, it appears that only $3.5 billion is presently invested in unit trusts in Singapore.[8]

The Report also recommended that employees be allowed to elect to have their retirement funds placed with private pension funds rather than with the Central Provident Fund ('CPF') Board. Central to this proposal was the success of Hong Kong where the fund management sector grew from having to manage pension funds. However, it has for some time been

2 MAS Media Release, 13 November 1998 (http://www.mas.gov.sg/newspeeches).

3 "The Organisation and Operation of a Mutual Fund", Investment Company Institute (http://www.ici.org/issues).

4 S 28(e) provides a safe harbour where the investment adviser determines that the commission was reasonable given the value of the brokerage and research provided. An adviser's policy with respect to the use of soft dollars has to be disclosed in the registration statements of the adviser and investment company. However, the US SEC has reported that there is an industry-wide failure to comply with disclosure requirements: "Investment Advisers Get $1.7b in Rebates", *Straits Times*, 24 Sept 1998. In Singapore, such arrangements might infringe the Prevention of Corruption Act (Cap 241, 1985 Rev Ed). This is an issue that plagues many other jurisdictions: see *eg,* the Hong Kong Securities and Futures Commission's Consultation Paper, "Cash Commission Rebates and Soft Dollar Benefits Received by Portfolio Managers from Brokers", 14 December 1996, (http://www.hksfc.org.hk/eng/index.htm)

5 "Call for a More Balanced Look at Unit Trusts", *Business Times*, 5 December 1998.

6 United States General Accounting Office, Report to Congressional Committees, Mutual Funds – SEC Adjusted Its Oversight in Response to Rapid Industry Growth, May 1997 at 3. This figure exceeded insured commercial bank deposits by US$0.8 trillion.

7 L Friedman, "The Dynastic Trust" (1974) 73 Yale LJ 547 at 554. Those states without such traditions adhered to legal lists of authorised trustee investments (at 561).

8 *Supra*, note 5, although the Report states that the total amount of funds managed by financial institutions here was $125 billion, most in discretionary accounts.

possible for CPF funds to be invested in CPF-approved unit trusts under the CPF Investment Scheme, although the choice is quite restricted. It is important to note, however, that what is envisaged by the Report is not the traditional defined benefit employee pension schemes, where the employer promises a certain level of benefit at retirement. The trust regime is more suitable here since the fund may be partly funded by the employer, who bears the risk that the investments do not adequately cover the promised benefits.[9] In contrast, in the defined contribution plan, such as the popular 401(k) plan in the United States, the employee bears the risk of investment performance. In such plans, a tax-deferred portion of an employee's income, with the employer matching some of it, is set aside every month for investment in an employer-approved plan. Such plans do not require the paternalism of a defined benefit plan, and probably should be regulated differently.[10] It is also closer to what is intended in Singapore, which is to allow CPF savings to be invested in unit trusts as part of a range of investment options open to CPF account holders.

One criticism is that CPF funds cannot be mixed with other after-tax funds in the same unit trust. This may be valid, since 401(k) funds are pooled with other funds in the US. However, our laws do not strictly disallow such pooling; what is needed is for the CPF Board/Minister for Labour to recognise the units in the relevant unit trust as a security that CPF members may invest in.[11] Another criticism is the involvement of different Ministries in approving unit trusts. As we have seen, the Ministry of Labour is involved in CPF-approved unit trusts. Since most of the substantive unit trust regulation is found in the Companies Act,[12] the Ministry of Finance (particularly MAS and the Registrar of Companies and Businesses ('RCB')) is also involved, not least in the approval of trust deeds and corporate trustees of public unit trusts.[13] Unit trust regulation and administration should be rationalised, but it must be borne in mind that even more government bodies are involved

9 Even here, it has been suggested that the corporate form is more appropriate: Scane, "Occupational Pension Schemes: Is the Trust an Adequate Form of Provision?" in Waters ed, *Equity Fiduciaries and Trusts* (1993) at 359; but see Walker "Some Trust Principles in the Pensions Context" in Oakley ed, *Trends in Contemporary Trust Law* (1996) at 123.

10 *Protecting Investors: A Half Century of Investment Company Regulation*, May 1992, Ch 3. This is a publication of the US SEC's Division of Investment Management.

11 Central Provident Fund (Investment Schemes) Regulations (Cap 36, S 77(1)(m)). The administrative requirements for approval under the CPF Investment Scheme are more stringent than for normal unit trusts: see Information Booklet on Unit Trusts and Discretionary Fund Management Accounts under CPF Investment Scheme (which requirements override the MAS/RCB Handbook on Unit Trusts).

12 Cap 50, 1994 Rev Ed.

13 Ss 108 and 110 respectively. The MAS and RCB have prepared a Handbook on Unit Trusts to aid fund managers and trustees setting up unit trusts.

in mutual fund regulation in the United States. Mutual funds covered by the Investment Company Act 1940 ('Investment Company Act') are regulated by the Securities and Exchange Commission ('SEC'), whereas pension fund products under the Employee Retirement Income Security Act 1974 ('ERISA') come under the Department of Labour. Consequently, ERISA provides specifically that mutual funds with 401(k) funds and after-tax funds do not come under ERISA but the Investment Company Act, since fund managers of retail mutual funds would not know the source of the funds under their control. Bank collective trust funds are, in turn, controlled by the Comptroller of Currency, Department of Treasury, under separate regulations.[14]

Consequently, over-regulation may not be a major reason why the fund management sector has not developed as quickly as hoped.[15] There is, as another example, no Glass-Steagall Act or its equivalent here that once prevented US commercial banks from operating open-ended mutual funds.[16] Instead, it is suggested that there are a number of other important reasons why the mutual fund industry developed as it did in the United States. First, a large number of money market funds were crafted to look like bank accounts, with easy redemption masquerading as checking facilities. These low risk funds accounted for 41% of mutual fund assets in 1992.[17] The reason why such funds were preferred to bank accounts was because the Banking Act 1933 prohibited interest on checking accounts, and the Federal Reserve Board's Regulation Q controlled the level of interest payable on bank deposits.[18] When interest rates rose in the late 1970s, investors were encouraged to try out money market funds; the low risk of such funds obviating the need for deposit insurance. It was from there a small step to move into equity or growth funds, especially with the strong bull market in the 1990s. Presently, slightly less than 25% of mutual fund assets are

14 Fiduciary Powers of National Banks and Collective Investment Funds, 28 FR 3309 (1963) (codified as amended at 12 CFR 9).

15 According to the American Heritage Foundation, Singapore has overtaken Hong Kong as the world's freest economy, *Business Times*, 2 December 1998.

16 *Investment Company Institute* v *Camp*, 401 US 617 (1971). Although closed-end funds were not prohibited: *Board of Governors* v *Investment Company Institute*, 450 US 46 (1981). The position has been further liberalised, due largely to judicial deference to the views of the Federal Reserve Board: see Macey and Miller, *Banking Law and Regulation* (2nd ed, 1997) at 523, even though the Glass Steagall Act still survives despite widespread opposition: see "Gramm Seems to Doom Vote for the Passage of Banking Bill", *Wall Street Journal*, 10 October 1998.

17 *Protecting Investors, supra*, note 10, at xix.

18 Macey and Miller, *supra,* note 16, at 30.

in money market funds,[19] although all assets managed by mutual funds tripled from about US$1 trillion in 1990 to US$3.2 trillion by June 1996.[20]

The difficulty with setting up money market funds here was the lack of low risk fixed income assets for such funds to invest in. The Report was also concerned about the absence of a deep bond market, and this has been partly addressed by the issuance of debt instruments in the latter part of 1998 by a number of government-linked companies. However, this ties in with the next point, which is the unrealistic expectations of an investing public that prefers equity to debt, and real property to security. This is manifested in the expressed concerns of some members of the public about the failure of unit trusts to match the performance of a broad market index, without their understanding that this is a phenomenon even in the United States.[21] Once transaction costs are factored in, it is extremely difficult for professional funds to outperform broad market averages.[22] Investor education will thus be crucial to the success of the fund management industry. Stockpicking in a developed market is futile,[23] and leaves the investor holding 'uncompensated risk', *ie* a likelihood of deviation from an expected rate of return that can be diversified away without a reduction in the expected rate of return by modern techniques of portfolio management.

Indeed, the Report acknowledges that substantial CPF funds have been invested in real property, at the expense of the fund management sector.[24] One reason for the preference for real property is the perceived lack of residential land in Singapore. Given that more than 85% of Singaporeans live in government housing, some may have also believed in an implicit government guarantee that property prices would not be allowed to fall, a moral hazard which led to over-investment in real property.[25] The present fall in property values, and even more importantly, illiquid nature of property assets in a recession, may in the longer term prompt more investors to look seriously at unit trusts.

19 Investment Company Institute, *Perspective, Mutual Fund Developments in 1997*, at 2.

20 *Supra*, note 6.

21 *Supra*, note 5. See 'Trying to Beat the Index? Don't Bet On It', Asian Wall Street Journal, May 27 1999.

22 Langbein and Posner, "Market Funds and Trust Investment Law II", 1977 ABF Res J 1 at 2.

23 See *eg*, Langbein, "The Uniform Prudent Investor Act and the Future of Trust Investing" (1996) 81 Iowa Law Review 641 at 648-9.

24 The Report at 10.

25 Krugman, "What happened in Asia" (http://web.mit.edu/krugman/www/DISINTER.html).

II. Regulatory Choice

The Report also recommended that trust deeds be standardised to expedite the approval process, which can take up to 3 weeks for approval of a corporate trustee, and 6 weeks for approval of the unit trust scheme.[26] There is little doubt that a trust deed with boilerplate provisions would also go a long way to inspire investor confidence, particularly since trust deeds are fairly inaccessible. But this raises the issue that is the concern of the first part of this paper, which is the regime for regulating unit trusts. Our present position is based on older Australian company law legislation, which was updated in 1989 to provide greater protection to investors, particularly in the context of property trusts.[27] In 1998, their unit trust regulation was drastically amended – the Managed Investments Act 1998, which has been incorporated into Chap 5C of the Australian Corporations Law 1989, adopts a very different legislative framework.

Under our system, the manager has to hold a valid investment adviser's licence,[28] or if a bank, a banking licence under the Banking Act.[29] It has to issue a statement deemed to be a prospectus.[30] The contents of the latter are determined by Schedule 7 of the Companies Act and administrative guidelines promulgated by the MAS/RCB. The protection offered by a prospectus is minimal, however, since studies in the United States show that they are seldom read,[31] and in any case, subscription for unit trusts by ATM at participating banks effectively bypasses the formal protection offered by a prospectus.[32] Indeed, the SEC has now approved the use of mutual fund profiles, which is a truncated prospectus.[33]

In addition, Part IV, Division 6 of the Companies Act, supplemented by regulation 9 of the Companies Regulations 1987,[34] requires the following:

26 Handbook on Unit Trusts at 26-7.
27 Division 5 of Part 7.12 Corporations Law.
28 S 26, Securities Industry Act (Cap 289, 1985 Rev Ed).
29 Cap 19, 1985 Rev Ed. Banks do not require an investment adviser's licence.
30 S 113, Companies Act.
31 A Levett, "Taking the Mystery out of Mutual Funds", Boston Citizens Seminar, 25 February 1997, referring to a 1996 Investment Company Institute survey which found that only half of all investors in a fund read the prospectus before investing in it (http://www.sec.gov/news/speeches/spch146.txt).
32 The prospectus requirements are, in theory, mandated by s 43 of the Companies Act but ATM electronic share applications have been given a class order exemption under s 106B(2)(a) of the Companies Act.
33 The profile has to disclose that investors have the option to request a full prospectus before making an investment decision. It this option is not exercised, the full prospectus has to be provided when the funds confirm the investor's purchase.
34 Cap 50, Rg 1, 1990 Ed.

- an approved trust deed;
- an approved manager and trustee;
- certain statutory covenants in the deed, including buy-back provisions;
- the existence of the deed prior to an offer to the public for subscription of purchase of units;
- a register of unit-holders.

These requirements appear more comprehensive than those for shares and debentures in the Companies Act. One reason for this is that it is perceived that less sophisticated investors invest in participatory interests, which covers a broad spectrum of interests.[35] It must be recalled, however, that offerings of shares and debentures have to comply with listing requirements if they are to be traded publicly on a stock exchange. In the event, these extra controls for participatory interests are somewhat illusory, since the statutory covenants in section 111 of the Companies Act and Schedule 3 of the Trustees Act exist in general form only. In reality, much is left to the trust deed, although this has to be approved by the RCB and adhere to MAS guidelines. It was therefore asked whether this area of activity in Australia was previously excessively under-regulated.[36]

Australia has now adopted a different approach to the regulation of unit trusts. Under their Managed Investments Act 1998, each scheme will have a single responsible entity licensed by the Australian Securities and Investments Commission (ASIC), instead of a separate manager and trustee. There are no longer any prescribed provisions, although these entities have to submit compliance plans to ASIC for approval. There are stricter reporting requirements, and an independent compliance committee is also required if less than half of the directors of the responsible entity are external directors. In the United Kingdom, there is a comprehensive regime regulating unit trusts under the Financial Services Act 1986, and the regulations promulgated thereunder.[37] There is separate categorisation of securities funds, collective

[35] Baxt, Ford & Black, *Securities Industry Law* (5th ed, 1996) at para 210.
[36] Hughes, *The Law of Public Unit Trusts* (1992), 45-6.
[37] S 81(1) provides that regulations can be made to cover the constitution and management of authorised unit trust schemes, the powers and duties of the manager and trustee of any such scheme and the rights and obligations of the participants in any such scheme. S 81(3) provides that regulations under this section shall be binding on the manager, trustee and

investment schemes, money market funds and property funds. Where the latter, for example are concerned, liquidity concerns are paramount.[38] In the United States, mutual funds are effectively forced to adopt the corporate form under the Investment Company Act. The Act's requirements apply even to entities that are not incorporated but organised in the form of a business trust or limited partnership. The SEC has recently concluded that 'a contractual or UIF (unitary investment fund) structure is fundamentally incompatible with the regulatory philosophy of the Act, which relies on boards of directors to monitor investment company operations and resolve conflicts of interest.'[39]

The drawback with keeping unit trusts within the present Companies Act structure is that it is grouped together with other 'participatory interests', and this includes arrangements as diverse as timesharing arrangements and interests in ostrich farms. From one perspective it is over-inclusive, since some participatory interests give rise to fiduciary duties and others do not.[40] From the unit trust perspective, however, the arrangement is under-inclusive in its regulatory detail. Given that the Report, for example, recommends detailed investment guidelines for CPF funds,[41] this may be more appropriately dealt with by autonomous omnibus unit trust legislation. However, it often takes a crisis to precipitate change. The Australians began strengthening their legislation after their difficulties with real estate investment trusts in the early 1990s. In the UK, the predecessor of the Financial Services Act, the Prevention of Fraud (Investments) Act 1939 (later replaced by the 1958 Act), and the Investment Company Act in the United States, were both the consequence of serious financial mismanagement by promoters of collective funds that contributed to the market turmoil of that era. There

participants independently of the contents of the deed and, in the case of the participants, shall have effect as if contained in it. New Zealand also has separate unit trust legislation: Unit Trusts Act 1960.

38 Vaughan, *The Regulation of Unit Trusts* (1990), Ch 4.

39 *Protecting Investors, supra*, note 10, at 254.

40 Ford and Hardingham, "Trading Trusts: Rights and Liabilities of Beneficiaries" in Finn ed, *Equity and Commercial Relationships* (1987), at 49.

41 These state that:

- Not more than 10% of fund assets may be invested in securities issued by the same group of companies.
- Securities in which more than 5% of fund assets are invested, should not in aggregate exceed 40% of total assets.
- For securities issued or guaranteed by governments and government-related bodies which are rated 'AA' or better by international rating agencies, the 10% limit is raised to 35%, and the limit of 40% in aggregate value will not apply.
- Cash and Singapore Government Securities are excluded from these limits.

is some judicial notice here about the abuse of unit trusts,[42] and the relevant authorities and legislature would certainly be vigilant in this regard, especially as CPF funds move into the hands of private sector fund managers. Financial service regulation has been criticised as being aimed at a process, in contrast with, say, utility regulation, which focuses on an outcome.[43] This criticism is largely met by the Report, which is a wish-list of local and foreign bankers in Singapore, but there remains a place for economic regulation, safety regulation, as well as regulations enhancing information and protection for the consumer.[44]

In the UK, the challenges faced by the new Financial Services Authority in balancing the demands of institutional investors and consumers led a leading banking lawyer there to comment that "[a]s the private sector enhances its role as the provider of pension and other welfare requirements previously provided by the state, consumer protection becomes a high priority."[45] It will be argued that the corporate form may be the best vehicle for striking a balance between the promotion of financial activity and investor protection.

III. Conceptual Problems with the Unit Trust

The unit trust is a progeny of the deed of settlement company, effectively an unincorporated joint stock company. The then notion of a company was a bit different from today's conception – where directors managed the unincorporated association and trustees held the association's assets; the association being unable to hold property in its own name. The deed of settlement operated like present day articles of association. After incorporation became desirable due to the attraction of limited liability, the deed of settlement structure fell into disfavour except where collective investment schemes were concerned. Dr Sin argues that the trust form continued to be used here in part because of the influence of the unit investment trust in the United States.[46] As we have seen, however, the corporate structure now dominates the US collective investment landscape, particularly for actively managed funds.

Consequently, the major influences on the unit trust no longer exist, and it has been argued that "[a]t some point, the limitations of trust law must

42 *Tarling* v *DPP* [1981] 1 MLJ 173 at 175.
43 C Ford and J Kay, "Why Regulate Financial Services" in Oditah ed, *The Future of the Global Securities Market* (1996) at 145.
44 L White, *The S & L Debacle* (1991), 32-3.
45 W Blair [1998] Journal of International Banking Law 43 at 44.
46 *The Legal Nature of the Unit Trust* (1997), Ch 1.

begin to show."[47] The starting point is that the unit trust has no settlor, nor does it involve the settlement of property for beneficiaries. Instead, it involves capital contributions by unit-holders to an existing trust that was initially created by the trustee and manager, as well as monetary investments by future subscribers after allotment, to whom fiduciary duties may also be owed.[48] Being a trust, difficult questions of perpetuities and accumulations, and where the property devolves upon termination of the trust, arise.

Sin argues therefore that the trust analysis, while correct, is heavily overladen by the tripartite contractual relationship between trustee, manager and unit-holder. Consequently, all relevant interests are vested at the inception of the trust, so that later unit-holders take their assignments from present holders.[49] The same argument has been made in the context of memberships of unincorporated associations,[50] and indeed trust and contract are not mutually exclusive.[51]

However, there has to be a point beyond which there is no purpose in calling the entity a trust, if all its principles can be abrogated by contract. Professor Hayton thus states that while "there is no core duty of care (other than to act in good faith) that cannot be excluded in relation to investment... The duty to act in good faith (*ie*, honestly and consciously) in respect of any trust matter cannot, of course, be excluded. To do so would make a nonsense of the trust relationship as an obligation of confidence."[52]

It may then be legitimately queried whether unit trusts should be caught by the Companies Act prohibitions against large unincorporated business associations. Section 17(3) states:

> No company, association or partnership, consisting of more than 20 persons shall be formed for the purpose of carrying on any business that has for its objects the acquisition of gain by the company, association 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 written law in Singapore or letters patent.

47 YL Tan, "Selected Issues in Unit Trusts", Equity and Restitution in Commercial Practice, 19 November 1993, Faculty of Law NUS Continuing Legal Education Programme.

48 *Famel Pty Ltd* v *Burswood Management Ltd* (1989) 15 ACLR 572 at 582.

49 Sin, *supra*, note 45, at 106 *et al*, citing Barker J in *Howe* v *Morse* 174 Mass 491, 55 NE 213 (1899). See also Ford and Hardingham, *supra*, note 39 at footnote 10.

50 Tjio, "Contract, Property and Unincorporated Associations" (1993) 5 SAcLJ 112.

51 Langbein, "The Contractarian Basis of the Law of Trusts" (1996) 105 Yale LJ 625.

52 "The Irreducible Core Content of Trusteeship" in Oakley ed, *Trends in Contemporary Trust Law* (1996) at 57.

Jessel MR in *Sykes* v *Beadon*[53] certainly thought that a unit trust scheme was caught by this provision, although the still leading Court of Appeal authority *Smith* v *Anderson* disapproved his Lordship's decision soon after on the basis that there was insufficient mutuality between unit-holders for them to be in partnership; that investment in securities was not a business; and that if there were a business it was carried out by the trustees and not the unit-holders.[54] This though is a fiction but a necessary one since contravention of section 17(3) renders direct contracts with the unit trust invalid, and indirect contracts are valid only if the third party has no notice of the contravention.

The fiction is sometimes exposed. In *Gra-ham Australia Pty Ltd* v *Perpetual Trustees WA Ltd*[55] the trust deed contained rules stating that units were to be redeemed at net asset value seven days before the redemption request by the unit-holder. A unit-holder requested for redemption immediately after Black Monday on 19 October 1987. The majority of unit-holders then held a meeting to alter the terms of redemption to the current net asset value. Utilising corporate law principles, the court held that the majority was entitled to do so as long as they acted in the best interests of the unit trust.

While some academics warn against the direct import of company law principles,[56] we have seen that the contractually modified trust analysis is not completely satisfactory either. Professors Ford and Hardingham thus query: "Would the State be too paternalistic if it said to promoters of collective public investment for trading that their efforts should be channeled through a registered company? Such a requirement would enable investors to have ultimate control of the enterprise while enjoying limits on their liability."[57]

We shall examine some of the possible benefits of more detailed regulation, a number of which necessitate the corporate framework, within the context of unit trusts.

53 (1879) 11 Ch D 170.

54 (1880) 15 Ch D 247. For a detailed analysis of the case, see Sin, *supra*, note 45, at 131-146.

55 (1989) 1 WAR 65. Although the Court of Appeal noted that the provisions of the trust deed gave the majority the power to amend it.

56 Sin, *supra*, note 45, at 176, Ford and Hardingham, *supra*, note 39, at 79, fearing that aligning the interest of unit-holders with shareholders increases the likelihood that there is a partnership between the unit-holders and trustees, so that the beneficiaries could be made to assume the liabilities of the trustee.

57 *Supra*, note 39, at 84.

IV. Valuation and Redemption

One of the main advantages of the unit trust structure, particularly when companies were not allowed to repurchase their own shares, and even now, given the restrictive conditions imposed for such activity, is the liquidity of its units. This is facilitated by rules allowing the manager to redeem units when requested. Section 111(1)(b) of the Companies Act provides:

> ...
>
> (ii) that the management company will not sell any interest to which the deed relates otherwise than at a price calculated in accordance with the provisions of the deed;
>
> (iii) that the management company will, at the request of the holder of an interest, purchase that interest from the holder and that the purchase price will be a price calculated in accordance with the provisions of the deed;...

There is, however, no regulation to standardise the valuation or redemption process. In the United Kingdom, by contrast, managers are required to value the scheme's property at least twice a month.[58] The manager has, however, a choice of using a forward or historic pricing system.[59] Section 78(6) of the Financial Services Act 1986 provides that an authorised unit trust[60] has to provide for an investor to dispose of his units at a price related to the net value of the property to which the units relate.

By contrast, the Investment Company Act and SEC rules ensure that those securities that are widely quoted are valued at market value and those that are not must be valued at 'fair value' as determined by the Board of

58 Table 4.2 of the Financial Services (Regulated Schemes) Regulations 1991 ('1991 Regulations').

59 Regulation 4.26 of the 1991 Regulations.

60 S 76 of the Financial Services Act 1986 provides:

> ...[An] authorised person shall not –
>
> (a) issue or cause to be issued in the United Kingdom any advertisement inviting persons to become or offer to become participants in a collective investment scheme or containing information calculated to lead directly or indirectly to persons becoming or offering to become participants in such a scheme; or
>
> (b) advise or procure any person in the United Kingdom to become or offer to become a participant in such a scheme,
>
> unless the scheme is an authorised unit trust scheme or a recognised scheme under the ... provisions of this Chapter.

Directors according to their set of written procedures.[61] Mutual funds are required to calculate their current net asset value of their shares every day to set the per share price for purchases and redemptions on a forward basis, and payment must be made within 7 days of a request for redemption.[62]

Yet, more detailed regulation can also protect the unit trust (strictly the manager and trustee) from the actions of unit-holders. For those who believe that the real estate investment trust (REIT) is a panacea for investors in unit trusts and real property, the Australian experience should serve as a warning. Due to the downturn in commercial property prices in the late 1980s, many of such trusts had liquidity problems, and the Australian Government in July 1991 froze all redemptions. Rules are thus needed to deal with runs caused by massive redemptions, given the illiquidity of certain unit trust assets. One possibility mooted in Australia, since introduced by the Managed Investments Act 1998, was that redemption should only be possible in the case of illiquid schemes if the scheme has sufficient cash available.[63]

In the UK, managers are allowed to serve a notice on the unit-holder requiring the holder to accept a transfer of a proportion of the underlying property or securities, or if the holder so requires, to arrange its sale.[64] This applies to redemptions by unit-holders with more than 5% of their units. The regulations there also allow redemptions to be suspended by the manager, with the agreement of the trustee, for up to a month.[65] By contrast, section 22(e) of the Investment Company Act provides:

> No registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption...

To afford these restrictions, the SEC has stated that at least 85% of a registered open-end fund's assets should be in liquid assets, and money

61 15 USC 80a-2(a) 41(b) (1988) and 17 CFR 270.2a-4(a)(1)(1994).

62 17 CFR 270.22c-1(b)(1994).

63 *Review of the Law of Collective Investments, Other People's Money* (ALRC Report 65). Now see s 601 KB Corporations Law.

64 Regulation 4.28 of the 1991 Regulations.

65 Regulation 13.02 of the 1991 Regulations. Property funds are given additional protection by regulation 12.10.

66 Guide 4 to Form N-1A, Revision of Guidelines to Form N-1A, Investment Company Act Release No 18612 (March 12, 1992), 57 FR 9828. Liquid security is one that can be sold within 7 days. REITs are not registered under the Investment Company Act, which only covers funds investing in securities.

market funds 90%[66] and such funds may only borrow from banks while maintaining a 300% asset coverage.[67] There are however exceptions for certain exigencies in section 22(e): "where disposal by the company of securities owned by it is not reasonably practicable" or "where it is not reasonably practicable for such company fairly to determine the value of its net assets", or "(f)or such periods as the Commission may by order permit for the protection of security holders of the company."

In Singapore, MAS guidelines require that the trust deed state the restrictions on realisation rights, the period within which realisation proceeds will be paid and the conditions under which it may be suspended. But this means that different unit trusts will have their own restrictions, which may lead to investor uncertainty. The MAS/RCB Handbook on Unit Trusts also specifies that the unit trust may not borrow more than 25% of the value of deposited property.

As an aside, but still relevant to the issue of redemption; in Australia, section 1002H of the Corporations Law now specifically exempts a trustee from insider dealing prohibitions when it redeems or repurchases units in accordance with a buy-back covenant under a trust deed, where the price is calculated by reference to the underlying value of the assets less any reasonable charge for purchasing the interest. The trustee may possess material information relating to the unit trust and its underlying assets but the objection to the information not being publicly available is met by the fact that the redemption is at a predetermined price, and all unit-holders have equal access to available information. Clearly, unit trust trustees here need this exemption, since the Securities Industry Act's definition of securities' includes participatory interests, of which the unit trust is one.

V. Governance

The conceptual difficulties in using the trust analysis where unit trusts are concerned are symptomised in problems of governance. While the trustee holds the trust property, management is vested in the manager. Although it is not unusual to have trustee functions divided, as has been the experience with protectors and trustees of a trust, the reality is that the manager serves a function closer to that of a traditional trustee, whereas the unit trust trustee is, in reality, more like the trust protector.[68] Thus, section 118 of the Companies

67 S 18(f)(1) Investment Company Act.

68 See Waters, "The Protector: New Wine in Old Bottles" in Oakley ed, *Trends in Contemporary Trust Law* (1996), at 92, analogising the protector/trustee relationship with administrators and trustees of pension plans.

Act requires the trustee to ensure that the manager complies with the provisions of the trust deed, and to call a meeting of unit-holders where the manager fails to do so in order to determine if the scheme should be wound up. Similarly, in the UK, regulation 7.09 of the Financial Services (Regulated Schemes) Regulation 1991 provides that the trustee has to take reasonable care to ensure that the manager adheres to the mandate given by the trust deed.

Consequently, both the manager and trustee are principal participants; neither is an agent of the other. "The appointment of a trustee is understandably required by statute in this case as a safeguard to ensure that the interests of the unit holders are maintained, but the Manager also has this obligation, and in a sense also supervises the activities of the Trustee."[69] Sin believes that they are in an equal relationship, although they serve different functions.[70] This though causes problems in dividing responsibility and hence apportioning liability, since their separate duties are not always clearly defined or distinct.[71] The further problem in Singapore is that there are in effect just two trust corporations that serve as trustees to unit trusts registered here.[72] This is because MAS guidelines require the trustee to be independent of the fund management company, so that banks and investment firms cannot use their subsidiaries as trustees.[73] The danger though is that a trustee would not be sufficiently capitalised to meet all the possible claims on it. The crucial question from a governance perspective is thus whether the bank/unit trust manager is itself a trustee or fiduciary.

A. *Manager*

The first option can be ruled out, unlike the position in New Zealand, where section 3(2)(c) of the Unit Trust Act 1960 expressly imposes duties of trusteeship on the manager. Here, as was the case in Australia, the duties on a manager are at best fiduciary, and one view is that they are like promoters of a company.[74] However, the position is not uncontroverted, and even if

69 *Parkes Management Ltd* v *Perpetual Trustee Co Ltd* (1977) ACLC 29,545 at 29,551.

70 *Supra,* note 45, at 154-6. Sin also believes that they are in a fiduciary relationship with each other (at 167).

71 Sin, *supra*, note 45, at 231-3.

72 British and Malayan Trustees Ltd and Bermuda Trust Ltd.

73 The Australian Securities and Investments Commission has sometimes relaxed this requirement: see *The Laws of Australia* at para 4.8:258.

74 *Elders Trustee and Executor Co Ltd* v *EG Reeves Pty Ltd* (1988) 78 ALR 193; Sin, *supra*, note 45, at 170 *et al*. Also see *Famel Pty Ltd* v *Burswood Management Ltd*, *supra*, note 47, at 582.

the manager were a fiduciary, not all the powers vested in him are fiduciary in nature. The position is more explicit in the United States, where section 36(b) of the Investment Company Act states that the advisor has a fiduciary duty with regards to the advisory fees charged to the mutual fund.[75] This in fact may be going too far from our perspective, since the section 36(b) fiduciary duty "relates to the compensation received for performing fiduciary functions, and not the performance of those functions."[76]

On one view, fiduciary law has taken a step back in the Commonwealth. First, fiduciary obligations can be varied by the terms of the trust deed, and the concept of a core duty here is weaker than with trust liability.[77] Consequently, exculpatory provisions in the trust deed in favour of the manager probably work. Sin believes that the Unfair Contract Terms Act[78] does not catch such clauses since the Act does not apply to "any contract so far as it relates to the creation or transfer of securities or of any right or interest in securities",[79] and the definition of securities in the Securities Industry Act includes participatory interests, which definition includes the unit trust.[80] However, Professors Ford and Hardingham rely on the statutory covenant in section 111(1)(a) to suggest that managers may not be able to rely on wide exemption clauses. This requires a trust deed to contain "a covenant binding the management company that it will use its best endeavours to carry on and conduct its business in a proper and efficient manner and to ensure that any undertaking, scheme or enterprise to which the deed relates is carried on and conducted in a proper and efficient manner."

This though is a tenuous argument. In the United Kingdom, section 84 of the Financial Services Act 1984 provides: "Any provision of the trust deed of an authorised unit trust scheme shall be void in so far as it would have the effect of exempting the manager or trustee from liability for any failure to exercise due care and diligence in the discharge of his functions in respect of the scheme."

Our equivalent provision, section 120 of the Companies Act, however, only covers trustees or its representatives, and we have seen that the manager is probably a principal *vis-à-vis* the trustee. MAS/RCB guidelines only

75 The standard of duty was held to be an issue of equity and one for the judge, not the jury: *In re Gartenberg 636* F.2d 16 (2 Cir 1980); *Gartenberg* v *Pollack* 451 US 910. The court will examine factors including the performance of the fund, the nature and quality of the services provided and the adviser's cost and profitability to the adviser of the agreement.

76 *Protecting Investors, supra*, note 10, at 263, footnote 57.

77 *Clarke Boyce* v *Mouat* [1993] 3 WLR 1026; *Kelly* v *Cooper* [1993] AC 205; Nolan [1994] 53 CLJ 34; Langbein, *supra*, note 50, at 657 *et al.*

78 Cap 396, 1994 Rev Ed.

79 Schedule 1, Cap 396, 1994 Rev Ed.

80 Sin, *supra*, note 45, at 216.

require that the trust deed contain details of any exemptions from liability granted to the manager, thus presupposing that they are, in general, efficacious.

Second, real fiduciary duties have been narrowed to encompass only conflictual proscriptions, so that equitable duties of care and skill borne by fiduciaries have still to satisfy common law rules of remoteness and causation.[81] In any case, the causation rules for actual breaches of fiduciary duty are no longer strict, and there may be a need to show that the fiduciary acted fraudulently before he is made to bear all the losses flowing from the breach.[82] In other cases involving a breach of fiduciary duty, a common sense view of causation is adopted.[83]

B. *Trustee*

A trustee is, in theory, subject to extremely onerous duties. In the context of unit trusts, however, we have seen that the trustee's duties are more supervisory than active. Yet, the common law still imposes a fairly stringent duty of supervision, although the analogy is perhaps less with supervision of agents than of a co-trustee, since the manager is not the trustee's agent.[84] Nor is the manager a trustee, however, which is why the law runs into difficulties here. Further, a great deal of managerial responsibility is in the hands of the manager rather than the trustee. However, it is possible to argue that unit trust trustees do not *a priori* delegate their discretion to the manager, which they cannot do; rather, the trust deed should be seen to impose minimal duties of supervision on the trustee. Law and practice may, however, find a better fit if the corporate form were used. As Jessel MR noted in *Smith* v *Anderson,*[85] "(t)hey are called trustees, but they are, no doubt, directors."

Even if the trustee were to fail in its duties, exclusion and indemnity clauses, prevalent in unit trusts, may protect it. How far can trustees rely on such clauses? At common law, where exclusion clauses are concerned, the English Court of Appeal in *Armitage* v *Nurse*[86] drew a distinction between fraudulent breaches and non-fraudulent breaches of trust. Exclusion clauses

81 *Bristol & West Building Society* v *Mothew* [1996] 4 All ER 698; Tjio [1997] JBL 350.

82 *Swindle* v *Harrison* [1997] 4 All ER 705, Tjio and Yeo, (1998) 114 LQR 181.

83 *Ohm Pacific Sdn Bhd* v *Ng Hwee Cheng* [1994] 2 SLR 746; see further JD Davies, "Equitable Compensation: 'Causation, Foreseeability and Remoteness'" in Waters ed, *Equity, Fiduciaries and Trusts* (1993).

84 Despite the decision in *Re Vickery* [1931] 1 Ch 572, it is unlikely that ss 28 and 35 of the Trustees Act have lowered the standard of supervision expected of a trustee.

85 (1880) 15 Ch D 247 at 264.

86 [1997] 2 All ER 705.

could protect the trustee against the latter, even where gross negligence was involved, so long as the line is not crossed into fraud.[87] Recklessness probably crosses the divide.[88]

Section 120(1) of the Companies Act, however, provides:

> Subject to this section, any provision in a deed that is or at any time has been an approved deed, or in any contract with the holders or interests to which such a deed relates, shall be void in so far as it would have the effect of exempting a trustee or representative under the deed from, or indemnifying a trustee or representative against, liability for breach of trust where the trustee or representative fails to show the degree of care and diligence required of a trustee or representative.

Negligent breaches of trust cannot therefore be excluded. But what if the trustee is a straw man, or a straw company?[89] Would it be possible to impose liability on the directors of the trustee company? These directors are unlikely to come under a direct fiduciary duty to the beneficiaries.[90] If any liability were to attach it would be on the basis that they assisted in a breach of trust or received the proceeds of a breach of trust (what were once known as cases of constructive trusteeship).[91] With the removal of the requirement of a dishonest and fraudulent breach of trust in *Royal Brunei Sdn Bhd* v *Tan*,[92] it may not be difficult to show that the directors of a trustee company assisted in a breach of trust. All that is required is that the directors themselves assist with dishonest intent. The mens rea of knowing receipt is still uncertain, although strict liability may be the result of a broad acceptance of its restitutionary basis.[93] This then raises the difficult

87 It has been argued that this is a difficult line to draw: Tjio and Yeo, *supra*, note 80.

88 See also Hayton, "Irreducible Core Content of Trusteeship" in Oakley ed, *Trends in Contemporary Trust Law* (1996) at 59, distinguishing gross negligence from recklessness.

89 MAS guidelines require trustee corporations to have a paid up capital of at least $1 million. S 21(1) of the Trust Company Act (Cap 336, 1985 Rev Ed) requires the trustee to submit a statement to the RCB stating its liabilities to the public *qua* trustee.

90 Ford and Hardingham, *supra*, note 39, at 58-63.

91 Tjio, "Unconscionability and Personal Liability in Equity" [1991] SJLS 76.

92 [1995] 2 AC 378; presaged in *Goh Swee Fang* v *Tiah Juah Kim* [1994] 3 SLR 881 at 894-5.

93 See Lord Nicholls, "Knowing Receipt: Need for a new Landmark" in Cornish *et al* ed, *Restitution*: *Past, Present and Future* (1998); *contra* Lord Browne-Wilkinson, *Westdeutsche* v *Islington* [1996] 2 WLR 802. *Cf Citadel General Assurance* v *Lloyds Bank Canada* 152 DLR (4th) 411, noted L Smith (1998) 114 LQR 394. See also *Gold* v *Rosenberg* (1997) 152 DLR (4th) 385; *Yogimbikai Nagarajah* v *Indian Overseas Bank* [1997] 1 SLR 258.

question of whether the benefit of an exemption clause protecting trustees acting with reasonable care extends to directors in cases where liability arises without negligence. Professors Ford and Hardingham suggest instead that beneficiaries utilise section 409A to enjoin the directors of the trustee company from breaching the trust.[94]

Yet to seek to impose liability on the directors of the trustee company really highlights the anomaly of interposing the trustee company between the beneficiaries and those expected to monitor the manager or investment adviser, *ie*, the directors of the trustee company. It leads us back to the question whether corporatising the unit trust may not be more appropriate from a governance perspective.

In Australia, the Managed Investments Act 1998 has introduced the concept of a 'responsible entity' taking over the dual responsibility of trustee and manager. This responsible authority must have an independent compliance committee, where less than half of the directors of the responsible entity are external directors, with clear obligations to scheme investors.[95] This is somewhat similar to the position in the United States, where the Investment Company Act prescribes the number of outside directors required for its mutual funds – 40% of the board where no director is affiliated with the principal underwriter or advisor, and a majority otherwise.[96] Independent directors are supposed to represent the interests of fund shareholders since there is no underwriter as such to query the terms of the offering – arms length bargaining does not exist in the unit trust or mutual fund set up.

As a result, section 15(a) of the Investment Company Act, for example, requires directors to approve the advisory agreement with the manager. The agreement also has to:

- be approved by the majority of shareholders;
- precisely describe the adviser's compensation;
- continue for more than 2 years only if it is specifically approved at least annually by the board or a majority of shareholders;
- permit the board or a majority of shareholders to terminate the contract, with the payment of penalty, on not more than 60 days notice;
- terminate automatically if assigned.

94 *Supra*, note 39, at 68.

95 S 601 JA Corporations Law. However, Ford and Hardingham query whether the corporate form may not be more appropriate, *supra*, note 39, at 84-85.

96 Ss 10(a) and (b) of the Investment Company Act respectively.

Section 15(c) of the Investment Company Act requires the directors to review the employment and fee structure of the advisor. Fees are thus particularly well regulated in the United States, even if strict governance of mutual funds in other areas is more illusory.[97] By contrast, in Europe, in 1996, it was found that fees charged by European offshore funds were US$2 billion higher than the disclosed management fee.[98] In the UK, specifically, fund managers have been accused of seriously underestimating fund charges.[99] The US position is due, in part, to the rule 12b-1 requirement that all distribution and marketing fees out of the fund have to be made pursuant to a written plan describing the material aspects of the financing of the distribution and that the plan has been approved separately by the full board of directors and the independent directors. A number of requirements akin to those required for approval of the advisory agreement must also be present.[100]

In Singapore, MAS/RCB guidelines require that the manager not pay fees out of the trust fund that have not been provided for in the trust deed. Further, the prospectus has to set out the fees payable by the unit-holder, and also by the unit trust to the manager and trustee. Distribution and marketing fees are not specifically mentioned. Nor are there specific duties on the trustee to approve or review the fees.

VI. Other Regulatory Concerns

A. *Disclosure*

Managers and trustees may have duties, but without the spotlight of disclosure, it will be extremely difficult to enforce them. Mutual funds in the United States are under the same strict disclosure regimes as exist for listed industrial or commercial entities, since the securities issued by the mutual fund come under both the Securities Act 1933 and Exchange Act 1934.[101] For example, all expenses incurred by an investment company or mutual

97 See E Wyatt, "Mutual Fund Directors: Empty Suits in the Board Room", *The New York Times*, 7 June 1998, complaining that stockholder control of mutual funds and the power of independent directors over investment advisers are minimal.

98 P Moulton, "Fund Charges – Continuing to Paint a False Picture" *Marketing Investment Funds in Europe* (1997) at 20.

99 "Fund Managers hide the true cost of investing", *The Times*, 24 January 99.

100 17 CFR 270.12b-1.

101 Regulation S-K provides an integrated disclosure regime for the 1933 and 1934 Acts and the Investment Company Act 1940.

fund, including affiliate commissions *etc*, must be shown in a table in the prospectus.[102] Mutual funds must also comply with their continuous disclosure regime.[103] In the UK, Schedule 2 of their 1991 Regulations similarly requires detailed information in their scheme particulars, including all relevant charges to the fund. Their regulations require annual and half yearly reports and also prescribe the contents of those reports.[104] There has to also be published on a weekly basis in a national newspaper the maximum preliminary charge permitted, as well as the unit trust price.[105]

In Singapore, MAS guidelines require managers to prepare and send to unit-holders, semi-annually, performance reports in prescribed form. The prospectus is also required to state how unit-holders can obtain information about unit prices.

B. *Affiliated Transactions*

The 1930s in the US saw numerous affiliated sales of worthless securities to investment companies. The result was the introduction of stringent provisions in the Investment Company Act controlling transactions with affiliates. Thus, section 10(f) prohibits an investment company from purchasing a security while that security is the subject of an underwriting in which an affiliate is involved. Section 17(a) prohibits the fund's principal underwriter or an affiliate of the fund or any affiliated person of such persons from knowingly selling or purchasing any security or other property from the fund. Section 17(e) prohibits an affiliate broker from receiving any commission in connection with the purchase and sale of securities by the investment company, other than a salary, wage or reasonable brokerage commission.

In the UK, regulation 7.16 of their 1991 Regulations polices conflict of interest situations involving 'affected persons'. There are however many excepted transactions. Today, fund consolidation makes affiliated transactions a particular problem, and we may need to strengthen our safeguards in this regard. At the moment, MAS/RCB guidelines require the manager and trustee to conduct all transactions with or for the unit trust at arm's length. Section 111 (1)(d) of the Companies Act also prohibits the manager from investing in or lending to related companies any money held on behalf of the unit trust scheme.

[102] Item 2 – Form N-1A, Investment Company Act Release No 16244 (Feb 1 1988) 53 FER 3192.
[103] See *Protecting Investors*, *supra,* note 10, at 180.
[104] Regulation 10.01 and Schedule 3 of the 1991 Regulations.
[105] Regulation 4.24 of the 1991 Regulations.

C. *Indemnification Clauses*

There is still some uncertainty over the extent to which beneficiaries of a unit trust are expected to indemnify a trustee for expenses or losses incurred on behalf of the trust. On one view, beneficiaries are in general liable to indemnify the trustee.[106] Academics, however, argue that the duty to indemnify arises only in restricted circumstances – where there is either a request by the beneficiary for the trustee to assume its office, or where the beneficiary has an absolute interest in the trust property.[107]

During the currency of a unit trust, the unit-holder's beneficial interest is limited to a right of redemption. If the latter view above were correct, there has to be a request by the beneficiary to the trustee to assume the office before the duty to indemnify arises. It is, however, unlikely that this can be discerned in a unit trust structure that is created by the manager and trustee at the first instance. In any case, section 120 avoids the indemnity clause in cases where the trustee is in negligent breach of trust. There should, of course, still be a specific clause excluding the beneficiaries' duty to indemnify in other circumstances, which then achieves some form of limited liability despite the use of a trust rather than corporate vehicle. In the United Kingdom, Schedule 1 of the Financial Services (Regulated Schemes) Regulations 1991 thus requires a trust deed to contain a provision that "[a] holder is not liable to make any further payment after he has paid the purchase price of his units and that no further liability can be imposed on him in respect of the units which he holds."

D. *Liability to Third Parties*

Outside creditors have particular concerns when dealing with unit trusts. If the trustee company is insolvent, they will have to seek recourse against its directors. Under our current law, it is extremely difficult to make the directors of the trustee company liable, unlike the present position in Australia, where section 233 of the Corporations Law was enacted in 1985 to provide for such an eventuality.[108] This provision imposes liability on the directors where the trustee company is "for any reason not entitled to be fully

[106] *JW Broomhead (Vic) Pty Ltd (in liq)* v *JW Broomhead Pty Ltd* [1985] VR 891 at 936-7 *per* McGarvie J applying *Hardoon* v *Belilios* [1910] AC 118.

[107] Hughes, *supra*, note 35, at 178; Sin, *supra*, note 45, at 179-185. See also Ford and Hardingham *supra*, note 39, at 80.

[108] Introduced by the Companies and Securities Legislation (Miscellaneous Amendments) Act 1985 (Cth) s 66.

indemnified out of the assets of the trust in respect of the liability ..." In Singapore, creditors have to rely on sections 339 and 340 of the Companies Act, *viz*, wrongful and fraudulent trading, but the former requires a criminal conviction, and the latter, proof of fraud.

Creditors may want to sue the beneficiaries personally as well. They can only do so through the principle of subrogation, *ie* by stepping into the shoes of the trustee, and asking to be indemnified by the beneficiaries. However, we have seen that indemnity clauses in trust deeds are largely caught by section 120 of the Companies Act, and those that are not may not in any case be effective even in the trustee's hands.

Consequently, there is always the danger for third parties trading with thinly capitalised trustees, and some have objected to the subversion of the corporate form by the unit trust framework.[109]

VII. Advantages of Incorporation

From the viewpoint of governance, there may be some advantages if the corporate form were mandated for unit trusts. However, we have seen that this is not strictly necessary – the United Kingdom has promulgated detailed regulations under their Financial Services Act 1986 for unit trusts, and we have the MAS/RCB administrative guidelines. The authorities in the UK have, however, realised that many civil law countries do not recognise the trust (which conflict of laws rules are themselves extremely complex) and that it may be easier to market unit trusts overseas if the investment scheme were corporatised. Consequently, the UK has introduced legislation to this effect.[110]

The trust form also carries with it dangers of administrative suits by beneficiaries resulting in the multiplicity of actions, which the corporate form overcomes to a certain extent, particularly with the rule in *Foss* v *Harbottle*.[111] And, although trust deeds of unit trusts set out the investment powers of the trustee clearly, these trustees as we shall see are still, in theory, required to invest as prudent men of business. One of the duties when it comes to investments is the duty of impartiality. If we accept that there is insufficient mutuality between unit-holders for a unit trust to be caught by the prohibition against large unincorporated partnerships, we may

109 Ford and Hardingham, *supra*, note 39, at 85; Hughes, *supra*, note 35, at 32.

110 The Open-Ended Investment Companies (Investment Companies with Variable Capital) Regulations 1996, promulgated under s 2(2) of the European Communities Act 1972, came into force on 6 January 1997. The Financial Services (Open Ended Investment Company) Regulations came into force on 24 January 1997.

111 (1843) 2 Hare 461; 67 ER 189.

also have to accept that the duty of impartiality remains a problem with unit trusts, although in practice it is unlikely that one group of investors can be favoured over another.[112] By contrast, such a duty does not inhibit fiduciary investments, so that directors, for example, are bound only by the business judgment rule or something akin to it.[113] This is because shareholders, even where they belong to different classes, have a commonality of interest.

The difficulty with incorporation is that share repurchases, once prohibited without court approval, is still relatively restricted. It is only allowed out of distributable profits. Similarly, preference shares can only be redeemed out of such profits or the proceeds of a fresh issue of shares.[114] A separate regime is thus necessary for open-ended funds to assume the corporate form, and yet not be bound by rules concerning the maintenance of capital.

It has always been said that regulation is the price of deregulation. There is therefore little to fear from a race-to-the-bottom regulatory competition in this regard. Indeed regulatory convergence has been the experience of developed financial markets.[115] This is borne out by our brief examination of some of the comparative regulatory provisions in the US, UK, Australia and Singapore.

VIII. Trust Investments

We return to the question posed at the beginning of this paper – can trustees invest trust monies in unit trusts? The Report of the Sub-Committee on Finance and Banking of the Committee on Singapore's Competitiveness (the 'Report') recommended that the Trustees Act be amended to be more in accordance with the regulatory framework of ERISA. More specifically, this would entail a shift away from a prescribed list of authorised investments ('legal list'), to a generalised prudent investor standard. This was intended both to facilitate portfolio management, and to raise the quality of trustee investment. But would it *per se* directly or indirectly allow trustees to invest in unit trusts?

The first point to note is that the strictures of the legal list apply only in cases where the trust deed does not specify the trustee's investment powers.

112 ERISA, which governs pension funds in the US, has not been able to resolve the problems raised by the duty of impartiality: N Stein, "ERISA and the Limits of Equity" in *Equitable Doctrines and Remedies in Contemporary Regulatory Settings*, (1993) 56 Law and Contemporary Problems, at 80.

113 *Howard Smith* v *Ampol Petroleum* [1974] AC 821 at 832, *per* Lord Wilberforce.

114 S 70(3), Companies Act.

115 Greene, Braverman and Schneck, "Concepts of Regulation" in Oditah ed, *The Future for the Global Securities Market* (1996), at 174-5.

Where the trust deed contains an express investment clause, the only concern of the court is to construe that power,[116] and to see that the trustee adheres to the standard of care expected of one holding such an office, *ie* the prudence expected of an ordinary man of business investing on behalf of others.[117] The legal list therefore applies mainly in poorly drafted or small trusts, which do not have the benefit of solicitors, and also in the administration of estates and guardianships of infants.[118]

In any case, the Trustees Act does allow a trustee to invest in certain authorised unit trusts that have been approved by the Ministry of Law. But the more fundamental question, whether one is examining the prudence of a Trustees Act-constrained investment in an authorised unit trust, or in cases where there is an express power to invest as the trustee so decides, is the issue of delegation. The general rule is that trustees cannot delegate their discretion, and the decision to invest, and what to invest in, is personal to a trustee.

IX. Employee Retirement Income Security Act (ERISA)

As we have seen, ERISA covers pooled investment vehicles for employee benefit plans, *ie* pension plans, that are not covered by the Investment Company Act. It does, however, provide comparable investor protection. Governance concerns, for example, are dealt with by the requirement that an ERISA plan fiduciary act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man ... acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[119] Diversification of risk is expected, unless prudence dictates against it, and a fiduciary may be liable for another fiduciary's breach.[120] ERISA, however, preempts common law fiduciary duties.[121]

Yet, to bring the Trustees Act in line with ERISA may be an overkill.

[116] *Re Harari's Settlement Trusts* [1949] 1 All ER 430.

[117] *In re Whiteley: Whiteley* v *Learoyd* (1886) 33 Ch D 347 at 355.

[118] *Re Estate of Yong Wai Mun, ex p Yong Khai Mun* [1994] 3 MLJ 514, holding that the guardian is an implied trustee from the moment it comes into possession of property belonging to the infant. The court did not accede to the guardians' request that it be allowed to invest in a unit trust that was not authorised by the Trustees Act.

[119] 29 USC 1104(a)(1)(b). In contrast, Title 12 Part 9 of the Code of Federal Regulations, which covers collective trust funds of national banks, contains no specific fiduciary duties. However, the Comptroller of the Currency may fine a national bank for violating banking rules or regulations: 12 USC 93(b).

[120] 29 USC 1105(a).

[121] 29 USC 1144(a).

The structure is extremely comprehensive, with prohibited affiliate transactions and exemptions similar to those found in the Investment Company Act. These provisions are necessary since pension plans manage enormous sums of money, and conflict of interest problems proliferate in that specific context, as pension plan fiduciaries may be tempted to invest in such a way as to benefit the employer.[122] Trustees of private trusts are not in the same position. In the United States, such trustees are today largely governed by a general prudent investor standard, although there was a time when legal lists also existed. The main concern though is whether portfolio management is encouraged, or indeed, permitted by such a standard.

X. Portfolio Management

A. *Legal Lists*

States like Massachusetts never had a list of authorised investments, and this was largely due to the role of the Bostonian dynastic trust.[123] Professional trustees abounded and standards of trust management were high. Thus, in *Harvard College* v *Amory*,[124] the court rejected the argument of Harvard College, the remaindermen, that investment in insurance and manufacturing stocks was unsafe. It only required the trustee, when investing, to:

> conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.[125]

Professor Friedman argues that dynastic or long-term trusts required such a flexible investment policy as the economy evolved, and the notion of prudent investments changed over time. In contrast, short term 'caretaker trusts' benefited from rigid rules that stressed income over principal.[126] In other states, however, the end of legal lists was only later precipitated by

[122] Due to the temptation of trading an industry back to solvency, Australian legislation now has additional specific safeguards for pension plans.
[123] Friedman, *supra*, note 7.
[124] 26 Mass (9 Pick) 446 (1830).
[125] *Ibid*, at 461.
[126] *Supra*, note 7, at 551.
[127] *Ibid*, at 563.

the growth of trust companies.[127] But this did not settle the question whether portfolio management was a usable tool for trustees, which is something we shall examine later.

Legal lists are largely obsolete in the Commonwealth today. Canadian states[128] began abolishing their fixed lists from 1970. There was not the policy concern, found in the UK, that large family trusts holding listed securities would move out of them once the list was abolished, thereby causing the value of these securities to slump.[129] In Singapore, similarly, there are few large family trusts with such influence, although certain statutory bodies and town councils with substantial assets may currently be bound by the provisions of the Trustees Act, so that delinkage may result in a sell-off. Any dislocation will, however, be discrete and short term.

In New Zealand, the Trustee Amendment Act 1988 also abolished the legal list, and allowed trustees to net profits from investments with losses from other investments.[130] Australian states, however, retained their lists until quite recently. In 1995, South Australia, Victoria and Northern Territory abolished their lists. Western Australia and New South Wales followed suit in 1997. Their legislation mirrors the New Zealand position very closely. For example, both place a higher responsibility on professional trustees, and state clearly that the trustees' duty is in relation to the management of the affairs of other persons rather than their own affairs. In contrast, the Massachusetts rule requires trustees to "manage their own affairs not in regard to speculation but in regard to the permanent disposition of their funds." As an additional safeguard, the Australian legislation contains a *proviso* requiring trustees to consider [t]he costs (including commissions, fees, charges and duties payable) of making the proposed investment.[131]

The UK legislature is the most conservative in this regard, probably due to the fears of market de-stabilisation mentioned above. There are however constant calls for reform. The Law Commission recently reviewed this area of the law, and there is in fact draft regulation under the Deregulation and Contracting Out Act 1994 to amend and widen the legal list of authorised

[128] *Eg*, New Brunswick, Northwest Territories, Yukon, Manitoba.

[129] Waters, *Law of Trusts* (2nd ed, 1984) at 774-5.

[130] The anti-netting rule is a problem, unless a trustee can show that the investments were made pursuant to the same investment policy: *Bartlett* v *Barclays Banks Trust Co Ltd* [1980] Ch 515. But Lee, "Modern Portfolio Theory and the Investment of Pension Funds" in Finn ed, *Equity and Commercial Relationships* (1987) at 305 believes that netting is not as much a problem as the question of delegation.

[131] See also Lee, *ibid*, at 229-304, comparing the cost of active funds with index-linked funds.

trustee investments under the Trustee Investment Act 1961. The English common law itself is torn between the traditional trustee function of asset preservation and modern investment techniques of portfolio management.[132]

The ancillary advantages and disadvantages of the list will not be discussed here,[133] as it is assumed that portfolio management is desirable and indeed necessary, and that the best way this can be achieved by a trustee is for him to consciously choose which unit trusts to invest in, but to then leave the day to day monitoring of the underlying assets to professional fund managers. As Professor Langbein states:

> Managing a portfolio of marketable securities is as demanding a specialty as stomach surgery or nuclear engineering. There is no more reason to expect the ordinary individual serving as a trustee to possess the requisite investment expertise than to expect ordinary citizens to possess expertise in gastroenterology or atomic science.[134]

B. *Delegation*

This however forces us to consider one of the more difficult areas of trustee law – the rule that trustees may not delegate their discretions: *delegatus non potest delagare*. The problem with the unit trust is this: if the trustee unit-holder owns the underlying assets of the unit trust, he is duty-bound to consider what to do with those assets. As we have seen, however, the

[132] Contrast Leggatt LJ in *Nestle* v *National Westminster Bank plc* [1994] 1 All ER 118 at 142

> ("The importance of preservation of a trust fund will always outweigh success in its advancement. Inevitably, a trustee in the bank's position wears a complacent air, because the virtue of safety will in practice put a premium on inactivity.")

with Hoffmann J at first instance in the same case

> ("Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation ...").

Also see *Cowan* v *Scargill* [1985] 1 Ch 270 at 290, "the large size of pension funds emphasises the need for diversification."

[133] For a comprehensive discussion, see *Reform of Trustee Investment Law*, Working Paper No 1, Law Reform Committee Singapore Academy of Law, December 1990. From the feedback obtained by the Academy, some bankers saw trust funds as public funds that should not be exposed to the danger of aggressive fund management. Thus, Ford and Lee express the hope that "as for investment with fund managers the time must come when such managers construct products specifically for the trustee investor, that is oriented to savings rather than speculation.": *Principles of the Law of Trusts* (3rd ed, 1997), at para 10110.

[134] "Reversing the Nondelegation Rule of Trust-Investment Law" (1994) 59 Missouri LR 105 at 110.

assets of a unit trust are administered by the manager with the trustee of the unit trust acting as an overseer. Even a majority of unit-holders may find it difficult to control the investment decisions of the manager, let alone a single unit-holder. If so, a trustee unit-holder could be said to have delegated his duty to manage a trust fund to the manager when he purchases a unit in that particular fund.

There are two ways to circumvent the problem. The first is to expressly confer on the trustee the power to delegate. The other is to argue that a unit is a separate chose in action, and its holder not therefore the owner of the underlying assets of the unit trust, much like the position of a shareholder in a company.

Where the first possibility is concerned, the US experience is instructive. We have seen that states like Massachusetts never had a legal list, and others have abolished their lists. Yet this was not sufficient, by itself, to allow trustees to adopt portfolio management techniques. The flexibility afforded by the old 'prudent man' rule was more imagined than real.[135] It was the *Restatement (Third) of the Law of Trusts (Prudent Investor Rule)* that proposed a revised rule on trustee investment that incorporated ideas of portfolio management. The Uniform Prudent Investor Act 1994 was then promulgated by the Uniform Law Commission to codify the Restatements, and has been adopted by a number of states. It augments the duty to diversify, replaces the prohibition against speculation with a requirement of risk sensitivity, and allows trustees to delegate their investment decisions. Somewhat like the Australian *proviso* mentioned above, a minimum cost requirement is built into section 7 of the Act.

Langbein now states that his "most confident prediction is that the future will see trustees making ever greater use of pooled investment vehicles like mutual funds and bank common funds."[136] But the recent amendments are crucial, and overcomes, respectively, the common law restrictions on netting, the restricted meaning of investment, and no-delegation of duty rule.

The Antipodean amendments do not deal with the issue of delegation directly, although it does provide for set-offs between gains and losses on investments. While it is argued that the New Zealand legislation, for example,

135 Langbein, (1996) 81 Iowa LR 641.

136 *Ibid*, at 655, although he admits that the duty of impartiality is still an unresolved problem (at 669).

137 A Butler (1995) 7 Bond LR 119. He argues, relying on *Jones* v *AMP Perpetual Trustee Company NZ Ltd* [1994] 1 NZLR 690, that "(w)hatever the doubts which one may have over this issue, the investment community in New Zealand has adopted portfolio management in the trust area ..." (at 152).

is sufficient to allow portfolio management within its prudence threshold,[137] the question of whether a unit trust can be purchased by a trustee goes beyond that, since the duty to diversify is there delegated to the manager of the unit trust. The danger in expecting the trustee himself to diversify is that portfolio management requires a certain degree of skill and sophistication, as well as a sufficiently large trust fund to allow for meaningful diversification. It would, for example, be simpler for a trustee to buy units of an index-linked fund rather than individually construct a portfolio of stocks that mirrors a stock index. In the latter case, however, employing an agent to carry out his instructions would be a permissible delegation of an administrative act by the trustee.

A further problem where unit trusts are concerned, which the power to delegate does not resolve, is the rule which prohibits a trustee from leaving securities in the name of nominees without an express provision in the trust deed allowing him to do so.[138] Trustees are expected to keep control of trust assets. This is a particular problem if unit-holders are deemed to own the underlying assets of a unit trust, since those assets are obviously left in the names of the trustee or custodian of the unit trust. It is just as much a problem where trust funds are large enough for the employment of a discretionary fund manager.

The problem would be largely resolved if it could be successfully argued that a unit-holder did not own the underlying assets of the unit trust. Thus, Dr Sin contends that:

> (i)f a unit is a kind of property, then when a private trustee invests in units, the sole issue in determining whether he has acted properly is one of construction of his investment powers. He cannot be regarded as in breach of fiduciary duty on the ground that he has delegated his investment decision to the unit trustee.[139]

The argument is a difficult one since, unlike a company, a trust does not have a separate persona. Consequently, the beneficiaries should own the equitable interest in the assets administered by the trustee. For example, regulation 2.05 of the UK Financial Services (Regulated Schemes) Regulations 1991 provides that "the interests of the holders in an authorised unit trust shall consist of units (including fractions of a unit), each unit

[138] Hayton [1991] NLJ 210. Within the unit trust structure, the trustee of the unit trust will be empowered to vest the unit trust investments in a custodian. There seemed to be some difficulties with this in New Zealand, but the problem has been cured by the Unit Trusts Amendment Act 1998.

[139] *Supra*, note 45, at 256.

representing one undivided share in the property of the scheme...".

Sin's argument is that the tripartite contract between unit-holder, manager and trustee modifies these proprietary rights so that during the currency of the unit trust, the unit-holder can only seek to redeem his unit and not seek his undivided share in the underlying assets.[140] Each unit is analogous to a share, a chose in action carrying with it contractual promises and certain mandated statutory rights.

However, even if a unit were a separate chose in action, it does not rule out the fact that the underlying assets are still owned by the unit-holders.[141] As in an unincorporated association, where members do not have an aliquot share of the association's assets, unit-holders jointly own the assets of the unit trust but are contractually bound not to sever their shares or interests. As a general rule, the law abhors a vacuum of ownership,[142] so that even though unit-holders own a separate chose in action represented by rights of membership, they also own the underlying assets (which cannot exist unowned), though these are subject to contractual restrictions on alienation and use.

But the truth is that the unit trust is not unlike a company, and units in it like shares in a company. Their modes of transfer are certainly similar; requiring the execution of a transfer instrument and registration by the manager, which like the company secretary is required to keep and maintain a register.[143] In contrast, assignments of equitable choses in action have to comply with rules for assignment, the statutory form of which is provided by section 4(6) of Civil Law Act.[144] Sin also argues that the priority rules for unit trusts should be similar to the rules for shares,[145] rather than the rule in *Dearle* v *Hall*.[146] This rule, intended for trust interests and pure choses in action, modifies the rule that the first interest that is created in time prevails. For such interests, the first to give notice to the obligor has priority. Such a rule would be difficult to administer in the case of unit trusts, as it was with shares in a company.

[140] *Ibid*, at 263 *et al. Baker* v *Archer-Shee* [1927] AC 844 is seen as concerned only with the locus of the right to the dividend and the consequent burden of paying income tax, and not with ownership of the underlying shares.

[141] See *eg*, Ford and Hardingham, *supra*, note 39, at note 6a, citing *Costa & Duppe Properties Pty Ltd* v *Duppe* [1986] VR 90.

[142] *Singapore Island Country Club* v *Lee* [1992] 2 SLR 900 at 920 *per* Hwang JC, Tjio, *supra*, note 49. *Cf* Sin, *supra*, note 45, at 291.

[143] S 115, Companies Act.

[144] Cap 43, 1994 Rev Ed. Sin sees the transfer of units as involving a novation, where there is a substitution of the rights and obligations of unit-holders, *supra*, note 45, at 319.

[145] *Supra*, note 45, at 322-5. These are rules of estoppel: *Pan-Electric Industries Ltd (in liq)* v *Overseas-Chinese Banking Corp Ltd* [1994] 3 SLR 695.

[146] (1828) 3 Russ 1.

XI. Conclusion

Having the unit trust adopt the corporate form thus has its advantages. The two crucial benefits are in enhancing governance through the use of a board of directors with specific duties; and in circumventing the rule that trustees cannot delegate their investment decisions to an agent. Trustees will instead be seen to have consciously chosen to invest in an investment company, with all the benefits of diversification that brings, without being saddled with the duty of portfolio management. This may be necessary since it is unrealistic to expect trustees, particularly non-professional trustees in the case of small trusts, to actively manage trust assets.

But beneficiaries, and investors generally, also have to temper their expectations. A properly diversified portfolio does not earn extraordinary gains in an efficient market and, periods of high inflation aside, there is something to be said for the preservation of trust assets. A well-informed trustee, investing in a well-regulated unit trust, should therefore not be expected to do much more than try to match a broad index of financial assets.[147]

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[147] But there are those who are sceptical of the efficient capital market hypothesis, *eg*, Butler, *supra*, note 135.

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