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Presentation to STEP December, 2008

Investment Risk Management: A Trustee's Perspective

What are the legal issues for trustees?

- Duties
- Powers
- The standard of care to be met
- Delegation

What are my duties as trustee?

- To carry out the terms of the trust subject to any overriding provisions of applicable law.
- To exercise the powers only in the interests of the beneficiaries.
- To preserve the value of the trust fund?
- To diversify the investments?

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What are my powers as trustee?

- Subject to the terms of the trust a trustee shall in relation to the trust property have all the same powers as a natural person acting as the beneficial owner of such property.
- A trustee shall exercise the trustee's powers only in the interests of the beneficiaries and in accordance with the terms of the trust.
- Have any powers been reserved to the settlor or a protector?
- Have they been otherwise restricted?

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What standard of care must I meet?

- Prudent person

- English test "ordinary prudent man of business" Speight v Gaunt (1883)

- Prudent investor rule applied in US (and likely to have some influence in other jurisdictions)

- Professional trustee will be held to a higher standard of care Bartlett v Barclays Bank (1980)

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Can my powers be delegated?

Delegation (article 25 TJL modified):

(1) Subject to the terms of the trust, a trustee may delegate the execution or exercise of any of his or her trusts or powers.

(3) A trustee who, in good faith and without neglect, makes such delegation or permits the continuation thereof shall not be liable for any loss arising from a delegation.

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Case study – The litigation

- The plaintiff was a Beneficiary of a trust.
- The first defendants were the Trustees (a bank owned trust company).
- The second defendant was the bank Investment Manager (who owned the trust company).

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Case study – The litigation

- The Beneficiary alleged that the bank's in-house Investment Manager acted negligently and/or in breach of contract in the way in which they managed the portfolio.

- The Beneficiary sued the Trustees for:

  - Compensation for the decline in value of the portfolio.

  - Lost opportunity of increasing the capital value of the portfolio.

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Case study – What went wrong?

- Inadequate risk profiling and failure to discuss the investment objectives with the Beneficiaries.
  - Trustees did not complete an investment questionnaire.

- The Trustee appointed their own Investment Manager as a matter of course.
  - Were alternatives considered?

- Income targets were set.
  - The portfolio was not structured to meet these requirements.

- The investments were predominantly in equities.
  - Performance fell to third / fourth quartile.

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Case study – What went wrong?

- Portfolio had a high technology stock bias prior to 2000.
  - In subsequent years materially underperformed.

- Failure to monitor the investment performance against an appropriate benchmark or peer group.
  - Portfolio was only monitored on a half-yearly basis.

- Trail fees were taken by the Trustees.
  - These were not declared to the settlor / Beneficiaries.

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Case study – What should have happened?

- The Trustees should have considered their duties regarding investments including restrictions in the trust deed and in the governing law.

- The Trustees should have considered the needs of the Beneficiaries.

- Consideration should have been given by the Trustees as to whether they would undertake the investment management or delegate it.

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Case study – What should have happened?

- After due consideration the Trustees could have decided that they would delegate the function to their own in-house Investment Manager.

- The Trustees should have taken all necessary steps to ensure that the bank was formally appointed as the Investment Manager with an appropriate mandate.

- The investment performance should have been monitored on a regular basis and periodically re-appraised in line with the changing circumstances of the trust.

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Case study – What were the warning signs?

- The Beneficiary's frequent complaints regarding performance – Highlighted lack of risk profiling and investment objectives.
- Performance – 3rd / 4th quartile – Should have been spotted if an appropriate benchmark or peer group analysis had been used. Relegation criteria?
- Infrequent monitoring of the portfolio – During the last bear market six monthly reviews would have been materially inadequate.
- No independent review of investment agreement.

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Case study – The outcome

- Trustees accepted responsibility, leading to:

  Settlement out of court - **Trail fees were a factor in the settlement** as their receipt had not been declared by the Trustees.

  Compensation awarded to the Beneficiaries and paid **by the Trustees** amounted to **25% of the value of the portfolio** at the start of the relationship.

- The bank and the Trustees lost a long term relationship due to poor investment performance and their failure to address basic investment issues.

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Summary of legal issues and solutions

- **Duties**
  - understand them
  - remove duty to preserve and enhance
  - no obligation to diversify
  - anti Bartlett clause

- **Powers**
  - as wide as possible (or intentionally narrow?)
  - reserve powers to settlor or protector

Summary of legal issues and solutions

- **Delegation**
  - do you have adequate power?
  - delegate to whom?
  - how do you ensure adequate ongoing monitoring?
  - bank trust companies need to be able to manage their inherent conflict of interests when appointing the bank as investment manager

- **Ultimately** you can manage down the duties but there will still be an “irreducible core” of obligations.

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Trustee Risk Management

In relation to our case study, what would have helped the Trustees?

- Understanding the requirements and the objectives of the trust in the context of the governing law.

- Meaningful and on-going dialogue with the Beneficiaries so that their requirements are assessed and understood.

- Clearly defined process for choosing an investment manager – Can you delegate to an associated company? If not, what are the procedures for choosing an alternative manager?

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In relation to our case study, what would have helped the Trustees?

- Risk profiling procedures - These should have been completed and applied.
- Benchmarks – These should have been defined in accordance with the mandate and agreed at the outset.
- Ongoing monitoring – This should have been performed on a regular basis, if necessary outsourced.
- Performance relegation criteria – This should have been defined and clear, providing guidance to the Trustees.

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Trustee Checklist

- Duties – Do you understand them?
- Settlor / Beneficiary expectations – Have you discussed them?
- Risk profiling – Do you have a company policy/procedure?
- Powers – Who is going to do what?
- Delegation – Should you employ outside expertise?

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Trustee Checklist

- Mandate – Is the understanding correct?
- Conflicts – How do you manage these?
- Trail fees – Transparency issues.
- Performance monitoring – Is it done and who by?
- Performance relegation criteria – What happens if you think you should remove and investment manager?

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Conclusion – Be careful out there!

- Understand your responsibilities.
- Understand how to discharge them.

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Otherwise…..

- You will lose clients and….
- You will get sued!

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