

The Law on Investment Entities

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PREFACE

The urge to write this book first came to mind because I perceived a gap in the legal scholarship in relation to the private law covering investment entities. As I looked closer at the area, a little like observing pond-life, I could see more and more lifeforms swim into view - some of which had previously been considered extinct. On examining the surprising range of species, I became particularly interested by the ways in which they had all evolved from core notions of the trust and of partnership contracts in the common law. New relationships and new contexts had caused some structures to fall into comparative disuse (or even, misuse) while others had become such powerful economic actors that statutory regulators had to be created to control them. This development of regulation was an acceptance that the logic of the legal principles which had given birth to the laws of trusts and contract were no longer sufficient to manage the continued development of investment entities. So it was that the incorporated company with limited liability grew out of contract and trust, similarly unit trusts and pension funds: all are now subject to differing kinds of regulation. Concomitantly, friendly societies, co-operatives and latterly trade unions had seen first a dip in their fortunes followed by a small resurgence in activity in the wake of the 1990's boom in financial services - a feature of the observable increase in social complexity, discussion of which will form a background to this book.

The use of investment entities has grown in importance in a changed world. With the election of the Labour government in 1997, the impetus for giving new life to many ancient community-based investment models has led to a renewed interest in credit unions and a spurt of consultation papers dealing with social welfare provided by means of investment by ordinary citizens. This enthusiastic governmental activity was born out of an intellectual attraction to the American communitarian movement. At the same time global financial markets began to use investment structures like trusts and bond trustees to structure collateralisation and other credit support systems in highly complex financial transactions. Pension funds have clearly begun to displace state pension provision both in the minds of the policy-makers and also in the practicalities of individual citizens' lives. So it was that the lacuna I had seen in the discussion of these topics transformed itself from being a simple lack of descriptive accounts of these entities, into an absence of any discussion attempting to survey the broad sweep of these structures in either descriptive or theoretical terms. This book constitutes an attempt to conceive of this ever-growing area of our social life from the perspective of law both in practical and in theoretical terms. From the perspectives of commercial law practice, of the sociology of law and of the ever-changing welfare state.

The text examines the legal nature of the structures through which various forms of investment take place. At that level it is designed to supply practitioners with a discussion of the key legal issues surrounding the use and operation of investment entities; and to provide the academic reader with a theoretical context within which those entities can be placed. My primary interest is in the structures and the obligations of the legal persons involved, and less in the detail of contracts or the regulatory rules - although both are addressed time and again in the analysis that follows. The principal concern of this book is located within the legal rights and obligations acquired by the investor, borne by the manager, and expressed by the investment entity itself. For too long English law has been content to pretend that one system of vague fiduciary principles will encapsulate all of the social complexity that is locked up in these disparate structures. This book seeks to expose the profound divisions that exist between the intrinsic nature and legal treatment of different forms of entity.

In terms of public sector finance this book will contrast commercial investment (dubbed *speculative, financial investment*) with public sector investment (dubbed *social investment*) using private sector models (such as NHS trusts) and initiatives which throw responsibility off central government and onto private citizens (such as credit unions). The book will advance a thesis that there are often theoretically unaccountable distinctions in the legal treatment of many of the entities considered on the following lines: between the public and private sectors, between professional and non-professional investment managers; between structural creativity and ownership control; between contract and property; between management of commercial investment and communal investment; between private law norms and regulation; between risk allocation in sophisticated contracts and the risk society bound up in social investment.

The structure of the book

Perhaps the most puzzling aspect of this enterprise for the reader is whether this book is a practitioner's book (being a descriptive account of the law, analysing practical problems, suggesting scholarly solutions) or whether it is an academic book (constructing theoretical models, chasing chimerical arguments, seeking to stimulate the reader). In truth, it is consciously attempting to be both. The structure of the book separates those two functions. The practitioner need not be troubled with theory if she would prefer not to be; the academic reader can pass through passages which detail regulatory rules and record mechanical caselaw. However, the threads of the academic discussion are followed through the 'practitioner' sections.

The beginning of each separate part creates the intellectual context for the following material. The detailed legal material is presented in a way which follows those arguments through for the academic reader and also analyses that material for the practitioner. In the style of the great texts of the late nineteenth and early twentieth centuries continued in many editions today (Snell on Equity, Underhill on trust, Chitty on contract, Clerk on tort, Lindley on partnership, and so on), this book seeks to organise the material so as to draw out common principles and establish a coherent legal category from the welter of caselaw and statute. These books have seized on one

aspect of ordinary life or one group of legal principles and sought to correlate them into a collection of rules: thus the assertion of a unified law of tort by Winfield, the principles of Equity in Snell and so forth. This book will seek to isolate investment as a significant category of social activity and to divide it in principles terms between speculative investment and social investment for the communal welfare. To mimic the achievements of the great legal writers is the aim at least - its level of success in that regard is for others to judge.

The core analyses of investment - trusts and companies

Part A *The Legal Nature of Investment* introduces the particular legal context of investment. This is the core of the theoretical discussion: the lion's share of what might be considered 'purely academic discussion' is contained here. The first chapter *Introduction: law and investment entities* breaks out the main themes of the discussion: two key meanings of the term 'investment', globalisation, risk, the legal nature of money, the underpinnings of the law on fiduciary duties, the inter-action between investment and social welfare, and the intervention of human rights legislation. The second chapter *Theories of contract, property and money in law* sets out the key legal components of investment structures: in particular the inter-action of contract law and property law. The argument advanced from this Part is set out at its beginning.

Part B *Law and fundamental investment structures* considers two, core legal concepts. In Chapter 3 there is a discussion of *Ordinary trusts used for investment purposes* which examines the fundamentals of the law of trusts and in particular the principles governing the investment of ordinary trust funds. The standard of the duty of trustees and the rights of beneficiaries against trustees in person, the trust fund specifically, and against third parties are considered. The 1990's saw rapid and seismic developments in these areas which expanded the liability of third parties involved in investment of the trust fund and shored up the rights of the beneficiaries not only to take rights in the trust fund but also to receive any anticipated profits in relation to that investment fund.

Chapter 4 considers *Ordinary companies used for investment purposes* in three sections: the nature of the rights of the shareholder in an ordinary company, the obligations of the director as an investment manager, and the legal rules governing the issuing of share capital. The legal nature of an ordinary share is surprisingly little discussed in the main texts although the importance of understanding precisely the relationship between the shareholder, the directors and the company has seen a renaissance in the journals. The context of this discussion is contrasted with the detail of the London Stock Exchange Yellow Book to establish the equivocal position of the shareholder in relation to public companies and undertaking on a comparatively smaller scale but with higher proportionate stakes.

Specific trusts structures

Broadening out the discussion from straightforward trust principles, two particular contexts in which the trust is used in investment structures are considered in Part C

Specific trusts used for investment purposes. Chapter 5 considers *Pension funds* in particular detail. The social significance of investment in pension funds, in particular its replacement of state welfare programmes over time, is the first analysis. The discussion then considers the respective rights of investors (who occupy the role both of settlor and beneficiary), the managers (who divide between investment management and ordinary trusteeship in accordance with the scheme rules), and companies in relation to occupational pension schemes (occupying the role of settlor, manager, and also contingent owner of the pension fund surplus). Noticeably traditional trusts law understandings of title in the trust fund (in this context, the scheme property) are disturbed in favour of rights resulting the settlor. Significantly the trusts law assertion of the absolute protection of the beneficiaries by means of the strict liability of trustees is displaced in part by the creation of a regulatory structure.

Chapter 6 considers a clutch of issues under the rubric *Bonds, eurobonds and collateral transactions*. The specific ‘entity’ referred to here is the (euro)bond trustee required to administer the issue to the public, alongside the nominated managers of the bond issue. Along with the entities considered in *Collective investment schemes*, there is a common feature in their structure: the use of a so-called ‘trustee’ to hold the investment property and to oversee (in subtly different ways) the conduct of the investment process. The trustee used in these contexts is not a trustee as ordinarily understood - really being a nominee with narrowly defined fiduciary duties (and powers). The ‘trust’ label is also used here (as elsewhere in this book) as a means of suggesting solidity and confidence in the investment process and the people managing it.

Collective investment

The equivocal categorisation of many investment entities is shown up by the discussion in Part D *Collective Investment Schemes and other mutual funds* which considers not only those entities falling within the statutory definition of ‘collective investment schemes’ but also investment trust companies which, while not within that definition, share some similarities with them. So in Chapter 7 *Unit trusts* are analysed as a form of trust, nominally at least, which divides responsibility for fiduciary activities between a manager and trustee. The genesis of the unit trust was in parallel to the emergence of corporations and joint stock companies - particularly in the wake of the South Sea Bubble when the creation of companies was strictly controlled by Parliament. The modern unit trust still retains many of these features leaving the investor (or, participant) in an equivocal position mid-way between a trust beneficiary (in having contingent, qualified proprietary rights in the scheme property) and a form of company member (given the principle interest of the participant in a cash return in her investment, as opposed to straightforward rights in property).

Chapter 8 considers the comparatively (in relation to the unit trust) recent creation of the *Open-ended investment companies* through which English law now permits investment in a corporate form of unit trust in parallel with other European jurisdictions (thus overcoming the long-standing prohibition on companies acquiring their own shares). Included in this discussion is a detailed analysis of the applicable regulations dealing with the issue of share capital in oeics.

Chapter 9 then carries out an examination of *The nature of rights under collective investment schemes* which compares and contrasts the unit trust and the oeic. The conclusion of that analysis is that the oeic bears some resemblance to the trust in that, exceptionally for a company, the participants have rights in the scheme property on *Saunders v. Vautier* principles. Similarly, the nature of the unit trust as a trust properly so-called is questioned, particularly given the equivocal rights of the participants in the scheme property as governed by the contractual nexus created with the investment manager. The collective investment scheme is therefore presented as really being a contractual relationship with qualified proprietary rights for the participants.

Chapter 10 *Investment trusts* focuses on a form of entity which receives little textbook analysis, being outside the range of collective investment schemes. Its similarity in structure is as a form of company in which shareholders invest in the expectation that the investment trust company itself will carry out financial investments in other entities of a type prescribed in the memorandum of association. In truth, the investor here is primarily an investor in an ordinary company except that the ordinary company is not carrying on a trade - instead, it is merely a vessel which makes investments. There are close parallels with the ordinary company considered in chapter 4. Indeed, following on from that discussion, investment trust companies are possibly more akin to the trading company than the 'shell' companies which do not carry on any activity other than merely holding property as a legal person effectively as a nominee for a sole shareholder in tax avoidance schemes or in group company situations.

Social investment

The discussion then moves beyond straightforwardly speculative-financial investment entities and in Part E considers *Community-based investment entities and co-operatives*. The aim of this part is to look at a number of structures which have come back to prominence in governmental policy (as well as in academic social policy) in the late twentieth century. They have 'come back to prominence' in the sense that the structures themselves were formed by the emergent working class during the industrial revolution and corralled into legal straitjackets when the criminal law permitted associations of the new working class with the repeal of the Combination Acts over time. So in Chapter 11 *Friendly societies* are considered as the longest standing legal form of community association. These societies continue to market their insurance services and tout their mutual status as many building societies have converted into banks. They constitute a structure roughly akin to the old joint stock company but with a regulatory structure grafted on by legislation in 1993. As a result of that legislative intervention, friendly societies fall into two kinds: the unincorporated association and the incorporated society. Chapter 12 examines the co-operative nature of the *Industrial and provident societies, and credit unions* which operate as community banks and savings institutions, and chapter 13 the *Trade unions*.

The investment function of these entities is not as apparent as the entities considered in the earlier sections of the book. Some may even think that it constitutes an unnatural stretching of the term 'investment'. However, the term 'investment' in this book covers *social investment* every bit as much as speculative, financial investment.

In the spirit of the report of the Borrie Commission on Social Justice, this categorisation recognises the imperative which is being placed on ordinary citizens to invest for their own welfare as social investment strictu sensu through the welfare state is being rolled back. The theoretical discussion in this book, particularly in chapter 16 *Rethinking the legal treatment of investment*, examines (albeit with heavy heart) this development as a form of *social welfare*.

To continue that discussion into expanding areas of practitioner concern, Part F *Public sector investment structures* looks in chapter 14 at *NHS trusts* and in chapter 15 *Local government: PFI and the social fund* at the ways in which the public sector seeks and structures investment either from the private sector (in the case of PFI) or by use of private sector models (in the case of NHS trusts). The applicable investment principles constitute an amalgam of public law and private law norms it is suggested, particularly in the context of the fiduciary obligations owed by public bodies making allocations and investment with public funds. This distinction is then picked out again in the concluding chapter (*Rethinking the legal treatment of investment*) which draws areas of commonality and difference from the range of structures considered throughout the book.

This book is concerned with the manner in which law should conceive of “investment” and of what that could mean. In broader, political terms the question of investment and of the possibilities of stakeholding are a vogueish attempt to fill the gap left by the existential dilemmas posed by modernity and a globalised economy. Thus, the idea of ‘investment’ has become a rhetorical tool to mask the current malaise in state welfare to favour instead to possibilities offered by global capitalism.

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