

THE TRUST AS SPECIAL-PURPOSE INSTITUTION*

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SUMMARY

The trust figure has undergone interesting developments in South African law during the last century. Due to its flexibility and multi-functionality it has developed as the legal institution of choice for many holistic business structures: from estate-planning and risk-protection, to financial-instrument entity. Particular financial innovations, such as securitization, required regulators to come up with fresh solutions within existing legal and regulatory systems.

The traditional role of the *inter vivos* 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 securitization and other investment roles, but also fulfil an increasingly important role in organizational law, which includes a variety of business-legal fields. The evolutionary process of the trust as collective investment-scheme vehicle to that of a legal entity in structured-finance programmes, such as a special purpose instrument, matured without any resistance in South Africa.

It is submitted that, in the trust-development process, South Africa should not necessarily find its inspiration solely in developed nations, but should rather position itself in its real context of a developing Southern African democracy, with the potential of becoming an important financial innovator in a world of economic turmoil.

It is submitted that a sound legal and regulatory framework for the application of trusts in the financial sphere is crucial. International best practice requires a definite

and effective regulatory environment for economic expediency. It is submitted that a hybrid system, as found in South Africa, is better suited to adapt to the challenges of an ever-changing legal and economic reality.

It is submitted that legislative interventions should be limited to the bare minimum and a holistic approach should be adopted, including the ratification of The Hague Convention on Trusts and some focused soft-law interventions.

1 INTRODUCTION

The trust figure has established itself as an indispensable part of the South African legal landscape. The original idea of the trust was quite different from some of its modern applications, as it originated as a means of transferring wealth within the family and remained “an intergenerational wealth transmission” device¹ up until the 21st century.

Although historically, scholars largely focused on the trust as a gratuitous figure, it is clear 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 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 1834.²

The development of the trust figure in South Africa was influenced by English as well as Roman-Dutch law – resulting in a distinctly South African law of trusts.³ 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.⁴

As a common-law figure the trust concept 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. In 1989 the common-law development was supported by the Trust Property Control Act (TPCA),⁵

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¹ Langbein “The Secret Life of the Trust: The Trust as an Instrument of Commerce” 1997 107 *Yale LJ* 165.

² See Cameron, De Waal, Kahn, Solomon and Wunsch *Honoré’s South African Law of Trusts* (2002) 21 with 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.

³ In *Estate Kemp v McDonald’s Trustee* 1915 AD 491 the court ironically rejected the trust figure as such but accepted it as far as it was a form of *fideicommissum*.

⁴ Honoré “On Fitting Trusts into Civil Law Jurisdictions” (Legal Research Paper 27/2008) *University of Oxford* <http://ssrn.com/abstract=1270179> (accessed 2012-01-18) 10–11.

⁵ The Trust Property Control Act 57 of 1988 came into operation on 31 March 1989 as a result of the “Law of Trusts” Working Paper prepared by the Law Commission, and repealed the Trust Moneys Protection Act 34 of 1934. The 1987 Law Commission 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”. De Waal described the TPCA in “Authorisation of Trustees in terms of the Trust Property Control Act” 2000 63 *THRHR* 472 as

which did not codify the figure, although it purposely addressed some problematic trust-property issues.

The trust figure 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.⁶ The uniqueness of what the trust as legal figure can offer has, however, guaranteed its survival, irrespective of apparent antagonism from the legislative authorities. 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 the trust as a financial-instrument entity.

The financial 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 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 more particularly securitization, required the regulators to come up with fresh solutions within the existing legal and regulatory systems. When the securitization concept was born in the minds of financial strategists, the various jurisdictions had to address their respective lacunas by way of new legislation.⁸

2 THE TRUST

It has become legal practice in the South African context to distinguish between the trust in the wide and in the narrow (or strict) sense. In the *wide* sense it exists when someone is

“bound to *hold or administer property* on behalf of another”, while in the *narrow* sense it exists 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’.⁹

In *Goodricke*¹⁰ Muller J stated that the two essential elements for the trust in the narrow or strict sense are

an “evolutionary, rather than a revolutionary, step in the development of the South African trust”.

⁶ The flexibility and adaptability of the South African trust figure contributed largely to its popularity. See Hyland and Smith “Abuse of the Trust Figure in South Africa: An Analysis of a Number of Recent Developments” 2006 1 *Journal for Estate Planning Law* 1.

⁷ The Unit Trust Control Act 54 of 1981 was amended by a number of subsequent Acts before CISCA 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 the Unit Trusts Control Amendment Acts 53 of 1996 and 12 of 1998. CISCA was 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.

⁸ The concept of “securitization” is discussed in more detail further on in this article.

⁹ Cameron *et al Honoré’s South African Law of Trusts* 3–4.

¹⁰ *Goodricke and Son (Pty) Ltd v Registrar of Deeds, Natal* 1974 (1) SA 404 (N) 408D.

“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.¹¹

Although there are no substantial differences between family, business and financial-instrument trusts, those used in the financial environment are usually trusts in the wide sense and are not regulated by the TPCA.¹² It seems as if little research has been done 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.

Hansmann and Mattei¹³ submit that trust law should be evaluated from a functional perspective, rather than a doctrinal, 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.¹⁴ 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 securitization and other investment roles, but also fulfil an increasingly important role in organizational law,¹⁵ 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.

A person can 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.¹⁶ The rights as mortgagee constituted, at most, *jura in re aliena* and not ownership. Brand J ruled in the *Conze* case that Masterbond acted as nothing more than an agent or nominee of the debenture-holders.¹⁷

¹¹ The exception is the case of “bewind”. Compare Cameron *et al* *Honoré’s South African Law of Trusts* 6–7; Olivier, Strydom and Van den Berg *Trustreg en Praktyk* (2009) 1–4–1–6.

¹² In *Conze v Masterbond Participation Trust Managers (Pty) Ltd* 1996 (3) SA 786 (C) 794D–795B the court decided that “(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 TPCA”.

¹³ “The Functions of Trust Law: A Comparative Legal and Economic Analysis” 1998 73(2) *New York University LR* 434 435. They refer to the following roles of the trust in more particular: pension funds, mutual funds, and asset securitization.

¹⁴ Trusts have been introduced by way of legislative interventions to Japan, China, South Korea, Taiwan and some South American jurisdictions.

¹⁵ See Hansmann and Mattei 1998 73(2) *New York University LR* 436. Since these observations were made the role of trusts in the corporative and financial spheres have increased dramatically. In South Africa in particular the trust has further become an important functionary in black economic empowerment processes.

¹⁶ Friedman JP referred to *Zinn NO v Westminster Bank Ltd* 1936 AD 89 96–97 as authority.

¹⁷ 795B.

The evolutionary process of the trust as collective investment-scheme vehicle to a legal entity in structured-finance programmes matured without any resistance in South Africa. The regulatory authorities, such as the Registrar of Collective Investment Schemes, were used to the application of trusts in this environment. The local innovators of financial instruments decided to use the most appropriate legal structures available to achieve their purposes.¹⁸

3 THE TRUST IN THE COMMERCIAL MILIEU

During the past three decades the trust has been positioned as a major legal instrument in the business and investment environment. It is submitted that internationally the future of the trust is locked up in its application in the commercial milieu. European jurisdictions, such as Italy, Luxembourg, Switzerland and Monaco, have started developing a more vibrant trust law and some even ratified The Hague Convention on the Law Applicable to Trusts and their Recognition of 1986. The original interest in the European jurisdictions 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 today is that trusts are found from Central and South American states, to Japan, China, Taiwan and South Korea.¹⁹ 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 application in the provision of security for commercial loans, by means of establishing a separate juristic entity in between the owner and the management of assets.²⁰

It is submitted that, in the trust-development process, South Africa should not necessarily find its inspiration solely in developed nations, but should rather position itself in its real context of a developing Southern African democracy, with the potential of becoming an important financial innovator in a world of economic turmoil. Moyo²¹ 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

¹⁸ For discussion on financial innovation see Karoly *A Case Study of South African Commercial Mortgage Backed Securitization* MComm dissertation University of South Africa (2006) 73 <http://uir.unisa.ac.za/bitstream/handle/10500/1665/dissertation.pdf?sequence=1> (accessed 2011-07-29).

¹⁹ Japan introduced the trust in 1922 and China only in 2001.

²⁰ Waters "The Future of the Trust: Part II" 2007 14(1) *Journal of International Trust and Corporate Planning* 1–22 and 3. See also Hansmann and Mattei 1998 73(2) *New York University LR* 434–479.

²¹ Moyo *How the West was Lost – Fifty Years of Economic Folly and the Stark Choices Ahead* (2011) 7. 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".

nations. With China moving closer to a position of a superpower, South Africa should capitalize on its own position as a BRICS country.²²

Even more important in the short term is the role of South Africa in the Southern African Development Community (SADC). The aforementioned organization, with its 15 member states, strives for regional integration in order to promote economic growth, peace and security in the region.²³ No formally developed SADC legal system exists, although a body of principles, rules and institutions have been developed with the purpose of achieving regional integration.²⁴ The main areas of SADC law are trade, investment, agriculture, infrastructure, services, national resources and security. Member states are encouraged to coordinate and harmonize national policies and laws with that of the SADC. The integration and harmonization 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.²⁵

It is submitted that the importance of sound, certain regulatory mechanisms for legal entities is of the utmost importance in a region that desires to achieve objectives conforming with the nature of the SADC. It is submitted that the trust-figure can partly fulfil this role, as in many individual jurisdictions.

4 SECURITIZATION

Mminele²⁶ submits 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.”

Securitization is generally regarded as an important and successful form of financial innovation. The general process of securitization is often

²² 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 a better understanding of the 2008 financial crisis.

²³ See <http://www.southafrica.info/africa/sadc.htm#ixzz1Im4udsNF> (accessed 2012-02-08). 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.

²⁴ See Zongwe “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 2012-05-18).

²⁵ *Ibid.* The Finance Protocol focuses on investment, taxation, central banking and regional capital and financial markets.

²⁶ Mminele “Benefits and Risks of New Instruments: Derivatives and Securitization – The Case of South Africa” *Conference on Financial Innovation and Emerging Markets* http://gc.21.inwe.nt.org/ibt/en/ilt/ibt/programme/megacities/media/eme_mminele.pdf (accessed 2011-07-29).

interchangeably referred to as asset or credit securitization. It describes the process of converting a pool of financial assets into 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 is effectively separated from the ultimate investors.²⁷

Although the end-result of securitization is financing, it is not financing in the ordinary sense of the word, as the entity securitising its assets is not really borrowing 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 manage 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 receives all excess income. The property is not, however, transferred to the bank, but the bank registers a mortgage bond over it to secure its position.

In the structured finance milieu, and particularly in securitization,²⁸ a variety of legal entities are used to make the scheme work effectively. As it is impractical to secure thousands of different debt instruments, a special-purpose instrument (SPI) is used as transformation device, by converting a large number of smaller financial assets into one tradable capital-market security.

The major *benefits* of the securitization process are summarised by Schwarcz²⁹ as follows:

- to obtain financing at a lower cost;
- to better deploy the capital;
- to increase its internal liquidity; and
- to more efficiently distribute the risk.³⁰

²⁷ Rosenthal and Ocampo *Securitization of Credit: Inside the new Technology of Finance* (1988) 25. See Locke *Aspects of Traditional Securitization in South African Law* LLD thesis University of South Africa (2008) 15, for explanation of traditional securitization and distinction from synthetic securitization. Compare Smith *The Implication of Basel II on Securitization Transactions of Banks* MComm dissertation University of Johannesburg (2007) 16, for the building blocks of the securitization process.

²⁸ Van Vuuren "The Awakening of Securitization in South Africa" <http://www.sasf.co.za> (accessed 2010-10-10), defines securitization 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 SPI), and last-mentioned funds the purchase by issuing debt securities in the capital markets. Another way to define securitization 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". See <http://www.sasf.co.za/aboutsecuritization/definition.htm> (accessed 2010-10-19).

²⁹ Schwarcz "Securitization Post-Enron" 2003 25 *Cardozo LR* (Symposium Issue on *Threats to Secured Lending and Asset Securitization*) http://www.securitization.net/pdf/duke_enron_052303.PDF (accessed 2011-05-23) [2].

³⁰ As a funding tool it creates new sources of financing as the SPI issues notes to fund the assets purchased from the originating bank; as a risk-transfer tool it allows banks to fund riskier financial assets because the risk is taken from its balance-sheet which results in less spending on insurance to cover the risk; as a regulatory arbitrage tool it may reduce the

For a securitization transaction to be *feasible*, the following minimum requirements should usually be met:³¹

- (a) the receivables must be sufficient to cover the notes issued by the purchaser to finance the purchase price;
- (b) the originator must be able to transfer the receivables to the purchaser freely; and
- (c) the sale must be treated as a complete and final transfer of the receivables from the originator to the purchaser.

The *goal and effect* of the securitization transaction is 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 that originated the assets. In this sense it differs from traditional debt and equity financing where the investors rely on the performance of the financed enterprise itself for their returns.³²

By entering into a securitization process, a lower-rated entity can successfully access capital that would usually be preserved for higher-rated institutions. The process involves a number of participants. The issuer (SPI) 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 in order 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. Thus the originator can secure lower cost funding than in the usual unsecured market.

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 cards receivables, bonds, vehicle finance and loans to small and medium-size enterprises can all be securitised in this way.³³

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 therefore actually irrelevant in assessing the sustainability of the loans. SPIs are applied in a variety of situations, such as in securitization, 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 (that is, airplanes, ships, large real estate projects); and in leveraged buy-outs.³⁴

bank's capital requirements; and, as a performance tool it may improve the potential growth of the originating institution.

³¹ Wood *Law and Practice of International Finance* (2008) 452.

³² See Smith *The Implication of Basel II on Securitization Transactions of Banks* 32.

³³ Cardone-Riportella, Samaniego-Medina and Trujillo-Ponce "What drives Bank Securitization? The Spanish Experience" 2010 34 *Journal of Banking and Finance* 2639. In Europe the volume of securitized assets grew from 78.2 billion Euros in 2000 to 711.1 billion in 2008 – a ten-fold increase.

³⁴ Caselli and Gatti *Structured Finance: Techniques, Products and Markets* (2005) 2. See also Coval, Jurek and Stafford "The Economics of Structured Finance" 2008 (Working Paper 09-

The goal in locking a pool of assets in an *ad hoc* organization (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) may have very different credit ratings. The principle determining factor for securitization has been proved as being the need for liquidity. This need is addressed by way of structured-finance transactions which firstly reduce the cost of funding of new financial resources for the specific initiative, and secondly separates the initiative from the originator, which prevent existing credit lines and funding programmes of the originator to be affected by the new initiative.³⁵

Securitization activities in South Africa are currently regulated by way of the 1st of January 2008 regulations, under the heading “Designation of an Activity not Falling within the Meaning of ‘the Business of a Bank’ (Securitization Schemes)”.³⁶ Although these regulations replaced the 2004 regulations in their entirety, they 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 2007,³⁷ were largely the result of the acceptance of the Basel II Accord by the South African Reserve Bank.

5 THE SPECIAL-PURPOSE INSTITUTION

Norman Muller,³⁸ 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”.

The securitization process takes place within the wider field of securities, which does not form part of this contribution. Both traditional and synthetic securitization schemes have been properly regulated in South Africa since 2004 and they also make provision for the definition of the 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 securitization scheme”.³⁹

060) *Harvard Business School* <http://www.hbs.edu/research/pdf/09-060.pdf> (accessed 2010-07-06) [5].

³⁵ Caselli and Gatti *Structured Finance: Techniques, Products and Markets* 3. See further Cardone-Riportella *et al* 2010 34 *Journal of Banking and Finance* 2640.

³⁶ GN R2 in GG 30628 of 2008-01-01 repealed and replaced the 2004 Regulations in their entirety. GN R1 and R3 were also published on 2008-01-01 in GG 30627 and 30629 respectively and regulate, together with GN R2, the current regulatory environment of securitization.

³⁷ This Amendment Act amended the Banks Act of 1990 dramatically and came into operation on 01-01-2008.

³⁸ Muller “New Securities Act Aligns South Africa with best International Regulatory Practice” unpublished paper <ftp://ftp.co.za/public/finmarks/SSAArticleMay20052.pdf> (accessed 2010-04-16). The Financial Markets Bill, first published in 2011, will at promulgation repeal the Securities Services Act in its entirety.

³⁹ As defined in the Exemption Notice regulating Securitization Schemes R2 of 2008-01-01 in evenly numbered GG 30628.

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 for the holding of the assets on behalf of the investors as its main purpose. 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.

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 usually 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.⁴⁰

Although the term "special-purpose *vehicle*" is commonly used internationally, the South African legislature has opted to use the term "special-purpose *institution*".⁴¹ Coupled with other relevant legislation, the process was undertaken to incorporate this latest invention in international financial instruments into the South African market.

The major parties to a securitization transaction are the borrower and the originator, the SPI, the investor, the rating agency, the servicer and the trustee,⁴² of which both the SPI and the servicer or the trustee may be housed in a trust as juristic institution.⁴³ Although SPIs⁴⁴ are not unique to securitization schemes, they can be regarded as the most important feature of these transactions. The SPI fulfils a central role in the securitization process and may be established as either a company or a trust.

In the process of retaining relevance in the international financial sphere, current legal concepts and entities have to be utilized by both the financial product developers and the legislator. In many jurisdictions the trust figure has been used as SPI for the past 20 years or more.⁴⁵ In South Africa the trust has been successfully employed as an SPI in a number of roles within a securitization structure. An SPI trust is created by way of a formal trust instrument. A deed drafted with the purpose to create an SPI for a securitization process should adhere to all the general requirements of a

⁴⁰ See Smith *The Implication of Basel II on Securitization Transactions of Banks* 300.

⁴¹ See the 2008 Securitization Regulations.

⁴² See Saayman "Securitization and Bank Liquidity in South Africa" *School of Economics Risk Management and International Trade, Potchefstroom University for Christian Higher Education*.

⁴³ Tavakoli *Structured Finance: Uses (And Abuses) of Special Purpose Entities* www.Tavakoli structuredfinance.com (accessed 2010-04-17). See also Smith *The Implication of Basel II on Securitization Transactions of Banks* 46.

⁴⁴ SPIs have been used for a variety of other financing purposes, such as joint ventures, isolation of certain assets or operations, and in economic empowerment transactions, to mention but a few.

⁴⁵ In some jurisdictions it is referred to as a "special-purpose vehicle" (SPV) or a "special-purpose entity" (SPE). See Schwarcz "Commercial Trusts as Business Organizations: Unravelling the Mystery" 2003 58 *The Business Lawyer* 559–564. Wood *Law and Practice of International Finance* 38–39 submits that the global harmonization of financial law is not necessary as the division of the world into legal families on the basis of financial law criteria are reasonably clear and non-confusing.

legitimate trust, although it is not registered with the Master of the High Court.

6 THE TRUST AS SPECIAL-PURPOSE INSTITUTION

Many financial institutions, like pension funds, friendly societies, unit trusts and participatory bonds, function in the form of a trust. The Securitization Regulations specifically stipulate that SPIs may be in the form of either a company or a trust.⁴⁶ The trust figure 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 instrument in which the interest is housed.

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;⁴⁷ and
- (d) the trust must have a lawful object.⁴⁸

Any trust, including one housing an SPI, must include these elements to qualify as a trust. 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.⁴⁹

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 must be to the benefit of an object – even if it is impersonal. 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 defined in section 1 of the TPCA as:

“a written agreement or a testamentary writing or a court order.”

⁴⁶ See the definition in s 1 of GN R2 in GG 30628 of 2008-01-01.

⁴⁷ This is the “subject” requirement. In *Conze v Masterbond Participation Trust Managers (Pty) Ltd supra* 786 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).

⁴⁸ This object may be to benefit one or more parties or it may be impersonal. In *Peterson NNO v Claassen* 2006 (5) SA 191 (CPD) 197B Bozalek J states that there is “a material difference between the object of a trust and the purpose thereof”. According to Pace and Van der Westhuizen *Wills and Trusts* Issue 11 (2007) 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”.

⁴⁹ See *Nel v Metequity Ltd* (2006) SCA 140 (RSA); 2007 (3) SA 34 (SCA); 2007 (2) All SA 602 (SCA); and *Peterson NNO v Claassen supra* 191.

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”.⁵⁰ 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 collective-investment-scheme instrument or as a special-purpose institution.⁵¹

In South Africa a trust deed, and specifically a discretionary business-trust deed, is usually drafted in the form of a contract.⁵² 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.⁵³

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 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.

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, decision-making processes, tax, application of income and capital, termination of the trust, record-keeping requirements, liabilities, amendments to the trust instrument, limitations, compensation and testamentary dispositions.⁵⁴

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.

Considering the above one can argue that each trust instrument registered in terms of the CISCA must at least:

- clearly indicate the intention of the parties to create a trust;
- identify the portfolio as subject;

⁵⁰ S 1 of the CISCA.

⁵¹ “Deed” is defined in the Concise English Dictionary (2005) 84 as “a legal document recording a transaction”.

⁵² The definition of “trust” in the Trust Property Control Act 57 of 1988 also confirms the establishment of *inter vivos* trusts by way of agreement. Hyland and Smith 2006 1 *Journal for Estate Planning Law* 17 refers to the trust deed as the “constitutive charter” of the trust.

⁵³ See *Crookes NO v Watson* 1956 (1) SA 277 (A).

⁵⁴ See discussion in Olivier *et al Trustreg en Praktyk* 9-5–9-15.

- state the fact that the public or other investors can participate in the scheme as objects of the trust; and must
- state the fact that the trustee agrees to accept delivery of and shall hold in safe custody the assets of the portfolio.

7 CONCLUSION

In light of the above, a sound legal and regulatory framework for the application of trusts in the financial sphere is crucial.⁵⁵ 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, sound legislation became more important as the regulatory environment developed. The business needs of the 21st century cannot be satisfactorily addressed by the traditional common-law sources alone. Aforementioned should be complemented by a holistic approach to intervention: well-drafted, responsible regulation, balanced with sufficient room for self-regulatory and soft-law opportunities.⁵⁶ 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 coexistence of the trust as a business entity is sometimes questionable. Sitkoff⁵⁷ claims the business trust to be somewhat “of an orphan in the domestic [United States] legal academy”. He further submits that the business lawyers assume it to be a subject for the trust scholars and the trust scholars as a subject of business law – resulting in a “scholarly and teaching lacuna”.⁵⁸

The pertinent question 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 adequately robust in light of recent developments in the international business and financial environment.

The question can 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. If the local trust-law environment does not instil the same confidence as company law does, it may have a negative effect on the development of South Africa as a competitive financial and investment jurisdiction. It may even contribute to

⁵⁵ In terms of international market sophistication South Africa ranks 12th, in the banking sector 15th, and its investor protection mechanisms 9th. Other features include a sound banking sector and strong securities exchange. The National Payment System Act 78 of 1998 has brought the South African settlement system in line with international best practices. See www.weforum.org/documents/GCR0809/index.html *The Global Competitiveness Report 2008/09, World Economic Forum, Financial Market Sophistication* (accessed on 2012-01-10).

⁵⁶ Kleyn “Possession” in Zimmerman and Visser *Southern Cross: Civil and Common Law in South Africa* (1996) 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”.

⁵⁷ Sitkoff “Trust as Uncorporation: A Research Agenda” 2005 *University of Illinois LR* 31 34.

⁵⁸ Sitkoff 2005 *University of Illinois LR* 34.

positioning South Africa as a target for regulatory-arbitrage initiatives, in which event it may lose its credibility in the global financial and investment environment.

If South Africa aspires to become an attractive host jurisdiction for major international business activities and a juristic jurisdiction of choice, it will require sound and reliable legal structures that are internationally competitive. There is no doubt that the trust as legal vehicle has a central role to fulfil in such an objective.

In the quest to develop the international image of South Africa, the following interventions in the trust arena are suggested:

- South Africa should seriously consider ratifying the Hague Convention and incorporating its principles into domestic law. Such incorporation will address potential uncertainties, such as the applicable conflict-of-law rules, and instil confidence in South Africa as a trust, investment and business destination.
- Soft-law interventions and initiatives, such as directives, circulars, practice notes, guidelines and guidance notes by the Master of the High Court, should be developed before further legislation is considered. These initiatives can be supported by strong academic and task-team position papers, with regulatory and board-notice interventions at a ministerial level where necessary. Other forms of soft law may include model laws, restatements and standard contract forms.⁵⁹
- The development of the South African common law on trusts should be allowed to continue its natural course.
- Legislative interventions by the national government should be limited to the bare minimum.
- The use of standard contract forms by legal practitioners may be considered.⁶⁰

Other aspects affecting the position of commercial trusts in the international context are adequate legal, tax and financial information; the efficiency of trust management and supervision; the costs involved; transparency; the quality of independent trustees; compliance requirements; confidentiality; language barriers; legislation; regulatory restrictions; and internal customs.

South Africa will have to depart from the current perception of a fairly well-regulated, but poorly administered jurisdiction, to an excellent, but not overly regulated, sound and flexible jurisdiction, where trust administration and services are world class, with minimal red tape from official sources.

⁵⁹ See Gopalan "Transnational Commercial Law: The Way Forward" 2003 18 *American Universities International Law LR* 803–847 http://eprints.nuim.ie/2493/1/SG_Transnational.pdf (accessed 2011-09-10) 817 for discussion on soft-law options.

⁶⁰ *Ibid.*