

HK Trustees Association Limited

A Seminar on

Trustee Investment Risk Management How To Avoid the Costs of Litigation

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Key Summary Points

Trustees are at the highest risk of investment related litigation if they do not implement:-

- 1) Robust performance monitoring.
- 2) Internal investment risk profile procedures.
- 3) Portfolio reviews.
- 4) Investment Manager reviews.
- 5) Robust and implemented policies and procedures.

Introduction - Trustee Investment Related Litigation

Litigation is relatively rare in Hong Kong but when determining best practice, the tolerable guidelines are not local but the highest standards anywhere in the world, subject to local Trust law.

Driven by Pension Fund Trustee guidelines, the offshore Trust industry has for the last fifteen years invested heavily in Investment Risk Management Policies and Procedures. The implementation of these procedures has followed several well worn paths of implementation:-

- a) Delegated to internal member of staff with investment expertise.
- b) Outsourced to Investment Consultancies .
- c) A hybrid of a) + b)

Key Areas to Consider

When looking at Investment Risk Management, it is no longer acceptable to only focus on performance monitoring as the easy solution. Trustees must now perform the following:-

- 1) Trust investment profile reviews – ensuring that the Trustee understands the requirements of the Settlers / Beneficiaries. Relying on external institutions who have a different mindset to the Trustees is not acceptable.
- 2) Asset Allocation / Mandate guidance – whilst the Trustees are not expected to be experts, they are expected to be able to interpret the needs of the Trust relationship or to outsource to independent experts who can interpret these very same needs and determine what the correct investment objective should be and which asset classes should be considered.

Whilst investment institutions have the facility to do this, it is usually driven by the sale of their products rather than the needs of the Trustees.

- 3) Investment Manager / Bank Selection – whilst it remains commonplace for Trustees to select investment institutions whom they are personally familiar with for whatever reason, it is incumbent upon the Trustee to demonstrate that there is a process for that selection and that they have considered the investment institution not only from a performance perspective but also the security, service, pricing and performance of the institution as well.

A procedure and policy needs to be in place for vetting Investment Managers, whether they be “Approved” or “Core Managers”.

- 4) Fees – Trustees are traditionally uncomfortable negotiating fees with investment institutions but their duty of care is such that not negotiating the fees whilst receiving other benefits can often be seen to be a clear conflict and hinders any future defence.
- 5) Performance Monitoring – must be applied to all entities whether they be execution, advisory or discretionary. The greatest risk often lies in execution and advisory relationships as they are predominantly Settlor directed.
- 6) Policies and Procedures – all of the above must be incorporated into defined and implemented policies and procedures. It is negligent to not have policies and procedures and grossly negligent to not follow them.

Litigation Examples

Peritus Investment Consultancy has acted as expert witness on many cases and the key observations that can be made are:-

- a) Trail fees / Motivational Fees – unless completely and transparently communicated to the client and treated on a level playing field across all investment institutions, act materially against the Trustees.

- b) Performance Monitoring – failure to do so or failure to follow the signals that are presented by the performance platform, create massive risks for Trustees.
- c) Risk Profile Reviews – infrequent or insufficient profiling of client relationships and the miscommunication of the account profile to the investment institution / banks concerned is a very frequent source of contention.
- d) Investment Manager Change – whilst this is very challenging for the Trustees to be aware of corporate, team and investment developments, it is incumbent upon the Trustees to be aware of key developments and ignorance is not accepted. A monitoring / review procedure is absolutely essential.
- e) Performance Platform – Settlor / Beneficiary Direction – this area is the highest source of litigation and Trustees should compare investment results and all decisions relative to what a prudent Trustee would do in an unfettered situation. Reserve powers or indemnities provide a small degree of protection but ultimately if material losses arise, the Trustees will not be protected.
- f) Global Practices – many cases of litigation arise in jurisdictions where Investment Risk Management practices are in their infancy but local standards are frequently not a valid defence as the best practices seen elsewhere in the world were perceived to be the standard applied.
- g) Conflict – referring business due to “motivational fees”, personal relationships, ease of access, local connections often hinder the Trustees’ case unless explicit benefits can be proven at the outset of the relationship. Robust policies and procedures can support the defence of this.

Costs

The cost of litigation traditionally is the variance between an average / third quartile manager and the results that have been secured by the institution concerned. In many cases, this seems to account for about 25% of the value of the initial pre crisis investable assets.

Legal costs are always very significant and finally, the Trustee costs in terms of time spent and lost revenue sometimes are even higher than the legal fees, more so in terms of lost opportunities.

The costs of a single case as outlined above, would justify implementing Investment Risk Management policies and procedures across a firm.

Benefits

However, most Trust Companies who have robust Investment Risk Management policies and procedures market them to their clients as being a differentiator between other competing Trust Companies and even include sections within their marketing literature,

highlighting their performance monitoring, policies and procedures and the benefits this affords the client.