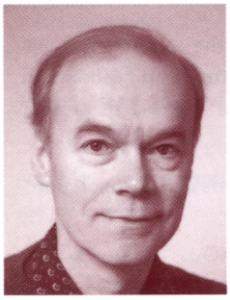
Trusts and governments

by Andrew Edwards



Andrew Edwards

In a recent address to the International Bar Association Andrew Edwards, formerly a Director and Deputy Secretary at HM Treasury and author of the *Edwards Report on Financial Regulation in the Crown Dependencies*, highlighted the need for regulation of the trusts sector, modernisation of legal frameworks, international standards and an inter-governmental forum. He called on the government to take the lead, in co-operation with legal professionals and practitioners. The following article is a lightly edited version of his address.

INTRODUCTION

May I say first what a tremendous honour it is to be here this evening. Thank you for inviting me.

You've kindly asked me to offer you some thoughts on trusts and governments. This is a subject in which I became keenly interested when reviewing financial regulation in the Crown Dependencies for Jack Straw, Home Secretary, in 1998.

I'm not a lawyer. But the trust sector involves public policy as well as law. And I've received much help from some leading authorities on trust law, David Hayton, Christopher McCall, John Mowbray and Donovan Waters, and from some leading authorities on related matters, Michael Blair and Andrew Lewis (UCL). I do thank them all. But please don't imagine that they would necessarily share my views.

I'd like to address four questions, all rather elementary:

- How important is the trust sector?
- Is all well in the sector?
- If not, what needs to be done?
- Who needs to do it?

HOW IMPORTANT IS THE TRUST SECTOR?

First, then, how important is the trust sector?

I've no doubt it's very important indeed. Trusts must, I believe, be among the most ingenious and remarkable instruments ever devised by the wit of man.[1]

The explicit separation in *express* trusts of beneficial from legal ownership of assets facilitates neat solutions to all manner of otherwise intractable problems, especially for testators, donors and charities, and increasingly for the financial and commercial sectors as well.

And *constructive* trusts enable the law to resolve otherwise intractable problems with sense and equity *by analogy* even where no express trust has been formed.

Important as the trust sector is already, I think its importance will increase. The sector's potential for growth seems considerable. This for several reasons.

First, many people living in jurisdictions without trust facilities would doubtless find them invaluable: not least, perhaps, those who live in countries with rigid inheritance laws. So we're likely, I believe, to see more trust jurisdictions, and more people making use of trust facilities in other jurisdictions. The recent growth of South American trusts in the Caribbean centres has, for example, been remarkable.

Second, there seems much scope for developing the old trust forms and inventing new ones in ways that will further enhance the value of trust instruments and the demand for them.

Third, the commercial applications of trusts have burgeoned in recent years and will, I believe, continue to do so. Trust instruments give the City of London a considerable advantage compared with non-trust centres. Commercial applications now include not only the familiar pension fund, unit trust, bankruptcy and sinking fund applications, but also trusts for purposes such as: employee share ownership, bondholders, loan note issues, nominee shareholdings, securitisation, client accounts, future income streams, subordinated creditors, and retention funds.

Like other financial instruments, however, trusts can also be *vehicles for abuse*. That's a further, less welcome, reason why they're important.

We all know what the potential abuses are. There are two main categories:

(1) *Settlor abuses*. Trust arrangements may be designed to deceive. They may be spurious or double-mirrored. They may be used to hide or disguise assets, to protect assets from creditors and others with a right to them, to evade taxes, to frustrate other due processes of law, to shelter the proceeds of crime.

(2) *Trustee abuses*. Trustees may aid and abet settlors in the abuses just mentioned. In addition, they may fail in their duties towards settlors and beneficiaries. They may fail to carry out the terms of the trust deed. They may be incompetent in conducting the trust's business, including investment. They may be negligent. They may charge unreasonable fees. They may even steal the assets.

Such abuses, if they became widespread, could all too easily bring the whole trust sector into disrepute. The continuing use of these remarkable instruments could be put at risk.

IS ALL WELL IN THE SECTOR?

So we come to my second question: is all well in the sector?

The answer has, I believe, to be: No, not quite. There are, I suggest, three *substantive* problems. First, the trust sector has remained substantially *unregulated* at a time when all other financial institutions, and even companies to some extent, have been regulated. There's no external regulation of professional trustees, except for any investment business they may undertake. And there's not much self-regulation either. Anyone can set up in business as a professional trustee. There's no requirement to be fit and proper, competent, free of conflicts of interest, properly organised to combat crime, or anything else. Mainly as a result of this, the scope for abuses of the kind we just mentioned, by settlors and trustees alike, remains considerable, more so perhaps than in any other part of the financial sector.

Second, the *potential* of the trust sector risks being *increasingly unrealised*. The ancient framework of the common law, miraculously good and miraculously relevant as much of it is, can't readily handle the challenges of modernisation and development. Judge-driven, case-driven law simply can't cope on its own, in my opinion, with the demands of the 21st century or the new and changing requirements of persons, companies and financial institutions.

That is not to criticise the judges. On the contrary, judges have done a remarkable job over the centuries in developing the law of trusts. The point is rather that we can't expect judges to do a job they're not employed to do. The critics would castigate them if they did.

The problem lies not with judges but with governments. Governments in the old trust jurisdictions have done little to modernise, develop, or otherwise reform the trust sector. Instead, the offshore centres, notably the Caribbean, are making the running.

Third, there is *little international co-operation* on trust matters between the authorities in trust jurisdictions. And there are *no international standards*.

Corresponding to these substantive problems, there are two problems of *governance*.

First, in the UK at least and I suspect in the other old trust jurisdictions too, no one inside the government accepts responsibility for oversight, sponsorship or regulation of the trust sector. There is a *vacuum of authority*.

Second, there is no international *inter-governmental forum* of trust jurisdictions for the discussion of international standards and co-operation.

In all the respects I've mentioned, the contrast between trusts and other parts of the financial sector, such as banking, investment and insurance, could hardly be greater.

WHAT NEEDS TO BE DONE?

So we come to my third and main question: what needs to be done?

In my opinion the sector needs a judicious combination of regulation, modernisation and international standards. It needs above all to *join the rest of the financial sector.*

To elaborate this a little, I would see three main elements in the substantive *reform agenda*, all corresponding to what happens elsewhere in the financial sector:

(a) *regulation* of professional providers of trust services providers, including modern systems for customer protection and combating crime and money laundering;

(b) *modernisation and development* of the sector through legislation to facilitate new trust forms, codification and improvement of existing forms, and removal of present imperfections and anomalies; and

(c) development of international standards and co-operation.

(a) Regulation of trust services providers

Taking these in order, there seems to me a compelling case for *regulating professional providers of trust services,* both to protect customers and to combat crime.

With regard to *customer protection*, professional trustees and other providers of trust services should be obliged to serve their customers in a professional way. They should be licensed as being fit, proper and competent. They should undergo professional development training on a continuing basis. Management structures should be in place to make abuses as difficult as possible. Conflicts of interest should be scrupulously avoided. The four-eyes or six-eyes principle should be scrupulously observed. There should be proper accountability and accounts, procedures to deal with vacuums of accountability, and a methodology for restraining fees.

We should in short have the same expectations and requirements of those who offer professional trust services as we have of those who offer banking, investment and insurance services.[2]

With regard to *combating crime*, professional trustees, like others in the finance sector, have a duty towards society as well as their customers. They should not aid or abet their customers in laundering the proceeds of crime or in other criminal activities but should play a full part in the new regimes for combating money laundering. They should know their customer, including the beneficial owner and provenance of the assets to be settled or added. They should co-operate with the regulatory and law enforcement authorities in providing information, assisting investigations, obtaining evidence, restraining assets, and confidential reporting of suspicions to the law enforcement authorities.

In the UK, these principles mostly apply already, in theory at least, to the trust sector just like everyone else in the country.

But making them work in practice depends, in this as in other parts of the financial sector, on *enforcement*. And enforcement in turn depends on the existence of a *regulatory regime*: a regime where the regulator requires regulated bodies to have modern systems in place for combating money laundering and other forms of crime. In the absence of such systems, there is no way that regimes to combat money laundering will work.[3]

So that's another reason why it seems to me essential to regulate providers of trust services.

In practice, the forthcoming Financial Services and Markets Act will give the Treasury wide powers to extend regulation into new areas. And the secondary legislation now proposed envisages that regulation should in principle cover all who have discretionary management of funds belonging to another. So there *may* be an element of preaching to the converted in this part of the reform agenda.

But the new texts aren't explicit. And the intention seems to be that many trustees would be exempted from regulation even for discretionary fund management.

So maybe the authorities *haven't* been converted after all. At the very least, the draft exemptions will need to be reconsidered.

It seems to me essential that regulation should cover trust services, not implicitly and partially, but *explicitly and comprehensively*.

It should be clear that *all* professional providers of trust services are covered. Regulating some but not others would be wrong in principle and troublesome in practice.

It should likewise be clear that regulation will cover *all the services* they provide: not just discretionary management of others' funds but all the other fiduciary and professional services as well, such as guarding and distributing the assets.

If the government will only proceed as I'm suggesting (which would I may say be somewhat unusual), we shall be following some well-established offshore precedents. The Channel Islands and the Isle of Man, for example, are all poised to implement legislation and regulatory regimes for professional providers of trust and company services. And incidentally, if they introduce these regimes successfully, they'll put the bad providers there out of business. And many of the bad providers will shift their practices to less well-regulated jurisdictions, including the old trust jurisdictions if we persist in having no regulation.

(b) Modernisation and development of the trust sector

The second main item of agenda is to modernise and develop the sector through legislation to facilitate new trust forms, codification and improvement where necessary of existing forms, and removal of present imperfections and anomalies.

As we saw earlier, the trust sector is probably not realising its potential. No one in the old jurisdictions is modernising or developing the sector so as to meet the expanding and changing needs of persons, families, commerce, charities and other purposes, world-wide, in an age of electronics with minimal exchange controls. We're leaving others to make the running, particularly offshore centres.

With regard to *new trust forms*, I suspect there is much scope for developing and modernising trust forms for commercial uses.

There may also be a case for a more constructive, but still cautious, approach to *purpose trusts*. Is the law in England right, I wonder, to frown so heavily on trusts set up for purposes analogous to charity which the Charities legislation does not recognise as charitable? Was it right in 1957 to strike down Bernard Shaw's two trusts for the reform of English spelling?[4]

At the very least there seems to me to be an issue here. Judges and QCs can't make such a reform. So it has to be an issue for public policy.

If the law *should* be amended to allow non-charitable purpose trusts in certain circumstances, there would need I think to be certain conditions:

(i) Such trusts would preferably be *registered*, perhaps by an extended Charity Commission, in much the same way as charities

(ii) There would need always to be an *Enforcer*, so that such trusts do not become 'black holes' with trustees accountable to no one. Perhaps the Charity Commissioners or an Office reporting to the Law Officers should appoint or approve Enforcers and act as Enforcer of last resort. And certainly others with an interest should be able to enforce against the Enforcer.

(iii) The trusts concerned (or their settlors) would need to *finance* the regulation and enforcement themselves. As with the licensing and regulation of trustees, so too here there is no case for financing from public funds.

(iv) There is of course no reason why such trusts should receive *tax* relief. That's a matter for the Chancellor to propose and Parliament to decide.

The removal of *imperfections, anomalies and obscurities* in the present legal regimes for trusts is again likely to require legislation, including some codification of existing case law.

In any trust regime there needs to be absolute clarity that trusts, like other parts of the financial services sector, may not be used to violate accepted standards of international behaviour.

This is largely a matter for the statutory schemes of regulation we discussed a moment ago. There are also, however, some issues peculiar to trust instruments which the codified law ought preferably, in my view, to tackle specifically.

In the area of *settlor abuses*, the law in all trust jurisdictions needs preferably to establish two principles as explicitly as possible:

- First, trusts *may not be used to frustrate due processes of law*, law enforcement or regulation, for example by *concealing* or *disguising* assets or giving them special *protection* against creditors and others with a right to them; and
- Second, *settlors may not control trusts* while pretending not to, in particular by setting up 'sham' or spurious arrangements which misrepresent the real position. Honesty and transparency are as vital in trusts as in other areas.

If I'm not mistaken, the law of England goes a long way towards enshrining these key principles already. But there are other trust jurisdictions where the principles seem not to apply.

And it would anyway, I believe, be best if in *all* trust jurisdictions these principles could be explicitly codified in statute.

At a more technical level, the law in all jurisdictions should explicitly confirm the rights of *judgment creditors* to information about trusts and trust assets.

From this point of view, and in the wider interests of transparency, there's a case, at least, for requiring *confidential registration* of trusts with the authorities as well. But governments are unlikely to contemplate this further step until a later stage in the reform agenda, when we have international standards.[5]

In the area of *trustee abuses*, there seems to me a strong case for a codified law to establish explicitly that:

- professional trustees must be licensed and regulated;
- sole trustees, other than licensed trust companies, are not permitted;
- trustees must always be accountable to someone genuinely able to oversee what they do;[6]
- trustees must within reason keep beneficiaries and objects of a power informed;
- they may not exempt themselves from liability for negligence;
- they may not seek to escape justice by invoking the privilege against self-incrimination. (Why *do* the laws of Europe and America continue to grant this long outdated privilege?)

On the subject of *anomalies*, the rules for tracing and imputing assets ought preferably, I suggest, to reflect a more conventional view of algebra.

Lastly the trust frameworks in all jurisdictions include *arbitrary features* such as the length of perpetuity periods and limitation (or 'hardening') periods. These may or may not be nicely judged. But they would better, I believe, be decided as matters of public policy, and then codified in statute.

These then are some of the issues that could usefully in my opinion be addressed in the context of developing and modernising the trust sector. I don't want to suggest that the solution in all cases lies in revisions to trust law. In some cases, solutions would better be sought in other areas of the law, such as criminal justice and insolvency, or in Codes of Conduct forming part of the regulatory process. But revisions to trust law, and codification of some parts of the existing law, will be key elements in the programme and will be all the more necessary as we move towards international standards.

(c) International standards and co-operation

So we come to the third and final element of our agenda: international standards and co-operation.

The world's banking, securities, investment and insurance regulators have come together in recent years to define international standards for each of the industries concerned, including prudential and conduct of business aspects, and to promote international co-operation.

In the trust sector, this has not happened. But the requirement for an international inter-governmental forum of trust jurisdictions is equally great.

Without international standards, suitably enforced, there tends to be competition between jurisdictions in looseness of standards: the proverbial 'race to the bottom'.

Sadly to say, I believe we can see signs of such a race in the trust sector today. Some of the small jurisdictions, in particular, are clearly looking for extra business from would-be settlors who wish to do any of a number of borderline or less than reputable things.

As with schools examination boards, so with trust regimes, the temptation to gain business by indulging the customer may be very strong.

In a civilised world, there should I believe be *international standards* for trusts in areas such as:

- Legal frameworks
- Establishment of trusts subject to the laws of other countries
- Judicial capabilities
- Regulatory standards and codes of conduct
- Transparency to law enforcement and regulatory authorities
- Co-operation with the same authorities
- Transparency to interested parties
- Professional resources and qualifications
- Settlor control of trusts
- Spurious trusts
- Non-obstruction of due processes of law
- Accountability of trustees
- Perpetuity periods
- Limitation periods
- Flee clauses
- Wind-up provisions
- Charitable and purpose trusts
- Recognition by non-trust jurisdictions
- Co-operation between jurisdictions.

Some of these matters have an increased urgency in the new globalised world, not least the practice of writing trusts subject to the law of some foreign jurisdiction, flee clauses and recognition of the trust laws of other jurisdictions.

The governments and regulators of trust jurisdictions ought preferably to meet regularly to develop standards in these and the other areas and to promote international co-operation.

WHO NEEDS TO DO IT?

All that was about what needs to be done. So now we come to the final question: who needs to do it?

In my opinion, the short answer has to be that *the government* must do it, in close co-operation of course with the professionals and practitioners. Why so? Because only the government is able to deliver the agenda we just discussed. Only the government is able:

- to introduce an explicit *regulatory regime* for professional trust service providers;
- to decide a national policy for *modernising* the trust sector, through the development of new forms and resolution of existing problems, and then to promote the necessary legislation and implementation; and
- to promote establishment of an international *inter-governmental forum* on trust matters.

It's no part of my purpose to castigate the UK government for past inaction. In the wider area of financial regulation, the government has been exceptionally active.

I *do* think, however, that the government needs to tackle the governance problem I mentioned earlier: the vacuum of authority and responsibility for trust matters inside the government. It needs to identify who inside government is to be responsible for oversight, sponsorship and regulation of the trust sector and to set up some standing inter-departmental machinery.

In my opinion:

- The Treasury, with its new responsibility for Financial Regulation generally, needs to be responsible, in consultation

with the Financial Services Authority, for regulation of the sector.

- The Financial Services Authority needs to implement the regulation.
- The Lord Chancellor's Department or the Home Office need to lead on development of the trust law.
- And one department, probably the Cabinet Office, should chair a standing inter-departmental committee of these and other departments (including the Inland Revenue and DTI) for bringing the strands together and promoting an international inter-governmental forum for international standards and co-operation in trust matters.

Some may object that the government itself is hamstrung: that constraints on the government's *legislation programmes* in Parliament will make this whole agenda for trust reform impracticable.

For myself, I wouldn't be so pessimistic. As Bismarck said, there's no need to commit suicide for fear of death.

Parliamentary time constraints are the easiest and most common of all excuses for inaction.

But such constraints don't, in my opinion, pose any threat to the *regulation* of trust services providers. The new Financial Services and Markets Act will give the Treasury wide powers to extend FSA regulation to new areas through *secondary* legislation. And the secondary legislation already proposed could readily, I suspect, be adapted so as explicitly to cover trust services providers. If there is anything in the primary or secondary legislation that prevents this, it should I suggest be promptly changed. More serious, perhaps, are the threats to the project to *modernise and codify the legal framework* of trusts. That clearly *would* require primary legislation. But this project too is far from being a lost cause. Governments *do* find time to do what's important. It's mainly a matter of persuasion. And the City, the lawyers and the practitioners between them, if they have the will, could do much to promote the cause.

EPILOGUE

In all my remarks this evening I've assumed that, just as war is too important to be left to military men, so the trust sector is too important to be left to lawyers *alone*.

If this assumption has offended you, I ask for forgiveness.

In the hope of mitigation, I admitted at the outset I was not a lawyer.

In conclusion, I ask that one more offence be taken into consideration. I believe the problems of *company* regulation to be *several times more serious* than those of trust regulation.

But that's for another evening!

This text is an edited version of an address delivered at the closing dinner of the 6th International Wealth Transfer Practice Conference of the International Bar Association, London, on 14 March 2000.

[1]**Origins of trusts** Trusts are an enduring monument from the 15th century. Unlike the monasteries, they survived the assaults of Thomas Cromwell in the 1530s.

[2]**The case for licensing and regulation of trust services providers** Compelling as the case for licensing and regulation appears to be, government sources have traditionally questioned the need to look after the rich few, whether settlors or beneficiaries, who have trusts, and in particular to spend public resources on such a purpose.

This always seemed to me wrong, for three reasons. First, the country cannot afford to let anything happen in one of the most valuable services offered by the City of London, among others. Reputation is a fragile thing. And that's how reputations are lost. Second, trusts do not involve only the rich few. Directly or indirectly, a high percentage of the population must now have some dependence on trusts, personal, commercial or charitable. Third, on the point about public resources, regulation of providers of trust services should not be a drain on public finances but should be financed from licence fees of the regulated population.

[3]**Suspicion reports** The 14½ thousand suspicion reports filed by the UK's finance industry in 1999 included one report by a company formation agent and none by professional trustees (though the reports by banks and others could include some trust cases).

[4]**Bernard Shaw Trusts** Shaw himself recognised the risk of protracted litigation culminating in the kind of verdict that Mr Justice Harman later delivered. 'My ghost', he wrote, 'will be perfectly satisfied if the lawyers and litigants keep the subject in the headlines for the twenty years perpetuity limit.' See Michael Holroyd's biography, final section.

[5]**Pros and cons of registration of trusts** A scheme for registration of trusts would preferably oblige trustees to report in confidence to the authorities in standard format: the true identities of the ultimate settlor and beneficiaries, the trustees, the custodians, protectors and enforcers, if any, a copy of the Trust Deed, some basic information about the trust assets, including provenance, and any significant changes subsequently.

The database the authorities would have under such a scheme would be helpful in: (a) combating the abuse of trust instruments for crime and money laundering, (b) making it more difficult for settlors or beneficiaries to conceal assets and income from others with claims on them, (c) monitoring trust service providers, and (d) monitoring in statistical terms the development of the trust sector.

The main arguments against registration are: (a) privacy should not be lightly set aside, (b) bureaucracy should not be lightly multiplied, and (c) compliance costs should not lightly be imposed on regulated populations. However, the privacy argument loses much force if disclosure is to the authorities only. The bureaucratic costs would likewise be reduced by technology and the easier monitoring of service providers. And compliance costs would be minimal unless the service providers would otherwise fail to conduct due diligence (in which case the costs would be well justified).

A more important consideration in practice, perhaps, for individual governments is that a unilateral requirement for registration of trusts would risk major losses of business to other trust centres. That is why registration, if introduced, should preferably be in the context of an international standard.

[6]**Solving deficiencies of accountability** A particular problem for accountability is how to ensure that someone impartial but competent represents the interests of those who cannot represent themselves: those not yet born, minors, mental patients and those not yet ascertained.

The solution to this may lie in two parts. First, all trustees should (as suggested in the main text) be obliged to ensure that they are accountable to someone genuinely able to vet what they do. Second, a body such as the Official Solicitor should preferably be prepared, at the trust's expense, to appoint representatives or litigation friends for those who cannot represent themselves; or in the last resort to act in these roles themselves.