A Critical Analysis of the Regulation of Unit Trusts in South Africa

By

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May God bless you all!

Declaration

I Bob Makukunzva, hereby declare that the thesis entitled "A Critical Analysis Of The Regulation of Unit Trusts in South Africa" is the result of my own investigation and research and that it has not been submitted either in part or full for any other degree or to any other University.

Signature

Date

Summary

The regulation of unit trusts as an example of the regulation of all financial investments in general is a fast changing and dynamic field of law, which is constantly evolving in order to keep pace with changes in the industry it regulates. It is apparent that the entire world's capital markets are grossly affected by fraud and misconducts that pose a challenge to the regulator to implement strict and counteractive legislative measures aimed at weeding out any potential misconduct.

However, the aim of the regulation of unit trusts as well as any other investments is to protect the investors and at the same time promote industry growth. In most cases when legislation is changed, chiseled and improved to ensure maximum protection of investors it may as well become so burdensome to the industry that it seeks to promote and thereby defeating one of its major purposes.

In this research a critical analysis of the regulation of unit trusts in South Africa has been undertaken to examine and analyse the extent to which legislation has achieved its two major purposes; that is investor protection and the promotion of the unit trusts industry on the other hand.

Fortunately the period during which the research was done was that in which the winds of change in the regulation of unit trusts were blowing in their strongest intensity. This provided an excellent opportunity to analyse and evaluate the purpose and effect of the legislative control of unit trust investments, beginning from the time when the Unit Trusts Control Act 54 of 1981 (the 1981 Act) was in operation through

to the introduction of the Collective Investment Schemes Control Act No 45 Of 2002 to the final repeal of the 1981 Act.

The introductory chapters discuss the nature and characteristics of unit trusts, the general regulatory aspects as well as the importance of investor protection in the regulation of financial investments. This is followed by an evaluation of the changes effected in the unit trusts legislation from 1947 up for until the final repeal of the legislation in 2002.

The last three chapters concentrate on the analysis of the purpose and effect of the new legal dispensation; that is its appropriateness for an ever-changing global economic environment.

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CHAPTER 1

INTRODUCTION

A "unit trust scheme" now referred to as a "collective investment scheme" under the new Act[1] means any scheme or arrangement including an open-ended investment company[2] in pursuance of which members of the public are invited or permitted, as beneficiaries under the scheme, to acquire an interest or undivided share in one or more unit portfolios and to participate proportionately in the income and profits derived therefrom.

The structure of a unit trust scheme consists of a management company[3] which is involved in the day to day operation of the scheme, a trustee, which is the custodian of the investors' rights in the scheme[4], the Financial Services Board (FSB) which is the regulatory body of the industry as well as an Association of Collective Investment schemes which oversees the interests of the industry as whole.[5]

In South Africa the first Unit Trusts legislation was passed in 1947.[6] However, the first unit trust was only launched in the country on the 14th June 1965.[7]

[1] The Collective Investment Schemes Control Act No. 45 of 2002 hereinafter referred to as the CISCA. This Act repealed in whole the Unit Trusts Control Act 54 of 1981, which previously regulated the operation of Unit Trust Investments.
[2] This means a company with an authorised share capital, which is structured in such a manner that it provides for the issuing of different classes of shares to investors, each class representing a separate portfolio with a distinct investment policy s 1 of the CISCA.
[3] Usually an institution of sound financial standing.
[4] Section 68 of the CISCA.
[5] Section 2 of the CISCA.
[6] The Unit Trusts Control Act 18 of 1947.
[7] The delay was caused by the necessity for amendments to the original Act, which amendments were introduced in 1962 and 1963.

Compared to the British and American Unit Trusts which were already in operation by the early 1930s[8] the South African Unit Trusts Industry is still young and small.

Despite the numerous amendments on the legislation from 1947 up to 2002[9] South Africa's financial regulatory bodies have been criticised for not keeping up with the "revolution in the financial services industry."[10] In particular the unit trusts regulatory structure was seen as no longer corresponding to the new shape of the industry and its products.[11]

1.1 Hypothesis and/ or assumption

Given the risks associated with unit trust investments[12] the need for a strict regulatory system to restrict the conduct of management companies and their funds is inevitable. Indeed, the assumption is that, greater emphasis should be placed on the protection of investors or that the importance of regulation should be measured in its benefits to the investors rather than the industry itself.

1.2 Problem outlining

Basically, the role of law is to ensure the smooth functioning of the industry and the protection of the investing public. In fact, regulation should strike a balance between investor protection and conservation of the industry on the other hand.

However, in an effort to eradicate the risks associated with investments, the legislation usually becomes over-regulatory thereby unnecessarily

[8] H C Burton *Investments and Unit Trusts in Britain and America*, (1968) at 254.
[9] When the legislation was totally repealed by the CISCA.
[10] F H Van Zyl " Financial regulation lagging" at http://www.btimes.co.za/98/0329/btmoney/money17.htm.
[11] Hence the total repeal in 2002. See the CISCA.
[12] Despite the high diversification thereof.

hindering innovative and beneficial products and services, imposing needless compliance burdens and as a result frustrating national policies designed to benefit fund shareholders and thereby disserving the very investors it intends to protect.[13]

1.3 Motivation

The motivation behind this research is, in light of the above assumption, the enthusiasm to critically examine the extent to which the South African Unit Trust legislation has managed to maintain a balance between strict investor protection and promotion of the investment industry on the other hand.

1.4 Aims and/ objectives

The purpose of the current research is to undertake a critical analysis of the regulation of unit trusts in order to appreciate the role of law in investor protection as well as satisfying the needs of the investment industry.

At the end of the research it is aimed that the following would be achieved:

1.4.1 A detailed understanding of the rules and principles governing unit trust investments and application thereof to day to day problems;

1.4.2 An analysis of the extend to which the law ensures protection of investors and at the same time promote the development of the investment industry;

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[13] M Fink "Mutual fund regulation: Forging a new federal and state partnership" (1996) *ICIP* Vol. 2, No. 1, at 1.

1.4.3 To evaluate and understand the extend to which changes in legislation, that is, the various amendments and repeals have managed to keep pace with changes in the industry;

1.4.4 The extend to which local legislation has managed to accommodate foreign investment products or competitors as well as compliance with international best practice; and lastly

1.4.5 Clarification on the question whether there is not too much emphasis on investor protection at the expense of the growth and survival of the industry.

1.5 Value and limitation of study

The value of this research lies in the requirement that the law needs to be constantly analysed and reviewed to ensure that necessary changes are effected in time to keep pace with the changes in the industry, improve protection on investors as well as promoting industry growth.

The study will be limited to the analysis of unit trusts regulation in conjunction with the above- raised objectives.

1.6 Structure of dissertation

The thesis has been divided into nine chapters. The first chapter is a brief introduction to unit trusts. It outlines the problem or the reasons for the research, its aims and objectives as well as the structure. Chapter 2 discusses the salient features of unit trusts as an investment scheme.

Chapter 3 provides a brief history of unit trusts starting from origin in selected countries up to present day status. In this chapter the focus is centered on how the past has influenced the present day status of unit trusts regulation. Chapter 4 is mainly a detailed discussion of the nature and characteristics of unit trust investments. A historical and comparative analysis of the regulatory aspects of unit trusts in South Africa is in chapters 5 and 6.

Chapters 7 and 8 provide an in depth analysis of the new legal dispensation with emphasis on the benefits, challenges and the future of unit trust regulation. The final chapter 9 provides conclusive remarks on all points discussed in the preceding chapters.

CHAPTER 2

UNIT TRUSTS IN GENERAL

2.1 Definition of a Unit Trust

A "unit trust scheme" is defined in terms of the Unit Trusts Control Act, "the Act"[1], as any scheme or arrangement in the nature of a trust in pursuance of which members of the public are invited or permitted, as beneficiaries under the trust, to acquire an interest or undivided share (whether called a unit or by any other name) in one or more unit portfolios and to participate proportionately in the income or profits derived there from." This definition is expanded upon and qualified by other provisions in the Act, which gives some essential features of the scheme.

2.2 Essential elements of a unit trust scheme

Firstly, the scheme is created by a trust deed, in terms of which certain assets "the underlying securities"[2] are held by the trustees in trust for the beneficiaries, the holders of unit certificates[3]. The parties to the deed are the management company and the trustee.

[1] Section 1 of the Unit Trusts Control Act 54 of 1981 as amended by the Unit Trusts Control Amendment Act 12 of 1998. However this Act has now been repealed and therefore its reference shall solely be for the purpose of alluding to the history and development of unit trusts law. Otherwise, its demise is reflected in subsequent chapters.

[2] 'Underlying Securities', in relation to a unit portfolio, are defined as the securities comprised in or constituting the unit portfolio and include any moneys derived or resulting from the management of the unit portfolio which are held by or are due to the management company or the trustees for the benefit of unit certificates in that unit portfolio. S1.

[3] W.A. Joubert *et al* *The Law of SA* vol. 26 (1996) at 111 para 91.

Secondly, although the participants or beneficiaries in the scheme may have the right to be consulted, in as far as amendments are concerned they can not exercise day to day control over the management of the scheme property[4].

The third aspect is that the scheme must possess one or both of the following features:

2.2.1 pooling of funds by a large group of investors, that is contributions of unit holders, and the profits or income from which they are to be paid are put into one common fund; and

2.2.2 the property in question is managed as a whole[5].

Section 6[6] of the United Kingdom Act, goes further by listing a series of arrangements that do not fall within the definition of a unit trust which are as follows[7]:

2.2.2.1 a scheme operated otherwise than by way of business;

2.2.2.2 arrangement entered into for the commercial business of the participants where this is not an investment business;

2.2.2.3 a scheme under which all the participants as well as the person managing or controlling the arrangement are companies in the same group of companies;

2.2.2.4 employee share schemes;

2.2.2.5 franchise agreements under which a person exploits a right to use a trade name or design or other form of intellectual property or the good-will

[4] J W Vaughan *The Regulation of Unit Trusts* (1990) at 1.
[5] Section 2 of The Act.
[6] Herein referred to as the UK Act. See chapter VIII of the Financial Services Act 1986 of UK as amended by the Financial Services Act of 1988.
[7] J W Vaughan *op cit* note 4 at 3. Also S 3 (2) of the Collective Investment Schemes Act of Zimbabwe 1997. Hereinafter, "The Zimbabwean Act".

attached to it;

2.2.2.6 time share type agreements where their predominant purpose is to enable participants to share in the use or enjoyment of a particular property;

2.2.2.7 a contract of insurance;

2.2.2.8 where the contributions are taken in the course of a deposit taking business, for example in a bank or financial institution, a building society and a post office savings bank;

2.2.2.9 where the purpose is the provision of clearing services for a stock exchange, commercial bank or other financial institution;

2.2.2.10 occupational pension scheme, provident fund or retirement annuity fund;

2.2.2.11 membership of a building society, co-operative society, a company or other body corporate with a purpose that does not fit the definition of Unit Trust in terms of the applicable Act;

2.2.2.12 under which the participants' property is held in trust but;

(i) each participant remains the beneficial owner of part of the property and is entitled to withdraw that part from the scheme at any time; and

(ii) there is a pooling of the participants' contributions, profits and income; and

(iii) parts only of the property are bought and sold together and the property is not otherwise managed as a whole; and

(iv) any other scheme, arrangement, contract or disposition, or any class thereof, that may be prescribed.

The above listed schemes, due to their particular nature and characteristics can be easily confused with unit trust schemes. The importance of marking them out within the Act as is done in the Zimbabwean[8] and United Kingdom legislation is that it provides clarity on their exclusion from the definition of what a unit trust is, as well as taking them out of the prohibition of schemes considered as neither authorized nor recognized. It therefore, becomes easier to understand the schemes that fall within the (Unit Trust Control) Act. Point (iv) above also provides room for prescription by the act of such similar schemes as may be developed in the future but fall out of the ambit of the definition of unit trust schemes.[9]

Unit trust investment schemes are also referred to as mutual funds (especially in theUnited States of America.), and as collective investments (especially in the UK and other countries such as Zimbabwe[10]). Unit trusts must be distinguished from investment trusts,[11] because the latter are usually not trusts at all but companies limited by shares, the main purpose of which is to hold securities or other property for investment. Investment trusts are therefore ordinary companies incorporated under the Companies Act.[12] In terms of section 38 (3) of the Act, no person is permitted to carry on a unit trust scheme under a name, which includes the word 'invest' or 'any derivative thereof. This implies that investment trusts are not recognized as unit trust schemes.

[8] The Zimbabwean Act, s 7.
[9] However, the South African Unit Trusts Control Act of 1981 does not contain a similar provision,viz, one which clearly states arrangements not falling under the Act because they are regulated by different legislation.
[10] The new South African Act on Unit Trusts is entitled the Collective Investment Schemes Control Act No. 45 of 2002 (hereinafter referred to as the CISCA). The Act replaced the Unit Trusts Control Act of 1981.
[11] See Honore *South African Law of Trusts* (1992) at 532 para 381; and also Joubert *op cit* note 3 at 112 *para* 91 for the distinction between a unit trust and investment trust.
[12] 61 of 1973.

Unit Trusts are also called open-ended trusts. This is because the number of units in a trust can be increased (by creating new units) or decreased (by canceling units) as the supply or demand varies[13]. Apparently, a distinction has to be made between an open-ended trust and an open- ended investment company. The latter are defined by section 75 of the United Kingdom Financial Services Act.[14] These companies differ from open-ended trusts or unit trusts in that the property of the scheme is beneficially owned by a corporate body which has the aim of investing its funds to spread investment risk and giving its members the benefit of this. Shares or securities in the corporate body represent the participants' interests in these companies. Similar to unit holders, they have the right to redeem their shares or sell them on a stock exchange.[15]

[13] See W F Sharpe *Investments* (1978) at 437.
[14] See note 6. See also J W Vaughan *op cit* note 4 at 4.
[15] Open–ended investment companies are excluded from the category of being unit trusts through the application of section 38 of the Act dealing with "Prohibition of misleading names and acts". Section 38(3) provides that, "no person shall carry on a unit trust scheme under a name which includes the word invest or any derivative thereof" except with the approval of the registrar. However, the CISCA incorporates open –ended investment companies as a "collective investment scheme" or unit trust. This means therefore, that open-ended investment companies are now recognised as unit trusts as long as they are not collective investment schemes "authorised by any other Act". The purpose for this is to allow for innovation of new investment products and therefore, expansion of the industry – see chapter on reform with special reference to the CISC Bill.

CHAPTER 3

A BRIEF HISTORY OF UNIT TRUSTS: ORIGIN AND DEVELOPEMNT

3.1 Unit Trusts in Europe[1]

The first European unit trust of the fixed type was created in Switzerland during 1930. Subsequently the first British fixed unit trust was established in 1931. Basically the idea of a unit trust scheme originated earlier in America under the name Mutual Funds. Hence, the growth of mutual funds in North America had attracted the attention of a number of persons in financial circles in London towards the end of the twenties and during the same period American Fixed Unit Trust certificates had been sold in the UK on a small scale.

The trust deed of the first British fixed trust, contained inter alia, provisions for winding up the trust after a life of twenty years and the criteria for the selection of securities to be held. Despite opposition from many brokers who feared a diminution in business and felt there was no need for such innovations on the British scene, the trust got off to a good start. The unit trusts in Britain had the advantage of being launched at a time when stock market prices had reached an all time low and prospects for recovery were fair. Therefore, the number of schemes established began to multiply quickly once the recovery of the British economy got underway through devaluation and the availability of cheap money.

[1] H C Burton *Investment and Unit Trusts in Britain and America* (1968) at 254.

The early types of unit trusts were either fixed trusts or flexible trusts depending on whether the scheme was obliged to invest in specified types of assets or not.[2] Initially, the fixed type[3] of unit trust prevailed, since they were easier for the general investing public to understand. Later flexible unit trusts[4] came into being in 1934 and by 1936 had completely dominated the industry in so far as new schemes were concerned.[5]

3.2 Regulatory Aspects

A number of factors contributed to the evolution of legislative control of Unit Trusts in Britain. Firstly, public concern over the dangers of "over-accumulation"[6] and the possibility of "share-pushing"[7] led to demands for public inquiries and legislative action to protect unit holders. Secondly, Professor Hughes,[8] points out that unit trusts have most often had a "chequered" history. He notes that the need for regulation of unit trust investments has often been caused by the suspect activities of promoters of investment schemes, which operated on the fringe of the corporate investment market. Henceforth, there was the desire to bring unit trust investments under corporate legislation.

Moreover, the history of the unit trust industry has been attended by a series of notable failures of large schemes and a lack of certainty about the rights of

[2] See R A Hughes "Unit Trusts" (1999) 3 *Journal of South Pacific Law Working Papers* at 2.
[3] Which concentrated their portfolios almost entirely on the quoted securities of large and well established UK companies.
[4] The flexible type of unit trust involved selection of shares depending on performance. This allowed the need to increase the number of eligible securities and therefore reduce risk.
[5] H C Burton *Investments and Unit Trusts in Britain and America* (1968) at 256.
[6] A situation that arises where a popular share made an irresistible appeal to a number of separate trust managers resulting in reduced capital security and an increase in risk.
[7] Where the manager acts as principal in the appropriation type of flexible trust.

unit holders. The relationship between the two controlling bodies that is, the trustee and the manager was another problem. This was due to the fact that some argued that the divided structure of unit trust administration (with the trustee and manager) created some confusion on the proper limits of the authority of each entity[9]. However, such a structure of administration was implemented for purposes of effective investor protection.

Towards the end of 1935, a sub-committee of the council of the stock exchange produced its findings. Whilst it recognized the importance of fixed trusts for the investing public, the sub-committee did not think that adequate safeguards existed. Apparently, the Stock Exchange Committee wished fixed trusts to be subject to the type of controls already existing for the publicly quoted company.

Amongst other important requirements the committee recommended the following:

3.2.1 more and specific information to be supplied in the trust deed and to be available to unit holders;

3.2.2 total sales of certificates to be supplied and percentage limits to be placed on the proportion of a trust's portfolio which might be held in any one security

3.2.3 limits on the amount of stock which the trust could own in any one company;

3.2.4 method of calculation of yield; and

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[8]See the Zimbabwean Collective Investments Act, section 3(2).

[9] R. A Hughes *op cit* note 2 at 2.

3.2.5 the specification that the trustee should be a bank or insurance company authorized to do trustee business.

In March 1936, the Board of Trade set up a departmental committee – the Anderson-Committee- to undertake full investigation of unit trusts' prior to legislation. In its report the committee recommended the following;

3.2.5.1 legislative control over advertising, clear and specific instructions to all trusts as to the manner and calculation of yields and prices of their units;

3.2.5.2 control over the issue of certificates;

3.2.5.3 provision in the trust deed for the removal of managers by the trustee or a large proportion of the unit holders should this be in the interests of unit holders as a whole;

3.2.5.4 provisions for the audit and circulation of accounts and how they should be drawn up; and

3.2.5.5 future provision for meeting administration expenses.

However, the Government had no early intention of implementing legislation to control the unit trust movement. Therefore, provisions relating to unit trusts were only incorporated in the Prevention of Fraud (Investment) Act of April 1939.[10]

Successive committees, like the Jenkin's committee, were instituted in preparation for a new Companies Act incorporating regulation of unit trusts. Characteristically, they were delayed but such was the nature of evolution of legislative control in Europe. Today, British unit trusts are regulated by a separate piece of legislation which is contained in Chapter VIII of the Financial Services Act 1986[11] under the title "Collective Investment Schemes".

3.3 The South African Context[12]

Compared to the American and British unit trust industry the South African industry is very young and small indeed. Although the first unit trust legislation[13] in South Africa was passed in 1947, the first unit trust was only launched in the country on 14 June 1965. The delay was caused by the necessity for amendments to the original Act, which amendments were introduced in 1962 and 1963.[14]

Unit trusts were established to offer the general investing public a convenient investment product, which could counter inflation. Another important reason was to accomplish a link between the products of particularly the insurance companies and unit trusts.[15] Units trust investments were identified as an effective mechanism with which a diversified portfolio of growth assets (listed shares) could be profitably marketed to the public as well as providing a link between these same benefits, life assurance policies and pension funds.

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[10] Which contained provisions covering the major part of the Anderson's Committee recommendations, and unit trusts continued to be governed by this Act until it was revised as the Prevention of Fraud (investment) Act 1958.
[11] As amended by the Financial Services Act 1988.
[12] Hugo Lambrechts "Unit Trusts in SA – A Historical overview" in Profile's *Unit Trusts Handbook* (1996) at 22-35.
[13] Unit Trusts Control Act No 18 of 1947.
[14] To be discussed below.
[15] Hugo Lambrechts *op cit* note 12 at 22.

The 1947 legislation did not allow any significantly wider potential for specialization or for development of new types of trusts such as the money market funds in the U.S.[16] However, the South African unit trust investments had an advantage of being launched during a period of rapid economic growth and increasing prosperity.[17] Indeed the unit trust concept offered a flexible, simple and convenient way of participating in the future growth of the country and its economy, particularly to the wider general public who until that time had not been directly involved in the stock market to any significant degree or been afforded a suitable or sufficiently secure means of equity participation. The unit trusts promised a full-time professional management for the benefit of all investors, large and small, and held out the prospect of sound long-term capital appreciation and income growth, coupled with a high degree of security.

3.4 The Boom Years

The attractiveness of unit trust investments grew rapidly as the industry's potential became more widely understood. Initially, there was great demand for more information on the precise functioning of unit trusts. The concept of an "open –ended" trust was completely strange whilst on the other hand the issue pertaining to initial charges was not yet settled. By 1966 the few existing funds had assumed an alarming growth rate.

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[16] To be discussed below.
[17] Hugo Lambrechts *op cit* note 12 at 29.

The devaluation of the British Pound in November 1967 was an event that provided an immense stimulus to the local market which started to rocket towards a financial speculative spree.

An out-pouring of highly successful new listings reinforced the momentum and introduced large numbers of new investors to the market place. In November 1967 the Unit Trusts Association was established. It comprised of six management companies operating unit trusts at that stage. Further, the growth of the unit trust was vitalized by inflation expectations and by convincing the public that by investing their money in unit trusts, they could beat inflation. However, the unit trust association, seeing that the rapid growth in the industry was increasing fast agreed during the third quarter of 1968, apparently voluntarily, to stop advertising for a period of three months. Notwithstanding that, more and more people got attracted to the unit trust market giving the investment a stronger and more favorable appeal and growth. This sense of elation in the industry progressed to greater intensity towards the year 1969.

3.5 THE CRASH OF 1969

In May 1969 the bubble finally burst. As Professor Hugo Lambrechts[18] indicates: "April 1969 was the last good month of the Johannesburg Stock Exchange for many years". The crash was perceived as a "deliberate and organized attempt at creating an economic Sharpville" in South Africa coupled

[18] *Op cit* note 12 at 26.

with a massive drop in prices on the stock exchange[19]. From then on, the bull phase had devastating effects on public perception of the unit trust industry. Unfortunately, it resulted in near total preoccupation in the media and elsewhere, with capital inflows and outflows as well as an almost equal neglect of the truly important criteria of investment performance. For this reason the unit trust industry became a scapegoat on whom both the rise and subsequent decline of the stock market could be blamed. In order to correct this the industry had to take drastic action based on the following considerations:

3.5.1 the regulatory bodies adopted a much more cautious attitude to the industry and thereby discouraged an early revival of active marketing;

3.5.2 the combination of a falling market, a continuing level of repurchases and an absence of sales greatly reduced industry size as well as profitability.

In 1985 a prolonged social unrest and instability in the country ensued. However, the unit trust industry continued to flourish. Against such a background 1986 turned out to be the industry's most successful year since inception.[20] Even during the market crash of October 1987 the industry continued to perform well.

With respect to regulation of the industry, the coming into operation of the Financial Services Board (FSB) on the first of April 1991 heralded a new

[19] "Die Vader land" 21 August 1969.

[20] Hugo Lambrechts *op cit* note 12 at 33.

regulatory era in which both government and the private sector combined to supervise the activities of financial institutions. This board effectively replaced the Financial Institutions Office. During the same year, the creation of the unit trusts Advisory Committee was another important move. This was pre- conceived in the amending legislation passed in may 1991 which reduced certain of the rigidities of the Unit Trusts Control Act by enabling nominated clauses to be amended by proclamation in the Government Gazette.

3.6 Summation

The history of unit trusts is characterized by issues that pertain to the rapid growth of the industry, failure of some schemes, boom years as well as market crashes and evolution of legislative control. The industry is one that has gone through a speedy changing process coupled with uncertainties and innovations. However, the dynamic and competitive nature of the industry is the major reason behind the successive amendments to the legislation from inception to the present date.[21] This indicates that continued progress in refining the regulatory landscape will prove to be a defining factor for the future growth of the industry.

[21] To be discussed below.

CHAPTER 4

NATURE AND CHARACTERISTICS OF UNIT TRUST INVESTMENTS

4.1 Structure of adminstration

For purposes of effective investor protection the structure of administration and control of unit trusts is divided. There is a management company, an independent trustee and a registrar of unit trust schemes. Other bodies involved in the control and proper functioning of the industry are the Association of Unit Trusts (AUT), the Financial Services Board (the FSB) as well as the brokers or intermediaries. Since a detailed discussion of the legal nature and purposes of each of the above structures will be done in later chapters, only a brief explanation will be given below:

4.1.1 The Management Company

This is a company registered as a management company under the Act[1] to manage or carry on a unit trust scheme.[2] It is involved in the day-to-day control of the unit trust scheme through administration of the scheme and receiving funds from investors in exchange for units. The management company, therefore, is legal "*persona*" acting in a capacity of agent on behalf of unit-holders[3]. However, the management company is

[1] The Unit Trusts Control Act 54 of 1981. "Hereinafter referred to as "the Act".
[2] T Honore and E Cameron *Honore's South African Law of Trusts* (1992) at 533.
[3] McGregor *The Mechanics of the Johannesburg Stock Exchange* (1989) at 233 for the general definition of a management company.

also obliged to repurchase units offered for sale by its unit holders.

In return for its professional management services the company is reimbursed by charging entry and administration fees. This gives the management companies the incentive to perform well and attract a large asset base[4]. Most unit trust management companies in South Africa are of high financial standing and are affiliated to largest life assurance companies and banks in the country.

Practically the management companies are accountable to their investors, their trustees , the registrar and the Financial Services Board (FSB).

4.1.2 The Trustee

This is a separate entity that every unit trust scheme is legally obliged to have as an independent arbiter. The contract between the trustee and the management company is contained in a document called the trust deed[5]. The trustee ensures that the trust is managed within the terms of the trust deed and basically, the most important aspect of the deed is the investment aim of the fund. It is therefore the task of the

[4] See H Lambrechts *Unit Trust Handbook* (1994) at 22. See also W F Sharpe *Investments* (1978) at 437 for the role of a management company and the performance of a fund.
[5] To be discussed below.

trustee to ensure that the investment aim or policy is adhered to[6].

The trustee performs other important functions which inter-alia includes the following:[7]

4.1.2.1 safe-guarding the fund's assets against potential mismanagement by the management company;

4.1.2.2 acting as the guardian of the assets on behalf of the beneficiaries or unit holders;

4.1.2.3 ensuring that daily transactions are conducted in accordance with the trust deed;

4.1.2.4 protecting the rights of unit-holders. If the trustee has any

4.1.2.5 suspicion that the manager is not acting in the unit holders' interests, he has the power to replace him;

4.1.2.6 Acting as the custodian of all cash and securities in the fund. All the assets of the funds are held in the trustee's name;

4.1.2.7 Protecting the public from any possibility of fraud on the part of the managers.

The Act provides for the duties and responsibilities of the trustee as well as contents of the trust deed.[8]

[6] McGregor *op cit* note 3 at 223, para 3.1.2.

4.1.3 The Registrar of Unit Trusts

This is the authority appointed in terms of Section 1[9] for purposes of registering Unit Trust Schemes. The registrar must ensure that registration is consistent with the requirements of the Act, based on sound financial principles and in the public interest[10]. At the end of each year the registrar must submit an annual report to the Minister concerning all matters in relation to unit trusts.

There is also an Advisory Committee, which has the responsibility of conducting investigations and advises or makes recommendations to the registrar with respect to any matter relating to unit trusts.

The duties of the registrar and Advisory Committee as well as the procedures for registration and cancellation thereof, are contained in the Act and shall be discussed in detail.

4.1.4 The Auditor of a Unit Trust Scheme

The auditor is appointed by the management company and should be approved by the Registrar for purposes of auditing the books of the company.[11]

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7 H Lambrechts *op cit* note 4 at 41.
8 These will be discussed in the following chapter.
9 Of the Financial Services Board Act 97 of 1990.
10 S4(3) a-c of the Act.

4.1.5 The Association of Unit Trusts

This association was established in 1967 to represent the collective interests of unit trust management companies and their unit holders. Its major aim is to facilitate the development and growth of the industry through its dealings with the authorities and regular communication with the media and the investing public[12]. The association acts as a custodian of codes of practice and standards throughout the industry as well as being a forum for identifying and fulfilling common goals. In principle the association works for both management companies and unit holders. However, since management companies and unit holders have apparently opposing needs, it is important that the association takes caution against making decisions that investors may perceive as being contrary to their interests. Therefore a balance should be struck between facilitation of the industry's development and the protection of investors.[13]

In 2002 the Association was also charged with the task of overseeing unit trust training courses as part of its objective of educating the investing public.

[11] Section 11 (1) of the Act. See also chapter 2 for an in-depth discussion on the duties and responsibilities of an Auditor.
[12] See Liz Still and Nic Oldert *Understanding Unit Trusts* (2000) at 18.
[13] See Wechler, Ross and Partners *South Africa: A Well Developed Financial History* (2001) at 2.

4.1.6 The Financial Services Board (FSB)

This is the regulatory body of the unit trust industry. It is a quasi – governmental body funded by the financial services industry. The FSB in addition to its supervisory roles functions in an advisory capacity to the Minister of Finance.

Indeed, the FSB is guided by a spirit of constantly reviewing the legislation in order to introduce improved protection for the investing public, expanding the industry and creating a more flexible and transparent framework of regulations for the unit trusts industry.[14]

4.1.7 The Financial Service Intermediaries or Brokers

The 'unsophisticated' or person "on the street' investor, since she is not familiar with the *pros* and *cons* of investing will always need the services of a broker to help her with financial planning and making investment decisions. Many unit trust management companies utilize the services of brokers who can either be 'tied' (meaning that the broker sells exclusively for one management company) or be 'un-tied' (meaning the broker is a free agent).

Presently, there is new legislation to ensure the effective regulation of intermediaries.[15]

[14] To be discussed in the chapters 7 and 8 especially with respect to the CISCA and the FAIS Act.

4.2 The potential merits of unit trusts

4.2.1 Professional Management

Very few people have the necessary time, skills or experience to actively manage their investments and to research the best ways to make the most of their money on a day-to-day basis. Intrinsically, unit trust management companies employ analysts and portfolio managers who have expert knowledge and experience in their specialized fields. This enables unit-holders to access expensive services that they would not otherwise afford as individuals.

The need for professional management in making investments should not be underestimated. This is because the intricacies of managing a fund can be very high and risky especially with respect to the unsophisticated investor. Rugg[16] points out that "it is unfortunate, that mostly it is the 'sophisticated investor' rather than the beginner or 'unsophisticated investor'[17] who utilizes and appreciates the 'reduced burden and responsibility' as well as the resulting peace of mind afforded by professional management".

Most of the South African unit trusts are managed by reputable banks and insurance companies of high financial standing. These institutions use the unit trust industry as a stage for showcasing their expertise. This gives fund managers an extra incentive to perform well.

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[15] The Financial Advisory and Intermediary Services Act No. 37 of 2002 – to be discussed in the chapters that follow.
[16] H Lambrechcts *op cit* note 4 at 51.

However, evidence suggests that contrary to their definition unit trusts do not provide the relative level of investment performance to justify the much-emphasized assumption that unit trust portfolio management provides consistently superior investment returns. What is important therefore, is to seek and select the most experienced and gifted fund managers[18].

4.2.2 Diversification

This term refers to the spreading of capital among different shares and industries,[19] which removes the risk caused by unforeseen changes in any single company. Since, unit trusts employ a high degree of diversification, they are most suitable for a major commitment of an investor's fund[20]. Unit trusts provide diversification in a manageable way because each unit represents a pro rata share of an entire portfolio.

Diversification may take several forms or a combination of forms:[21]

4.2.2.1 it may involve investing in securities offered by many issuers; or

4.2.2.2 spreading of risk between several types of securities like ordinary listed industrial and mining shares; listed property shares ; long term

[17] These are investors with no time, resources and the aptitude necessary to monitor their own portfolios.
[18] H Lambrechts *op cit note 4* at 51.
[19] *Ibid.*.
[20] W F Sharpe *op cit* note 4 at 457.
[21] H Lambrechts op cit note 4 at 51.

to medium and short-term bonds and money market instruments;

4.2.2.3 investment of funds in many different industries for example the different sectors of listed ordinary shares on the Johannesburg Stock Exchange (JSE); or

4.2.2.4 Investment within the government, semi-government and corporate bonds as well as money market securities, negotiable certificates of deposit and fixed deposits.

The pooling of investor funds by unit trusts provides a low cost way of diversifying risk. Therefore, individual investors who cannot afford the services of a private portfolio manager or brokerage firm (with regard to managing a diversified fund) can access it through investing in unit trusts. In order to safeguard unit-holders the law provides for a wide spread of investments and holding of 'liquid assets' by management companies.[22]

4.2.3 Tax Effectiveness

A unit portfolio comprised in any unit trust scheme managed or carried on by any company registered as a management company under section 4 or 30 of the Unit Trusts Control Act[23],must disregard any capital gain or capital loss. This provision applies to regulated unit

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[22] See W van der Walt *"Special Feature – Unit Trusts"* (1987) (November) *De Rebus*.
[23] *Supra* note 1.

trust schemes that invest in financial instruments or shares in companies that own immovable property.[24]

A unit trust management company will not itself be concerned with liability for capital gains tax (CGT).[25] Therefore, having CGT paid outside of the unit trust means that unit trust portfolio managers can focus on their core business of managing an investment portfolio according to a mandate, rather than being distracted by tax issues. This results in more focused and better investment performance.

However, there is liability for capital gains tax on a gain made by an individual taxpayer on the disposal of units[26]. This applies to investors of unit trust schemes created in terms of the Act as well as similar collective investment vehicles abroad.[27] In other words, all local and foreign unit trusts will be subject to CGT, except for money market funds, which have a fixed price and which generate income rather than capital gains or losses.

Given that unit trust investors are empowered to decide when to become liable for CGT, it gives them an opportunity to defer tax and plan their investments appropriately. But, investors must be aware not

[24] See R C Williams CGT – *A Practitioner's Guide – Eighth Schedule to the Income Tax Act* (2001) at 21.
[25] See para 61 of the Eighth Schedule to the Income Tax Act of 1962. See also, D Davis, *Capital Gains Tax* (2001) at 74.
[26] *Ibid.*
[27] *Ibid.*

to become obsessed with not paying CGT, thereby losing sight of the overall investment objectives.

The CGT policy is transparent and therefore, easy for an investor to know when it is incurred. Nevertheless, the tax policy is complementary to the unit trust objective of being a medium to long-term investment scheme.

4.2.4 Fees and other charges

The Unit Trusts Control Amendment Act[28] amended the Act[29] to deregulate unit trust fees and charges. The deregulation came into operation on 1st June 1998 thereby removing the ceiling of 1% on the annual management fees. Management companies, therefore, have the freedom to charge fees depending on market forces and the actual costs incurred can differ from fund to fund. Thus, management companies are obliged to disclose all fees and charges to their investors and these are usually disclosed on all marketing material. The fees charged include initial fees or once-off entry costs,[30] VAT on initial charge[31],

[28] Act No.46 of 1988.
[29] Section 1(a)-(b) of The Unit Trusts Control Act, *supra* note 1.
[30] Which are first levied when purchasing units and used to pay broker commission, marketing and administration costs.
[31] Which is tax levied on the initial charge.

compulsory fees[32], annual fees[33], trailer fees,[34] switching fees[35], exit fees[36] and performance –based fees.

The effect of the deregulation of fees is that there will be greater competition amongst management companies to charge fees favourable to investors. This places a greater responsibility on investors to be vigilant and take enough time to consider charges and fees before selecting an investment since fees can significantly affect the growth of an investment. Investors should also be aware that investing in too many funds increases the cost of investing and can lead to over-diversification.

Unit trusts are affordable because the pooling of money increases the buying power and it enables fund managers to buy shares, bonds, money market instruments and other instruments that the small investor normally would not be able to afford.

4.2.5 Flexibility and Convenience

The following considerations make it convenient to invest in unit trusts:[37]

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32 Charged on equity-based unit trusts for brokerage and Marketable Securities Tax (MST).
33 An ongoing fee levied by the management company for administering the units and managing the investments.
34 Paid to brokers to provide ongoing investment advice to their clients.
35 Levied if an investor switches from one fund to another.
36 Levied for selling an investment within the first year. However, not all management companies charge this fee.
37 L Still and N Oldert *op cit* note 12 at 13.

4.2.5.1 they are easy to buy and sell. In terms of the Act management companies are obliged to redeem units offered to them by unit holders;

4.2.5.2 ivestors have the choice of buying unit trusts on the internet, through a broker or agent, a bank or directly from the management company;

4.2.4.3 debit orders can be cancelled, increased or decreased without a penalty unlike in life assurance company investment;

4.2.4.4 switching of investment is easy;

4.2.4.5 they are transferable and can be invested in somebody else's name.

However, the flexibility of unit trust investments must be taken with caution. This is because it may allow investors to react emotionally to volatile market conditions resulting in selling when the market is falling and buying when stocks are rising. Infact, unit trusts are medium to long-term investments and therefore, a habit of buying high and selling low lacks investment discipline and hence a sure way to lose money. On the other hand, it pushes managers into 'forced trade' situations, where they have to buy into an expensive market because of large inflows and then to sell into a weak market because of outflows due to investors redeeming units. All in all, it is required of investors to be more knowledgeable and disciplined in their investment approach.

4.2.6 **Inflation Hedge**

There is no doubt that inflation is a major concern for investors.[38] Unit trusts have provided more average returns compared with traditional investment products. According to history, they have

[38] Sharpe *op cit* note 20 at 160.

proved to be an excellent way of beating inflation[39]. As a medium to long term investment unit trusts have a greater opportunity for growth.

4.2.7 Variety of Unit Trust Products to choose from

The unit trust legislation puts emphasis on investor protection. However, the reality is that it cannot protect investors from unsuitable investment choices. There are hundreds of unit trusts available in South Africa including other locally registered off- shore unit trusts, plus offshore unit trusts that investors can purchase directly from overseas management companies. These funds have a wide range of objectives and mandates, which suits different investors in various circumstances. In order to ensure investors' satisfaction there is therefore a wide range of unit trusts to choose from.

Unit trusts generally are classified as equity funds and income funds. These funds are classified according to their general investment objectives and they have subcategories as follows[40];

4.2.7.1 **General Equity Unit Trust:** it has its assets invested in a wide range of shares and securities listed on the Johannesburg Stock Exchange (JSE). The objectives of this fund are:

4.2.7.1.1 to have a good spread of investments with sound medium to long term growth prospects in unit price and dividend yield;

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[39] See H Lambrechts *op cit* note 4 at 22-37.

4.2.7.1.2 to achieve a balance between growth, income and stability; and

4.2.7.1.3 to invest in undervalued, high growth companies;

4.2.7.2 **Specialist Equity Funds:** concentrate on specialized sectors such as gold, mining, financial and industrial sectors. It aims at deriving capital profits rather than dividend growth and by their nature they are less diversified and therefore, more risky than general equity unit trusts.

4.7.2.3 **International Funds:** aim to benefit from foreign earnings through the optimal utilization of the rand exchange rate by investing in shares of companies, which are involved in the export and import field, or companies obtaining their income from abroad.

4.7.2.4 **Managed Or Balanced Funds:** Involves constant monitoring of the market and adjustment of the portfolio structure (by the manager) in compliance with the Prudential Investment Regulation in order to achieve a balance between income, capital growth and security. The objective is to provide investors with good capital growth potential, investor stability and reduced risk.

4.2.7.5 Gilt and Income Funds: invest in high-income earning securities like fixed interest investments. The objective is to maximize potential capital growth and stability as well as a steady income.

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[40] *Ibid* at 67.

4.2.7.6 **Money Market Funds:** are short-term and highly liquid investments. The aim is to maximize interest income and to provide immediate liquidity for investors. Investors can use them as a temporary investment or as an attractive alternative to a bank fixed deposit because of the higher interest rates.[41]

The unit trust funds are dynamic and expanding. In order to promote innovation in the industry, there are improvements in the CISC Act aimed at enabling the introduction of new products.[42] Whilst new investment products are being introduced to the unit trust market it becomes more important for investors to choose unit trusts that have underlying investments, which are appropriate to their particular circumstances.

4.2.8 Transparency

The Act contains provisions[43] which places an obligation on management companies to transmit to every unit holder of a unit certificate details of underlying investments and performance statistics to the public.[44] The proposed Collective Investment Scheme Control Bill[45] requires additional levels of disclosure in unit trust reporting. This ensures increased investor protection and sustainance of confidence in the unit trust market.

[41] L Still and N Oldert *op cit* note 12 at 89.
[42] Discussed in chapters 7 and 8.
[43] *Ibid.*
[44] Section 10 of the Act.

4.2.9 Investor Security

There are various mechanisms in place to ensure efficient protection of investors of unit trusts. Firstly the divided structure of administration involving the management company, registrar and trustee makes it difficult for management companies to operate without approval (by registrar) and consequently mismanage funds. Secondly, the unit trust legislation, which was originally implemented in 1947,[46] has been amended several times and finally replaced by Act No 54 of 1981. The amendments signify the regulator's appreciation of the changing nature of unit trusts as well as the shortcomings of the law with regard to investor protection and expansion of the industry. Progressive restructuring of the regulatory system (as is taking place now) will ensure continued investor protection in the backdrop of a fast changing investment industry.

4.3 The role of law and the development of the unit trusts industry

The unit trust industry like any other financial services industry is highly competitive and dynamic. It is driven by a strong desire to expand through innovation of new and sophisticated products and services. Inherently, the integration of international financial markets brings about challenges with regard to the requirements of complying with internationally accepted standards in order to compete successfully in the global economic environment.

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[45] Clause 10.

Usually there are difficulties with regard to sustaining a fair balance between investment incentives and legislative constraints. Whilst the role of law basically is to ensure the smooth functioning of the industry and protection of the investors, it is always common that in an effort to achieve such a purpose restrictions on the development of the industry are imposed.[47] Therefore, in order for legislation to maintain such a balance it has to be consistently reviewed and amended so as to correspond to the new shape of the industry and its products.[48]

[46] The Unit Trusts Control Act No. 18 of 1947.
[47] See Mathew Fink "Mutual Fund Regulation: Forging a new Federal and State Partnership *Investment Company Institute- Perspective* (1996) Vol 2 January issue at 1.
[48] *Ibid* at 2.

CHAPTER 5

REGULATION OF UNIT TRUSTS IN SOUTH AFRICA

5.1 Evolution of legislative control

The first legislation to be passed for the purpose of regulating the promotion and carrying on of unit trust investments was the Unit Trusts Control Act[1] in 1947[2]. However, this act was not implemented until 1965. The delay was due to the fact that the act was not effective enough to control the proper functioning of unit trust investments and therefore, prior amendments were necessary. Hence, the first unit trust in the country was launched on 14 June 1965.

5.1.1 The key amendments to the Principal Act: purpose and significance

Since 1962[3] various amendments were effected on the original Act. These amendments serve a very important role in portraying the trend in unit trust regulation. They help in understanding the nature of the law, its application as well as reformation.

5.1.2 Amendments Prior to the Launch of Unit Trusts

5.1.2.1 The Unit Trusts Control Amendment Act 1962[4]

The above was the first Act to amend the principal Act in several important respects. Its main purpose was to remove most of the

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[1] Act 18 of 1947 herein referred to as "The Principal Act".
[2] Joubert *The law of South Africa* (1996) at 111.
[3] The Unit Trusts Control Amendment Act No. 11 of 1962.

[4] A Suzman "Unit Trusts" (1962) *Annual Survey of SA Law* at 331.

restrictions contained in the principal Act. The basic idea behind was to permit the creation of the so-called open-end trusts[5]. These kinds of trusts provide a suitable means of investment, in equities with a large spread of risks both for individual and institutional investors[6].

The other amendment (to the principal Act) was with respect to capital resources of the management company. The minimum capital resources of the management company of a scheme in securities (other than property shares) were increased from R50 000 to R600 000[7].

The following limitations were imposed in respect of the securities (other than "approved securities") that is, those issued by the Government or local authorities, which may be included in the unit portfolios:

5.1.3.1 that, not more than five percent of the total assets in a unit portfolio may be invested in the securities of any one concern; and

5.1.3.2 that no investment may exceed five percent of the total securities issued of the class in which the investment is made.

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[5] *Ibid.* An open-end trust is a special type of unit trust consisting of a portfolio of underlying securities in which members of the public are invited to acquire an undivided share and to participate proportionately in the income or profits derived there from. The portfolio is continually increased with securities to cover the inflow of capital from the public and units held by the public are priced by the market valuation of the underlying securities.

[6] During the second reading of the Bill, the Minister of Finance pointed out that open-end trust could offer a particularly valuable service to the economy of the country by ensuring the availability of more risk capital. Further, this would ensure a more balanced economy by allowing the savings of the community to be employed in those sectors where the general interest of the country is greatest. *House of Assembly Debates Vol* 2 Cols ff (31 January 1962).

[7] This would ensure greater security for investor funds.

The purpose for these provisions was to ensure the wide spread of investments[8] and to ensure, as far as is practicable, that unit trusts will not acquire the control of an entity in which it holds an investment.

The amending Act [9]also prescribed the following, (with regard to a unit trust scheme):

(i) that at least ninety five percent (95%) of all the securities included in a unit portfolio must be stock exchange securities and the remaining five percent be stock exchange securities within a period of one year as from the date of their inclusion.

(ii) in line with the policy that the number of open-end trusts should be limited, the amending Act prescribed that, every open- end trust must at the time of its formation comprise underlying securities to the market value of at least R500 000.

(iii) that every management company must, from its own resources, maintain an investment in every unit portfolio of at least ten percent of the total assets. These investments could, however, in the discretion of the Registrar, be limited to R200 000. The purpose of this was to ensure that the management company itself participates in the scheme in which it invites the public to participate.

(iv) that the contents of advertisements and brochures for purposes of promoting the sale of units must contain particulars relating to inter-alia the management company's initial charge[10] and service charge. Further the Act provided that the terms and conditions upon which the management company undertakes to redeem units from the holders must be stated, and also whether or not securities in respect of wasting assets included in the unit portfolio concerned are amortized and if so, on what basis.

(v) that fuller disclosure must be made with regard to information concerning the operation of the unit trust scheme[11]. The Registrar was also given authority to demand for such further information and explanation, as he considers necessary.

(vi) an increment to the amount of the prescribed capital and unimpaired reserves for a trustee of a unit trust scheme was made (from R100 000 to R1 000 000). Amendments with regard to matters which must be provided for in trust deeds were also made. For instance, it was provided that the proceeds of capital gains, rights and bonus issues may not be distributed but be invested in the scheme concerned for the benefit of holders of unit certificates;

(vii) amendments relating to unit trust schemes in property shares were made in order to increase the prescribed capital of a management company managing a scheme in property shares from a minimum of R50 000 to a maximum of R100 000;

[8] Or in other words "diversification of investments"; this concept remain a basic requirement for a unit trust scheme.
[9] A Suzman *loc cit* note 4.
[10] Expressed as a percentage of the made-up price of the unit offered.
[11] Disclosure of information is the cornerstone of investor protection in regulation of investments because it empowers the investor with the knowledge to plan and make the right decisions.

(viii) it was made compulsory for the management company either to undertake to repurchase or obtain a stock exchange quotation for the units.

(ix) for purposes of income tax, open-end trusts were classified as companies and therefore not taxable on their dividend income but only on interest income. Gains from the varying of share investments would normally be regarded as capital gains and therefore not taxable in the hands of the trust. Finally, the dividends distributed by trusts would continue to be taxed in the hands of certificate holders in the same way as ordinary company dividends.

5.1.4 **The Unit Trusts Control Amendment Act No. 65 of 1963**[12]

Following the amendments in 1962[13], the 1963 Act[14] did not introduce any radical changes beyond doing some tidying up of the original Act. It introduced some flexibility with regard to the stringent minimum capital requirements specified for management companies. This was done by permitting the Registrar to exempt companies from these requirements for a period not exceeding six months. Companies not so exempted and which cease to comply with these capital requirements were obliged to report to that effect to the Registrar within a period of three months.

[12] M S Lipschitz "Unit Trusts" (1963) *Annual Survey of SA Law* at 407.
[13] By the Unit Trusts Control Amendment Act of 1962.
[14] See M S Lipschitz loc cit note 12.

The date on which the unit portfolio of an open-end trust scheme is obliged to comprise the minimum underlying securities and cash was extended from the date of formation of the unit portfolio to the date on which selling actually commences to the public.

The requirement for diversification of investments was still further extended in regard to securities in the form of shares in an investment company. In addition the Act also emphasized the following requirements:

5.1.4.1 more frequent returns to the Registrar of the lists of underlying securities in unit portfolios;

5.1.4.2 the fact that a management company is obliged to repurchase units offered to it by holders; and

5.2 the basis upon which the repurchases are to be made as well as the form of advertisements to that effect in circulars, brochures, etc.

Finally, the amending Act relaxed (to some extent) the restrictions upon a management company's right to advertise the prospective yield to be derived from units offered for sale[15]. Subsequent to these amendments, in 1965, the first unit trust scheme was launched in the Republic.

5.1.5 **Amendments after 1965**

After the launching of unit trusts in 1965, further amendments were effected to the principal Act. The aim was to improve the regulatory system in order to ensure the smooth operation of unit trusts as well as protection of investors.

5.1.5.1 The Financial Institutions Amendment Act, No. 99 of 1967[16]

Sections 19 and 22 of the Unit Trusts Control Act[17] were amended by Section 1 and 2 of this Act. The amendments were aimed at limiting competition for funds on the part of companies managing unit trust schemes by restricting their revenue. Section 1 had the effect of abolishing the round-off accrual which could formerly be added to the made up price of a unit and section 2 was to limit the initial charge on such price to five percent.

5.1.5.2 The Financial Institutions Amendment Act 65 of 1968

In 1968 further changes were introduced by the above amending Act[18]. The proportion of approved securities and of government securities which must be contained in each unit portfolio were increased. This was provided for by section 5 of the Amending Act[19], which required that fifteen percent of each portfolio must consist of approved securities of which half must be government securities.

With regard to schemes in property shares the following amendments were made:

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[15]Both the Amending Acts No.11 of 1962 and No. 65 of 1963 were brought into operation on 6 September 1963 (*Reg. Gas. No. 228*).
[16] See W P Shutz "Banks and other Financial Institutions, Stock Exchange and Business Regulation in General" *Annual Survey of SA Law* at 259 (for a brief outline of the effects of the Financial Institutions Amendment Act, No.99 of 1967 on the Unit Trusts Control Act).
[17] *Ibid.*
[18] This Act amended four Acts governing different classes of Financial institutions, viz, the Insurance Act No.27 of 1943, the Unit Trusts Control Act No.18 of 1947, the Pension Funds Act No.24 of 1956 and the Friendly Societies Act No.25 of 1956.

- An increment to the minimum resources required to be available;[20]
- The sum of paid up share capital and capital reserves was increased from R100 000 to R1 000 000 and that the Registrar could grant an exemption from this requirement for up to six months

Section 4 (a) and 9 (c) of the Amending Act by then required that all the issued shares in a property company be included in a unit portfolio. It also prohibited the holding of such shares if any assets in the property company were encumbered or if the company was subject to guarantee obligations. The aim was to ensure that property companies in which such schemes (or schemes in property shares) hold shares are not subjected to malpractices to the prejudice of the schemes.[21]

Section 7[22] made provision for the inclusion in a trust deed of a basis for the valuation of property shares held. The main purpose of the provision was that increases in values of properties could be taken up in the appropriate units.

Lastly, Section 8 provided for the publication of considerably more information by a management company in property shares than was required before.

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[19] *Supra* note16.
[20] Section 6 of the Financial Institutions Amendment Act No.65 of 1968.
[21] W P Shutz "Unit Trusts" (1968) *Annual Survey of SA Law* at 299.
[22] See W P Shutz *loc cit* note 16.

5.1.5.3 **The Second financial Institutions Amendment Act**[23]

This Act made provision for allowing the sale of approved securities where this would formerly not have been possible[24]. The reason behind this was to counter the prevailing downswing on the performance of capital markets. In fact, the downward trend on the Stock Exchange, which had begun in 1967, continued in 1970 and management companies selling shares out of unit portfolios in order to obtain cash to repurchase units accelerated it. Therefore, the amendment of section 8 of the Unit Trusts Control Act[25] brought change by allowing the Minister of Finance to exempt management companies from holding 15% of all securities comprised in a unit portfolio in the form of approved securities[26] to such extent and for such a period as he could determine.

5.1.5.4 **The Financial Institutions Amendment Act of 1980**[27]

This Act enacted a new provision (section 23A)[28], which provided for the amalgamation of unit trust schemes and portfolios and for the transfer, cession and take over of the rights of holders of unit certificates[29]. The new provisions required consent of the holders of a majority in value of unit certificates in each unit trust scheme or portfolios and the consent of the Registrar in respect of the following:

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[23] Act 75 of 1970.
[24] The provision became effective from 1 April 1970.
[25] *Supra* note 1, as amended by section 2 of the Second Financial Institutions Amendment Act No. 75 of 1970.
[26] And half of this to be securities issued by government.
[27] Act 99 of 1980.
[28] *Ibid at* S 31.
[29] See also F R Malan "Unit Trusts" (1980) *Annual Survey of SA Law* at 340.

- every amalgamation of two or more schemes or portfolios;
- cessions, and
- transfer or takeover of the rights of the holders of unit certificates[30].

In terms of Section 23A (2)[31] a copy of the proposed transaction was required to be furnished to the Registrar. The Registrar could then grant his consent only if satisfied that every unit holder had been given particulars of the proposed transaction, including particulars of the procedure to be followed to ensure that each unit holder would receive units with an aggregate monetary value of not less than those he held previously.[32] Section 23 A (3) (b) provided further that the proposed transaction should not be detrimental to any holder in any original scheme or portfolio and that[33] the majority of the holders in value have not refused their consent to the proposed transaction.

Section 23 A (5) (a) provided that when a transaction becomes effective, the provisions of the trust deed of the new scheme or portfolio would bind the holders of unit certificates in the original scheme or portfolio. Concurrently, the assets of the original scheme would vest in the new scheme[34] and the provisions of the trust deed of the new scheme would apply thereto and to the benefits, which accrue therefrom[35]. When a transaction becomes effective a unit holder in the original scheme would acquire units in the new scheme or in the scheme, which acquired rights by way of cession, transfer or take over. These new units would have the same monetary value as those held before the

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[30] Section 23 A (1).
[31] Section 23.
[32] Section 23 A (3) (a).
[33] And in terms of section 23 A (3) (c). See also section 23 A(4).
[34] Section 23.
[35] Section 23.

transaction became effective.[36] Section 23 A (6) placed a duty on every Registrar of deeds to make such endorsements or entries as would be necessary to give effect to any transfer following a transaction under this section. Therefore, no transfer or stamp duty or registration or other fees would be payable in respect of such transfer[37] and no amalgamation, cession, transfer or take over in terms of section 23 A would affect the rights of creditors or any obligation relating to an original scheme or portfolio.[38]

5.2 Consolidation of the law and post-consolidation amendments

The enactment of the Unit Trusts Control Act of 1981[39] consolidated the laws relating to the regulation and control of the establishment, carrying on and management of unit trust schemes. This Act was in turn amended in 1984 by the inspection of Affairs of Financial Institutions Act[40]. The later Act consolidated the laws relating to the inspection of the affairs of financial institutions, including a management company registered in terms of a unit trust scheme as defined in the Unit Trusts Control Act[41].

During the same year (1984) the Financial Institutions (Investment of Funds) Act[42] consolidated the laws relating to the investment, safe custody and administration by financial institutions (including a "unit trust scheme" as defined in the Unit Trusts Control Act) of funds and trust property.

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36 Section 23.
37 Section 23 A (7).
38 Section 23 A (8). See also section 27 of the Amending Act, which amended S8 of the Principal Act to give effect to Section 23 A in so far as it relates to prescribed investments.
39 Act 54 of 1981.
40 Act No 38 of 1984.
41 54 of 1981.

Subsequent amendments were effected[43] on the Unit Trusts Control Act[44] of 1981. However, only a few of the most important amendments will be discussed here.

5.2.1 The Financial Institutions Amendment Act of 1988[45]

This Act amended the definitions of "licensed stock exchange", and "recognized stock exchange" in section 1 of the Unit Trusts Control Act of 1981[46]. The same section also provided for unit trust schemes in listed securities to be invested in units in a unit trust scheme in property shares listed on the Johannesburg Stock Exchange. This amendment was made at the insistence of management companies of unit trust schemes in order to enable unit holders to share in the benefits of a wider distribution of shares, immovable property and fixed interest-bearing investments.[47]

A section 2A of the Amending Act was inserted in the Act[48] in order to authorize the Registrar of unit trust companies to delegate or assign any power or duty assigned to him under the act to an officer or employee in the public service. Section 3 (2) (b) substituted the old section to increase the amount of share capital and non-distributable reserves to be held by the management companies of unit trust schemes from R600 000 to R2

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[42] Act No 39 of 1984.
[43] By the Inspection of Financial Institutions Act 38 of 1984; Financial Institutions Amendment Act 51 of 1988; Financial Institutions Amendment Act of 1990; Financial Services Board Act 97 of 1990; Financial Institutions Amendment Act 54 of 1991; Financial Services Board Act 41 of 1992; Financial Institutions Amendment Act 83 of 1992; Financial Institutions Amendment Act 7 of 1993; Financial Institutions Second Amendment Act 53 of 1996; Abolition of Restrictions on the Jurisdiction of Courts Act 88 of 1996; and the Unit Trust Control Amendment Act 12 of 1998.
[44] Act 54 1981.
[45] Act 51 of 1988. See also A J Itzikowitz "Unit Trusts" (1988) *Annual Survey of SA Law* at 328.
[46] Act 54 of 1981.
[47] See *House of Representatives Debates* 18 February issue 1988. Col 7707.

million. Another amendment to section 9 of the Act[49] increased the minimum amount of investment of a management company in a unit portfolio to R1 million and extended the powers of the Registrar in regard to such amount[50].

Through an amendment to section 20 (1) (b) a close corporation was prevented from acting as a trustee of a unit trust scheme.

5.2.2 The Financial Institutions Amendment Act of 1990[51]

In terms of the Unit Trusts Control Act[52] a person could not carry on a unit trust scheme, which included the word "invest", or any derivative thereof. However, this section was amended in 1990[53] to empower the Registrar to allow a person to carry on a Unit Trust Scheme under a name, which included the word "invest". The purpose of the amendment was to allow flexibility with regard to the establishment of the unit trust schemes under the Act as well as ensuring investor protection by requiring the approval of the Registrar[54].

[48] Act 54 of 1981.
[49] Act 54 of 1981.
[50] Before the Amendment the amount was R200 000.
[51] Act 64 of 1990. See also A Itzikowitz "Unit Trusts" (1990) *Annual Survey of SA Law* at 347.
[52] Section 38 (3).
[53] By Act 64 of 1990, section 12.
[54] Section 12 of Act 64 of 1990.

5.2.3 **Financial Services Board Act of 1990**[55]

The definition of "registrar" in the Unit Trusts Control Act[56] was amended to mean the Registrar or Deputy Registrar of Unit Trust Companies referred to in section 2 of the Act[57]. A new section 2 substituted for the old by Act 97 of 1990 provided that the executive officer and the deputy executive officer mentioned in section 1 of the Financial Services Board Act will also be the Registrar and the Deputy Registrar respectively of Unit Trust companies. Section 2A was deleted by Act 97 of 1990[58].

5.2.4 **The Financial Institutions Amendment Act of 1991**[59]

Very important amendments to the Unit Trusts Control Act of 1981 were made by this Act. The insertion of Section 2B provided for the establishment of a Unit Trust Advisory Committee. This provision was aimed at increasing investor protection in the Unit Trust Investment Industry.

Another amendment was with respect to the definition of "securities" in section 1 of the 1981 Act[60] to include loan stock as defined in section 1 of the Financial Markets Control Act of 1989[61], and to provide for investments by units in trust schemes in derivative financial instruments. The significance of the

[55] Act 97 of 1990.
[56] Act 54 of 1981.
[57] 54 of 1981.
[58] Act 64 of 1990.
[59] Act 54 of 1991. See A J Itzikowitz "Unit Trusts" (1991) *Annual Survey of SA Law* at 283.
[60] Act 54 of 1980.

amendment was that it would allow innovation of more investment products and thereby ensuring greater diversification of investor funds.[62] To ensure investor security a consequential amendment to section 6 (1) prohibited a management company from including in the unit portfolio derivative instruments except in the manner and on the conditions prescribed.

Since unit-trust investments are primarily medium to long-term and any uncontrolled involvement in short-term market movements would place the unit holder at risk, some safeguard measures were put in place. A sub-committee of the advisory committee was instituted for the purpose of drafting guidelines with regard to ensuring the prudent use of derivatives by the industry. This would include making decisions on the maximum permissible exposure of a portfolio to derivatives, accounts and returns to be rendered, and the advisability of a requirement that the investment manager of a unit trust management company endorse any use of futures and options.

For purposes of, inter-alia, promoting self-regulation and to give effect to the suggestions of the advisory committee, section 45 was inserted in the 1981 Act,[63] by section 8 of the Amending Act, to authorize the Registrar of Unit Trust companies by notice in the

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[61] Act No 55 of 1989.
[62] *Ibid.*
[63] *Supra* note 56.

Gazette, to grant exemption from certain provisions of the act and to revoke or amend such exemption.

5.2.5 **The Financial Institutions Amendment Act of 1992**[64]

This Act inserted subsection 2(A) in s37 of the Unit Trusts Control Act of 1981[65] to inter-alia empower the Registrar to withdraw or amend an exemption granted to managers to operate participation mortgage bond schemes in terms of Section 37 (2) of the Act.

5.2.6 **The Financial Institutions Amendment Act of 1993**[66]

In terms of this Act, the Unit Trusts Control Act of 1981[67] was amended to empower the Minister to make regulations with regard to the payment of fees, including the payment of interest on overdue fees. Section 42 (5) was amended to provide that a penalty payable under section 42 (3), as well as fees and interest payable on them, would be a debt due to the Financial Services Board, and could be recovered by the Registrar in a competent court.

The Financial Institutions Second Amendment Act of 1993[68] did change the definition of "compulsory charge"[69] to mean any fiscal

[64] See also A J Itzikowitz "Unit Trusts" (1992) *Annual Survey of SA Law* at 330.
[65] *Supra* note 56.
[66] Act 7 of 1993. See A J Itzikowitz "Unit Trusts" (1993) *Annual Survey of SA Law* at 509-510.
[67] *Supra* note 56.
[68] Act 104 of 1993.
[69] See section 1 of the Unit Trusts Control Act 18 of 1947/ the principal Act.

charge or such other charge as the Registrar could determine by notice in the Gazette.

Within the same section[70] the definition of a "fixed property company" was amended to include companies whose principal business consists of the acquisition and holding of undivided shares in or leasehold in certain immovable property. Before the amendment, property unit trusts were restricted to investing in the subsidiaries of holding companies whose principal business was investment in immovable property. However, an amendment to the definition of "property shares" allowed unit trust schemes to own securities in holding companies with "fixed property companies" as their subsidiaries.

An amendment to the proviso to section 3 (2) of the principal Act empowered the registrar to exempt any management company registered before the commencement of section 15 of the Financial Institutions Act of 1988[71] from compliance with the increased capital requirement, which had been in force since 1988, subject to certain conditions. A corresponding amendment was made to section 29 (2) of the principal Act[72].

[70] Of the Principal Act.
[71] Act 51 of 1988.
[72] Also note that Section 3 applies to unit trust schemes in securities other than property shares and section 29 to unit trust schemes in property shares.

In order to bring the Unit Trusts Control Act[73] into line with the provisions found in other legislation administered by the Financial Services Board an amendment in terms of section 11 (1) was made. This provision required every management company within 30 days from the date of appointment of a person as auditor of the management company to apply to the Registrar for approval of such appointment. The registrar could without giving reasons, refuse an application for approval or confirmation, or withdraw any prior approval granted by him.

Section 35 of the principal Act[74] was amended in order to compel every management company in property shares to apply for permission for units to be dealt in on a licensed stock exchange. These management companies were also required to ensure that the rules of such exchange for inclusion of the units are complied with. Before the amendment only management companies in property shares, which did not undertake to repurchase units issued by it had to comply with these listing requirements.

Lastly, section 40 was amended to provide that the Trust Property Act would not apply in respect of a unit trust scheme operated in terms of this act.

[73] Act No 54 of 1981.

5.2.7 **The Unit Trusts Control Amendment Act of 1996**[75]

This Act was a landmark in the evolution of legislative control of unit trusts because it introduced a very important investment tool for the unit trusts industry, which was money market fund. (MMFS).[76] In Europe and the USA money market funds have sustained a record of considerable success since 1981. This has been due to the following advantages, which give the funds an appeal to investors:[77]

5.7.1.1 they are totally liquid, that is, unit holders can withdraw money at any time without a charge;

5.7.1.2 they are safe by virtue of the existing regulatory system;

5.7.1.3 they are pure "no-load" funds since no sales commission is charged to buy and sell shares except for a meager expense ratio of assets deducted from shareholders' returns;

5.7.1.4 they are a convenient investment since investors can easily withdraw, switch or verify the status of their accounts;

5.7.1.5 transparency- through the daily publication of prices and yields as well as the compulsory reporting requirements of the unit trusts industry;

5.7.1.6 money market funds provide an increased diversification in the investable assets available to the public.

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74 Act No 54 of 1981.
75 Act 53 of 1996. See also A J Itzikowitz "Unit Trusts" (1996) *Annual Survey of SA Law* 595-596.
76 These are unit trusts that invest in liquid short-term debt obligations of governments and companies. Though they are not insured, they are extremely safe because the securities they hold are of high quality and are short-term, thus reducing investors' exposure to the risk of changing interest rates or the possible deterioration of the financial strength of the issuers of money market securities. See Lambrecht "Unit Trusts Handbook" (1996) at 75.
77 *Ibid.*

However, South Africa before 1996 was precluded from offering these short-term instruments despite the attention they (money market funds) received. The Financial Services Board established a group to investigate the establishment of this type of unit trust[78]. The group unanimously recommended that provision be made for the establishment of MMFS (Money Market Funds) in South Africa[79].

Several benefits of allowing MMFS were identified and they include[80];

(i) the creation of a new channel for short-term investments;

(ii) making available to the small investor a method for sophisticated cash management;

(iii) the creation of an interim facility for the short-term investment of certain funds of the investor;

(iv) the provision of access to instruments not normally included in the portfolio of small investors which also have higher interest yields;

(v) the expansion of the commercial paper market; and

(vi) the reduction of the difference between wholesale and retail interest rates.

In 1996 the Unit Trusts Control Amendment Act of 1996[81] amended the Unit Trust Control Act of 1981[82] to give effect to the recommendations of the study group. The following changes were therefore made;

[78] This group met first in September 1993 and the final report and recommendations regarding the establishment of money market funds were issued at the end of August 1994.
[79] See The Memorandum on the objects of the Unit Trusts Control Amendment Bill (1996) (B65-96).
[80] See A J Itzikowitz *loc cit* note 75.

- the definition of "securities" in section 1 of the Act[83] was amended to include money market instruments of maturity not exceeding 12 months.
- the Registrar of Unit Trust Companies was authorized to determine by notice in the Gazette, after consultation with the Unit Trust Advisory Committee, the money market instruments which could be included;
- the inclusion of money market instruments in a money market unit portfolio was to take place in the manner and subject to the conditions to be prescribed by the Minister of Finance by regulation[84].

The Unit Trusts Control Amendment Act of 1996[85] came into operation in May 1997[86] to regulate the manner and conditions for the inclusion of money market instruments in money market portfolios.

5.2.8 The Unit Trusts Control Amendment Act of 1998[87]

The principal purpose of this Act was the deregulation of charges levied by a unit trust scheme on a purchaser or holder of units in a unit portfolio. The definitions of "compulsory charge", "initial charge" and "service charge" in section 1 of the Act[88] were deleted. The aim of deregulation was to enable unit trust companies to charge whatever they liked subject to full disclosure of

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81 Act 53 of 1996.
82 The Act.
83 *Ibid.*
84 See section 6 (1) (d) inserted in the 1981 Act by S2 of the Amendment Act for which see note 4. The date of commencement of the amendment Act was 1 May 1997. Also regulations relating to the manner and conditions for the inclusion of money market instruments in money market unit portfolios were promulgated with effect from 1 May 1997. See *GN R439 GG17864 of 25 April 1997 (Reg Gaz 5887).*
85 Act 53 of 1996.
86 *Proc, 25 GG 17865 of 25 April 1997.*
87 Act 12 of 1998. See A J Itzikowitz "Unit Trusts" (1998) *Annual Survey of SA Law* at 529.
88 Act 54 of 1981.

the charges that were to be levied[89]. In addition to disclosure, the trust deed was required to provide for three months' notice to be given to unit holders of any increase in any charge, or of any change of the basis of calculation of charges, which could result in an increase[90].

Before the amendments, fees and charges were regulated to maximum levels. The act of deregulating the charges was in keeping with international practice where generally, fees are left to be determined by market forces[91]. The importance of deregulation was that it would most certainly introduce innovative ways of pricing[92]. For example some companies would offer a single price for units with costs charged separately, or charge exit rather than entry costs, while others would charge a performance fee. All in all, deregulation would stimulate competition amongst management companies resulting in lower charges to investors[93].

Another important amendment was the insertion of a definition of "funds of fund" by section 1(b).[94] "Fund of Funds" means a unit portfolio that, apart from liquid assets and approved securities, consists solely of units or any other form of participation in unit portfolios of unit trust schemes or other similar schemes, other than schemes in property shares.

[89] See sections 12 (1) (9) and 22 (1) and (2) of the Act.
[90] *Para* (iA) added to section 22 (2) by section 7 (c) of the Amending Act, *supra*, note 92.
[91] See the Memorandum On the Objectives of the Unit Trusts Control Amendmend Bill, supra note 79.
[92] *Ibid.*
[93] *Ibid.*
[94] Of the Amending Act, *supra* note 92.

Section 6 (1) (e) of the 1981 Act as amended by section 2 of the amending Act provided that the manner and conditions subject to which units may be included in a unit portfolio would be prescribed by regulation by the Minister of Finance. The effect of the amendment was that unit trust companies themselves would now be able to sell investors different combinations of unit trusts tailored to different needs. Given the opportunity to create "funds of funds" or to invest in the units of unit trust schemes, management companies would increase their participation in international markets as well as diversifying the investment risks of investors[95].

The definition of "securities" in section 1 of the 1981 Act was amended by section 1 (c) of the amending Act[96]. The purpose was to enable management companies to include in their unit portfolios, units in unit portfolios of any collective scheme whether the units are listed on a recognized stock exchange or not. Before the amendment, it was only units in a unit trust scheme in property shares that could be included in a unit portfolio.

In terms of a new section 10 substituted for the old provision by section 3 of the amending Act[97] the information to be furnished by the management company to the Registrar of unit trust companies and unit holders was provided for. A management company was also obliged to furnish to the Registrar a full list of all underlying securities in any unit portfolio managed by it, reflecting in respect of each unit portfolio the total market value of the

[95] See Memorandum on the objects of the Unit Trusts Control Amendment Bill 1998 (B1-98) [Unit Trusts Memorandum].
[96] 12 of 1998.
[97] *Ibid.*

several securities included in that portfolio[98]. The value of each of those securities expressed as a percentage of the total value of assets in the portfolio and as a percentage of the total amount of securities of the class issued by the concern in which the investment was held was also required to be reflected. In addition, the management company was obliged to indicate which securities are stock exchange securities and which are not, and the amount of liquid assets held in the unit portfolio. All the details were to be kept at the registered office of the management company for inspection by any unit certificate holder or person interested in the purchase of unit certificates from the company.

The inclusion of subsection (4) to section 21 by section 6 of the Amending Act[99] enabled a trustee under a unit trust scheme to appoint a representative. This representative, who would be independent from the management company, would perform the functions pertaining to the registration of securities and the safe custody of documents where it would be impracticable for the trustee to perform that function. Inherently, paragraph (b) provided that a trustee who had appointed such a representative would not be divested of any of his or her functions.

Lastly the insertion in the 1981 Act of a new section 37 A by section 8 of the Amending Act prohibited any person from promoting the business of collective investment schemes carried on outside South Africa unless such a scheme had been approved by the Registrar. In addition, the prohibition

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98 Section 5 of the Amending Act.

would also be effective unless the promotion (of the business of collective investment schemes) complied with the conditions that the Registrar would determine by notice in the Government Gazette. The major purpose of the prohibition was to ensure sufficient protection of investors.

5.2.9 Other proposals for change

The above discussion of the evolution of legislative control demonstrates that the major aims of unit trusts regulation are:

5.2.9.1 to ensure the smooth operation of unit trust schemes;

5.2.9.2 to protect the investors;

5.2.9.3 to expand the industry by implementing regulations that are flexible enough to allow for innovation and introduction of sophisticated investment products;

5.2.9.4 to ensure competitiveness of South African unit trusts on an international scale; and

5.2.9.5 to keep abreast of any changes affecting the industry.

Further changes are still to be effected on the 1981 Act, which is now considered to be old and outdated. These changes are to be introduced through the enactment of the new Collective Investment Control Bill (CIB)[100] and the Financial Advice and Intermediary Services Bill (the FAIS Bill)[101].

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[99] Act 12 of 1998.

[100] Which will replace the 1981 Act.

[101] Which will regulate the business of financial brokers, and any other investment intermediaries with respect to the offering of advice to investors.

Reference to these bills has been made in the previous chapter but a detailed analysis will be done on the chapter on reform of the law.

5.3 Authorisation of unit trust schemes[102]

The Act requires that "no person other than a company which has been registered as a management company under section 4 shall manage or carry on any unit trust scheme in securities other than property shares or issue unit certificates thereunder"[103]. The effect of this provision is that generally only authorized companies may establish, operate and market unit trusts in the Republic.

The Registrar[104] of unit trust companies is the authority vested with the power to authorize unit trust schemes. In performing his duties the Registrar is assisted by the Unit Trusts Advisory Committee[105]. The Committee may from time to time conduct an investigation and advise or make recommendations to the Registrar or Minister concerning any matter relating to unit trusts. This committee may also advise the Minister on any such matter referred to the advisory committee by the Minister[106].

[102] Under the Unit Trusts Control Amendment Act of 1981.
[103] Section 3 (1) of the Unit Trusts Control Act 54 of 1981.
[104] And Deputy Registrar. See section 2 of the Act of 1981.
[105] This Committee consists of the Registrar as chairperson and other members as the Minister may designate from time to time.
[106] Section 2B of the Act 54 of 1981.

5.4 **Restrictions on the management of unit trust schemes in securities other than property shares**

In order for a company to become or remain a registered management company, it has to comply with the following two requirements:

5.4.1 It must be registered as a public company under the Companies Act of 1973[107]; and

5.4.2 Must have a paid –up share capital and non-distributable reserves which together amount to not less than two million rends actually employed or immediately available for employment in its unit trust business.

5.5 **Exemptions**

The registrar, may however, in his discretion and on the conditions he deems fit, exempt any management company from compliance with the minimum financial requirement in section 3(2)(b) for a period not exceeding six months as he may determine.

In the case of a management company, which has not been exempted, the company must if at any time it ceases to comply with the financial requirement report this to the registrar in writing within three months after ceasing to so comply[108].

[107] Act 61 of 1973.

5.6 Penalties

A person who contravenes the restrictions on registration of a management company is guilty of any offence. She is liable on conviction to a fine not exceeding R2 000 or to imprisonment for a period not exceeding five years or both[109].

5.7 The procedure for authorization of management companies

For purposes of ensuring protection of investors the law provides for requirements, which aim at preventing unfit companies from operating unit trust schemes. Section 4 (1) of the Act provides that a company wishing to register as a management company must lodge an application with the Registrar of Unit Trust Companies.

The application must be in the prescribed manner and form and must also disclose the prescribed particulars.[110] According to the Zimbabwean legislation[111] the application should be accompanied by the following;

5.7.1 a copy of the scheme's trust deed; and

5.7.2 a copy of any prospectus or advertisement issued or proposed to be issued in respect of the scheme; and

5.7.3 the prescribed fee, if any; and

5.7.4 such other documents and information as may be prescribed or as the

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108 Section 3 (3) of the Act, 54 of 1981.
109 *Ibid.*
110 Section14 (1) of Act 61 of 1973.
111 Section 7 (1) of the Collective Investment Schemes Act No.25 of 1997 (Zimbabwe).

Registrar may reasonably require. In terms of the 1981 Act[112] the Registrar may call the company to furnish relevant information.

Before the Registrar can however, register the applicant as a management company and issue a certificate of registration, he must take the following into consideration[113];

5.7.4.1 that the trust deed which the applicant proposes to enter into for the purposes of the unit trust scheme in question does not contain anything inconsistent with the provisions of the Unit Trusts Control Act and is based on sound financial principles;

5.7.4.2 that the proposed trustees are qualified under the Act to act as trustees. According to the United Kingdom legislation[114] both manager and trustee must be authorized persons and neither must be prohibited from acting in their intended capacity; and

5.7.4.3 that the manner in which the business of the applicant company is to be carried on is not inconsistent with the provisions of the Act and is based on sound financial principles.

If the above is satisfied, then the Registrar has to register the management company and issue to it a certificate of registration subject to the provisions of subsection 4 of Section 4 of the Act and on such conditions as he may deem fit. This Section provides further that the registrar must also be satisfied of the following;

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[112] Section 4 (2).

[113] See Section 4(3) of the 1981 Act.

[114] The Financial Services Act Order of 1988 of the United Kingdom. See also J W Vaughan *The Regulation of Unit Trusts* (1990) at 18.

5.7.5.1 that the general financial and commercial standing of, and the nature of the business conducted by the company are such as to fit it for assuming the duties and responsibilities of a management company; and

5.7.5.2 that its registration as a management company will be in the public interest.

Section 7 (1) (c) of the Zimbabwean Collective Investment Schemes Act 1997[115] contains also the requirement that the name of the scheme must not be undesirable or misleading. The purposes of the scheme must also be capable of being successfully carried into effect[116].

Presumably if the Registrar is not satisfied as to any matter referred to in Section 4 (1) to (4) of the Act[117] he will not register the scheme concerned. In terms of section 7 (3) – (4) of Collective Investment Schemes Act, 1997 of Zimbabwe[118], the Registrar may not register the management company provided that:

5.7.6 before reaching a final decision he shall notify the applicant in writing that he proposes to reject the application and of his reasons for doing so, and shall afford the applicant an adequate opportunity to make representations in the matter;

[115] Act No. 25 of 1997.
[116] For purposes of Unit Trusts Control Act 54 of 1981, this requirement is qualified by application of section 38 (1) of the Act which prohibits the use of misleading names and acts. See also J W Vaughan op cit note 14.
[117] Act No. 38 of 1984.
[118] Act No. 25 of 1997.

5.7.7 within ten days after deciding not to register the scheme, he shall notify the applicant in writing of his decision and of the reasons for it.

It appears then that the above will ensure that refusal of a company's application will be justifiable. However, it appears that the above procedure cannot be classified as an appeal and is also followed where it is intended to cancel authorization to operate from a scheme[119].

5.8 Termination or suspension of a scheme[120]

Despite a management company's responsibility to continue a scheme for as long as there are investors wishing to participate situations do arise which demand termination or cancellation of a scheme. The registrar of unit trusts may at any time cancel the registration of a company as a management company at any time:

5.8.1 if he is satisfied that the company has contravened or failed or neglected to comply with any provision of the Act (that it is obliged to comply with) or with any direction or requirement lawfully given or imposed under the Act. This applies when the failure or neglect has resulted or is calculated to result in serious prejudice to the interests of the public at large or of the holders of unit certificates;

5.8.2 if he is satisfied, after an investigation has been held under his powers of inspection[121], that the manner in which the business of the company is carried

[119] To be discussed in detail below under cancellation of a scheme. See also J W Vaughan *op cit* note 114 at 23.
[120] See section 5 of the Unit Trusts Control Act 54 of 1981.
[121] In terms of section 26 of the Act 54 of 1981.

on is unsatisfactory or not calculated to serve the best interests of holders of unit certificates.

Although the Act does not indicate such, it seems however, that in deciding whether authorization is contrary to the interests of the investors the Registrar is specifically empowered to take into account any matter relating to the scheme, the manager or trustee, a director or controller of the manager or trustee or any person employed by or associated with the manager or trustee in connection with the scheme.

5.8.3 if it appears that the registration was obtained through fraud on the part of the management of the company; or

5.8.4 in the event of the company being wound up, either voluntarily or by the court. In other words if the scheme has ceased to exist.

If the Registrar's complaint is in respect of the grounds mentioned in paragraph (a) and (b) above he might alternatively suspend the company's registration for a period not exceeding twelve months at a time[122].

The Registrar may cancel or suspend the registration after observing the following requirements:

5.8.4.1 giving notice to the company of his intention and of the grounds on which he proposes to do so;

5.8.4.2 allowing the company to make any representations to him which it may

[122] Section 5 (1) of the Principal Act.

wish to make in connection with the proposed cancellation or suspension; and

5.8.4.3 at the company's request, affording it a reasonable opportunity of rectifying or eliminating the defect or irregularity complained of.

In terms of section 8 (5) of the Collective Investments Scheme Act of 1997, the Registrar in Zimbabwe may also cancel the registration of a collective investment scheme if the scheme's manager or trustee so requests. In such a case the Registrar should be satisfied that cancellation will be in the best interests of any participants in the scheme.

The procedure in section 5 (2) the Unit Trusts Control Act[123] described above shows that there is no appeal available against a decision to revoke authorization. All that the Act provides for is the right to be informed of the intention to make an order to cancel; to make representations to the Registrar as well as a reasonable opportunity of rectifying or eliminating the defect or irregularity complained of[124].

The Registrar is clearly given considerable power by this provision and taking the case as it simply is there is arguably a cause for concern that there are inadequate safeguards built into it to protect a scheme from unfair cancellation. The English case of *R v Chief Registrar of Friendly Society, Ex parte New Crow Building Society*[125] illustrates that the judiciary is reluctant to intervene in decisions of the supervisory authorities. In this case Griffiths L.J

[123] 54 of 1981.
[124] This position is similar to the United Kingdom regulation. See J W Vaughan op cit note 114 at 23.
[125] (1984*) 2 ALL ER 27, 42.*

declared "if the registrar forms the view that for relevant considerations it is expedient to act, the court should not impede him by introducing a fetter on this discretion in order to limit his power. Parliament has placed its trust in the Registrar and so should the courts". To justify this in a less controversial manner J.W. Vaughan[126] notes "the reality of the situation is that UK regulatory authorities have long traditions of using statutory powers only as a last resort when informal methods have failed to produce results". Therefore, a notice of the intention to revoke authorization would not come "out of the blue" but rather would be the culmination of a protracted period of behind the scenes activity. In terms of the Unit Trusts Control Act[127], the above can be justified through the obligation on the Registrar not to cancel registration before affording the management company a reasonable opportunity of rectifying or eliminating the defect or irregularity complained of.

5.9 Re- registration and continuance of a scheme

With respect to re-registration as a management company whose registration has been cancelled, the Act[128] provides that the application for such shall be dealt with in all respect as if it were an application for registration by a company, which was not, at the commencement of the act managing a unit trust scheme in securities other than property shares.

[126] *Op ci,* note 114 at 23.
[127] Section 5 (2) (c) of Act 54 of 1981.
[128] Section 5 (4) of Act 54 of 1981.

If the registration of a management company is cancelled on the grounds listed in section 5 (2) of the Act[129] other than winding-up, the provisions of the Act with regard to the continuance or the winding-up of the unit trust scheme in the event of the winding up of the management company apply *mutatis mutandis*. There is also a proviso that the registrar may in any such case direct the former management company to defray in whole or in part the expenses incurred in continuing the management of the unit trust scheme or in realizing any of the underlying securities[130], and also any commission to which a trustee or a person appointed to take over the duties and obligation of a trustee may be entitled in dealing with trust property on the winding up of the management company.[131]

Section 5 (6) of the Act provides for registration of a management company suspended under subsection 1. In terms of this provision the company shall not, during the period of the suspension issue any fresh unit certificates, but shall, in respect of certificates already issued, continue the management of the unit trust scheme. The company must also deal with such certificates in all respects as it would have been bound to do had its registration not been suspended. This procedure will ensure the security of investor funds.

[129] No. 54 of 1981.

[130] "Underlying securities" in relation to a unit portfolio are defined as the securities comprised in or constituting the unit portfolio and include any moneys derived or resulting from the management of the unit portfolio which are held by or are due to the management company or the trustees for the benefit of unit certificates in that unit portfolio. See section 1 of Act 54 of 1981.

[131] See section 28 of the 1981 Act, supra, on the manner of dealing with trust property on winding-up of a management company.

Any person who fails to comply with the above requirement is guilty of an offence and is liable on conviction to a fine not exceeding R 600 or to imprisonment for a period not exceeding 18 months, or both.[132]

5.10 **Recognition and approval of foreign collective investment schemes[133]**

After discussing the authorization of local unit trusts it is perhaps appropriate to also discuss the registration of foreign investments since the two topics are almost similar though in fewer respects.

Section 37 A (1) of the Act provides that no person may promote the business of or solicit investment[134] in a collective investment scheme carried on outside the Republic unless if the scheme;

5.10.1 has been approved by the Registrar upon application and payment of the prescribed fee; and

5.10.2 that the scheme complies with the conditions that the registrar may determine in the Gazette.

The conditions that the scheme may be required to comply may inter alia include the following:

5.10.2.1 the regulation of the scheme within the country or territory where it is established affords local participants a level of protection generally comparable to that provided for participants in schemes within the Republic[135]. In considering the above, matters that have to be looked

[132] Section 43-44 of the Principal Act.
[133] Section 37 A of the Principal Act.
[134] By means of publishing cause or permit to be published any price list, advertisement, brochure or similar document or perform any similar act. See section 37 A (1) (a) and (b).

at would include: whether the operator or trustee is fit and proper; the name and purpose of the scheme; and the arrangements for the redemption of units.

5.10.2.2 that the local residents will be able to participate in the scheme on terms generally equivalent to those on which other persons may participate; and

5.10.2.2 that participation in the scheme by local residents will not be contrary to any regulations made under the relevant legislation, for example the Financial Services Board Act 1990[136], and the Inspection of Financial Institutions Act 1984[137];

5.10.2.3 also that the scheme generally would be authorized if it was locally based. This implies, thus, that the foreign scheme should also satisfy the requirements that local schemes are expected to meet. In terms of United Kingdom (UK) law[138] the management company of a foreign scheme must also have a local representative who is an authorized person and has power to act generally for the foreign scheme and accept the service of notices. However, in the event of the application being rejected the applicant has no right to make representations. She

[135] This is the position generally taken by many other countries with regard to approval of foreign collective investment. See The Collective Investment Schemes Act 1997 of Zimbabwe and the UK Legislation. See also J W Vaughan *op cit* note at 26.
[136] Act 97 of 1990. For purposes of Section 14 of this Act a scheme approved in terms of subsection (1) of the Unit Trusts Control Act of 1981 shall be deemed to be a financial institution and the provisions of that section shall apply, with the necessary changes required by the context to such a scheme. See section 37 (A) (2) of the Principal Act.
[137] Act 38 of 1984 which requires that a scheme approved in terms of subsection (1) of the Unit Trusts Control Act of 1981 be deemed to be a financial institution as defined in that Act and the provisions of that Act shall apply, with the necessary changes required by the context, to such a scheme. See section 37 (A) (3) of the Act.

cannot even have a right to be advised of the reasons for the rejection[139]. With regard to revocation of recognition of a foreign scheme the UK regulation[140] provides that the power can be exercised in one of the following circumstances:

(a) That it is desirable to do so in the interests of actual or potential local participants;

(b) That the operator or trustee is in breach of any provision of the Act, rules or regulation made under the applicable Act.

Before recognition is revoked, notice must be served on the operator specifying the grounds for revocation. A period for representation is also allowed but the final decision is not subject to appeal[141].

5.11 Community law and recognition of foreign investments[142]

At present there is no form of community legislation, which regulates the South African unit trusts with other foreign collective investments as one body in the same manner as the European Union system. This is unfortunate considering the influx of foreign collective investments into the Republic and the advantages offered by community regulations[143]. This kind of regulation of unit trusts exists in Europe and has shown that community regulation brings the advantages of easy regulation of unit trusts as well as simplified compliance procedures, which are beneficial to both the authorities and the

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[138] J W Vaughan *op cit* note 114 at 30.
[139] *Ibid.*
[140] *Ibid.*
[141] *Ibid.*
[142] Discussed in detail in chapters 7 and 8 below.
[143] Community regulation refers to regulation, which equally binds two or more countries by way of either a treaty or any agreement.

industry. The standards set within the system are also high, which ensures no diminution in the security of individual investors.

In Europe the framework for a market of this nature was created by the EC Directive on Undertakings for Collective Investment in Transferable Securities (UCITS), published in 1985. This directive does not apply to countries or territories, which are not signatories to the Treaty of Rome[144]. The operator or trustee of schemes constituted in member states of the UCITS Directive are granted automatic authorization with respect to promotion of their schemes in other member states.

Schemes that are not constituted under the UCITS Directive (in Europe) but are constituted in other member states can also be authorized upon fulfilling some basic requirements. Section 86 of the Financial Services Act 1986 (UK) provides that schemes constituted in other member states can be authorized in UK if:

5.11.1 hey are authorized under the law of a member state, either by contract or under a trust;

5.11.2 they are managed by corporate bodies; or

5.11.3 they take the form of open-end investment companies incorporated under the law of the relevant state;

5.11.4 they satisfy requirements prescribed by the secretary of state;

5.11.5 they make an application containing the prescribed information; [145]

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[144] J W Vaughan at 13 for an illustration of the application of the UCITS Directive on the regulation of Unit Trust Schemes.
[145] The Financial Services (Information and Documents) (Recognised Schemes) Regulations 1988, *reg.* 8 (1) (C).

5.11.6 that the scheme complies with UK law.

Another method of recognition is by authorization of a scheme in designated countries or territories. In this instance the secretary of state is given a discretionary power to designate countries or territories for purposes of authorization under the applicable Act[146]. The secretary must however, be satisfied that the country or territory in question offers investors in collective investment schemes at least equivalent protection to that provided by the Act. After the operator has given notice (to the Board) of his intention to have his scheme recognized, the scheme can then be marketed in the UK. In fact, the process of recognition is similar to that which applies in the case of schemes constituted in member states as discussed on the paragraph above.

All other schemes not falling within the above three categories[147] can be authorized if they prove that they provide protection comparable with that offered by a UK based scheme.

[146] J W Vaughan *op cit* note 114 at 27.

[147] That is schemes in designated countries or territories, schemes constituted in other member states and member states of the UCITS Directive.

CHAPTER 6

REGULATION OF UNIT TRUSTS UNDER THE UNIT TRUSTS CONTROL ACT[1]

6.1 Introduction

As illustrated in the previous chapter the regulation of the unit trusts industry in South Africa under the above Act is one that underwent a thorough process of amendment and improvement. The main reason for such a historical development was the legislature's desire to ensure investor protection and promotion of efficient financial markets against the backdrop of a fast changing economic environment characterized by globalization, advances in technology and rapid financial innovation.[2]

The regulatory structure was designed to govern the traditional trust based schemes[3] or unit trusts. These were placed in two categories viz unit trust schemes in property shares[4] and unit trust schemes in securities other than property shares.[5]

[1] Act No. 54 of 1981. Hereinafter referred to as "the Act".
[2] The Memorandum on the Objectives of the Unit Trusts Control Bill, 1998 (B1-98).
[3] These are schemes requiring a management company which has the responsibility for the operation of the scheme and a trustee who, inter alia, will hold the property in trust for the participants. The nature of this holding is that it is a trust for sale for the participants in proportion to their respective entitlements as determined by the number of units registered against their names. The management company has the responsibility to issue units as well as the certificates. See J W Vaughan The regulation of unit trusts (1990) at 183.
[4] Which means securities in and of a fixed property company or a holding company which has no subsidiaries in terms of Section 1 (5) of the Companies Act 61 of 1973 See sections 3-28 of the Unit Trusts Control Act.
[5] Which refers to shares, stock, including loan stock as defined in Section 1 of the Financial Markets Control Act 55 of 1989, units in a trust scheme in property shares, debenture stock and debenture bonds, and includes unsecured notes, whether or not they have inherent option rights or are convertible. See sections 29-36 of the Act.

The Act however, was considered outdated. This was as a result of the consequences of the integration of financial markets, which include the following:

6.1.1 The existence of numerous foreign financial institutions soliciting investments from local investors;

6.1.2 The introduction of new investment products from abroad which has resulted in; [6]

6.1.3 a significant increase in the investment options available to local investors;

6.1.3 the relaxation of exchange control measures; and

6.1.4 immense innovation in the unit trusts industry.

It is submitted that the erstwhile regulatory system, which governed trust-based schemes, did not allow for greater innovation, competitiveness and compliance with international best practice within the collective investment industry[7]. Therefore in this chapter a critical analysis of the key provisions of the Act will be done for purposes of shedding some light on the motives and principles underlying the call for legislative reform. This will ensure a better and substantiated understanding of the new legislation – the Collective Investment Schemes Control Act that was recently enacted.

6.2 Analysis of the key provisions of the Act

6.2.1 **The Trust Deed** is the document that prescribes the rules for the administration of the unit trust scheme. It sets out the investment policy to be adhered to in

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[6] Memorandum on the Objectives of the Collective Investments Control Bill. Available from the Financial Services Board or at www.fsb.co.za.

[7] *Ibid.*

respect of such schemes and both the trustee and management company are bound by the trust deed[8].

6.2.2 Policy Objectives of the Trust Deed

Section 229 (1) of the Act provided that the trustee should hold the underlying securities[9] in trust for the holders of unit certificates and be the custodian of their rights. It also sets out the contents of a trust deed, indicating in terms of Section 23 (1) that any provision in a unit trust deed, which is inconsistent with the Act, was void.

The main purpose of the provisions as to the contents of trust deeds was to protect the unit holders and secure to them certain rights: Firstly, Sec 22 (1) (b) to (d) provided that no certificate could be issued without the countersignature of the trustee, and that this would not be given unless the value of the units in cash or securities was in the hands of the trustee. The income from the unit portfolio and capital gains derived from it was required also to be handed to the trustee. And since the trustee as well as the management company were required in principle to be separate and independent entities there was therefore, little opportunity for fraud or theft if the provisions of the Act are complied with unless the management company and trustee are acting in collusion.

The second objective was secured by placing a duty on the management company to redeem units at a determinable price whenever offered by the holder. This offered the unit holder

[8] Section 22 of the Act.

the equivalent of a free market for her investment since units could be sold at any time[10].

The trust deed inter-alia provided for the following important aspects[11]:

6.2.2.1 the method in which the selling price of units was to be calculated;

6.2.2.2 the terms and conditions upon which the management company would redeem units;

6.2.2.3 The creation of additional units, transference thereof, as well as the charges that could be levied and finally the cancellation of units.

In order to avoid the possibility of uncertainties and prejudice to the unit holders the Act required that written notice be given to every holder of unit certificates (in not less than three months) of any increase in any charge, any change in the method of calculation thereof, which could result in an increase thereof and the introduction of any additional charge[12].

6.3 Variation of the Trust Deed[13]

In order to safeguard the interests of unit holders with respect to the amendment of a trust deed, the Act[14] provided that the parties to a trust deed,

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[9] See section 1 of the Act for the definition of underlying securities.
[10] Section 22 (1) (f) of the Act. See also The Memorandum on the Objects of the Unit Trusts Control Bill, note 2 above.

[11] See Section 22 (2) (a) – (j).
[12] Section 22 (2) (iA).
[13] Section 23.
[14] Section 23.

that is, the manager and trustee could alter or rescind any provision in a trust deed but such an alteration or rescission would be valid:

6.3.1 Only if the consent of the unit certificate holders had been obtained as provided in the trust deed. However, the consent of unit holders could be dispensed with in the following circumstances:

6.3.1.1 Where the registrar of unit trust was satisfied that the alteration, rescission

6.3.1.2 or addition was required only to enable the provisions of the trust deed to be given effect to, more conveniently or economically; or

6.3.1.3 Otherwise to benefit the holders of the unit certificates without prejudicing their interests; and

6.3.1.4 That the alteration did not change the fundamental provisions or objects of the trust deed; or

6.3.1.5 Release the trustee or the management company from any responsibility to the holders of unit certificates; and

6.3.1.6 If the registrar was satisfied that the alteration, rescission or addition did not contain anything inconsistent with the provisions of the Act or with sound financial principles.

Honore[15] submitted that the effect of the section as drafted was to give the registrar the power and duty if satisfied that there was nothing in the proposed amendment inconsistent with the provisions of the Act and with sound financial principles, to agree to it even though it prejudices the

[15] *South African Law of Trusts* (1992) at 537.

interests of the unit holders. The perception was therefore, that circumstances could arise where the registrar would agree to an amendment or rescission that was prejudicial to unit certificate holders if their consent were disregarded[16]. However, it remained questionable if the legislature really intended to give the registrar so wide a power and one so potentially harmful to the interests of the unit holders[17].

The Parties to the Trust Deed

The parties bound by the trust deed were the management company and the trustee. These parties were liable to unit certificate holders and were as well required to follow the investment policy as outlined in the trust deed. Section 23 (3) of the Act provided that:

"A provision in any trust deed, whether entered into before or after, the commencement of this Act, purporting to relieve any party thereto from liability to the holders of unit certificates on account of his own negligence, shall be void".

There were duties and obligations placed on the trustees and management companies in terms of the Act as well as the trust deed. These duties and obligations were aimed at ensuring the protection of the interests of unit holders as well as the smooth operation of the unit trusts industry.

[16] *Ibid.*

6.4 The Management Company[18]

The management company was the one involved in the day-to-day control of a unit trust scheme on behalf of the unit certificate holders. It was required in terms of the law to adhere to the investment policy as outlined in the trust deed so as to prevent prejudice to unit holders. A number of duties and obligations were placed on management companies in terms of the Act for purposes of ensuring the security of investments and the most important ones are discussed below;

6.4.1 General powers and duties of the manager

6.4.1.1 The duty to submit Financial Statements and other Information to the Registrar and Unit Certificate Holders[19]

The manager of a unit trust scheme was required to transmit to the registrar the duly audited financial statements of the company as well as other statements and information as could be prescribed. This was to be done not later than three months after the close of the company's financial year. With regard to every holder of a unit certificate the manager was obliged to send information relating to the state of affairs and results of the operation of the unit trust scheme as could be prescribed.

The regulations[20] also imposed some record keeping duties on the manager. She was required to keep financial and other statements at

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[17] *Ibid.*
[18] Hereafter referred to as the manager.
[19] Section 10 (1)- (4) (b).
[20] Section 10 (3).

the company's registered office for inspection during ordinary hours by any holder of unit certificates in the scheme or any person bona fide interested in the purchase of unit certificates from the company.

Other documents that a management company was required to lodge with the registrar were copies of all advertisements, brochures and pamphlets published or proposed to be published by the company or of any or it's authorized agents. This duty could only be dispensed with if the registrar in terms of the stipulated conditions exempted the management company there from.

The importance of the above duties of the management company was that it exposed the general and financial status of the company to both the registrar and unit holders. This would thereby enable the registrar to efficiently supervise the operation of unit trust schemes and ensure protection of the investors. Holders of unit certificates in the unit trust scheme would also be placed in a fairer position to determine and make an informed assessment of their investments.

6.4.1.2 The Duty To Appoint an Auditor[21]

It was a duty of the management company to appoint an auditor for purposes of auditing the books of every unit trust scheme managed by the company. The auditor, however, was required to be approved by the registrar, who held the power to refuse, grant or withdraw any prior

[21]Section 11.

approval (of the appointment of an auditor) without giving reasons for her decisions[22]. It is questionable however, on grounds of fair practice why the lawmaker granted the registrar such wide powers to refuse or withdraw an appointment of the auditor without giving reasons. Perhaps the implication denoted the unsurpassable objective of investor protection in which it is implicit that the registrar will most often act in the interests of unit certificate holders. The auditor so appointed by the Management Company was not required to be the company's director or servant of a firm of which such director or servant was a member[23].

The manager also had the powers to remove an auditor from his office as auditor of the company. However, if the auditor was of the opinion that she had been removed for improper reasons, she had the right to inform the registrar by registered post so that the matter could be given due consideration.

The auditor was required to perform her duties in accordance with approved auditing standards. She was required to state whether the accounts gave a true and fair view of the financial position of the scheme and then write a report to:

(a) The Management Company – on any irregularity or undesirable practice in the operation of the business of the company. The manager was required to rectify or

[22] Section 11 (1) (b).
[23] Section 11 (2).

discontinue the irregularity or malpractice, failure of which would result in the requirement that the auditor report it to:

(b) The Registrar of Unit Trusts – who had the power to deal with the issue in terms of the requirements of the Act.

The Act did not clearly stipulate that the auditor's report had to be sent to the unit certificate holders but it can be implied that the report was to be included in the manager's own report to the holders.[24]

In terms of Section 33 of the Act and with respect to unit trusts in property shares, the manager was required to submit to the registrar and holders of unit certificates the following:

- Accounts and returns that is, a balance sheet and an income and expenditure account, duly audited; and

- Such other statements as would be necessary in the operation of the scheme.

These documents were required to be kept at the registered office of the management company and be available for inspection during ordinary office hours by interested parties. A similar practice was also

[24] This is what is practised in terms of the Financial Services Act 1989 of U.K, and the Financial Services (Appointment of Auditors), Rules 1987 of the UK Legislation, See J W Vaughan *op cit* note 3 at 35.

required with regard to variation of underlying securities by the manager of unit trusts in property shares[25].

6.4.2 Voting powers of the management company[26]

A management company voting by virtue of a right bestowed on it by the underlying securities held in trust under a unit trust scheme had a duty to vote in a manner as to serve the best interests of holders of unit certificates in the scheme. However, such a purpose was balanced with the interests of the company for which the voting power was held.

6.4.3 Restrictions on dealing

It would be quite prejudicial to the interests of unit certificate holders if the management company and or directors thereof could be allowed to enter transactions or engage in the sale and purchase of assets of the scheme in a manner aimed at unduly enriching themselves. In order to protect unit certificate holders, the Act placed some restrictions and prohibitions on certain transactions entered into by the manager with regard to the assets of the scheme.

6.4.4 Restriction on loans against security of units[27]

The Act prohibited the management company or its directors from lending or advancing money or any sale or offer for sale of units under a unit trust scheme without payment of the full purchase price of the units.

[25] Sections 18, 32 and 33.

The prohibition extended to the practice by management companies or their directors of deriving unauthorized gain from acquisition of underlying securities. In terms of Section 16 of the Act no management company or director thereof was to gain either directly or indirectly any pecuniary advantage from the acquisition or sale of securities in a scheme run by it except in the following circumstances:

6.4.4.1 where the pecuniary advantages accrued to the company in the ordinary course of its business by virtue of any difference between the price at which units therein were subsequently sold or by virtue of any underwriting business done by it;

6.4.4.2 where the management company acting as the agent of the holders of unit certificates shares in a stockbroker's commissions arising out of transactions in securities in respect of a unit trust scheme;

6.4.4.3 where a management company appointed as an authorized dealer in foreign exchange earned a profit on any foreign exchange transaction involving the purchase or sale of securities held outside the country;

6.4.4.3 finally, where the director of a company who acquired securities of the company did not vote on the transaction and had prior to the acquisition, made full disclosure to the management company of her interest in the securities in question, and the price at which they were acquired was not higher than the current market price.

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[26]Section 14.
[27] Section 15 (a) – (b).

The major purpose of the above restrictions on dealings was to avoid any conflicts of interest, which could arise in the affairs of the parties responsible for the unit trust scheme. Subsequently, this would also prevent prejudice to the unit certificate holders of the scheme.

6.4.5 Investment powers of the management company

Unlike a private individual investor the manager of a unit trust scheme had restrictions applied to her with respect to the investment of a scheme's funds. However, according to Vaughan[28] it would be advantageous to allow managers some freedom of action. He submitted that allowing them such freedom:

"... Would mean that they could use the funds of their schemes in what they felt to be the most profitable way and arguably would only be an extension of the powers available to the individual participants of the scheme".

Notwithstanding that, it was inevitable that the manager's power be limited due to the following reasons:

6.4.5.1 In order to allow for the diversification of investments, which in turn would provide participants with an adequate spread of risk:

6.4.5.2 in order to make it easier for the portfolio to be valued and also be readily realizable; and

6.4.5.3 Since securities were to be held only as investments, to prevent the manager from controlling the companies in which the scheme had invested[29].

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[28] *Op cit* note 3 at 79.

[29] Section 6 (4) stipulated that "an investment company means a company which is engaged primarily in the business of investment in the shares and stocks of other companies for the purpose of revenue and profit and not for the purpose of exercising control...."

6.4.6 The permitted investments

6.4.6.1 **Approved Securities** – management companies were permitted to invest in these securities. They are securities issued or guaranteed by the Government of the Republic or issued by any local authority in the country; the Land and Agricultural Bank of South Africa, the Rand Water Board or the Electricity Supply Commission as well as other securities approved by the Registrar for purposes of the Act.[30]

6.4.6.2 **Stock Exchange Securities** – which are securities, listed and authorized to be dealt in on a recognized stock exchange, and the prices thereof are quoted in a list issued for publication by such stock exchange.

6.4.6.3 **Liquid Assets**[31] – Except for managers for unit trust schemes in property shares, every management company was required to include in every unit portfolio liquid assets with an aggregate market value of not less than five percent of the aggregate market value of all the assets comprised in the unit portfolio. The percentage could also be greater or smaller as prescribed from time to time and the registrar could also exempt a management company from the above requirements.

6.4.6.3 Securities issued by any one that did not exceed five percent of the market value of the securities comprised in the unit portfolio. An exception to this provision [32] is only in so far as the excess was due to appreciations and depreciations of the value of the underlying securities comprised in that portfolio. The purpose of the limitation here was meant to allow managers a

[30] Section 1.
[31] These were defined in terms of section 1 as the aggregate amount of such approved securities, deposits and other assets as the registrar would by notice in the Gazette determine.

small degree of flexibility, while at the same time holding them to their main objects.[33]

6.4.6.4 Securities in any investment company that did not exceed ten percent of the aggregate amount of the issued securities of any one class in such company[34]. An exception to this provision was only in so far as the excess was due to an amalgamation, cession, transfer or takeover and subject to the prescribed conditions[35]. The aim of the ten percent limitation as in (iv) above was to satisfy Section 6 (4), which pointed out that those unit trusts, should be seen as vehicles for investment in companies and not control thereof.

6.4.6.5 Securities defined in terms of section 6(b)(iii) of the Act[36]. Other securities were permitted if included in a unit portfolio through the prescribed manner and conditions.[37]

6.4.7 Other powers of the management company

6.4.7.1 **Valuations** – a management had the duty to determine the fair market value for stock exchange securities. If however, the company failed to do so it had the power to request a stockbroker who was a member of a licensed stock exchange to determine the value of the securities. In case of there being a

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[32] The exception from this provision, subject to certain conditions, was granted by General Notice 1138 in Government Gazette 13644 of 29 November 1991. See also section 6 of the Act.
[33] Which includes the objective of risk spreading of investments, prevention from controlling the companies in which the managers invest; distortion of the market as well as difficulties in valuation of the scheme's funds.
[34] Section 6(a)(ii).
[35] Section 6 (11) (aa) and (bb).
[36] Which are securities other than stock exchange securities acquired by the management company pursuant to the exercise of rights attaching to any stock exchange securities, included in the unit portfolio or any combination thereof.

disagreement the matter could be referred to the committee of the stock exchange concerned to resolve it[38].

6.4.7.2 **The Power to Change Investments**[39] - the management company could sell or dispose of any of the underlying securities comprised in a unit portfolio. She could also substitute for such securities other underlying securities or cash equal in value to the net amount realized for the securities disposed of less the compulsory charges in respect of the securities substituted. The Act[40] however, aimed to protect investors against such powers of the management company by imposing two requirements:

(a) that the management company could do so only if it ass in the best interests of the holders of unit certificates. Therefore, a variation of investments, which could be prejudicial to the interests of unit certificate holders, was prohibited.

(b) that the management company should furnish to the registrar information concerning the change of investments. This would therefore, enable the registrar to determine whether the managers' acts were in the best interests of the participants in the unit trust scheme.

6.5 The Trustee

The other party to the trust deed was the trustee. The trustee acted as the custodian of the rights of the unit certificate holders in a unit trust scheme. She had the duty to ensure that the management company

[37] See s1 of the Financial Markets Control Act No. 55 of 1989; and s 6 (1) (d) of the Unit Trusts Control Act; s 6 (1) (e) of the Unit Trusts Control Act.
[38] Section 7 (a) and (2).
[39] Section 18 (1) – (2).

adhered to the investment policy of a scheme as stipulated in the trust deed. Since a lot has been discussed generally on the nature and characteristics of a trustee in the opening chapter of this work, much emphasis will here be placed on the qualifications and legal duties thereof.

6.5.1 Qualifications of the trustee

For a company or an institution to qualify as a trustee under the Act[41] it was a requirement of it to be of high reputation. This means that the general financial and commercial standing of such a company had to support its assumption of the duties and responsibilities of a trustee. Practically this implied that the company had to be, by reason of the nature of its business sufficiently experienced and equipped to assume such duties and responsibilities. The general requirements of a trustee were, thus, as follows:

6.5.1.1 it had be a company registered in terms of the Companies' Act[42] as a public company. By virtue of this requirement the particular company under this was also bound by the Companies Act and therefore unless if expressly provided for by the Act, the operation of the Companies Act could not be affected in relation to the concerned trustee company[43].

6.5.1.2 it could be company or institution that was incorporated under a special Act. However, this excluded a close corporation.[44]

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[40] Section 18-(2) (a).
[41] Section 21.
[42] 61 of 1973.
[43] Section 39 (1) –(5).
[44] As under the Close Corporations Act 69 of 1984.

6.5.1.3 it could also be a banking institution- these kinds of companies due to the nature of their business, for example, financial investment and keeping of bank deposits, were sufficiently experienced and equipped to assume "the duties of holding custody of a scheme's funds", The same applied to domestic insurers, which were registered under the Insurance Act.[45]

To make sure that investors were afforded sufficient security the Act further required that the above companies be registered by the Registrar of unit trusts and that they maintain a paid up capital and unimpaired reserves which in total amounted to not less than R100 000.

6.5.1.4 Another important requirement for registration as a trustee was that it had to be independent of the management company. This meant that it had to be either a holding company or a subsidiary[46] of the management company. This was aimed at avoiding conflict of interests since the trustee had to act as the custodian of the rights of investors.

6.5.2 Revocation of registration of trustee

The registrar could revoke a certificate of registration granted to a company to operate as a trustee if one failed or ceased to comply with the above requirement. This could be done through notifying the

[45] 27 of 1943.

company concerned and setting forth the grounds for such action as well as giving the company a reasonable opportunity to defend itself.

But contravention of the applicable sections of the Act[47] amounted to an offence involving a fine not exceeding R2000 or imprisonment for a period not exceeding five years[48].

6.5.3 General duties and obligations of the trustee

Most of the duties and obligations of a trustee have been highlighted in earlier parts of this work but for purposes of clarity and emphasis they are briefly set out as follows:

6.5.3.1 To take custody of the property of the scheme and hold it in trust for holders of unit certificates; and

6.5.3.2 To register securities in terms of the requirements of the trust deed. With regard to this duty and in (a) above if the trustee could not possibly perform them it was allowed in terms of the Act[49] to delegate the duties to a representative who was independent of the management company and any of its agents. However the Act provided that a trustee who appointed a representative as in above was not divested of the stipulated functions. This meant that such a trustee remained liable for its original responsibilities. The intention of legislation in this case seemed to be to protect holders from consequences of delegation of duties by trustees. Therefore, in order to protect the schemes the trustee seemingly was obliged to make reasonable

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[46] As defined in the Companies Act.
[47] Section 20 (1).
[48] Or to both such fine and such imprisonment – S 20 (4) of the Act.
[49] Section 21 (4).

enquiries that the agent or representative is fit and proper to perform such duties.

6.5.3.3 The duty to ensure that the manager complied with any investment limits imposed by statute or the trust deed. A trustee who failed to make sure that the above is complied with was guilty of an offence in terms of the Act.[50]

6.5.3.4 The duty to give notice of intention to retire – the trustee had a right to retire but, given the responsibilities that it held it would be wrong for it to do so without giving notice in time. Thus it could only retire when the manager had appointed a replacement and the procedure as laid out by the Act[51] had been followed.

In case of the management company failing to perform the section 21(1) requirement, the registrar could, after consulting with the management company direct it to appoint as trustee under the trust deed a fit and proper person. This person would have been nominated by the registrar and also would be willing to act as trustee.

6.6 Investor Protection Under the Act

It can be clearly noted from the preceding illustrations that the Act's main focus had always been the protection of unit certificate holders in a scheme. Legislation was strict on product providers and management companies by ensuring that funds were held to their stipulated requirements and mandates. Furthermore, the history of unit trusts regulation proved the legislation to be

[50] See section 21 (3).
[51] Section 21 (1) and (2).

well polished and therefore successful in protecting investors from fraud and the risk of "big bets" taken by fund managers[52].

However, there were some critical situations provided for in the Act in which the interests and rights of investors deserved more consideration. These situations include:

- the amalgamation of unit trust schemes and portfolios
- cession; or
- transfer; or
- takeover of rights of holders of unit certificates in a scheme;
- the inspection and investigation of a scheme by the registrar; and
- the winding up of a management company[53]

and they shall be discussed in detail below.

6.6.1 The consolidation, takeover, cession or transfer of rights of holders of unit certificates in a scheme

A transaction, which involved any of the above actions, was likely to cause prejudice to some, if not the entire unit certificate holders in the scheme. Therefore, there was an obligation to ensure that such a transaction were carried out in a fair and proper manner that did not violate any of the interests of the participants in the scheme.

Section 24 provided for the manner in which a cession, takeover, transfers or consolidation of participants' rights were to be done. The

[52] McGregor's *The Mechanics of the Johannesburg Stock Exchange* (1989) at 200.
[53] Section 25(i).

Act prohibited the above actions unless the consent of two bodies had been obtained that is:

6.6.1.1 The consent of a majority in value of unit certificates in each unit trust scheme or portfolio to which such action was proposed. Since only the consent of the holders of a majority in value of unit certificates in the trust was required one would question the treatment of the holders of the minority unit certificates on the other hand.

In order to make sure that all participants got a fair treatment the Act provided for further limitations, which would begin with the requirement that:

6.6.1.2 The registrar gave his consent depending on the fulfillment of various conditions which were:

(a) That all holders of unit certificates in the initial scheme be furnished with full information concerning the proposed transaction:

(b) That the proposed transaction would not be detrimental to any holder of unit certificates in an original scheme;[54] and

(c) Also that the holders of a majority in value of unit certificates in the initial scheme had not refused their consent.[55]

The requirement to furnish information to the investors in (a) above was a vital one because it equipped them (unit certificate holders) with information that was relevant to making important decisions on how to deal with their investments. This subsequently, helped unit certificate

[54] Section 24-(3) (b).

holders who did not give consent to the transaction to carefully exercise their right to redeem their investments if they so wished. The fact that the unit certificate holders could sell their investments at any time at the ruling price of the day guaranteed that such a transaction as a take over or cession of rights of holders would not be detrimental to them. This could be as long as the unit holders fully understand the nature and consequences of the transaction and thereby take the proper and necessary decision.

As an assurance of the proper completion of the transaction the registrar also certified it with regard to his consent as well as the conclusion of the deal. Above all, section 24 (8) guaranteed the security of investors by providing further, that, no obligation, cession, transfer or takeover could derogate from the rights of any creditor or any obligation relating to an original scheme or portfolio.[56]

6.6.2 The inspection of a scheme by the Registrar

Whenever the registrar felt that the interests of unit certificate holders could be prejudiced, she had the power in terms of the Inspection of Financial Institutions Act, 1984[57] to inspect and investigate the operation of a unit trust

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[55] Section 24-(3) (c).
[56] This can only be done if the particular section of the Act provides otherwise.
[57] Act 38 of 1984. Section 26 (i) of the Unit Trusts Control Act provides that any reference to an inspection or investigation made under it should be construed to refer to an inspection made under the Inspection of Financial Institutions Act of 1984.

scheme. After carrying out the investigation the registrar had powers[58] to make the following orders:

6.6.2.1 where the investigation brought to light any undesirable conduct or practice the registrar could direct the management company or the trustees to either refrain from doing or continuing with it. This would be done to remedy or eliminate the undesirable conduct. It seemed however, that the registrar could opt to make such an order only in circumstances where the misconduct or undesirable practice was not too serious to deserve the other options, which are:

6.6.2.1 the winding up of the management company in which the registrar applied to the Supreme Court[59] demanding such action as if she were a creditor thereof;

6.6.2.2 the judicial management of the management company[60];

6.6.2.3 replacement of the trustee – in this case the registrar would order the management company to appoint a trustee (according to the requirements of the trust deed) who was competent and willing to act as such; and

6.6.2.4 the retirement of the management company from the operation of the trust scheme – the registrar in this case would order the trustee to appoint another company to run the scheme[61].

Therefore, in circumstances where the practice of either the trustee or Management Company was undesirable to the rights or interests of unit certificate holders the registrar had the powers to terminate the scheme or substitute the manager or trustee.

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[58] Section 27.

[59] This is done in terms of section 346 of the Companies Act 61 of 1973. See also section 27 (a) of the Act.

[60] In terms of section 427 of the Companies Act.

6.6.3 Protection of unit certificate holders on winding up of a management[62]

The winding –up of a management company was a process that could result in unfavourable consequences for the investments of unit certificate holders. For instance, since it is an expensive process it could result in the unauthorized use of investor funds. In order to protect the rights of unit certificate holders in a scheme, the Act set out the procedure to be followed on winding up of the management company.[63]

Winding up of a management company involved the trustee transferring into his name all the underlying securities constituting each unit portfolio and holding them on behalf of the unit certificate holders pending realization. After realization of all the securities the trustee then distributed them amongst holders of unit certificates and the management company in proportion to their respective interests in the scheme. Upon performing this (the winding up of a management company) the trustee followed four very important procedures that were directed at protecting the interests of unit certificate holders, which are:

6.6.3.1 realizing all the securities as expeditiously as possible giving regard to the interests of holders of unit certificates. However, the trustee exercised discretion in this case and therefore could be held liable for the exercise thereof.[64]

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[61] This procedure was required to comply with the requirements as set out in section 3 and 4 of the Act.
[62] See section 28.
[63] Section 28.
[64] Section 28 (2).

6.6.3.2 When the registrar considered it to be in the interests of holders of unit certificates she could order the continuance of the unit trust scheme for a period of time. Thereafter, the registrar could direct the trustee on how to run the unit trust scheme. However, it is possible that a situation might arise, considering the trustee's own knowledge and expertise in investments that she (the trustee) might disagree with the registrar on continuing with a scheme after an initial decision to wind it up. Though it is clear in the Act that the registrar's decision would take precedence[65], her action would be unjustified if her decision could turn out to be prejudicial to investors whilst the Act placed no liability on her for mistakes in making such a decision.

6.6.3.3 Although the trustee who had been ordered to continue with a scheme in terms of section 28 (4) of the Act had the right to terminate her obligations as trustee, the Act still placed a duty on her to give six months' notice of such a intention. The importance of a requirement of a notice in such a period of time was that it gave the registrar enough opportunity to choose another fit and proper person to carry out such duties left by the original trustee.

6.6.3.4 The registrar remained responsible for the determination of the remuneration for services rendered by the trustee and the commission that the trustee would be entitled to shall not exceed five percent depending on all the moneys received[66]. This would prevent trustees from unfairly enriching themselves out of the winding up of a management company.

[65] See, section 28 (5).

6.6.4 Mandatory disclosure requirements under the Act

Since the key to any system of control is information, the importance of mandatory disclosure in the regulation of the unit trusts industry should not be underestimated[67]. Based on the expression that "forewarned is forearmed" disclosure of information by the management companies of unit trust schemes provided information to unit certificate holders in the scheme that would enable them to make rational and informed decisions on the investments they intended to make. In addition to this, disclosure served many purposes for the different participants in a unit trust scheme, which included inter-alia:

6.6.4.1 the promotion of fair and efficient financial markets. This of course depended on the frequency and speed at which the information could disseminated;[68]

6.6.4.2 it enabled the controlling bodies or the legislature to detect dishonesty and malpractice by some management companies at an early stage, thereby making it easier for them to prevent crime;[69]

6.6.4.3 it was the cheapest and easiest form of regulation of the unit trusts industry;

6.6.4.4 Whilst disclosure of information discouraged dishonesty and unfair dealing it encouraged those companies, which were results –oriented with market flair to excel upon the information revealed (about their performance).[70]

6.6.4.5 Compliance with the disclosure requirement helped management companies to dispense with the application of stricter and harsher statutory regulation.[71]

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[66] Section 28(7).

[67] J W Vaughan *op cit* note 3 at 166.
[68] Buckley *Corporations, Principles and Policies* (1995) at 348.
[69] F Van Zyl at 351.
[70] Phillip Wood *Law and Practice of International Finance* (1995) at 547.

6.6.4.6 Disclosure of information provided sufficient investor protection as long as it was applied in the correct manner. The most important aspect of the disclosure requirement was to make sure that investors[72] fully understood and appreciated the information given so as to put them in a position to make informed decisions about the investments. Therefore, the information had to be accurate and recent in order to serve the purposes.

The Act[73] placed an obligation on the management companies to disclose information relating to the state of affairs and results of the operation of the unit trust scheme, as might be prescribed. This information was required to be disclosed to three classes of people, which are:

(i) The registrar of the unit trust scheme

(ii) Holders of unit certificates in the scheme, and

(iii) prospective purchasers of units in the scheme.[73]

Nature of Information to be disclosed

The nature of information to be disclosed under the Act took various forms that was; financial statements, income and expenditure statements, price lists, returns, advertisements, brochures and similar documents.[74]

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[71] Cilliers Benade *et al Corporate Law* (2000) at 189.

[72] These investors can be categorised into two viz (1) sophisticated investors – or investors who are capable of analysing the nature and consequences of the investment transactions that they enter into; (i) unsophisticated investors are those investors usually referred to as the ordinary investors or the men on the street, meaning those investors who actually lack the capacity to fully understand the nature and consequences of the investments that they enter into and therefore are unable to make rational decisions about those investments.

[73] In terms of Sections 10, 11, 12, 31, 32, 33 and 34.

[73] Disclosure to this class of investors could only be provided upon request by the interested party. See section 31 (1) of the Act.

[74] These and the contents thereof shall be discussed in brief below.

Whenever, in the above documents reference was made to a particular unit portfolio the law required the following to be set out clearly,[75] that is:

(a) The statement to the effect that the value of units in each unit portfolio was subject to fluctuations from time to time relative to the market value of the underlying securities comprised in the unit portfolio.[76] This principle was based on the reasoning that the information given should fairly reflect the nature of the investment and not concentrate only on the positive attributes.[77] This would therefore, hint investors to be more careful when considering investments:

(b) a guarantee by the management company to redeem any number of units offered to it on the basis of prices calculated in accordance with the requirements of the Act[78] and on conditions set out in the trust deed:

(c) the commission or charges that the management company might levy as well as the method of calculation and amount of those charges and the time when they could be levied:[79]

(d) Disclosure concerning yields to be derived from any unit offered for sale by the company was required to be confined to the particulars of

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[75] Section 12.

[76] Section 12 (4). But where it would be unreasonable to require the Management Company or its agent to comply with this subsection the registrar could use her discretion to exempt the company.

[77] J W Vaughan *op cit* note 3 at 113.

[78] Section 12(1)(a).

[79] Section 12-(1) (a).

the yield as calculated in the manner prescribed in the trust deed as well as to a statement containing facts likely to influence future yields.

(e) A report on the participation of unit certificate holders in the profits of the company issuing the units was required to be accompanied with a statement containing the amount distributed during the previous year.[80]

The instruments of disclosure: nature and content

The nature and content of some of the instruments used for disclosure of information under the Act shall now be discussed in brief:

(a) **Statement as to the affairs of the operation of the scheme in Property Shares**

This statement was required to be furnished to the registrar and had to be in the prescribed form containing information as outlined in section 31 of the Act.

(b) **Statement as to the Variation Of Underlying Securities**

The manager of a scheme in property shares was required to furnish this statement to the registrar of unit trusts whenever the company alters the composition of any unit portfolio in which units had been sold. The information was required to be in the

[80] This amount was expressed as a percentage of the aggregate market value, as at the close of that year, of all the underlying securities then held by the trustees on behalf of unit certificate holders – see section 12 (3) of the Act.

prescribed form containing detail on the nature and form of the alteration of the underlying securities.[81]

(c) **Financial Statements**

These are documents that a management company was required to submit to the registrar and every holder of a unit certificate in the scheme at least once in every calendar year. These documents included a balance sheet; an income and expenditure account and such other statements, as may be required.[82] These documents had to be properly drawn up so as to show a true and fair view of the state of affairs of the management company.

Financial statements exhibiting information relating to the full particulars of the scheme, that is:

- capital resources employed – the value of the financial resources available to a firm is an important determinant of investor safety.[83]
- the amount invested by the management company from its own resources;
- a review of price fluctuations in the prices per single unit in respect of each unit portfolio at a specific period. This would enable unit certificate holders to determine the risky nature of an investment;
- all accruals and receipts of a capital nature,
- all income for distribution, for example, dividends and interests;

[81] See s 32 of the Act on the details required.
[82] Section 33.
[83] Vaughan *op cit* note 3 at 114.

- the value of units held in each unit portfolio;
- the charges made; and
- all amounts derived from the sale of units as well other relevant information.[84]

Auditing of the Financial Statements

The balance sheet, income and expenditure account as well as other relevant statements were required to be audited by an auditor appointed by the management company and approved by the registrar. The auditor had to satisfy herself that the financial statements of the company showed a true and fair view of its state of affairs.

In the event that there was an irregularity or undesirable practice in the operation of the company the auditor was required to report it to the management company which had an obligation to rectify or discontinue it.[85]

Advertisements, Brochures, Pamphlets and Similar Documents

The contents of the above documents had to be as prescribed in terms of section 34 unless the management company was exempted from doing so by the registrar.[86]

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[84] Section 33. The registrar of Unit Trust Schemes could also request from the Management Company such further information and explanations relating to any balance sheet, account or statement.

[85] However, if the irregularity or undesirable practice could not rectified or discontinued within a period of one month as from the date upon which it was reported to the company the auditor was required to forward it to the registrar. The registrar would then have the powers to deal with the matter accordingly. See section 12 (5).

[86] Section 34(3).

Advertising was defined as, "every form of advertising whether in a publication, by the display of notices, signs, labels or show-cards, by means of circulars, catalogues, price lists or other documents, by an exhibition of pictures or photographic or cinematographic films, by way of sound broadcasting or television, by the distribution of recordings, or in any other manner".[87]

In the context of advertisements of investments the wide meaning could be restricted to advertisements "inviting persons to enter or to enter into an investment agreement or to exercise any rights conferred by an investment to acquire, dispose of, underwrite or convert an investment or containing information calculated to lead directly or indirectly to persons doing so".[88]

It was important that where an advertisement was issued, the person issuing the advertisement had to make sure that her publication was clearly and unambiguously seen as an advertisement. The advertisement was not therefore, supposed to be misunderstood by the investors to whom they were addressed.[89] Every piece of information in the advertisement had to also be based on an initial effort to establish the truth. This extended to forecasts and any other related statements. Generally, the information was not supposed to be given in a misleading way or incomplete form.

[87] J W Vaughan *op cit* note 3 at 109. See also section 207 (2) of the UK Financial Services Act of 1986.
[88] Section 57(2).
[89] Section 57(2).

According to Vaughan[90] "where advertisements are aimed at the general public, anything which minimizes confusion and which prevents the reader from being misled, either intentionally or otherwise, should be applauded".

Untrue and Misleading Statements or Practices

It was an offence in terms of Section 43 of the Act for a person or the management company of a unit trust scheme to make a statement, promise or forecast, which she knew to be misleading, false or deceptive. This included the dishonest concealment of any material facts as well as cases in which the statement was made recklessly. In terms of UK Law[91] for the offence to occur the statement or concealment must coincide with an inducement to undertake investment business, or be made recklessly with regard to such an effect.[92]

Another offence was committed in circumstances where a person created a false or misleading impression about the market or the price or value of the investments concerned. The law was strict against creation of false markets in the financial investment industry. As in the above case there had to be an in intention to induce a person to undertake investment business[93]. A defense was available for this offence if the defendant could prove that she reasonably believed that her act or conduct would not create the impression complained of.

[90] At 114.

[91] Note 87 above.

[92] The statement also need not be made to the person who is the object of the inducement.

[93] See Vaughan *op cit* note 3 at 181. Even where there was no intention to create the false or misleading impression this offence would be committed.

Keeping of Records

Statements, copies of balance sheets, accounts, income and expenditure accounts (duly audited) as indicated in terms of section 31, 32, 33 and 34 of the Act were required to be kept at the registered head office and at every branch office or agency of the management company. The documents would be available for inspection during ordinary office hours by the following:

(i) every holder of a unit certificate issued by the company; and

(ii) any person bona-fide interested in the purchase of such unit certificates

The inspection of records by the above parties had to be done free of charge.[94] The records as well were required to consist of fairly accurate information, which enabled the interested parties or investors to fully understand the nature and consequences of the investment scheme. In other words, the information had to be such that the financial position of the firm could be determined with reasonable accuracy at any point in time.

6.7 Problems associated with the Act

Although the Act contained an impressive series of investor protection provisions, there were however, a number of aspects that it failed to address. These will be discussed briefly[95] below:

[94] S 32 (2) and 33(3).

[95] Since the Collective Investment Act has already repealed this Act it addresses the problems to be highlighted here and therefore they shall be discussed in detail in the next chapter.

6.7.1 Lack Of Alternative Dispute Settlement Mechanisms Under the Act

In terms of sections 43 and 44 of the Act it is clear that the legislation only gave recognition to adjudication on breaches of rules of law. The reality is that formal judicial action is too expensive and time-consuming resulting in investors being reluctant to pursue their remedies.[96] Therefore, there was a valid need to realize the fact that customers needed recourse to an independent system of redress which would be able to deal with complaints with undue formality and which was not restricted to adjudication only on breaches of rules of law. These independent forums were supposed to also be able to award compensation to investors so that they could recover any financial loss suffered as a result of a default on the part of a management company.[97]

The method by which the Act could provide for an arrangement for settlement of disputes was by creation of a unit trust Ombudsman,[98] a complaint investigation scheme and an investor's compensation scheme.[99] These systems could provide for a prompt and thorough investigation as well for the appropriate remedial action to be taken.

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[96] The court system has a problem in that it can only deal with breaches of legal rules yet there are some disputes between a firm and an investor which may fall out of this, for example, some market practices which do not form part of the contract.
[97] J W Vaughan *op cit* note 3 at 146.
[98] The Financial Services Ombudscheme Bill 2001 has made this provision and so the nature of the Unit Trust Ombudsman shall be discussed in the following chapter.
[99] This kind of scheme exists in UK and it is provided for under the Financial Services Act of 1986. See J W Vaughan *op cit* note 3 at 155.

(a) The Unit Trusts Ombudsman

This is an independent institution, which act as the protector of investors' rights in a unit trust scheme by ensuring the following:

- being readily accessible to investor complaints;
- Providing a consistent standard for a fair redress of such complaints or disputes; and
- Handling investor information efficiently.

In terms of the UK Legislation the Ombudsman can also make an award. Art. 66 (b) (ii)[100] provide that in making an award the Ombudsman is bound to act "in conformity with any applicable rule of law or relevant judicial authority and with general principles of good insurance investment or market practice". The same applies to the unit trust Ombudsman.[101] Finally in the event that the complainant is unsatisfied or rejects the decision of the Ombudsman she is free to follow any other course of action open to her.[102]

(b) The Complaints Investigation Scheme

This is another dispute settlement scheme that exists in terms of UK Legislation.[103] This system involves an investigation into malpractice or mala-fides or impropriety by management companies for purposes of considering the appropriate action to be taken. The person required to undertake this action

[100] Of the Articles of Association of the Insurance Ombudsman Bureau.

[101] See also the UK Building Society Act of 1986 sch 12 para. 4(1) which provides that the ombudsman must consider specifically the rules of society, any deed or contract, any relevant Code of Conduct and any advertisement.

[102] J W Vaughan *op cit* note 3 at 153.

[103] See The Financial Services Act of 1986, section 48 (2) (j) and Rule 2.10 of the Conduct of Business Rules.

need not be from outside the firm. What is important is that the adjudicator must be directly concerned in the matter which caused the complaint. She must also have the experience, competence and seniority to perform the task.[104]

In the event that the complainant is dissatisfied with the investigation she has to report the matter to the responsible Board[105], which will refer the matter to an independent investigator.

(a) **The Investor's Compensation Scheme**

This kind of scheme also exists in the UK Legislation. It is established for the purpose of compensating investors in situations where the participant firm is in default and thereby unable to satisfy claims in connection with its investment business.[106]

In cases of insolvency and similar circumstances of the participant firm, the advantage of this kind of scheme is that the fund will be able to make faster payments to affected investors than could the liquidator of the firm. Therefore, investors will need not to wait until assets are realized before receiving payment.

[104] J W Vaughan *op cit* note 3 at 149.

[105] As provided for in the financial Services Act of 1986.

[106] In terms of Rule 3.02 of the Compensation Rules, it is a requirement that the firm in question be in a position where it is unable, or likely to be unable to satisfy its liabilities in respect of its investment business. Examples of such circumstances are the existence of a winding –up order or a bankruptcy order. See J W Vaughan *op cit* note 3 at 155.

Funding of the scheme is by participant firms and depends on firm size and its type of investment business. According to the experience of the UK investment authorities,[107] this system of compensation is complicated and expensive. Therefore, its implementation in the South African Unit Trusts regulation system will demand greater caution in consideration of its benefits vis-à-vis its effectiveness.[108]

6.7.2 The limited scope of the Act

"The Memorandum on The Objects Of the Collective Investment Schemes Control Bill, realises that the "trust –based" nature[109] of unit trust schemes under the Unit Trusts Control Act is a stumbling block to the introduction into South Africa of new structures and investment products already existing in other overseas countries. A shift from a trust-based collective investment scheme to an open-ended investment company or company-based collective investment scheme is anticipated to allow for greater innovation in the industry.

6.7.3 Competitiveness of the industry

Since the Unit trusts Control Act could not accommodate some investment products that are being brought in to local investors from abroad, it means the South African industry will be limited in terms of efforts to create such

[107] See Consultative Paper No.20 "Investors Competition Scheme" January 1989.
[108] For detailed information on the structure and nature of an Investor's Compensation Scheme, see J W Vaughan *op cit* note 3 at 153 –160.
[109] Trust based schemes are those which have the purpose or effect of enabling those who participate in the scheme by becoming beneficiaries under a trust, to participate in or receive profits or income arising from the acquisition, holding, management or disposal of a unit trust property. This is similar to company based schemes but in the later, participation is through the holding of shares in a body corporate. The new Collective Investment Act 45 of 2002 provides for open-ended investment companies as collective investment schemes under the Act – Part 1(i) of the Collective Investment Act. Open–ended investment schemes differ from unit trust schemes in that they place no limit on the number of investors required under the scheme.

investments locally. Therefore the local unit trusts industry would not stand competition with foreign players in the market.

6.7.4 Limited diversification

The company-based scheme would allow for greater diversification of investor funds through introduction of more alternative investment options and products.

6.75 Limits on the sustenance of a dynamic industry

A change to a company-based scheme will promote the existence of a dynamic industry that is supported by constant enhancement of regulation, supervision and investor protection mandates.

Despite the continued improvements made on the Act, since 1947 the desire to encompass latest developments and keep abreast of changes has made it inevitable for the Legislation to be repealed.

The challenge that remains is to constantly assess and review the new system to see and ensure that it lives up to its anticipated standards.[110]

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[110] A detailed discussion of the Collective Investment Schemes Control Act follows below.

CHAPTER 7

REGULATION OF INVESTMENT SCHEMES UNDER THE COLLECTIVE INVEVESTMENT SCHEMES CONTROL ACT

7.1 Introduction

The end of year 2002 was a landmark in the history of the regulation of unit Trusts in South Africa. This is because it marked the eventual enactment of the Collective Investment Schemes Control Act (CISCA).[1] This Act was established in an effort to refine the image of the unit trusts industry by allowing for expansion, flexibility as well as keeping abreast of modern day changes.

The CISCA now replaces the Unit Trusts Control Act, of 1981,[2] which was considered inadequate to counter the current challenges facing the unit trusts industry. CISCA now provides for the control, regulation and supervision of all financially based collective investment schemes[3] including unit trusts and all foreign and local collective investment schemes.

Notable in the new legislation is the fact that it now includes "open-ended investment companies" as a form of a collective investment scheme. This signifies a shift from the trust-based schemes, which were allowed under the Unit Trusts Control Act of 1981 to company-based schemes under the present

[1] Act No. 45 of 2002 (hereinafter referred to as the CISCA).
[2] Act No 54 of 1981. A detailed discussion of the provisions of this Act has been done in the preceding Chapters.
[3] A Collective Investment Scheme in terms of Section 1 of the CISCA means a scheme, in whatever form, including an investment company in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio separately managed by a management company and kept in custody by a trustee as provided for in the deed of the collective investment scheme.

Act. The importance of such a move is that it allows for greater innovation and diversification.[4]

Open-ended investment companies (OEICs) are collective investment schemes, which already exist in most countries, particularly the United Kingdom. They are similar to unit trusts in that they are companies listed on the stock exchange. However, the difference with unit trusts is with respect to the fact that OEICs impose no limit on the number of investors. As a company-based scheme the OELCs encompasses new investment products which were not previously provided for under the repealed unit trusts Control Act. According to Stiaan Hyman[5] this new structure will enable South Africa to compete effectively with foreign players in the unit trusts industry.

7.2 **Background to the enactment of the CISCA**

Prior to the enactment of the CISCA, considerable effort had been made in amending and upgrading the erstwhile legislation.[6] This was done in an attempt to contain current challenges facing the industry as well as conforming to internationally accepted principles and best practice.

However, the desire to construct a regulatory system that would place all collective investment schemes under one Act,[7] as well as

[4] "The Memorandum On The Objectives Of The Collective Investment Schemes Bill, 2002"
[5] Specialist in Unit Trusts at the FSB. See L Still and N Oldert *Understanding Unit Trusts* (2001) at 24.
[6] That is the Unit Trusts Control Act of 1981.
[7] In its review of the regulatory framework of financial services industries, the Policy Board for Financial Services and Regulation, inter alia, proposed that all forms of collective investment schemes should be regulated by one Act as for which see "The Memorandum On The Objectives Of

incorporating all the newly developed investment products especially those from foreign jurisdictions called for the consequential replacement of the out-dated Unit Trusts Control Act. Other reasons behind the change include the following:

7.2.1 The need to provide a comprehensive legislative framework to regulate and supervise the collective investment schemes industry based on internationally accepted principles and best practice. Therefore, the operation of the Act will help South Africa to align its regulations to conform to those in use in more developed markets. This was very much inevitable especially in light of the integration of the world's major financial markets.

Due to an increase in the investment options available to local investors in foreign jurisdictions, South Africa has experienced an outflow of capital pursuing better investment products in foreign countries. This has also been exacerbated by the numerous foreign financial institutions, which are now actively soliciting investments from local investors.

As a result, there was a need to build a system that would allow for the invention and marketing of such similar products locally. Such a move will thereby make the country a better investment destination.

7.2.2 The need to change from trust-based unit trusts to the company-based collective investment schemes. Prior to the drafting of the Bill which later became the

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The Collective Investment Schemes Control Bill 2002.

CISCA, it was noted that introduction of new investment products could not be possible under old legislation.

7.2.3 To allow for increased diversification of investments in Unit trusts since the CISCA permits the introduction of new investment products from foreign countries into the local market. It means therefore, that local investors will benefit from a wide choice of such investments and Fund Managers on the other hand are offered a chance to place investor funds where they are likely to fetch greater returns at the lowest possible risk.[8] This would satisfy the diverse needs of modern day investors.

7.2.4 To enable the local industry to become more competitive and remain competitive. To achieve this purpose the Association of Unit Trusts (AUT) reviewed legislation and regulatory approaches of selected international authorities and the principles thereof. The CISCA will now allow South African unit trusts to compete fairly with those in foreign jurisdictions by accommodating a wide range of collective investment schemes and/ or product schemes.

7.2.5 The need to expand on the requirements of disclosure in order to further protect investors. Amongst the issues to be disclosed are the structure of a scheme, investment objectives of a fund, the basis and fluency of calculation of prices, charges and commissions, distribution of income and the different risks

[8] *Ibid.*

involved. As part of the supervisory process compliance with proper disclosure is monitored continuously under the Act.

However, since its original drafting in 1998 the implementation of the CISCA experienced more delays than anticipated. This was to allow for revisions and amendments to be made before proclamation of the Act in 2002 could take place.

7.3 Regulation of unit trusts under the CISCA

Although the CISCA carried forward most of the major principles embodied in the Unit Trusts control Act, various changes have been introduced too. At this stage the discussion will focus on new aspects brought up in the present act and therefore, principles that have already been analyzed under the discussion of the Unit Trusts Control Act shall not, be repeated.

7.3.1 Analysis of the key provisions of the CISCA

7.3.2 Structure of administration

The three-tier system of control of unit trusts which involves the registrar of collective investment schemes, the management company and the trustee as the custodian of investor rights has been maintained under the present Act. Nonetheless, it remains the most effective way of ensuring the security of investor rights. Other auxiliary bodies in the regulatory system like the auditor of the scheme as well as the Association of Unit Trusts have also been maintained.

The most interesting aspect concerning the above systems is that their scope and duties have been widened and increased respectively and especially with regard to protection of the rights of investors. Under the Unit Trusts Control Act there was no express provision for the Association of Unit Trusts despite its importance. However, the present Act now expressly provides for an Association of Collective Investment Schemes[9], which is established for purposes of ensuring maintenance of high standards of conduct, integrity and respect for investor rights within the collective investment schemes industry.[10]

7.3.2.1 The Registrar of Collective Investment schemes

The registrar is the executive officer who is enshrined with the duty to register collective investment schemes. She also has the power to exempt a management company from the provisions of the Act[11].

The registrar is assisted by a deputy registrar[12] of collective investment schemes in the performance of her duties. An advisory committee namely the collective investment Scheme Advisory Committee also assist the registrar through issuing instructions directed at investigating and reporting or advising on any policy, administrative, technical or supervisory matters relating to collective investment schemes.[13]

[9] Which is an Association registered in terms of section 26 of the CISCA. This association is formed by persons carrying on the business of a collective investment scheme.
[10] Schedule 4 and Section 32(1).
[11] Sections 5, 7 and 63.
[12] Section 1 of the Financial Services Board Act, No. 97 of 1990.

Extended powers and duties of the Registrar

Apart from the routine duties and powers stipulated under the previous Unit Trusts Control Act which include inter alia:

- the duty to register a scheme(s) under the Act;
- the power to cancel, withdraw or suspend registration of a scheme or manager;[14]
- the power to object to potentially misleading or undesirable documents in terms of Section 17 of the Act;
- the power to inspect a scheme in terms of the Inspection of Financial Institutions Act, 1998;[15]
- investigation of a scheme or manager of a scheme for purposes of protecting the interests of investors[16] by applying for either the winding up of a scheme or appointment of a curator for the business of the manager or stop the manager from performing certain acts;
- to request the auditing of a scheme;
- to exempt a manager or a category of persons from any provisions of the Act;
- to submit to the Minister an annual report on the activities pertaining to the operation of collective investment schemes;[17]

The registrar's powers have been extended to include the following:

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[13] Section 8. This committee was established by Section 2B of the Unit Trusts Control Act, 1981. It continues to exist under the present Act despite the repeal by section 117 of the CISCA.
[14] Section 16 of the CISCA.
[15] Act No 80 of 1998. See; also section 14 of the CISCA.
[16] Section 18.
[17] Section 23.

(i) **the power to declare certain practices as irregular or undesirable**[18]

This authority is an important one since it ensures the effective protection of investors as well as the maintenance of the integrity of the Collective Investment Schemes Industry.

Section 21(1) of the Act gives the registrar the power to declare a particular practice or manner of administration of a collective Investment Scheme to be an "irregular or undesirable practice" or an "undesirable manner of administration".[19] After making such a declaration the Registrar has powers to further direct the rectification of anything that arose out of performance of the irregular, undesirable practice or manner of administration in a way required by it.

(ii) **the powers to impose penalties for failure or inability to comply with the basic supervisory and prudential requirements under the Act.**[20] The registrar, since she has the closest knowledge of the affairs of a management company by virtue of her authority to perform the following:

- the inspection and investigation of a scheme in terms of section 14 and 15;[21]
- demand reports, audits and financial statements and most important of all;
- the registration of the management companies;

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[18] Section 21 of the CISCA.

[19] See section 21(1)(a) - (b). However, this declaration can only be made upon approval by the Minister in the Gazette. The importance of this requirement lies in that it aims to strike a balance between protecting investors' rights and also protecting the interests of managers of Collective Investment Schemes. This is achieved by requiring notice to be given by the Registrar in the Gazette, consultation with the advisory committee by the Registrar and allowing the affected party or management company to make representations

[20] Section 18.

[21] Of the Act.

is most appropriately vested with the authority to punish the same companies for failure to comply with requirements of the Act. This will consequently ensure the effective protection of investors' rights.

Instances in which the registrar can impose a fine on a manager for failure or inability in terms of section 18 requirements are:

- failure to maintain, in liquid form the capital for the matters and risks determined by the registrar.[22] Maintenance of the required liquid capital is an important aspect in the operation of a scheme by the management company. This is because Unit trusts are, in most cases considered as a major investment for most investors. Therefore, the Registrar is under obligation to make sure that their risk levels remain low.

- failure to submit reports statements, returns or any other documents as prescribed by the Act. In order to guarantee the security of collective Investment Funds, transparency in the operation of the fund must be maintained. This can be achieved through placing a duty on management companies to submit required reports and statements within the prescribed time limits under the Act.

- inability to comply with other prudential or supervisory requirements under the Act can result in the Registrar imposing fines on the concerned management companies.

[22] Section 88(1).

Under the present system, it consequently becomes difficult for management companies to escape the wrath of the Registrar as well as the criminal justice system. Therefore, protection of investors becomes more reinforced.

(iii) the authority to attend meetings of the Association and to request furnishing of certain documents by managers.[23] The Association of Collective Investment schemes is an association licensed in terms of section 26 of the Act and is composed of members who are involved in the carrying on of the business of Collective Investment Schemes in terms of the Act. The association is representative of the interests of the industry [24] as well as those of the investors.[25]

Involvement of the Registrar in the meetings of the Association will therefore ensure transparency in the activities of the operators of collective investment schemes. This means that the managers of collective investment schemes will be obliged to administer schemes "honestly and fairly, with skill, care and diligence and in the interest of investors and the collective investment schemes industry".[26]

7.3.2.2 **The management companies of collective investment schemes**

The functions and duties of managers of collective investment Schemes under the previous Unit Trust Control Act of 1981 have been maintained under the CISCA of 2002. However much emphasis has also been placed on

[23] Section 20.
[24] Section 26(a).
[25] Schedule 4 or Section 32 (1)(x)(x).
[26] Section 2.

compliance by managers[27] with internationally accepted principles or best practice. Managers are required to uphold values that reflect a dignified and responsible Collective Investment Schemes Industry, which accords greater respect to the interests of the investors.

A. **Functions and duties of the manager**

The manager of a collective investment scheme is a person or company authorized in terms of the Act to administer a collective investment scheme. She is obliged to comply with all requirements of the Act as well as the Companies Act, of 1973.[28] Administration of a scheme by the manager should always be in terms of the policies and objectives stipulated in the trust deed.[29] Since most of the duties of a manager have already been discussed in chapter 3 of this work only the new principles introduced by the CISCA will be discussed:

The Duty to Disclose information with regard to the following:

(i) **Investment Objectives**

Before entering a transaction with an investor the manager must

ensure that she explains the investment objectives of a scheme. This is to ensure that each investment made will appropriately suit the particular needs of a specific investor.

[27] Of collective investment schemes.
[28] 61 of 1973. Compliance is required particularly to aspects regarding registration as well as control of the scheme.
[29] A trust deed is the document of incorporation in terms of which a collective investment scheme is established and administered. S 1 of the CISCA.

(ii) The calculation of the net asset value and dealing prices, the charges, risk factors and distribution of income accruals [30]

Since risk is involved in collective investment schemes it is important that investors be made aware of all the above so as to be able to determine the actual value of each investment. All in all, information that is necessary to enable an investor to make a decision on an investment must be given timeously and in a comprehensible manner.

(iii) **Interests of the management company and its directors**

A conflict of interests between the manager or its directors with those of the investors, must in all circumstances be avoided.[31]

Since conflict of interests between the manager and the investors can be prejudicial to the rights of investors, the registrar of collective investment schemes is entitled in terms of section 16(1)(a) and (b) to cancel or suspend the registration of the manager.[32]

(iv) **Financial statements and other documents**

Section 90 of the Act[33] places an obligation on managers of collective investment schemes to report to the registrar and every investor under a scheme. This is done by means of submitting the duly audited financial statements as well as other statements that the registrar may request. The

[30] Section 3(a).
[31] Under section 4(1) and (2).
[32] Suspension or cancellation of registration of a manager is done upon completion of an investigation which proves that the manner in which a manager carries on the business of a collective investment scheme is unsatisfactory or undesirable or not calculated to serve the best interests of its investors.
[33] *Supra* note 1.

above mentioned information and documents are also required to be kept available for inspection at every office of the manager.

2. **The obligation of a manager to maintain adequate financial resources to meet its commitments and any risk**[34]

The major reason why a management company is required to maintain a specific amount of capital in liquid form is to cover the scheme or fund against potential risk. Since the registrar has close supervision of collective investment schemes she is, on the other hand authorized to determine the matters and risks that a manager should guard against.[35]

The duty to payout investors wishing to redeem their investments is another very important commitment of a management company. Therefore, a management company must maintain enough liquid capital to satisfy such requirements.

The capital requirements of a manager as prescribed in the Act have now refined activities of local managers in line with international standards. These include:[36]

(i) Providing enough liquidity to ensure sufficient resources to continue the operation of a scheme for three months in the winding up of a management company;

[34] Section 4(3).
[35] The registrar also has the power to exempt the managers of a particular type of collective investment scheme from any or all of the above-mentioned requirements. See section 88.
[36] J Thomas "Stiff New Regulation For The Investment Business" *The Business Times*, September 8, 2002 at 11.

(ii) Providing seed capital of R1, 000 000-00 (R1m) at a portfolio's inception.

(iii) Holding an additional amount for any further position taken so as "to provide liquidity in adverse market conditions".

Whilst the capital requirement provisions under the Act enhances confidence in collective investment schemes it also provides effective security for the safety of investor funds[37]

3. The duty to exercise her (the manager) voting powers in the interests of investors[38]

4. The obligation not to derive unauthorized gain from acquisition of assets in a portfolio.

5. Duty to deduct from a portfolio, only the amounts stipulated in terms of Section 93 of the Act and those determined by the Registrar;

6. Duty not to sell "participatory interests"[39] before payment of the full selling price.

7. The power to borrow funds for purposes of bridging insufficient liquidity in a portfolio.[40]

[37] To ensure that this requirement is complied with, Section 89 (1) of the Act, read with Section 18 of the same Act supra note 1, authorizes the registrar to refuse registration of a manager before she complies with requirements or in case of failure to comply, to impose a fine or stop continuance of the management of a scheme by the concerned person.

[38] Discussed in detail in chapter 3 above.

[39] A "participatory interest" is defined in terms of the Act as "any interest, undivided share or share whether called a participatory interest, unit or by any other name, and the value of such interest, unit, undivided share or share remains constant or varies form time to time, which may be acquired by an investor in a portfolio. See section 1 of the CISCA.

8. **The duty to maintain a principal office in the Republic**

In terms of Section 101 of the Act a manager is required to maintain the above office and appoint a public officer. The purpose is to ensure that all legal proceedings against the manager are served at the principal office.

9. **The duty to separate funds of investors and other persons**[41]

This duty is one of the most important provisions of the Act, which aims to ensure the effective protection of investor funds as well as other creditors to a fund. Section 2(2) of the Act emphasizes that the assets of an investor must be protected by the application of the principle of segregation and identification.

The principle of segregation and identification under the Act

This principle places an obligation on the manager to open and maintain a separate operational trust account. This account must be controlled by the trustee who can only make a withdrawal if payment to an investor, person or manager entitled to such payment is required or any payment in terms of the Act, the deed and any other law. The importance of the application of the principle of segregation and identification is that it prevents misuse of investor funds by managers and thereby guarantees the security of investor interests.[42]

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[40] Section 96.

[41] Sections 104 - 10.

[42] *Ibid.* Any person having a financial interest in or a claim against an operational trust account has a right, on good cause shown to apply to court for the prohibition of a manager from operating such a trust account. In such cases a curator may be appointed to control and administer the account in terms of the duties and powers as the court may prescribe. See also section 105 of the CISCA.

10. **Liability for loss to investors and other persons**

Previously the investor had only common law to rely on for a claim. In terms of Section 109 of the Act the investor's right is now recognized and statutorily entrenched. Presently, a person or manager who fails to comply with any provisions of the Act, and consequently cause a loss to an investor will be liable for such loss or damage[43].

Other duties of the manager relating to the proper administration of a scheme include inter alia:

11 **The promotion of investor education**

This can be done directly or through initiatives undertaken by an association. Information for purposes of investor education relates to the nature of unit trusts, the risk involved the charges, commissions or fees as well as the various available funds.

12 **The keeping of proper records** for purposes of inspection by interested parties, for instance, investors, the registrar and other persons:

13 **The maintenance of an open and cooperative relationship between manager the office of the registrar.** This duty is a very important one because since the Registrar plays a supervisory role in the administration of collective investment schemes, her (the registrar) role in that regard will therefore, be made easier.[44] The manager must organize and control the collective investment in a responsible

[43] To be discussed in detail under the heading "Investor protection" below.
[44] Section 4(4)(e).

manner[45] taking into consideration the interests of the investors as well as the integrity of the industry as a whole. This should be founded on well-defined compliance procedures.[46]

Notable under the present Act is that the duties and obligations of the managers of collective investment schemes have been significantly increased and comprehensively defined with an effect on improvement of the protection afforded to the interests of investors. This is quite laudable in light of the potential risks and sophistication of investments, which can be anticipated to germinate out of an industry recently, restructured to absorb new schemes and products emanating from foreign financial structures.

7.3.2.3 The Trustee of a Collective Investment Scheme[47]

Appointment and Termination of a Trustee

The principles and procedures for the appointment and termination of a trustee or custodian under the present Act have remained the same with those under the previous Act or the Unit Trusts Control Act, of 1981.[48] However, a change has been introduced only in terms of Section 3(3)(a) - (a) of the Act which places a duty on the trustee to report to the registrar any contemplated

[45] Section 4(4)(a).
[46] Section 4(4)(d).
[47] For the meaning of a trustee refer to chapter 3 of this work under definition of a trustee of a unit trust scheme.
[48] Section 21(1) - 4(b).

irregularity or undesirable practice arising or anticipated to arise out of the termination of an appointment which is not in terms of Section 69(3).[49]

This requirement is an important one, because it safeguards the security of investor rights from any adverse consequences, which can possibly emanate from such a termination of appointment by the trustee.

The qualifications and registration of a trustee

Except for a few additions the qualifications of a trustee have also been maintained as from the previous Unit Trusts Control Act:

An addition of the phrase "or branch of a foreign institution which is entitled to carry on the business of a bank" in Section 69(c) was appropriately inserted. The significance of including branches of foreign institutions to be appointed as trustees is in line with best practice,[50] which accommodates the influx of foreign investment schemes and products into the country. This reflects on the consequential advent of the integration of financial markets.

The other change has been with respect to the capital and reserves that a trustee should maintain for it to be registered. This has been increased from a minimum of R1 000 000 under the Unit Trusts Control Act of 1981 to not less R10 000 000 rands under the present CISCA. The effect of such substantial

[49]This section provides for the refusal of registration of a trustee by the registrar if she is not satisfied with regard to the general financial and commercial standing of the trustee, its experience, as well as its independence.
[50] Or internationally accepted standards.

increase will justify the intention of legislation to guarantee the safety of investor funds under a collective investment scheme.

The duties of the trustee

Greater emphasis on the duties of the trustee has been expressed under the CISCA.[51] The duties and responsibilities of the trustees have been clearly and comprehensibly outlined but they shall be discussed briefly here:

(a) The duty to ensure that the administration of a collective investment scheme is being carried out properly and in compliance with the Act and policies as stipulated in the trust deed, including all acts involving the administration of a scheme such as the following:

- the calculation of units as well as yields;
- limitations imposed on investments and the borrowing powers of the manager;
- the requirements for the legal separation of assets under custody as well as the legal entitlement of investors to such assets;
- the proper keeping of records;
- the maintenance of appropriate internal control systems and any other matter relating to the operation and control of a scheme.

(b) The duty to carry out the instructions of the manager as regards the investments which comprises the property of the scheme.[52] However, it

[51]Section 70.

should be noted here that this demand is subservient to the duty to ensure that the manager complies with any investment limits imposed by statute or the trust deed.

A more specific duty related to this is that the manager may direct how the funds of investors should be separated and segregated. To give effect to this, the trustee is obliged to operate different accounts for the various specific investment funds.[53]

On the contrary, the trustee is expected to turn down the instructions of a manager, for instance, in cases where it rejects acceptance of property, which infringes the provisions of the Act and the trust deed.[54]

(c) The duty to take custody of scheme property in terms of the requirements of the Act and policies of the trust deed;

(d) The duty to inquire into and prepare a report on the administration of the collective investment schemes by a manager. This is one of the most important obligations placed on a trustee by the present Act.[55] Under this provision the Trustee is required to make an inquiry into the administration of a scheme by a manager for purposes of verifying compliance with the Act or trust deed.

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[52]The trustee is however obliged to comply with this duty only as long as the manager's instructions are consistent with the Act or the deed. See section 70(1)(c).
[53]J W Vaughan *The Regulation of Unit Trusts* (1990) at 38.
[54] Practically this refers to property or any other instructions which do not represent a proper and prudent investment of the scheme's funds.
[55] Section 70(1)(f).

Following such an inquiry the trustee has to report any irregularity or undesirable practice in the following manner:

(i) Firstly to the manager[56] who must immediately rectify such irregularity or practice to the satisfaction of the trustee; or

(ii) Report to the registrar when the manager fails to correct the irregularity or practice to the satisfaction of the trustee.

All in all, an annual report by the trustee of the administration of a scheme and compliance with the rules must be prepared. This requirement places a duty on management companies to administer a scheme in a fair and transparent manner, thereby protecting the interests of the investors.

(e) Duty to treat as trust property any money or other assets received from an investor and an asset of a portfolio.[57] The purpose of this provision is to avoid misuse of investor funds by managers of collective investment schemes.

Liability of a trustee in respect of loss of assets

The Act through application of section 72 entrenches the right of investors to make a claim against loss of their assets. The investor can now be compensated in terms of statute law for any losses or damages to their funds due to negligence by a management company's trustee.[58] Previously, the

[56] Section 70(2).
[57] This is required in terms of the Financial institutions (Protection of Funds) Act, No. 28 of 2001. See section 71(b).
[58] J Thomas *loc cit* note 36 at 11.

investor had only common law to rely on for a claim. Therefore investor rights in this regard are now fully recognized.[59]

In order, to ensure that the trustee carries out its duties properly and effectively the act further provides that no person should interfere with the performance by a trustee or custodian of its functions.[60] However, failure by a trustee to perform such duties as prescribed by the Act renders it guilty of an offence.

7.4 Ancillaries to the structure of regulation

There are other subservient bodies within the three-tier structure of administration of collective investment schemes. These bodies serve a purpose of ensuring the effective control and operation of collective investment schemes. They are the auditor of a collective investment scheme and an association of collective investment schemes.[61]

7.4.1 The auditor of a collective investment scheme

The appointment as well as the duties of the auditors in the previous Unit Trusts Act, has been maintained under the present Act. However, two more significant factors have been included and these are:

7.4.1.1 that the auditor must conduct her audit and maintenance of accounting records in conformity with generally accounting practice. This is in line with the

[59]For a trustee to be liable to indemnify a manager or investor for a loss the loss must have been caused by willful or negligent act or omission by the trustee. See section 7 of the CISCA.
[60] Section 70(5) of the CISCA.
[61] Previously known under the Unit Trusts Control Act as the Association of Unit Trusts.

objectives of the present legislation that is; to bring regulation of collective investment in line with internationally accepted standards and best practice.

7.4.1.2 that an auditor who fails to perform her duties in terms of the Act is guilty of an offence. This will ensure compliance with the provisions of the Act as well as protection of the investors.[62]

7.4.2 The Association of Collective Investment Schemes[63]

This body or association has been in existence long before the enactment of the present legislation. Previously, it was referred to as the Association of Unit Trusts. However, the rules for the establishment and operation of the association were not expressly provided for under the Unit Trusts Control Act. Notwithstanding that, the Association serves quite a number of worthwhile purposes in the administration of a collective investment scheme.

7.4.2.1 Objectives of the Association of Collective Investment Schemes

The Association of Collective Investment Schemes[64] has the following aims:

- mainly to represent the interests of the industry and the public as a whole. This is achieved by ensuring that managers of collective investment schemes administer the schemes honestly and fairly, with skill, care and diligence and in the interests of investors and the collective investment

[62] Chapter 6 of this text for a detailed discussion on the duties of an auditor of a collective investment scheme.
[63] Sections 25 - 38.
[64] Which is an association registered in terms of Section 26 of the CISCA is a body of persons carrying on the business of collective investment scheme.

scheme industry.[65] If a member of an association fails to comply with the above, then the executive committee of the association can stop or suspend the administration of a collective investment scheme by such a member.[66]

- to ensure that all members of the association comply with the rules of the association[67] and the Act;
- **investor education** - a very important role of the association under the act, involves educating investors and the public on all information concerning collective investments including the risks to which an investor is exposed.[68] This provision recognises the fact that maintenance of an investment industry of high integrity depends on the existence of an adequately informed investing society;
- to ensure that members comply with financial requirements under the Act, they are required to be sufficiently trained and experienced to perform their duties;[69]
- the association envisages the existence of a *Complaints Investigation Scheme*[70] by providing for standards of conduct of members and the investigation of complaints in respect to their activities;[71]
- also envisaged by the association is the existence of an *Alternative Dispute Resolution* mechanism.[72] This is for the equitable and speedy settlements of disputes between members in respect of the carrying on of their business.[73]

[65] Sections 2 and 26(a) and (b).
[66] Section 31(1)(a).
[67] Section 32.
[68] Section32(1)(vii).
[69] Section 32(1)(v).
[70] See, chapter 6 of this work for the functions of a complaints investigation scheme.
[71] Section 32(1)(vii).
[72] See chapter 6 for the detailed discussion of such a mechanism.
[73] Section 32(1)(x).

- to ensure sufficient disclosure of information by members to all the interested parties, for instance, the registrar and the investors.
- to ensure the sufficient protection of investor funds by providing for the establishment of a *Fidelity Fund* to which every member is obliged to make a contribution. The purpose of the fund is to provide compensation for the liabilities of members arising out of their activities.

In addition to the above, member companies are required to provide sureties to the satisfaction of the executive committee, for the discharge of liabilities arising out of their activities.[74]

Although the main purpose of the Association is to serve the interests of the managers, its desire to maintain the integrity of the industry subsequently promotes the protection of the interests of investors too.

7.5 Scope of Regulation

The items regulated under the Act include, inter alia: collective investment schemes in securities, collective investment schemes in property, declared collective investment schemes, investments in foreign collective investment schemes, the conversion of collective investment schemes as well as other matters related to requirements for trust deeds and rules of association.[75]

[74]See section 32(1)(b)(ii) and (iii).

7.5.1 **Collective investment schemes in securities**[76]

The Act provides for some restrictions on the administration of collective investment schemes in securities as well as the procedure for registration of the manager.[77] The determination of market prices of securities should be done in terms of section 44 of the Act, which requires securities to be valued at a fair market price.

A very important aspect introduced by the Act is giving the registrar the power to determine the instruments that may be included in a portfolio.[78] This will protect investors form risky underlying holdings. The registrar also has powers to determine the amount that may be held in any one counter, thereby avoiding over-exposure to any one share or instrument.[79]

With regard to investments in foreign securities, the Act[80] prescribes specific requirements to be adhered to. Firstly, investments in non-equity securities should be from issuers located in a country, which has a foreign currency sovereign rating. In addition the issuer should have a long-term issuer credit rating on the international scale. This requirement helps to safeguard investor funds against risks connected with high market volatility, which are prevalent in international investments. With respect to non-equity securities the registrar has been given the authority to determine diligent guidelines to be followed by managers when considering such investments.

[75] Participation bonds are also under the scope of regulation. However, they do not form part of this discussion. See section 52 for the provisions relating to participation bonds.
[76] These are schemes whose portfolio consists, mostly of securities. See section 39.
[77] Sections 41 and 42. The restrictions and procedures for the registration of a manager are similar to those provided for under the previous Unit Trusts Control Act. See also chapter 3 of this work.
[78] Sections 40 and 46.
[79] J Thomas *loc cit* note 36 at 11.

In order to put local collective investment schemes in line with international standards a manager should consider only the equity securities that are traded on an exchange, which has been granted full membership by the World Federation of Exchanges.[81] Membership of an exchange in the world Federation of Exchanges reflects the exchange's compliance with best practice and is therefore, safe for investors seeking high returns for their investments at a lower risk.

Finally, the manager of a scheme is required[82] to obtain the approval of the registrar before doing any of the following:

- change of name of the manager;
- change of name of a portfolio; or
- of a shareholding or directors as well as
- the removal of appointees.

The purpose of this is to avoid prejudice to investors due to unjustified changes in the administration of a scheme.

7.5.2 **Collective Investment Schemes in Property shares**

In terms of Section 74(1) of the Act a "collective investment scheme in property" refers to a scheme the portfolio of which consists of property shares, immovable property as well as other assets determined by the registrar.

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[80] In terms of section 45.
[81] Section 45 (b)(i).
[82] In terms of section 43.

Restrictions applied to collective investment schemes in securities as discussed above also apply to investments in property shares, mutatis mutandis.[83]

7.5.3 **Declared Collective Investment Schemes**[84]

These are collective investment schemes declared to be such by the Minister. The business activities and matters to be provided in trust deeds of declared investment schemes are also defined by the Minister.[85]

Recognition of declared Collective Investment Schemes is one feature, which reflects on the flexible approach taken by the CISCA. The requirements for companies to engage in the business of collective investment schemes have become less stringent as compared to those under the previous legislation.[86]

The advantage of the flexible nature of the CISCA is that it places the legislation in a much more advantageous position to face current changes as well as being able to accommodate new products.

7.5.4 **Foreign collective investment schemes**[87]

The Act, in terms of section 65, provides some restrictions on the carrying on of business by foreign Collective Investment Schemes in the Republic. This is

[83] See section 47 to 51 of the CISCA, for the provisions pertaining to the regulation of collective investments in property shares.
[84] Section 63.
[85] However, some sections of the Act do apply to these schemes. See section 64 of the CISCA.
[86] The Unit Trusts Control Act, of 1981 which recognised no other unit trust schemes except those established in terms of its provisions.
[87] Section 65 - 67.

to ensure that such schemes are carried out in the best interests of investors[88] and also that the managers of such schemes provide accurate information which is not misleading in their application.

A very important principle embodied in the section 66[89] provision is that of *Reciprocity*.

Meaning of the principle of reciprocity

This principle is based on the requirement that if, in terms of any law of a foreign country a manager (foreign) connected with this country is disqualified, suspended or restricted from operating a collective investment scheme in that country the same action should also be taken against her in this country with the necessary changes.

The principle of reciprocity therefore, involves the mutual control of collective investment schemes by the Republic and its foreign counterparts.

Purpose of the principle of reciprocity

The purpose of this principle is that it promotes investor protection as well as compliance with international best practice by the local regulatory system. This is achieved by ensuring that the local Collective Investment Schemes industry does not become a hiding place for unscrupulous dealers from outside who may choose to operate would here rather than under the stricter regulation

[88] Or potential investors.
[89] Of the CISCA.

in their own countries. On the other hand, this will protect the integrity of the local investment industry.

7.5.5 **The conversion of a Collective Investment Scheme**

Section 76 of the Act is another provision, which reflects the flexibility of approach in the present legislation. In terms of this provision a Collective Investment Scheme can be converted to another form of a collective investment scheme permissible under the Act. However, the approval of the registrar must be obtained before such a conversion is effected.[90]

Before a registrar approves the conversion of a scheme the following requirements must be fulfilled by the manager of the prospective "conversion scheme":

(i) the reason for the proposed conversion must be stated clearly; including; the manner in which the investment scheme is proposed to be effected;[91]

(ii) clarity on the proposed deed of the scheme; the proposed directors of the management company;

(iii) clarity on the basis terms, conditions and costs of the conversion;[92]

(iv) that an offer to those willing to take up participatory interests in the prospective scheme has been made:

(v) that provision for repayment of any investor who chose to redeem her shares or participatory interests has been made; and

[90]After the approval of the registrar has been granted, a resolution adopted by a majority in value of investors should also be obtained in order to authorize the conversion. See s 80.
[91] Section 78(2).
[92] Section 76(2).

(vi) finally, that after approval by registrar, a resolution passed by investors authorising the conversion has been obtained by the manager. Subsequently, the memorandum and articles of association must be registered particularly with respect to schemes which were not registered under the companies Act, 1973.[93]

In order, to guarantee the safety of investors an offer to qualifying investors under the converted scheme should be accompanied by information that reflects the general state of affairs of the scheme. Section 84(1) of the CISCA places a duty on the manager to disclose the following information:

- all the details of the offer and conversion as well as the collective investment scheme's profit;
- the business prospects of the scheme; and
- any other information that the registrar may require in connection with the state of affairs of the scheme.

Significance of the conversion of collective investment schemes

The ability of managers to convert from one collective investment scheme to another is one that places them in a strategic position with regard to investing in schemes that provide higher and safer returns to the investors. Due to the flexible approach adopted by the present CISCA greater innovation in the collective investment schemes industry is anticipated and this subsequently provides an impetus on management companies to be versatile and conscientious in choosing the best

[93] Act No. 61 of 1973.

available schemes that match the different circumstances of investors within the scope of prevailing economic conditions.

7.6 Investor protection and disclosure requirements under the Act

Investor protection under the Act has been increased through the widening of the ambit of the duties and obligations of all the parties involved in the administration of collective investment schemes. These parties include the registrar, the manager, the trustee, the advisory committee, the Association of Collective Investment Schemes as well as the auditor of a scheme. The extent to which the above parties' duties and obligations have been increased for purposes of best serving the interests of investors has been discussed in detail above.

The requirement for managers of Collective Investment Schemes to comply with rules of association and policies stipulated in their trust deeds is a strong safeguard against the interests of investors. Rules of Association now provide for the investigation of complaints in respect of the activities of managers. This is reinforced by the civil remedies that are now available to investors in terms of the Act.[94] The provision for the establishment of a fidelity fund in terms of a section 32(ii)(aa) of the Act is another effort by legislation to guarantee the security of investor funds.

Given that the potential consequences of the Act will be to allow for innovation and introduction of new and foreign investment products it follows therefore, that the Collective Investment Schemes industry will become even more sophisticated. It would be very much unwise to provide a new product to an investing society that

[94] See sections 72 and 32 (viii).

bears no knowledge of such product. However, the legislation takes a very important step in terms of section 4(1)(f) of the Act to make sure that the investing public is adequately prepared for the new scenario.

Section 4(1)(f) of the Act, places a duty on the manager to promote investor education. This duty is also extended to the Association of Collective Investment Schemes.[95] The purpose is to ensure investor empowerment through financial literacy.

7.6.1 Disclosure of information

The Act provides for comprehensive disclosure requirements by management companies to investors, the registrar and other interested parties to a Collective Investment Scheme. Most of these requirements have been alluded to under the discussion on the duties of a manager.

All the information that is necessary to enable the investor to make an informed decision should be given to the investor in time and in a comprehensible manner. This information includes:

7.6.2 The policies and objectives of the collective investment scheme

The objectives of a scheme must be initially stipulated in its trust deed and then the manager will be obliged to comply with them.[96]

[95] By the 13th October 2002, The Association of Unit Trusts had published its fifth article in a series of investor education columns in the Business Times newspaper. The websites; www.fsb.co.za and www.aut.co.za are initiatives of the association to promote investor education on the world wide web.

[96] It is an important duty of the Trustee to make sure that the manager of a scheme administers it in compliance with the objectives as provided for in the scheme's trust deed.

It is very important for investors to know the objectives of a scheme in which they intent to invest. This is because it will enable them to make a choice of investments that are most appropriate for their distinctive purposes and circumstances. In other words the objectives of the investment scheme must also suit the objectives of the investors.

7.6.2.1 **The calculation of net asset value, dealing prices and charges**

The costs of making an investment is a serious aspect which investors neglect to consider when making an investment. Different funds charge different administration costs and this has a sensitive impact on the growth of an investor's fund. Therefore, it is important for managers of collective investment schemes to expose all the expenses or charges that an investor is expected to incur when making a particular investment.

7.6.2.2 The distribution of income accruals – it is also important for investors to be aware of the amount of yield they will get from the investment as well as the manner of distribution of such yields.

7.6.2.3The risk factor of an investment - knowledge of the risk factors of an investment empowers the investors with the ability to take appropriate decisions on their investments.

7.6.2.4 Financial statements of a scheme: the manager must disclose information that

7.6.2.5 shows the true financial position of a scheme. Any false and misleading statements will make the manager of the scheme liable to an offence in terms of the Act.[97]

7.6.2.5 The auditor's report - must disclose any irregularity or undesirable practice by the manager of a scheme. This helps to prevent financial loss to investors of a scheme.

The extensive disclosure requirements coupled with the investor education obligations in the Act definitely enhances the security and confidence of investors. On the other hand, it ensures the sustenance of the integrity of the Collective Investments Industry as a whole.

7.7 Enforcement action

The rules embodied in the Act, in particular provisions pertaining to the following:

7.7.1 duties of the manager, trustee, the registrar and the auditor of a scheme;

7.7.2 codes of conduct;

7.7.3 the rules of association and;

7.7.4 the principles of the trust deed,

Are every important in promoting the collective investment schemes industry as well as protection of its investors. In order to make sure that the rules under the Act are strictly complied with by the responsible parties, the Act also contains penal provisions.

[97] Section 109.

Section15(c) of the Act provides that "any person who fails to comply with any directive, requirement, notice, rule or regulation under any provision of this Act, is guilty of an offence". Most of the provisions of the Act, stipulate penalties for non-compliance. However, where no penalty is specifically provided for, section 116 of the Act, applies. In terms of this section any person who is guilty of an offence in which no penalty is specifically provided for, is liable to a fine or to imprisonment for a period not exceeding five years or to both a fine and such imprisonment.

Civil remedies are also available to either managers or investors who incur loss or damage due to a willful or negligent act or omission by the trustee or custodian. [98] This liability applies also to any person who contravenes or fails to comply with any provision of the Act resulting in subsequent loss or damage to another person.[99] Previously, the investor had to rely on the common law to effect a claim. Now this right is statutorily entrenched and it affords all parties full protection.

7.8 Potential effects of the application of the CISCA to the regulation of unit trusts

The adaptable nature of the act will do no less than promote the growth and development of the collective investment scheme industry. Since a lot of effort has been spent in trying to modernise the legislation so that it complies with international principles and best practice, it therefore, means that the influx of Foreign Collective Investments into the country will not pose a major challenge to the regulatory system.

The local Collective Investment Schemes industry will become more competitive whilst on the other hand, regulatory systems will be creating a more favourable

[98] Section 72.

condition for development of new schemes and products. More investment products will be created to the satisfaction of investor needs.

As more and more products are introduced into the industry, the emphasis on educating the consumers of such products will be inevitable. Nevertheless, the legislation has effective provisions for such initiatives.

However, the increasing innovation of new products as well as consequences of the integration of international financial markets will make the collective investment schemes industry much more sophisticated. The effect is that a constant review and repeal of the legislative provisions will be required in order to keep abreast of the changes. Therefore, the effect of the increased changes in the industry will also require change in the regulatory system, which will render the CISCA an object of continuous review and amendment.

[99] Section 109. Also, in terms of subsection (6), nothing in the section affects any liability that the offender may incur under the common law or any other law.

CHAPTER 8

REGULATION OF THE MARKETING AND DISTRIBUTION OF UNIT TRUST AND OTHER FINANCIAL INVESTMENT PRODUCTS[1]

8.1 Introduction

Despite the increased availability of modern sophisticated investment products in the unit trusts industry the marketing and distribution of such products was previously not regulated.[2] This created a haven for unqualified and irresponsible financial advisers and intermediaries of the unit trust products. The result was uncontrolled abuse by the advisers, which caused unjustified losses to a large number of the investing public.

8.1.1 Importance of brokers or financial intermediaries in the unit trusts industry

Brokers or financial intermediaries play a crucial role in the marketing and distribution of unit trust investment products. This is especially so against the backdrop of a financially uneducated population that needs advice. The innovation and availability of sophisticated investment products is another aspect that puts the services of financial advisers at a center stage.

Brokers or intermediaries in the unit trusts industry are either "tied" or "untied".[3] "Tied" brokers are intermediaries or agents who sell investment products exclusively for one management company. The "untied" is a free agent that can sell across different management companies.

[1] Henceforth reference to unit trusts should be construed to mean collective investment schemes in terms of the Collective Investment Schemes Control Act, No 45 of 2002 referred to herein as CISCA.

[2] However the only protection afforded by the Unit Trusts control Act No. 54 of 1981 to the marketing and distribution of investment products was through the requirement that no one may offer to the public for value an interest or undivided share in any assets or the right to participate proportionately in the income or profits so derived except in a registered unit trust scheme. Apparently, this was

However, due to lack of proper regulation of the conduct of intermediaries, gross abuse of investor rights occurred. The existence of unqualified and incompetent advisers resulted in the offering of bad financial advice to investors that were not appropriate to their needs. In most cases brokers and intermediaries would prefer to sell those investment products that would bring them a higher commission rather than those appropriate to the needs of the investor.

To cure the above mischiefs Parliament introduced the Financial Advisory and Intermediary Services Act 2002.[4] This piece of legislation was introduced to regulate the business and conduct of those rendering financial services to clients on a wide range of financial products.[5]

8.1.2 Extent of the application of the FAIS Act to unit trusts

Section 45 (iv) of the Act provides that the Act does not apply to the rendering of financial services by a manager or an authorized agent as defined in section 1 of the Collective Investment Schemes Control Act, 2002.[6] This provision is applicable only to the extent that the rendering of such services is sufficiently regulated by the Collective Investment Schemes Control Act.

Since the administration and operation of unit trusts involves the investment of investor funds into a diversified number of investment portfolios the services of "financial

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inadequate.

[3] Liz Still and Nick Oldert *Understaning unit trusts* (1999) at 20.

[4] 37 of 2002. Hereinafter referred to as the FAIS Act.

[5] In terms of section 1 of the Act, financial products refer to inter alia: securities and investments, including shares in a company, debentures and securitised debt, any money-market instruments; participatory interests in collective investment schemes; and long term or short term insurance contract or policy.

service providers"[7] becomes an important part of the unit trust chain. This places the Financial Advisory and Intermediary services Act in a subordinate position to the Collective Investment Schemes Control Act.

8.2 Background to the enactment of the FAIS Act

Before the enactment of the FAIS Act the predicament of consumers of services of the unqualified financial advisers was that they had no way of verifying the credentials of such financial service providers. Furthermore, they had no form of redress unless the product was registered with the Financial Services Board.[8] This reflected a gap in the regulation of financial services, which allowed financial service providers the opportunity to insidiously benefit at the expense of naïve investors.

The landmark judgement in *Durr v Absa Bank Ltd and Another*[9] was the first to expose the negligent conduct of financial intermediaries and recognise that strict standards had to be set for the industry.[10] In this case the duties and conduct of financial service providers was placed under a thorough examination that subsequently motivated the enactment of the present FAIS Act which regulates the business of financial intermediaries or brokers.

8.2.1 Analysis of the *dicta* in *Durr v Absa Ltd and Another*

In this case a broker was held liable for recommending an inappropriate investment to a client. The investor had no need of the highest returns available, instead what she

[6] Act No. 45 of 2002.

[7] Financial services provider, in terms of Section 1 of the Act means any person, other than a representative, who as part of her regular business furnishes advice or renders an intermediary service for purposes of effecting the sale of a financial investment product.

[8] E Ryan "Focus on the Financial Advisory and Intermediary Services Act" *Business Times* 2002 September 29 at 20.

wanted were secure investments. In contradiction, the broker strongly recommended debt-financing instruments describing them as "variously as 'safe', 'very solid', 'very secure', and 'very sound' investments".

In reality debt-financing instruments were extremely risky investments which a broker cannot be expected to advise a client to invest in unless a thorough investigation of the viability of the investment scheme has been undertaken. Therefore, it was held that it was negligent to engage in a dangerous activity without the skills and knowledge usually associated with the proper discharge of duties connected with such an activity.

In addressing the issues arising out of the matter, the court stipulated some principles and standards that should underlie the activities of financial advisors and intermediaries. These principles form the guidelines from which the present FAIS Act was established and therefore, shall be discussed below:

8.2.2 Defining the limits on the duties and Responsibilities of brokers

Amongst the issues addressed by the court was the question as to what constitutes a broker. The court rejected the category of a traditional or "typical broker"[11] who in other words is a broker though good at marketing a product would not be able to assess the risk associated with the product or the soundness of the investment. This type of broker would have no obligation to undertake an investigation to ascertain the viability of an investment before recommending it to an investor.

[9] 1997 (3) SA 448.
[10] The financial advisory and intermediary services industry.
[11] Or the kind of brokers who were common before the coming into being of the FAIS Act.

On the other hand, the question as to whether investors are not entitled to expert advise from a broker who exhibits herself as an expert with confirmative backing by large financial institutions was also discussed. In addressing this and the above questions the court brought up two aspects into perspective which are:

8.2.2.1 the level of skill and knowledge required with regard to a broker; and

8.2.2.2 whether the standard against which that skill and knowledge should be judged is that of an ordinary or average broker or that of a proficient broker professing investment skill and offering expert investment advice.

To tackle these questions the court adopted the dicta in *Van Wyk v Lewis*[12] to determine what skills the particular kind of broker should exhibit depending also on what skills the broker was held out to possess. The court held that in deciding what is reasonable it would have regard to the general level of *skill and diligence* possessed and exercised at the time by "the members of the branch of the profession to which the practitioner belongs"[13] As to point (b) above it was held that the appropriate standard to be attached to a broker should be that of an expert providing professional advice. This approach was preferred because it was envisaged that to allow standards for an "average or typical broker" would be to allow the brokers an opportunity to manipulate the investors.

8.2.3 The duty of care, skill and diligence

In *Mitchell v Dixon*[14] it was held, in support of the decision in *Van Wyk v Lewis*,[15] that although a professional cannot be expected to bring to bear upon the case entrusted

[12] 1924 AD 438 at 444 and 448.
[13] In this instance the court would pay high regard to the views of the profession, though not bound to adopt them.
[14] (1914) AD at 525. This case dealt with the standard of care and skill expected of the medical practitioner.

to her the highest possible degree of professional skill, she is bound to employ "reasonable skill and care".[16]

Furthermore, the principle of *imperitia culpae adnumeratur*[17] stipulates that lack of skill is regarded as culpable. This points to the fact that a broker has no right to recommend an investment until she has satisfied herself by sufficient means that the investment is safe and appropriate. Alternatively, a broker is not entitled to venture into a field and profess skills that she does not possess and proceed to give investors assurances (about the soundness of investments) which she is not qualified to give. Commission of the above conduct amounts to negligence.

8.2.4 Liability for negligence and the duty to undertake investigations

In LAWSA series[18] it is stated that:

> *"Lack of skill or knowledge is not per se negligent. It is, however, negligent to engage voluntarily in any potentially dangerous activity unless one has the skill and knowledge usually associated with the proper discharge of the duties connected with such an activity."*

This statement places a duty on brokers to ensure that in circumstances in which they choose to recommend risky investments they should also bear the burden of the duty to investigate the potential viability of the investment. This duty suitably emphasizes the professional aspect of the business of brokers and consequently ensures the effective protection of investor rights.

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[15] (1924) AD 438.
[16] See the remarks of *Scott L J in Mahon v Osborne* (1939) 1 All ER 535 (CA) at 549 D-E.
[17] D50.17.132.
[18] *The Law of South Africa para* 94 at 468 E-F.

8.2.5 Investor analysis and provision of appropriate advice

Finally, inferable from the above case is the duty placed on brokers to analyse the circumstances of each particular investor, the needs and the risk profile thereof before making a recommendation on any investments. This will enable brokers to recommend to investors only those investment products that suit their needs.

The effects of the *Durr v Absa,* are uncompromising in providing a basis for the establishment and maintenance of a professional financial brokerage standards that ensures access to competent financial planning by investors. A strong onus is therefore placed on financial advisers to exercise due diligence before advising clients. As well, there are serious disciplinary procedures in place to make sure correct advice is given.

8.3. Objectives of the FAIS Act

Following the exposure of the misconducts of financial brokers and planners as shown in the *Durr v Absa* case and other unreported cases[19] the FAIS Act was enacted to achieve the following key purposes:[20]

8.3.1 protection of the consumers of the services of financial planners and brokers;

8.3.2 education of investors;

8.3.3 establishment of a new properly regulated financial services profession which assumes responsibility for the industry that it serves;

8.3.4 The systematisation and rationalization of the regulation of the conduct of financial advisers;

8.3.5 the creation of stringent standards for the registration, licensing and control of the activities of financial advisers;

[19] For example *Nathan and others v Absa Bank Ltd and Another. D & C & D.* 30.11.1995.

8.3.6 the establishment of a legislative tool which is freestanding, complete, "user friendly" and flexible. Unlike most other legislative Acts the FAIS Act was formulated in a much simplified content and language for ease of interpretation and clarity;

8.3.7 the provision of varied and easily accessible enforcement mechanisms such as civil remedies as well as the services of an ombudscheme. This is to ensure the speedy resolution of disputes and compensation of affected parties.

8.3.8 ensuring compliance with the legislation through avoiding unnecessary costly regulatory requirements. During the drafting process it was accepted that it would not be in the public interest if the authorization and compliance requirements were too strict or burdensome for the authorized financial service providers and their representatives.

Briefly, the Act is aimed at removing confusion in the financial advisory and intermediary services industry, thereby bringing about a much more professional and responsible intermediary sector with a strong emphasis on the protection of investor rights. According to Eamon Ryan,[21] the Act is one piece of legislation, which is a "consumer protection measure" and therefore should "be measured in benefits to the consumer rather than inconvenience to the profession".

The above conception is quite appropriate. Though the FAIS Act's strong motive to protect investors may in areas err on the side of over-regulation, the fact that South Africa has a society with a considerably large element of financially uneducated but

[20] "The Memorandum on the Objects of the Financial Advisory and Intermediary Services Bill" (2001).
[21] E Ryan *loc cit* note 8 at 20.

curious investors makes a strong case for the need to give greater protection to such investors.

8.4 Analysis of the key provisions of the FAIS Act

8.4.1 Structure of administration of the FAIS Act

Three key bodies are involved in the administration of the Act. These are the registrar and deputy registrar of financial service providers as well as the advisory committee.[22] The main purpose of these bodies is to ensure the effective administration of the Financial Advisory and Intermediary services industry in terms of the FAIS Act.

The Registrar of Financial service providers has a number of the important functions in the administration of the FAIS Act. She *inter alia* performs the following duties:

8.4.1.1 Registration and licensing of financial advisers.

8.4.1.2 Supervision of the activities of all financial intermediaries as well as ensuring that they comply with the requirements of the FAIS Act.

8.4.1.3 Protection of the consumers of financial services from misconduct by financial intermediaries;

8.4.1.4 Ensuring the existence of a sound and dignified financial services industry with fair, efficient and transparent markets; and also

8.4.1.5 Ensuring that financial service providers comply with the code of conduct stipulated in the FAIS Act. The registrar sees to it that financial service providers observe high standards of integrity, fair dealing as well as acting with due care and diligence in the best interests of clients.

[22] On financial service providers see section 5 of the FAIS Act.

In performing her duties the Registrar is assisted by a deputy registrar who is the deputy executive officer of the Board of Financial Service Providers (FSB).

8.4.2 **The Advisory Committee on Financial Service Providers**

This committee consists of a chairperson and other relevant stakeholders, which include, amongst others, persons representative of product suppliers, financial service providers and clients. The registrar is also a member of the committee by virtue of her office.[23]

The major purpose of the advisory committee is to carry out investigations and provide reports or advise on any matter relating to financial service providers.

The provisions of the Commissions Act, of 1947[24] applies to investigations by the Advisory Committee with regard to the summoning and examination of persons and the administering of oaths of affirmations, the calling for the production of books, documents and objects and offences by witnesses.[25]

Serving a vital enforcement objective is the office of the ombudsman for Financial Service Providers. This office was established in terms of the FAIS Act to facilitate the speedy, economical and informal resolution of disputes and complaints arising out of the operation of the financial services industry.[26]

[23] However she does not have voting powers on matters on which she is to be advised by the committee see section 5(3) of the FAIS Act.
[24] Act No 8 of 1947.
[25] This applies *mutatis mutandis*, see section 5(11) of the FAIS Act.
ection 20(1). Also, to be discussed in detail below.

8.4.3 The registration and licensing of financial service providers[27]

As one of her major responsibilities the registrar has to determine the form and manner of applications by prospective financial service providers. This is to ensure that only "fit and proper" persons are allowed to engage in the provision of financial services.

Anticipated in the description of "fit and proper persons" are those applicants who possess the following qualities:

8.4.3.1 honesty and high integrity;[28]

8.4.3.2 possession of high degrees of competence and operational ability to fulfil the responsibilities imposed in terms of the FAIS Act; and

8.4.3.3 possession of a sound financial status so as to enable effective discharge of the duties of financial service providers as required by the FAIS Act.

After being satisfied in terms of the above, the Registrar may authorize a financial services provider. However, having regard to the available facts and information as well as guidelines provided by the Advisory Committee, the registrar may also impose such conditions and restrictions on the exercise of the authority granted, as is necessary[29]. If on the other hand, the registrar, is not satisfied with respect to the fitness or appropriateness of an applicant she can refuse the application[30].

In order to give effect to the purpose of the requirement for licensing of financial service providers the following further requirements are essential[31] namely that it

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[27] Section 7(1) of the FAIS Act.
[28] Section 8(1) (b).
[29] Section 8(4) (a).
[30] Apparently, the registrar, will do only what can be considered as justified and in the interests of clients of financial service providers when either granting or refusing authorization.
[31] Section 8(7) of the FAIS Act.

should be clearly ascertainable that a person intending to give financial advice is duly authorized and licensed. In terms of this requirement[32] a licensee must:

- clearly display the license in all her business premises;
- indicate in all business documentation, advertisements and other promotional material that such a license is being held;
- make sure that the license is immediately available upon request to any person requesting proof of licensed status under authority of law or for the purpose of making a business transaction with the licensee; and
- not to use in any manner a license that has lapsed or has been withdrawn or suspended.

The requirement for financial service providers to display their licenses is a very important one in instilling confidence in clients thereof. However, clients should always be cautioned that the holding of a valid license is not a total guarantee of a professional's expertise. Therefore, it is crucial that clients try their best in evaluating the merits of each and every transaction made with a financial service provider.[33]

8.4.4 **The suspension or withdrawal of authorization**

Whenever, the licensee no longer meets the requirements as stipulated in section 8 of the FAIS Act the registrar has powers to suspend the license in order to avoid prejudice to the interests of the clients of such a licensee.[34]

Suspension of a license by the registrar can be made provisionally in terms of section 9(3) of the Act. In terms of this provision, the registrar may in urgent circumstances

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[32] Section 8(7).
[33] To be discussed below.
[34] Before suspending a license the registrar is obliged to comply with requirements of section 9(2) of the FAIS Act regarding giving notice to the licensee and reasons for the proposed suspension.

where she is satisfied on reasonable grounds that substantial prejudice to clients or the public in general may occur, provisionally suspend the license. The purpose of this provision is to ensure the urgent protection of clients from prejudice due to the misconduct of financial service providers in particular circumstances.

Whilst under suspension the licensee concerned is regarded as an unauthorized person in terms of the Act. A suspension made provisionally can either be made final or lifted depending on the available facts.

In adverse circumstances the registrar can withdraw a license that was already issued, or is under a provisional suspension. Circumstances that would demand withdrawal of a license by the registrar are most appropriately those that constitute a deviation from the requirement of " fit and proper " persons in the financial service providers industry. These include inter alia:[35]

8.4.4.1 where a licensee intentionally omits to make a full disclosure of all relevant information to the registrar when applying for the license; or

8.4.4.2 simply furnished false or misleading information; or

after having been issued with a license contravene or fail to comply with any material provisions of the Act.

A withdrawal of a license will therefore result in the debarment of the licensee from applying for a new license for a specified period. Although this could appear as a harsh step, it is however, the most appropriate action to protect clients from fraudulent financial service providers.

[35] Section 10(1) of the FAIS Act.

8.4.5 **Lapsing of a license**

In order to make sure that no person who is not " fit and proper " in terms of the legislation act as a financial service provider, section 11(1) of the Act provides for the lapsing of a license in the following circumstances:

8.4.5.1 where the licensee in certain cases voluntarily surrenders the license to the registrar;

8.4.5.2 where, with respect to licensees who are natural persons, the licensee becomes permanently incapable of carrying on any business due to physical or mental diseases or any serious injury; or is finally sequestrated or dies or;

8.4.5.3 in case of the licensee being any other person is finally liquidated or dissolved; and

8.4.5.4 where the business of the licensee has become dormant.

The basic requirements for the authorization of financial service providers as provided for under section 8 of the Act also extend to the agents or representatives of those financial service providers[36]. These agents should be competent to act and amongst other things comply with the Act.

Any contravention of the provisions of the Act or misconduct by the representatives would be a justifiable ground for the cancellation of their services by the registrar. Moreover, the authorized financial service providers will be held responsible for the misconduct of their representatives. This will subsequently ensure the effective protection of the clients of financial service providers.

[36] Section 8 and 13 of the FAIS Act.

8.4.6 Discretionary powers of the registrar with respect to authorization of product suppliers[37]

The registrar has the power[38] to exempt a company with qualities of a " fit and proper " person as contemplated in section 8 of the Act by virtue of it being registered under any other relevant law from submitting some or all of the information otherwise required from an applicant.

In the above case it appears that the registrar would have satisfied herself as to the competence of the "product provider" in providing genuine financial services to clients before granting the exemption. The granting of an exemption to companies by the registrar makes it convenient for competent and compliant persons to suitably and conveniently engage in the business of financial services. On the other hand protection of the interests of clients will be guaranteed since only suitable companies can be granted the exemption.

8.4.7 Duties and responsibilities of financial service providers:

One of the strongest points of the FAIS Act is that it gives the registrar the power[39] to draft a code of conduct for the financial service providers and their representatives. The major purpose of the code of conduct provided for in terms of the Act is to eliminate the malpractices of financial service providers as exposed in cases like *Durr v Absa Bank Ltd and Another other.*[40]

As emphasized in *Durr v Absa*[41] the duty to comply with a code of conduct by financial service providers ensure that they do not just offer advice for the purpose of gaining a commission. In

[37] Product supplier means any person who issues a financial product to clients by virtue of an authority approval or right granted to such person under any law- see, section 1 of the FAIS Act.
[38] In terms of section 12.
[39] After consulting the Advisory Committee. Section 15(1)(a).
[40] *Durr v ABSA and another* 1997 (3) SA 448.

fact they should offer skilled services in order to ensure delivery of that kind of information that can place clients in a position to make informed decisions about their investments. Furthermore, it ensures provision of appropriate advice that satisfies the various needs of the clients. In other terms, an extra duty is placed on financial service providers to undertake a thorough analysis of the particular needs of a client and the subsequent offering of suitable advice.

In drafting the code of conduct the Registrar is guided by some principles[42]. These principles form the crux of the main objective of the FAIS Act and since they have already been alluded to in the analysis of the *Durr v Absa Case,* they are dealt with only briefly here.

Amongst other things the provisions of the code of conduct would place the following obligations on financial service providers:

8.4.7.1 **The duty to act honestly and fairly in the interests of clients**

Before the enactment of the FAIS Act there was no obligation on financial service providers to perform their duties honestly and fairly in the interests of clients. This resulted in financial service providers engaging in fraudulent dealings for the purpose of merely gaining higher commissions and undeserved profits.

Eamon Ryan[43] notes:

" in the past, professional financial advisers are fond of saying, a salesman would have been able to sell used cars in the morning and advise you on which financial products to buy in the afternoon " In addition Jenny Barbour, a partner at Delotte & Touche

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[41] *Ibid.*
[42] See section 16(1) - 2 of the FAIS Act.
[43] Focus on the Financial Advisory and Intermediary Services Act "The Business Times" September 29, 2002 at 20.

explains that, " A so- called financial adviser could approach a consumer and make any representation at all to close a sale. The product sold could even be a scam or set-up ".

To ensure that financial service providers act fairly and honestly the Act requires that they maintain a clean record. They should not have criminal records, nor fines, censure or disqualification from a professional, regulatory or financial services body and should not be disqualified by a court order.

8.4.7.2 **The duty to act with due skill, care and diligence**

This duty was emphasized in greater depth in the *Durr v Absa* case. In this case it was held that it is negligent for a financial advisor to engage in the work of providing advice or recommending a financial product to a client without the actual skills and knowledge usually associated with the proper discharge of such advice or recommendation.

This duty places a heavy burden on financial service providers to make an investigation of each particular investment before recommending it to a client. Therefore, financial service providers have no right to recommend an investment until they have satisfied themselves by sufficient means that such an investment is suitable and appropriate for a specific client.

The standard of care that advisers owe to clients is that of qualified and experienced planners. This entitles clients to expert advice and consequently ensures the protection of their rights.[44]

[44] E Ryan *loc cit* note 8 at *20.*

8.4.7.3 The duty to act in a manner that upholds and promotes the integrity of the financial services industry

Given the huge number of the financially uneducated investing population in the country vis-a-vis the increased invention of sophisticated financial investment products, the need for financial planners remains a crucial feature of the Financial Investments Industry. However, the survival of the industry depends on the usefulness of the industry to the investing public and consequently on the amount of confidence it instills in the public.

Malpractice within the industry would result in its collapse and consequently prejudice of the clients thereof. Therefore, proper compliance with the code of conduct will ensure the existence of a fair and efficient financial services industry.

8.4.7.4 The duty to perform and provide proper and professional services

To achieve this purpose financial service providers are required [45] to effectively employ the right resources, procedures and appropriate technological systems. This is required in addition to the employment of suitably qualified and skilled personnel.

8.4.7.5 To analyze the nature, circumstances and needs of the clients in order to provide the best advice and recommend the most suitable investments

In *Durr v Absa,*[46] Shulze, JA emphasized that it is a crucial role of the financial service providers to seek from clients appropriate and available information regarding their financial situation, financial product experience and objectives in connection with the

[45] In terms of section 16(1)(b).
[46] *Loc cit note 40 at 448.*

financial services required. This requirement emanates from the duty to act honestly and fairly, and with due skill, care and diligence by the financial services providers.

8.4.7.6 **The duty to disclose**

Disclosure of information by financial service providers pertaining to, amongst other things:

- information material to the making of a decision on an investment; and
- conflicting interests or any other interests a financial service provider has or may have in an investment

This also includes avoidance of fraudulent and misleading advertisements, canvassing or marketing.

In order to ensure sufficient disclosure to the registrar and the clients, financial service providers should also perform the following duties:[47]

- maintenance of records for a minimum period of five years. These records should contain all information pertaining to issues arising out of the performance of the services of financial service providers;
- maintenance and submission (to the registrar) of duly audited accounting records; and
- employment of a *compliance officer* to monitor compliance with the requirements of the Act and the code of conduct.[48]

[47] Section 18.

8.4.7.7 **The creation of Professional indemnity or fidelity insurance cover**

This requirement gives protection to the financial services industry with regard to sustaining the integrity of the industry. On the other hand it instills confidence in clients by assuring them of compensation in cases of loss due to negligence by financial service providers.

8.4.7.8 Creation of a Trust Account for the purpose of the safe and separate keeping of client funds and other transaction documents. Subsequently, this will prevent misuse of client funds.

All in all, the code of conduct is required to be drafted in a manner that gives effect to the objects of the FAIS Act.

8.4.8 **Enforcement mechanisms and Protection of rights of clients**

In order to compel financial service providers to comply with the requirements of legislation, the Act provides for a variety of enforcement mechanisms. These are the creation of an office of an ombud, civil and common law remedies.

8.4.8.1 **The Office of the Ombud for Financial Service Providers**[49]

The main purpose of the creation of the office of the Ombud is to ensure the consideration and disposition of complaints in a procedurally fair, informal, economical and expeditious manner and by reference to what is equitable in all the circumstances.

[48] Section 17(1),

[49] Sections 20-32 of the Act for the detailed provision on the office of the Ombudsman. See also 2003 (May) *De Rebus* at 54.

The office of the ombudsman has the powers to make the following determinations with respect to complaints:

- dismissal of the complaint;
- upholding of the complaint and most importantly awarding of fair compensation for any financial prejudice or damage suffered by a client; as well as;
- any just and appropriate direction that the ombud may give against the concerned financial service provider.

To protect the Ombudsman from any external interference with her work, section 31 provides for penalties against any persons who so interfere. Since, the creation of the office of the Ombudsman is for the benefit of the financial service clientele an additional duty is placed on the registrar to promote awareness of the nature and availability of the Ombudsman. The duty to educate clients in this regard also extends to disclosure of information to the general public on matters dealt with in the entire Act. As a result, the operation of the office of the Ombud ensures the effective protection of the rights of clients of financial service providers.

8.4.8.2 **Civil Remedies**[50]

Alternative to submitting complaints to the office of the Ombud, prejudiced clients can opt for civil remedies as provided for under the Act. Most appropriately the registrar may institute action in a court against a person who contravenes any provision of the Act for the following:

- payment of compensation for loss suffered by another person as a result of non-compliance with the Act;

[50] Section 33.

- a penalty for punitive purposes; and
- any interest or costs of suit.

8.4.8.3 **Declaration of certain practices as undesirable**

In circumstances where a financial service provider engages in a business practice that causes or is likely to cause prejudice to the client thereof, the Registrar has the power[51] to declare such a business practice undesirable. The consequences for a financial service provider whose business practice has been declared undesirable is that she may not carry on the business practice concerned.

If, however, in the above case a financial service provider carries on with a practice that has been declared undesirable, the Registrar may direct that particular provider to rectify or reinstate any loss or damage caused or arising out of the carrying on of the business practice concerned.[52]

8.4.8.4 **Common Law Remedies**

In terms of section 40 no provision of the FAIS Act may prevent or interfere with the right of a client or any other affected person to seek appropriate legal redress in terms of the common law. This is with respect to any matters arising from the rendering of financial services by service providers or their representatives.

8.4.8.5 **Criminal offences and penalties**

Section 36 of the Act provides for heavy penalties with respect to any contraventions of the Act or any deliberate false and misleading disclosures or statements as well as concealment of material facts.

8.4.8.6 **Closure, winding up and voluntary sequestration**

To prevent prejudice to the rights of clients in cases of sequestration or closure of the business of a financial service provider, the Act prohibits such winding up or closure until after the following have been done:

- giving of notice to the registrar; and
- the registrar satisfies herself that arrangements have been made to meet all liabilities under transactions entered into with clients prior to the intended sequestration, winding up or closure of the business.[53]

Although the above enforcement mechanisms may appear to be a heavy burden for the financial service providers, they are fundamental requirements in the moulding of a more professional and client-focused industry. The best results consequently are the effective protection of the clients of the industry.

8.5 Effects of the operation of the FAIS Act

In general, by adopting the practice of the world's major financial markets, that is, the U.K, USA and Australian markets the FAIS Act has taken a vital step in aligning local legislation with international practice. This is an important achievement.In fact, the operation of the FAIS Act has had both positive and negative effects on the financial

[51] After consultation with the Advisory Committee and by notice in the Gazette. See. section 34.

services industry as well as clients thereof. However, it is more appropriate to say that the Act has brought more benefits to the consumers of the financial services industry than the profession.

8.5.1 Effects on the financial services industry

Drawing from experiences in countries like the United Kingdom and Australia, in which a similar legislation was implemented, the effects of the FAIS Act on the Industry as expected are manifesting in South Africa. When similar legislation was introduced in the United Kingdom the number of financial planners dropped from 100 000 to 22 000.[54] According to Solly Keeste[55] the number of financial planners in South Africa is estimated to be around 30 000 and out of this number only 6700 are members of the FPI, a voluntary professional association.

Obviously, a significant number of financial planners, particularly the small firms and the unqualified ones are going to be weeded out of the industry. Most unfortunately, it becomes onerous and costly for smaller financial planners to operate effectively and within legislation. In particular, the costs of the extensive administrative and compliance requirements of the Act have left many independent financial advisers disgruntled.

As a result many independent financial advisers have been forced to band together in order to achieve economies of scale. Others have opted to merge with larger, more

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[52]Section 34.
[53] Section 38.
[54] Carol Paton "Financial Advisers Act will see shady intermediaries running for cover," *The Business Times* 17 November 2002.
[55] Legal head of the Financial Planning Institute (FPI).

established financial planning businesses in order to secure support, in respect of compliance requirements, technological, research and administrative orders.

In response to the outcry of the financial services providers, the FSB[56] contends that additional costs of compliance and licensing represents value for money to the consumer and it finds justification in the fact that the FAIS Act provides, for exemption in reasonable and appropriate circumstances.

Despite the adverse consequences of the Act on the industry, it cannot be doubted that the most important change brought about by this piece of legislation is a more ethical, professional and client-focused industry. Nevertheless, the integrity of the industry has been up-graded and as a result greater investor protection and confidence established.

8.5.2 Effects on the consumers of the financial services industry

Given the large number of the existing financially uneducated population of South

Africa, the FAIS Act plays a very important role for the investing public. The importance of the Act is very much noticeable especially against the backdrop of an industry previously dominated by dubious investment schemes such as the Masterbond. In any event, the Act is an effective consumer protection mechanism, which should appropriately " be measured in benefits to the consumer rather than inconvenience to the profession "[57]

The Act places greater emphasis on the protection of the consumers of financial services. This motive is reinforced by an investor education drive, which forms a major objective of the Act. Investors therefore, benefit from the improved services which

[56] The organization which oversees the regulation of the Financial services industry.
[57] E Ryan loc cit note 8 at 20.

comes with the increased standards placed on the industry. However, investors are likely to face the problem of increases in costs of financial planning services due to the relatively high costs of licensing and maintaining the financial planning businesses. There is a high possibility that the few, highly professional financial planners who survive the industry shakeout will move upmarket to high networth individuals who can afford to absorb the impact on investments of the high fees and commissions. This will be a big disadvantage to the smaller and "unsophisticated investors"[58].

8.5.3 Conclusion

The increased protection of investors brought about by the FAIS Act is one that should be seen as auxiliary to the efforts of the Collective Investments Control Act, which on the other hand brought flexibility and innovation to the financial investments industry. The wide variety of investments which is now available to investors (due to the implementation of the Collective Investments Control Act) introduces a more sophisticated industry which demands greater protection to be afforded to investors to circumvent the adverse effects of fraud and other misconduct prevalent in the industry.

As a final remark and with respect to the FAIS Act investors should be constantly warned that they should not stop exercising due care when selecting or dealing with advisers. This is because no matter how stringent the Act is, it will not always prevent outright scams, which circumvent the law[59].

[58] "Unsophisticated investors" are those investors who cannot be expected to fully understand the nature and consequences of an investment.
[59] Carol Paton *loc cit* note 54.

CHAPTER 9

CONCLUDING REMARKS

9.1 The future of unit trusts regulation

As indicated in the preceding chapters, it cannot be doubted at this stage that the overhaul of the unit trusts legislation[1] has placed regulation of the industry in a very strategic position to face future challenges. The rapid changes which characterise the unit trust industry demands a legislative instrument that is relatively dynamic and at the same time flexible. For all that, the present system or regulation has been chiselled properly in a way to adapt to any possible changes.

There are a variety of factors that affect the future of unit trusts regulation. Some of them have been highlighted under the discussion on the objects of the CISCA and FAIS Acts. To avoid repetition and over-emphasis of points already discussed only the few major challenges shall be outlined below.

9.1.1 Effects of globalisation and the need to comply with international standards

It should be reckoned that in drafting the CISCA and the FAIS Acts South Africa engaged in consultations with regulatory bodies of the world's major capital markets which include, amongst others the United Kingdom, Australia and the United States of America. This was a necessary step considering the current influx of foreign-based investment products into this country, which demand uniform regulation.

[1] Through the enactment of the Collective Investment Schemes Control Act 45 of 2002 and the Financial Advisory and Intermediary Services Act 37 of 2002.

The future trend in the control of unit trusts is that of community legislation which carries with it the following advantages:

9.1.1.1 equivalent protection of investors in different jurisdictions;

9.1.1.2 fair competition amongst different markets;

9.1.1.3 diversity in investments coupled with increased innovation in the investment industry; and

9.1.1.4 promotion of industry growth.

It is interesting to note, however, that the CISCA is structured more in the form of the United Kingdom Collective Investment Schemes regulation, which operates under the European Community legislation.[2] In Europe unit trusts are regulated under community legislation which is referred to as the UCITS Directive.[3]

The association of the local regulatory system with the U.K regulation will guarantee the readiness of the CISCA to comply with International standards.

9.1.2 Technological advancement and the consequences of e-commerce

It is obvious that improved technology and particularly transacting on the Internet is more efficient and productive. However, these benefits do not come without a price.

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[2] The Council Directive 85/611/EEC Official Journal of the European Communities 1985 No. L 375/ as amended by Council Directive 88/220/ EEC, Official Journal 1988 No. L.100/31.
[3] UCITS stands for Undertakings for Collective Investments in Transferable securities. This directive harmonises the law that governs the operation of unit trusts in European union member states.

Increased fraud due to the use of computers in transacting poses a challenge for legislation. This consequently results in high costs of regulation and the need to review it in order to keep abreast of the changes.

9.1.3 Problems of over-regulation and its effect on the unit trust industry

The Collective Investment Schemes Control Act, 2002 has been welcome by both investors and players in the unit trusts industry. This is because the Act is more flexible and easy to comprehend as compared to the former Unit Trusts Control Act of 1981.[4] Whilst increasing the protection requirements for investors, the Act also promotes expansion of the industry by allowing for innovation.

However the problem of over-regulation has been experienced with respect to the FAIS Act which regulates the marketing and distribution of unit trust products. The increased costs of licensing and administration of a financial planning practice could have some negative consequences for the unit trust industry in the future. Despite an assurance on the existence of a more professional financial planning industry the smaller investors who cannot afford the high costs (of getting financial advice) will remain marginalised.

All in all, since the unit trusts industry is a fast changing trade, the continued review and reform of the law applicable to it is the only way to guarantee the future existence and success of unit trust schemes.

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[4] 54 of 1981.

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