Leap of Faith

Launching the First Maltese Unit Trust Fund

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The Maltese funds industry is has just seen the launch of its first collective investment scheme structured as a unit trust. In this paper, the author examines some of the legal and regulatory challenges which the launch of this structures gave rise to, such as the question of the role of the custodian. The author suggests a number of changes to the regime which are necessary if the structure is to become more widely used and highlights some of the advantages of the unit trust as a vehicle for funds.

While the unit trust is commonly used as a vehicle for collective investment schemes (CIS) throughout the world, particularly in common law jurisdictions, the unit trust structure is very much unfamiliar in the context of the local funds industry.[1] Although structuring CISs in the form of unit trusts is permissible under local legislation,[2] and a regime regulating such CISs does exist, until recently no such funds had been launched in Malta, and so far local funds have been almost invariably structured as SICAVs.[3] However, the situation has now changed as the regulatory process leading to the licensing and launch of the first Maltese Professional Investor Fund (PIF) structured as a unit trust has just been completed.

Unsurprisingly, the process has raised a number of legal and regulatory challenges and has highlighted a number of deficiencies in this previously 'untested' area of our local and legal regulatory regime. This paper will not attempt to wrestle with each and every legal and regulatory issue involved in the setting up of this structure. Instead, it will analyse some of the principal challenges raised by the use of the unit trust structure, identifying areas of weakness or ambiguity in the present regulatory regime, suggest improvement and, in conclusion, make the case for more widespread consideration of this alternative fund structure.

[1] For a detailed account of the history and origins of the unit trust, refer to Kim Fan Sin, The Legal Nature of the Unit Trust, Clarendon Press (Oxford), 1997, Pgs 7 - 46.

[2] Vide Investment Services Rules for Professional Investor Funds, Part A: The Application Process and Investment Services Rules for Retail Collective Investment Schemes, Part A: The Application Process

[3] The MFSA's list of licensed PIFs indicates that all local PIFs so far have been structured as SICAVs, with the exception of one PIF structured as a partnership. The list of license holders can be found on the MFSA's website: http://www.mfsa.com.mt/

The legal and regulatory challenges that will be discussed in this paper are the following:

- The role of the custodian
- The creation of the trust
- The applicability of the sub-fund regime
- The relationship between the trustee and the fund's service providers
- The role of the trustee and its relationship with the fund manager

Before exploring further the regulatory challenges raised by the implementation of the unit trust structure within the Maltese regulatory environment, it is useful to first explore nature of the unit trust structure itself.

The nature of the Unit Trust

The Trust and Trustees Act ('the TTA' or 'the Act') defines the term 'trust' as follows[4]:

"A trust exists where a person (called a trustee) holds, as owner or has vested in him property under an obligation to deal with that property for the benefit of persons (called the beneficiaries) whether or not yet ascertained or in existence, which is not for the benefit only of the trustee, or for a charitable purpose, or for both such benefit and purpose aforesaid."

A Unit Trust is a specific form of Trust. The Trust and Trustees Act defines a Unit Trust as follows[5]:

"'unit trust' means any trust established for the purpose of, or having the effect, or providing, for persons having funds available for investment, facilities for the participation by them as beneficiaries under the trust, in any profits or income arising from the acquisition, holding, management or disposal of any property whatsoever, being a collective investment scheme as defined in the Investment Services Act."

In a typical scenario, the unit trust is initiated by the fund manager entering into a trust deed with the trustee. The trust deed will provide that the assets of the investors (i.e. the unit-holders) will be held on trust by the trustee and invested in accordance with the instructions of the fund manager, subject to the terms of the trust deed, the fund management agreement and the offering memorandum.[6]

Generally speaking, a trust is a **relationship** in which a person, known as a ***settlor,*** settles property with a ***trustee*** for the benefit of the ***beneficiaries***. The trustee is the *legal owner* of the trust property but not the beneficial owner. What is immediately clear is that the unit trust differs from typical private trusts in that strictly speaking the settlor is absent from the trust creation process. This raises a number of questions which are dealt with under the section headed 'The creation of the trust'.

Another important characteristic of the unit trust is the fact that it has the character of a 'commercial trust' under Maltese legislation. The TTA contains a number of

[4] Chapter 331 of the Laws of Malta, Article 3

[5] *Ibid*, Article 2

[6] Kim Fan Sin, *The Legal Nature of the Unit Trust*, (Clarendon Press, Oxford 1997), Pg 1

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provisions which apply to trusts that are formed as part of a commercial transaction as defined in Article 2 of the Act. The general effect of these rules is to allow greater flexibility[7] and permit the alleviation of some duties imposed on the trustee by the Act by allowing the parties to regulate certain matters in the trust deed.

Legal and Regulatory Challenges

The role of the custodian

The Investment Services Rules for Professional Investor Funds (the 'PIF Rules') require PIFs marketed to Experienced Investors to appoint a custodian for the purposes of safekeeping the assets of the PIF. The custodian must then exert a monitoring function over the activities of the fund manager, overseeing the extent to which the fund manager is abiding by the investment and borrowing powers laid out in the offering memorandum.[8] PIFs marketed to Experienced Investors are often referred to as 'quasi-retail' funds,[9] and it is clear that the intention behind this requirement is that of introducing an added layer of investor protection.

It is also clear that the relevant Standard License Condition (SLC) has been drafted in a context in which the legal structure used for PIFs is almost exclusively that of the SICAV i.e. a corporate entity with separate legal personality. In a SICAV, the safekeeping and monitoring function is imposed on the custodian since the custodian, as an independent third party, is well-placed to fulfill these functions.

This requirement is not commercially or logically appropriate in the context of funds structured as unit trusts, since there is another party who is independent of the fund manager and who is bound to protect the interests of the investor i.e. the trustee himself. The requirement to appoint a custodian would therefore translate into unnecessary costs and duplication of work. Therefore for the unit trust structure to be commercially feasible, the role of the custodian needs to be replaced by the trustee.

Moreover, the trustee is not only well placed to monitor the fund manager and safeguard the assets, it is also very much in his interest to do so. The logic is the following:

- Trusts create fiduciary obligations, which means that the trustee has to adhere to a number of strict behavioural standards and act as a bonus pater familias[10]
- The TTA imposes on the trustee the obligation to 'safeguard the trust property from loss or damage'[11]
- The breach of any duty imposed on the trustee by the TTA, the terms of the trust or the proper law of the trust is deemed to be a breach of trust,[12] which can have serious consequences for the trustee[13]

[7] Vide articles 6, 21 and 29.
[8] Investment Services Rules for Professional Investor Funds, Part BI: Professional Investor Funds targeting Experienced Investors, SLC 1.13
[9] AIMA Journal, Q3, 'Malta's 'quasi-retail' alternative investment structures'
[10] Article 3 (6), Trusts and Trustees Act, Chapter 331, Laws of Malta
[11] Article 21, Trusts and Trustees Act, Chapter 331, Laws of Malta
[12] Article 4, Trusts and Trustees Act, Chapter 331, Laws of Malta
[13] Article 30 (1), Trusts and Trustees Act, Chapter 331, Laws of Malta

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- Thus the trustee will not want the fund manager to act unsupervised since the trustee could potentially face serious repercussions under breach of trust.[14]

The regulator seems to endorse this point of view, and has not requested the appointment of a custodian, requiring instead that the trustee specifically adhere to SLCs 1.13 to 1.16 and to any other rules imposed on the custodian which are applicable.

Umbrella Unit-Trust Structure

One of the many attractive flexibilities afforded by local legislation is the possibility of structuring funds as umbrella funds, with individual sub-funds within the umbrella fund having separate assets and liabilities i.e. 'ring-fencing'. In the context of funds structured as corporate entities this arrangement necessitated a legislative intervention by means of a legal notice.[15] The legal notice in question makes no reference to unit trust structures. The question that therefore arises is whether or not a similar legislative intervention is required under our law in order for umbrella structures to be permissible in the context of unit trusts.

The argument in favour of the permissibility of such a structure under the present legislation is closely linked to the notion of 'entitlement'. The TTA states that:

"9(1) A beneficiary has an entitlement, called a beneficial interest, in or to the trust property, as the case may be. The beneficiary may enjoy the beneficial interest subject to the terms of the trust and the provisions of this Act and any other provisions of law applicable to trusts."

This should be read in conjunction with sub-article 10 of the same article:

"(10) It shall be lawful for a trustee to be granted the discretion as to which beneficiaries are to benefit, the quantity of any benefit, at what time and in what manner beneficiaries are to benefit and such other powers relating to the appointment, application or advancement of trust property."

Therefore, 9(1) indicates that the entitlement of the beneficiary (the beneficial interest) is subject to the terms of the trust while 9(10) says that the trustee can be granted discretion with regard to the management of the benefit. This seems to be consonant and to implicitly permit sub-fund structures.

The argument can be illustrated by means of an analogy:

Let us assume that an immovable property is settled on trust. The entitlement to the 'fruits' of the property (e.g. rental income) is allocated in the trust deed to a beneficiary, 'A'. On the other hand, beneficiary 'B' is given entitlement to the capital (i.e. the immoveable itself). It is

14 *Inter alia*, under Article 30 of the Trust and Trustees Act, a trustee committing a breach of trust may be liable for the loss of depreciation in value of the trust property resulting from the breach and the profit, if any, which would have accrued to the trust if there had been no such breach. It is clear that these liabilities could be very significant especially in the context of larger funds.

15 Companies Act (Investment Companies with Variable Share Capital) Regulations, 2006, LN 241 of 2006

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clear that A and B both enjoy a different beneficial interest – A's beneficial interest is the entitlement to rental income, whereas B's beneficial interest is the entitlement to the capital. Should A be unable to meet a third party creditor's demands (i.e. have a liability which he cannot meet), such third party creditor would have the right to make a claim only against A's beneficial interest, and this is a fundamental rule of trust law which finds recognition under Article 9(2) of the TTA.

The position can also be argued *a contrario sensu*. Assuming that sub-funds, i.e. segregated sets of assets and liabilities, are not permissible within collective investment schemes structured as unit trusts, one would logically expect such a rule to apply consistently to all trusts (since the unit trust can be seen as a trust in which the entitlement to the benefit has been unitized). Following this logic one would conclude that it is not possible for trusts to 'segregate' entitlements between various beneficiaries or classes of beneficiaries. However, such an interpretation seems to run counter to the principles established in Article 3 and 9 of the TTA.

The argument can also be made that the parties to the deed are permitted to draft the deed, and thus structure the trust, freely in accordance with their lawful preferences in accordance with the rules on commercial trusts. From a regulatory perspective, the regulator should also be comforted by the fact that the interests of the investors are being safeguarded by the trustee.

The local regulator has not accepted these arguments. The principal argument against their acceptance appears to be the following:

"… [although the unit trust may be established for a commercial purpose] as defined in Article 2(1) of the TTA, Article 6(6) of the TTA states that in such a case 'the trust shall operate in accordance with the express terms of the trust instrument', and accordingly the fund has to operate within the general framework regulating trusts in Malta. In this regard, the Maltese legislative framework for trusts and trustees does not provide for the ring fencing of assets and liabilities of sub-funds within a unit trust as in the case of multi-fund companies (SICAVs) and protected cell companies."

While a number of counter-arguments may be made, it appears likely that the regulator will not authorize any umbrella unit trusts unless specific legislation is enacted in order to cater for such structures. Having said that, the regulator does recognise that it is acceptable for a trustee to, for internal, administrative and accounting purposes, allocate specific assets and liabilities of the trust to particular beneficiaries, without prejudice to the duties of the trustee under the TTA to provide an account to the beneficiaries of its entire trusteeship. However, in such a case the trust and the 'sub-funds' created within it would still be considered as a single trust and the trustee would be required to prepare accounts for the whole trust.

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The creation of the trust

In a typical private trust the terms of the trust deed originate from the settlor and reflect his will. They are the 'mandate of the settlor'.[16] In a typical trust scenario, the settlor will execute a trust deed with the trustee and transfer the property being settled on trust to the trustee. This differs from a unit trust, in which typically the trust deed is constituted without the participation of the settlor.

This raises two questions:

- Is a unit trust a trust at all, or is it something else entirely?
- At which point in time is a trust created?

Regarding the first question, it is useful to first re-examine the definition of the term 'trust'. Keeton and Sheridan[17], for example, define a trust as follows:

"The relationship which arises wherever a person (called the trustee) is compelled in equity to hold property, whether real or personal, and whether by legal or equitable title, for the benefit of some persons (of whom he may be one and who are termed beneficiaries) or for some object permitted by law, in such a way that the real benefit of the property accrues, not to the trustee, but to the beneficiaries or other objects of the trust."

Thomas and Hudson[18] give the following definition:

"The essence of a trust is the imposition of an equitable obligation on a person who is the legal owner of the property (a trustee) which requires that person to act in good conscience when dealing with that property in favour of any person (the beneficiary) who has a beneficial interest recognised by equity in the property."

The express trust is defined by the American Restatement of Trusts as:

"A fiduciary relationship with respect to property subjecting the person by whom the property is held to equitable duties to deal with the property for the benefit of another person which arises as a result of a manifestation of an intention to create it."[19]

In the local case of iWorld Group Europe Holdings plc vs Bettina Vossberg,[20] the court held the principal elements for the institution of a trust under Maltese law to be the following: (i) the assets of the trust are vested and under the control of the trustee; (ii) the trust property constitutes a separate fund; (iii) the beneficiaries possess a limited interest; (iv) the trustee has all the rights that are proper to an owner with respect to the trust property; (v) the principal obligations of the trustee are towards the beneficiaries.

These definitions are echoed by the TTA which does not require a settlor for a trust to come into existence, instead requiring

[16] Ibid. Kim Fan Sin Pg. 55
[17] Keeton and Sheridan, *Law of Trusts*, (12th edn., Barry Rose, 1993) Pg. 13
[18] Geraint Thomas and Alaistair Hudson, *The Law of Trusts*, (Oxford, 2004) para. 1.01
[19] American Law Institute, *Restatement of the Law: Trusts 2d*, (American law Institute Publishers, 1959) s. 2.
[20] iWorld Group Europe Holdings plc vs Bettina Vossberg- First Hall, Civil Court, 7/08/2004

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only a situation in which a person holds as owner property under the obligation to deal with that property for the benefit of others. It is therefore clear that the notion of the settlor is not necessarily essential to the concept of the trust and one can therefore conclude that the unusual nature of the unit trust does not mean that it does not have the character of a trust.

The fact that the concept of the trust does not necessitate a settlor is not sufficient in order to answer the second question since at the moment when the trust deed is executed another and more fundamental characteristic of the typical trust will be lacking i.e. the trust property. The question is not a purely academic one: can a regulator authorise (i.e. issue a license) to a unit trust, when the trust in question contains no assets whatsoever, and can thus be said not to exist as yet? Isn't there a logical inconsistency in the case where a unit trust fund is authorised and thus launched, only for it to require an initial investment by a trustee to come into existence?

This issue has not been raised by the regulator in the discussions involved in the structuring of this first unit trust and thus the above point has not been explored in detail. Having said that, a solution to the above problem can be achieved in an easy and practical way; the fund manager can take on the role of settlor and investor by providing the fund with an initial investment. A trust can be established under Maltese law without a minimum settlement value, and therefore the question of when the trust is created can be addressed by settling a nominal amount of cash (e.g. EUR 1).

The relationship between the trustee and the fund's service providers

The running of a CIS necessitates the appointment of a variety of service providers such as fund managers, fund administrators, custodians and investment advisors.[21] Where the CIS is structured as a SICAV, such appointments are made by the SICAV itself i.e. contractual relationships are entered into between the SICAV and the various service providers, spelling out the terms in accordance to which such service providers are being engaged.

In the context of a unit trust, such an arrangement could be replicated by having the trustee enter into contractual relationships with the service providers. However, while legally possible, such an arrangement is likely to be undesirable for the trustee from a commercial perspective. The reasons for such commercial undesirability are various; the trustee may lack the expertise required to assess to competence of certain kinds of service provider; an investment strategy may necessitate appointments to be made with a swiftness which the trustee is, for some reason or another, unable to provide.

The solution is that of allocating responsibility for the appointment of

[21] Local PIF regulations grant significant levels of flexibility in this regard, with funds able to self-administer and self-manage with no requirement to appoint custodians in the context of PIFs targeting Qualifying and Extraordinary investors, however in practice many PIFs will still want to retain a suite of service providers.

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service providers to the fund manager i.e. the fund manager enters into agreements with service providers for the provision of services to the CIS. This gives rise to a mandator / mandatary relationship between the trustee and the fund manager. This arrangement should be fixed contractually in order to ensure that the desired outcome is achieved i.e. the fund manager is able to contract in its own name with the third parties, with such third parties then being remunerated by the trustee from the fund's assets in accordance with the terms of the trust deed, the offering memorandum, and the agreements made between the fund manager and the third party.

This solution is a sensible one from a practical point of view; the fund manager will invariably be the entity most intimately familiar with the qualities which service providers need to have in view of the investment strategy being pursued, and is therefore well-placed to exercise decision making powers in this regard.

The role of the trustee and its relationship with the fund manager

The trustee, being the holder of the legal title to the assets of the fund, is a central figure in the unit trust and has wide powers under our law. Unit trust structures are not, however, created in order to bring the talents of the trustee to the fore; rather, they are there to permit investors to entrust their investments in the capable hands of the fund manager. In practice, the fund will almost invariably be the brainchild of the fund manager. An understanding of the relationship between these two key figures is therefore essential.

Since it is the manager that holds the relevant investment expertise, one will expect the fund documentation, and in particular the trust deed, to contain provisions indicating that the fund manager has full discretion over the choice of investments. Drafted in absolute terms, such a provision is unlikely to be accepted by any trustee, as the trustee retains responsibility for oversight of the trust assets. Therefore, it is likely that the trustee will want the fund manager's discretion to be tempered by the requirement to adhere strictly to the investment objectives, policies and restrictions laid down in the offering memorandum. The trustee may also want to specifically authorise the transactions; this can also be achieved by means of the introduction of appropriate mechanisms in the trust deed.

The trustee is also likely to want to restrict its responsibilities beyond the core functions of holding title to the assets, safekeeping and monitoring. In this context, the possibility of characterising the trust as a commercial trust is important. Characterisation as a commercial trust allows the parties more freedom in the drafting of the trust deed, and thus allows the parties to limit the responsibilities and liabilities which attach to the trustee. These responsibilities can be allocated contractually to the fund manager.

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Conclusion

It is clear that the unit trust can be a viable alternative to corporate structures as a vehicle for CISs. The legislative framework seems to be sufficiently robust to support the structure, and the regulator's approach regarding the key question of the custodian has been positive and sensible. The characterisation of unit trusts as commercial trusts is also useful and affords the lawyers of fund managers and trustees more elbow room when drafting documentation. Nevertheless, there is still some way to go before the jurisdiction can claim to be a favourable one for such structures.

First of all, there are certain practical limitations – such as the fact that practitioners and regulators are still unfamiliar with the structure and the fact that there are only a limited number of service providers authorised to act as trustees for CISs. More importantly, there are regulatory challenges that still need to be overcome. The inability to form umbrella unit trust schemes, in particular, renders the unit trust a significantly less attractive vehicle when compared to the SICAV.

Having said that, there is still much to recommend the unit trust as a fund vehicle in Malta: trusts are highly flexible instruments which do not need to adhere to the strict requirements imposed by the Companies Act; unit trusts may be structured as tax-transparent entities, which may lead to better results with respect to certain investment strategies; and investors in a unit trust benefit from the oversight of a trustee. It remains to be seen how far the local industry will take up this novel structure, and how much such uptake will be aided by efforts at a regulatory and legislative level.

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