

The Role of A Trustee in *Sukuk*: the Malaysian Perspective

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Abstract: In Malaysia, the legal and regulatory framework governing Islamic Capital Market industry provides for trust structure in *sukuk*. Trustee plays an important role in *sukuk*. In fact in every *sukuk* issuance save for the issue or offer which comes under the exceptions provided for under Schedule 8 of the Capital Market Services Act 2007 (“CMSA”), a trustee is required to be appointed and a trust deed to be executed. Thus, trust structure is central in *sukuk*, so far as Malaysia is concerned. This paper studies the important roles of trustees in *sukuk*, its nature and the extent of powers and duties of trustees appointed therein. It examines the categories of trustees in *sukuk* and their designated functions as well the nature and extent of powers and duties of a trustee with an insight on the current practices in the Malaysian Islamic Capital Market industry dealing with trust structure in *sukuk*. The study will also look at other relevant aspects in trust structure, which include the trust deed as the constitutive document and the role of trustee in the event of default of *sukuk*.

Key words: Islamic capital market, *sukuk*, trustee, event of default.

INTRODUCTION

The concept of trust is observed to be the key characteristic in debt capital markets transaction and a fundamental element of *sukuk*. In conventional securitizations, an originator will create a trust whereby legal title of an asset (the specified receivables) is held by a trustee (appointed by the originator) for the benefit of the SPV issuer, who is the beneficiary for the securities (Rahail Ali, 2009). *Sukuk* are also structured using the trust framework. The *sukuk* trustee is appointed by the issuer to serve as an intermediary between the issuer and the beneficiaries. The trustee are charged with safeguarding the interest of both parties, particularly in the case of issuer defaulting.

The utilization of the concept of trust is considered best particularly in ensuring that the investors’ interests are protected. By using the trust structure, the issuer will issue certificates to investors and the proceeds of this issuance are invested in assets that are held on trust for the *sukuk*-holders. This provides the mechanism for *sukuk*-holders to own an interest in the *sukuk* assets.

Materials and Discussion:

Regulatory Framework for Appointment of Trustee in *Sukuk*:

Trust structure in *sukuk* issuance, in so far as Malaysia is concerned, is provided for under the Malaysian legal and regulatory framework governing its Islamic Capital Market industry. It is a statutory requirement under Section 258 of the Capital Market Services Act 2007 (“CMSA”) that every person issuing, offering for subscription or purchase, or making an invitation to subscribe for or purchase, any debenture must enter into a trust deed, appoint a trustee and comply with the requirements and provisions of Division 4 of Part VI of the CMSA which deals with the requirements pertaining to trust deed, trustee and duties of trustee. The similar requirement is also stated in Paragraph 1.12 of the Islamic Securities Guidelines (*Sukuk* Guidelines 2011).

In a nutshell, the CMSA and the guidelines aforementioned, among others, provide for mandatory requirements on trust deed and trustee in *sukuk*. Consequently, any person, as referred to in the above, who does not enter into a trust deed and appoint an eligible trustee will, upon conviction, be liable to a fine not exceeding RM3,000,000 or imprisonment for a term not exceeding 10 years, or both (section 258(4) of the CMSA). The law however provides for exception of these mandatory requirements but only in situations set out in Schedule 8 of CMSA, amongst other, the *sukuk* issued or offered that does not involve an SPV and with credit rating of AAA or its equivalent.

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Section 260 of the CMSA provides that a trustee for *sukuk* shall be either a company registered as a trust company under the Trust Companies Act 1949; or a corporation that is a public company under the Companies Act 1965 or under the laws of any other country, which has been approved by the Securities Commission (Jal Othman, n.d). The Securities Commission requires that the trustee for *sukuk* to be registered under Practice Note on Registration by the Securities Commission for the Purpose of Acting as a Bond Trustee.

In line with the objective of providing investors' protection and for the purposes of enhancing disclosure and protection to the *sukuk* holders, the Securities Commission Malaysia has introduced the Trust Deeds Guidelines 2011. Trust deed (also known as a declaration of trust, or, in transaction governed by US law, the indenture) is the central *sukuk* document under which the terms and conditions of the issue will be set out, as well as the appointment of the trustee. The Guidelines provides for the minimum contents requirements of a trust deed in the issuance of *sukuk*, which must be followed. In addition to the minimum contents required, parties are free to determine additional provisions, covenants or terms and conditions of *sukuk* and/or trust deeds over and above that are stipulated in this guideline. However, any such addition should not in any way contravene with the minimum contents requirements as specified in this Guidelines.

Trust Structure in Sukuk:

Within the *sukuk* structure, a trustee is appointed by the trust deed to hold the benefit of various rights and covenants on behalf of *sukuk*-holders.

The issuer usually appoints itself in a different capacity to act as trustee. Although unusual in a straight (i.e. non-equity-linked) *sukuk*, the trustee may also act as security trustee to hold the benefit of any security, on behalf of the *sukuk*-holders (and other transaction parties whose interests are secured). The SPV issuer/trustee will usually delegate its trustee role to a professional corporate trustee company. This delegation also takes place within the trust deed.

The trustees in *sukuk* may generally be divided into three categories, based on their functions - that are *sukuk*-holder trustee, security trustee and share trustee. *Sukuk*-holder trustee is the trustee that is responsible to represent and protect the interest and rights of the *sukuk* holders in accordance with the trust deed. The trustee is responsible to ensure that the requisite administration and monitoring functions are carried out in a professional manner as required by the transaction documents. The trustee is also responsible to notify the *sukuk* holders of the occurrence of any trigger event(s) and/or event of defaults as soon as the trustee becomes aware of such event(s) occurring; and upon proper *sukuk* holders' instructions and indemnification, the trustee may take such steps and/or institute such proceedings to enforce the security for the *sukuk* and the repayment of the *sukuk* (Pacific Trustees Bhd., 2010).

Security trustee, on the other hand, is required when the issue of *sukuk* involves creation of charge or security and it is the duty of the security trustee to hold the legal charges or the assignment of assets (by way of security) for the benefits of the *sukuk* holders.

Share trustee is a trustee who holds the shares of the Special Purpose Vehicle (SPV) created for the purposes of *sukuk* issuance by way of a discretionary trust for the benefits of the named beneficiaries. The share trustee is to ensure to other parties that the trust shall be administered and the trustee powers exercised in accordance with the trust deed. The share trustee will do such act and sign such documents as may be required to be done or signed by a shareholder of the SPV, including signing transactions documents; to pass all necessary resolutions approving the annual audited accounts of the SPV; and to pass all necessary resolutions in connections with the winding up of the SPV following the conclusions of the transaction.

Powers and Duties of Trustee in Sukuk:

To administer a trust, trustees need a variety of powers and rights. These powers and rights are balanced with duties and liabilities. A power of a trustee, in this context refers to the trustee's ability conferred by law, to determine by his own will, the best cause of action taking into account the legal relations between himself and others. The various powers of trustee may be derived from the trust instrument, deed of appointment and under the Trustee Act 1949. Generally, under the Trustee Act 1949, the power of trustee may be classified under two sub-headings, namely, administrative and dispositive powers. Administrative powers are powers necessary for the administration of a trust whilst dispositive powers are powers of maintenance and advancement. Maintenance and advancement are the entitlements of a beneficiary. (Mary George, 1999).

Paragraph 20 of the Trust Deeds Guidelines 2011 sets out the minimum contents requirement of a trust deed pertaining to powers and duties of trustee. It is observed from this guidelines that there are three important aspects of the powers of the trustee which must be specifically set out in the trust deed, which it is observed, are in tandem with the statutory requirements of the Trustee Act 1949. Firstly, pertaining to matters that are within the powers of the trustee to decide without reference to the holders of the *sukuk*. This includes all reasonable diligent actions that are carried out according to the nature of transactions in which the trustee is entrusted to. The trustee, among others, is responsible to vet through the transaction documents of the *sukuk* to ensure, to the best of his ability that there are no inconsistencies or conflicts of interest between the provisions of the trust

deed and the conditions required by the Securities Commission. The trustee is also expected to ensure that the provisions in the transaction documents are not in conflict or inconsistent with trustee's duties (Bank Negara Malaysia and Securities Commission Malaysia, 2009).

Secondly, where there is a breach by the issuer under the terms and conditions of the *sukuk* and the provisions of the trust deed, the circumstances that the trustee may authorise or waive such breach. In this regard provisos must also be provided for in the trust deed that (i) to the satisfaction of the trustee, any such authorization or waiver is not materially prejudicial to the *sukuk* holders' interests; or (ii) it is authorised to do so by resolution of a stipulated majority of *sukuk* holders.

Finally, where there is a request from the issuer to vary or modify any terms and conditions of the *sukuk* and the provisions of the trust deed, the circumstances that the trustee may concur with the issuer in making the variation or modification provided (i) it is satisfied that it is not materially prejudicial to the *sukuk* holders' interests and it has informed the registered *sukuk* holders of the request in writing at least three business days prior to the concurrence; or (ii) it is satisfied that the modification is necessary for the issuer to comply with mandatory provisions of law or requirements imposed by the regulatory authorities and it has informed the registered *sukuk* holders of the request in writing at least three business days prior to the concurrence; or (iii) it is authorised to do so by resolution of a stipulated majority of debentures or *sukuk* holders.

On the duties of a trustee, the Trust Deeds Guidelines 2011 specifies the following provisions, which must be set out in the trust deed:

- (a) A duty to exercise reasonable diligence to ascertain, based on the accounts, reports, certificates, circulars or opinions furnished to the trustee, whether the issuer or each guarantor (where applicable) has committed any breach of the terms and conditions of the *sukuk* or provisions of the trust deed or whether an event of default or enforcement, where applicable, has occurred or is continuing;
- (b) In the case where an event of default or enforcement, where applicable, has occurred and is continuing, the trustee shall exercise such rights and powers vested in it by the trust deed and use a reasonable degree of skill and diligence in exercising such rights and powers; and
- (c) A duty to provide necessary information to credit rating agency (deemed to be authorised by the issuer and the registered bondholders by virtue of a trust deed) upon its reasonable inquiry over occurrence of material events in respect of *sukuk*, which are rated.

In addition to the rights and powers under the Trustee Act 1949 and at general law, the trustee may take action as it is directed by a special resolution of the *sukuk* holders and may take such action as it considers necessary to defend itself as trustee of the *sukuk* holders in any legal proceedings (GopalSundaram, 2007). The trustee may, in discharging its duties under the trust deed, have the right to obtain and act on the opinion or advice of or any information obtained from any party reasonably believed by the trustee to have the expertise in relation to the relevant matter and the trustee is not to be held responsible for any loss occasioned by so acting unless the trustee has notice of inaccuracy of the relevant opinion, advice or information. As such, the trustee may call for and rely upon a certificate signed by any authorised person of the issuer as to any fact or matter *prima facie* within the knowledge of the issuer as sufficient evidence of it.

Subject to any express provision to the contrary in the trust deed, the trustee have absolute discretion as to the exercise or non-exercise of all the trusts, powers, authorities and discretions vested in it by the trust deed or by the operation of law and may exercise such rights and powers in any manner which it considers satisfactory. The *sukuk* holders do not have the rights to direct the trustee as to how to exercise its rights and powers except by express provision in the trust deed and no loss and damage is recoverable against the trustee except in the case of default or negligence on the part of the trustee.

While performing his role as a trustee for *sukuk*, the trustee may perform different roles related to the issuer or the trust deed including roles in connection with any investment, transactions or arrangements entered into by or affecting the issuer or the trustee. The trustee is not prohibited from holding the *sukuk* or stock, shares, debentures or other securities of the issuer or its related entities or acting in any representative capacity for a holder of stock, shares, debentures, notes or other securities of the issuer or *sukuk* investors; provided that all these functions are, at all times exercise with reasonable diligence. While performing all these duties, the trustee may use and pay an agent to assist in doing all acts required to be done by the trustee under the trust deed (including the receipt and payment of money).

The trustee's main function is to protect the interest of the *sukuk* holders. Thus, the trustee shall at all times exercise reasonable diligence to ascertain whether the issuer has committed any breach of the terms and conditions of the *sukuk* or the provisions of the trust deed or whether an event of default has occurred. In such an event, proper notice should be given to the beneficiaries.

Powers and Duties of Trustees in the Event of Default:

W. Scott (2011) observed that "the tests of default serve as the acid test for *sukuk*, but also for the role of trustees that support them. It is the trustee who is responsible for answering the question of what happens when something goes wrong and what action is necessary to resolve the problem. Potential issues a trustee must deal

with can include what will happen if liquidity is squeezed, or what happens if investors have to come back to the table to find out what is happening with a transaction.”

It is thus important to look into what is required of a trustee to do and the extent of powers and duties that a trustee may have in addressing and managing the interests of *sukuk* holders in the occurrence of event of defaults.

The Trust Deeds Guidelines 2011 provides for a requirement that the events constituting default must be ascertained and the procedure to remedy such default must be provided for. The event of default refers to all events, upon its occurrence would entitle or oblige the trustee to declare the debentures or *sukuk* immediately due and payable. The events may include the following:

- (i) Where there is any default in payment of any principal, premium, interest or profit under the debentures or *sukuk*;
- (ii) Where a winding up order has been made against the issuer;
- (iii) Where a resolution to wind up the issuer has been passed;
- (iv) Where a scheme of arrangement under section 176 of the Companies Act 1965 has been instituted against the issuer;
- (v) Where a receiver has been appointed over the whole or a substantial part of the assets of the issuer;
- (vi) Where there is a breach by the issuer of any term or condition in the debentures or *sukuk* or provision of the trust deed or of any other document relating to the issue, offer or invitation in respect of the debentures or *sukuk*;
- (vii) Where any other indebtedness of the issuer becomes due and payable prior to its stated maturity or where the security created for any other indebtedness becomes enforceable; and
- (viii) Where there is a revocation, withholding, invalidation or modification of a licence, authorisation or approval that impairs or prejudices the issuer’s ability to comply with the terms and conditions of the debentures or *sukuk* or the provisions of the trust deed or any other document relating to the issue, offer or invitation in respect of the debentures or *sukuk*.”

The powers of the trustee in any of the events (of default) described above include:

- (i) the powers of the trustee to declare the debentures or *sukuk* immediately due and payable at its discretion;
- (ii) the powers of the trustee to declare the debentures or *sukuk* immediately due and payable as directed by a special resolution;
- (iii) the powers of the trustee to enforce the provisions of the trust deed;
- (iv) the circumstances under which the trustee shall be bound to enforce the provisions of the trust deed; and
- (v) the circumstances under which the holders of the debentures or *sukuk* are entitled to pursue their rights and remedies.

All these (powers) must be specified in the trust deed and it is a duty of a trustee to use a reasonable degree of skill and diligence in exercising such rights and powers.

In practice, it is observed, that the powers of a trustee in the event of default are made subject, to a certain extent, to the wishes of *sukuk* investors. This is designed to minimise the otherwise onerous legal burden to be discharged by the trustee to exercise its discretion. The trustee, as soon as practicable, after receiving actual notification of, or becomes actually aware of an event of default, must notify the issuer and the *sukuk* investors of that fact giving each of them details of it. The trustee must thereafter convene a meeting of the *sukuk* investors. At any meeting of the *sukuk* investors, the *sukuk* investors may vote on whether to direct the trustee by a special resolution of the *sukuk* investors to take such action as the *sukuk* investors may specify (in the terms of such special resolution).

A direct consequence of the occurrence of the event of default is that the *sukuk* shall become due and immediately redeemable. It would be a duty on the part of the trustee to enforce such redemption of the *sukuk*. How this duty to be carried out would depend on the wordings of the trust deed. A degree of discretion, to a certain extent, is to be exercised by the trustee in discharging his duty, to pursue the rights and remedies available under the general law or under the trust deed and effectively enforce the rights of the *sukuk* investors against the issuer.

Conclusion:

Trust structure is an important aspect in *sukuk*, the deficiency or absence of proper observance of its foundations and the nature as well as the extent of powers conferred upon a trustee may give rise to some legal issues. This may subsequently impede the process of *sukuk* issuance, have an effect on the protection of *sukuk* holders’ interests and would consequently hamper the aim of the regulatory body in promoting and developing a conducive Islamic Capital Market industry in Malaysia. In the Malaysian perspective, the important function of a trustee in *sukuk* is safeguarded by the regulatory framework in the form of legislation and guidelines issued by Securities Commission. The trustee owes statutory duty of care to the beneficiaries either *sukuk* holder or issuer. The trustee plays proactive role to ensure that the *sukuk* is enforced, and the rights of the issuers, *sukuk* holders and related parties are protected, especially in the event of default. The role of trustee may extensively cover the role as an intermediary or caretaker who manages the entire transactions of the *sukuk* to maturity, or may serve

as arbitrator when necessary. Trustee shall exercise such rights and powers vested in it by the trust deed and use a reasonable skill and diligence in exercising such rights and powers.

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