David Gunson

13 September 2005

The Clerk to the Bills Committee
Atention May Leung
LegCo Secretariat
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by email to mleung@legco.gov.hk

FINANCIAL REPORTING COUNCIL BILL

If the FRC Ordinance has found legislative space, then LegCo must undertake trustee investment law reform. Other jurisdictions have managed. It is essential that that be done to make a success of the FRC Ordinance. This submission may seem to the Bills Committee at first sight nothing to do with the FRC Ordinance. But if one stops to think it through, what use is an FRC Ordinance to administer antique law.

Attached is a report of reform of the law on trustee investment which I complied nearly 12 years ago. If the FRC Ordinance is to be successful in its operation, LegCo must give legislative time to moving Hong Kong from the middle of the 19th centruy to the 21st century by updating its trustee investment laws. Otherwise, the FRC Ordinance is an empty vessel.

Please refer to the attached extended submission I made on the Consultation paper. In that extended submission I gave details of specifically how the law could be updated and drafted. Those recommendations remain the same today.

The FRC Ordinance will need to also underpin some more supreme accounting principles such as:

- tax law and tax avoidance law in particular have a special role to play in the presentation of accounts
- clear explanations of assumptions about those tax laws must be stated, not ignored such as is the present practice
- where a collective investment scheme is operated not by company or fanciful partnership law, but by trust law, the deep differences in accounting standards must be clearly stated
- where the tax law conflicts with trust law or company law on accounting, it shall be subordinate for the purpose of published accounts

- accountants are not “ watchdogs " at all when it comes to their own audit of their own advice: it is impossible
- audit and tax advice wrapped together – especially on tax law – are a dreadful mix and might stand being legislated against.

Yours faithfully,
David Gunson

David Gunson

30 March 2005

Financial Services and the Treasury Bureau
(attn: Consultation paper on Legislative Proposals to Establish financial Reporting Council)
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Hong Kong

by email to consult-frc@fstb.gov.hk

Dear Sirs,

This letter is supplementary to my letter of 8 March 2005 itself written in response to the Administration's invitation for submissions.

Unreported contingent liabilities under s.35 Estate Duty Ordinance

Since my earlier letter, it has been announced officially that estate duty is to be abolished. That removes the problematic s.35 Estate Duty Ordinance (on controlled companies) and presumably therefore, the need for widespread use of doubtful trust and off-balance sheet devices allowing dubious avoidance of reporting of contingent liabilities arising under s.35.

Financial reporting consequences of abolition of s.35 Estate Duty Ordinance

That is, we can only assume that the cost-savings on eliminating redundant tax-avoidance Cayman and BVI and other trusts will mean that there is no need for such mechanisms anymore (assuming that they were sound in the first place, which I for one doubt). In turn that would surely mean that that large area of dubious accounting and audit vanishes: or it jolly well should do. That is one area that will reverberate through financial statements for years and therefore is a matter of concern to the proposed Financial Reporting Council.

Concomitant reform of trustee investment law

After 10 years of silence, suddenly reform of trustee law and the Trustee Ordinance is topical. Having studied the matter in a way that, I believe, no other person in Hong Kong has done (see my report of 10 years ago – supplied with my earlier letter); I have reached the conclusion that the smart, painless and fast way of reform is to copy the New Zealand method. That is because the pre-New Zealand-reformed Trustee Act 1956 was until 1988 almost exactly identical in most important respects to the present Trustee Ordinance. That is because both those laws were copied from the Trustee Act 1925 of the United Kingdom.

Copying the Canadian or American or British or Australian laws will be slow, expensive and unsatisfactory. So to speak you will have to trust me on this by reading my report of 10 years

ago. Even worse would be to copy the methodology of the Mandatory Provident Fund legal regime. That is a dreadful mix of oddities and simplistic ideas unclearly drafted by persons who clearly knew little about trust law. Take for instance the following bizarre invention:

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MANDATORY PROVIDENT FUND SCHEMES (GENERAL) REGULATION - SECT 43
Approved trustee's general duties with respect to administration of scheme
VerDate:03/08/1999


PART V

FUNCTIONS OF APPROVED TRUSTEES

The approved trustee of a registered scheme must perform the following
duties with respect to the administration of the scheme-

        (a) the duty to exercise a level of care, skill, diligence and
prudence that may reasonably be expected of a prudent person who is acting
in a similar capacity and who is familiar with the operation of registered
schemes;

        (b) the duty to make use of all relevant knowledge and skill that
the trustee may be reasonably expected to have because of the trustee's
business or occupation;

        (c) the duty to ensure that the funds of the scheme are invested in
different investments so as to minimize the risk of losses of those funds,
unless in particular circumstances it is prudent not to do so;

        (d) the duty to act in the interest of the scheme members and not
in the trustee's own interest;

        (e) the duty to act in accordance with the governing rules of the
scheme;

        (f) the duty to supervise and exercise proper control over all
service providers appointed or engaged for the purposes of the scheme.
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Incompetent drafting of reform of trustee investment law

Incompetent drafting because of poor knowledge of trustee investment law let alone trusteeship law itself can only lead to muddled financial reporting. I have already criticized the LINK REIT accounting basis as being muddled. If that can happen there and if there has been silence for 10 years on trustee investment law; then for sure an FRC Ordinance must have a Trustee Amendment Ordinance sitting right beside it to be successful.

Here follows the elegant Trustee Act 1956 (New Zealand) as amended in 1988 from a version very similar to the present Trustee Ordinance:

ANALYSIS
(List of Sections)

1. Short Title and commencement

PART 1 — PRELIMINARY

2. Interpretation and application

3. Act to bind Crown

4. Authorised investments (Repealed)

[4A. Investments, loans, and advances (Repealed)

5. Purchase of redeemable stocks at a premium or discount (Repealed)

6. Trustee carrying on business may invest in shares in co-operative enterprises (Repealed)

7. Discretion of trustees (Repealed)

8. Power to retain investment which has ceased to be authorised (Repealed)

9. Investment in bearer securities (Repealed)

10. Loans and investments by trustees not chargeable as breaches of trust (Repealed)

11. Liability for loss by reason of improper investment (Repealed)

[11A. Release of part of security (Repealed)

12. Powers in relation to company securities (Repealed)

13. Power to pay calls (Repealed)

[PART 2 — INVESTMENT

[13A. Power to invest

[13B. Duty of trustee to invest prudently

[13C. Duty of certain persons to exercise special skill

[13D. Provisions in trust instrument relating to duty of investing trustees

[13E. Matters to which trustee may have regard in exercising power of investment

[13F. Trustee's duties at law preserved

[13G. Duty to comply with requirements of trust instrument or statute as to consents or directions

[13H. Power to retain investments

[13I. Investment in bearer securities

[13J. Purchase of redeemable securities at a premium or discount

[13K. Powers in relation to company securities

[13L. Power to pay calls

[13M. Court may take into account investment strategy in action for breach of trust

[13N. Certain loans and investments by trustees not chargeable as breaches of trust

[13O. Liability for loss by reason of improper secured investment

[13P. Release of part of security

[13Q. Power of Court to set off gains and losses arising from investment

PART 3 — GENERAL POWERS AND INDEMNITIES OF TRUSTEES

General powers

14. Powers to sell, exchange, partition, postpone, lease, purchase, etc

15. Miscellaneous powers in respect of property

16. Power of trustee for sale to sell by auction, etc, or before date specified

17. Power to sell property on terms

18. Power to sell subject to depreciatory conditions

19. Power of trustees to give receipts

20. Power to compound liabilities

21. Power to raise money by sale or mortgage

[22. Protection of purchasers, etc, dealing with trustee

23. Devolution of powers or trusts

24. Power to insure

25. Application of insurance money where policy kept up under any trust power, or obligation

[25A. Power to treat share premium account distributions as income

26. Deposit of documents for safe custody

27. Reversionary interest

28. Valuations

29. Power to employ agents

30. Power to concur with others

31. Power to delegate trusts

32. Power to carry on business

[32A. Power of trustee carrying on trust business to acquire shares in co-operative enterprises

33. Power to convert business into a company

[33A. Trustee may sue himself in a different capacity

Indemnities

34. Protection against liability in respect of rents and covenants

[34A. Trustee to have lien on policy money for premiums

35. Protection against creditors by means of advertisements

36. Protection in regard to notice

37. Exoneration of trustees in respect of certain powers of attorney

38. Implied indemnity of trustees

39. Protection of trustee who pays trust money to bankrupt in good faith and without knowledge of bankruptcy

[39A. Protection of trustee in handing over chattels to life tenant

[39B. Protection of trustee in handing over chattels to infant

Maintenance, advancement, and protective trusts

40. Power to apply income for maintenance, etc, and to accumulate surplus income during a minority

41. Power to apply capital for maintenance, etc

[41A. Conditional advances for maintenance, etc

42. Protective trusts

[Special powers in respect of businesses

[42A. Power to set aside reserves out of income or profits of business

[42B. Power to apply capital of business for maintenance

[42C. Matters to be taken into consideration when exercising powers

[42D. Apportionment of income

PART 4 — APPOINTMENT AND DISCHARGE OF TRUSTEES

43. Power of appointing new trustees

44. Evidence as to a vacancy in a trust

45. Retirement of trustee

46. Discharge of trustee with assistance of Court or Registrar

47. Vesting of trust property in new or continuing trustees

48. Corporations acting as trustees

49. Advisory trustees may be appointed to assist responsible trustee

50. Custodian trustees

PART 5 — POWERS OF THE COURT

Appointment of new trustees

51. Power of Court to appoint new trustees

Vesting orders

52. Vesting orders of land

53. Orders as to contingent rights of unborn persons

54. Vesting order in place of conveyance by infant mortgagee

55. Vesting order consequential on order for sale or mortgage of land

56. Vesting order consequential on judgment for specific performance

57. Effect of vesting order

58. Power to appoint person to convey

59. Vesting orders as to stock and things in action

60. Vesting orders in respect of shares in ships and industrial property

61. Vesting orders of charity property

62. Orders made upon certain allegations to be conclusive evidence

63. Repealed

Jurisdiction to make other orders

64. Power of Court to authorise dealings with trust property and variations of trust

[64A. Power of Court to authorise variations of trust

[64B. Powers of Court in respect of capital dividends

65. Power of Court to direct sale or lease (Repealed)

66. Right of trustee to apply to Court for directions

67. Persons entitled to apply to Court

68. Applications to Court to review acts and decisions of trustee

69. Protection of trustee while acting under direction of Court

70. Powers of Court to give judgment in absence of a trustee

71. Power of Court to charge costs on trust estate

[72. Commission

73. Power to relieve trustee from personal liability

74. Power to make beneficiary indemnify for breach of trust

75. Barring of claims

76. Distribution of shares of missing beneficiaries

[76A. Service of notices, etc, under sections 75 and 76

Payment to Crown

77. Payment by trustees to Crown

78. Disposal of funds paid to Crown

79. Orders in respect of funds paid to Crown

PART 6 — GENERAL PROVISIONS

80. Indemnity to banks and others

81. Operation on bank account of trustees

82. Inclusion of non-charitable and invalid purposes not to invalidate a trust (Repealed)

[83. Special rules as to apportionment on purchase, sale, or transfer in certain cases

[83A. Examination of accounts of trust estates administered by trustee corporations

[83B. Audit of other trust estates

84. Costs and testamentary expenses to be payable out of capital of settled residuary estate of deceased

85. Application of income of settled property pending conversion

86. Fees and commission deemed a testamentary expense

87. Costs of inquiring regarding beneficiaries

88. Life tenant to have powers of a trustee in certain cases

89. Repeals, amendments, and savings

SCHEDULES

SCHEDULE 1 (Repealed)
OTHER ACTS AUTHORISING TRUSTEE INVESTMENTS

SCHEDULE 2
ENACTMENTS REPEALED

SCHEDULE 3
ENACTMENTS AMENDED

[SCHEDULE 4

Summary and other recommendations

Unless the above method of urgent reform is copied, the government will miss a window of opportunity to reform trustee investment law at the very least. Then it will never be done properly.

I also must mention the urgent need to reform the law of income and capital in the trust law area. This is a topic wholly separate from trustee investment law but, perversely, interlocked by definition. It requires a separate study in its own right.

Here, in closing, is a classic example of an ***ultra vires*** trustee investment law designed by a committee which did not understand trust law:

TRUSTEE ORDINANCE - SECT 4

Authorized investments VerDate:06/30/1997

PART II

INVESTMENTS

(1) A trustee may invest any trust funds in his hands, whether at

the time in a state of investment or not-

(a) in any investment specified in the Second Schedule;

(b) in any other investment (including deposits in a bank outside

Hong Kong) which may be authorized by the court on summary application for that purpose made in chambers. (Amended 9 of 1993 s. 7)

(2) Any application to the court made under subsection (1)(b) shall be made by the trustee ex parte and shall be supported by affidavit.

(3) The Financial Secretary may from time to time by order published in the Gazette amend the Second Schedule.

TRUSTEE ORDINANCE - SCHEDULE 2

AUTHORIZED INVESTMENTS VerDate:07/01/1997

Adaptation amendments retroactively made - see 29 of 1998 s. 105

[section 4]

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7. Any derivatives which are traded on a market listed in Schedule 5 to the Financial Resources Rules (Cap 24 sub. leg.); **except that an investment under this paragraph-**

(a) shall be made for hedging purposes only, that is to say, the derivatives acquired shall be of a type and specification suitable for reducing the impact on the trust fund of a diminution in the value of specific assets already held by the trust fund or which are to be acquired at the same time as the derivatives; and

(b) shall not be made except in accordance with the written advice of an investment adviser (as defined in section 2 of the Securities Ordinance (Cap 333)) or of a commodity trading adviser (as defined in section 2 of the Commodities Trading Ordinance (Cap 250)) expressly obtained as to-

(i) the nature and extent of the risk of diminution in the value of the assets in question, the type and specification of the derivatives suitable to reduce the impact of such diminution in value, and generally the strategy to be adopted in acquiring, holding and disposing of the

derivatives;

(ii) the potential loss that could result from acquiring and

holding the derivatives and the risk of such occurring; and

(iii) the nature and extent of the various risks of diminution in

the value of the trust fund and the suitability of using derivatives to

protect against those risks.

The parts in **red above** are **ultra vires** s.4 Trustee Ordinance.

Yours faithfully,
David Gunson

TRUSTEE ORDINANCE

HONG KONG

Report by David Gunson
to the Executive Committee of the
Hong Kong Trustees' Association Limited

22nd December 1993

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TRUSTEE ORDINANCE

HONG KONG

Report by David Gunson
presented on 22nd December 1993
to the Executive Committee of the
Hong Kong Trustees' Association Limited

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1. INTRODUCTION

1.1 This Report was initiated by the Legislation Sub-Committee of the Hong Kong Trustees' Association Limited (the "Association"). Its purpose is:

i) to provide the Association's Executive Committee with a comparative survey of the laws affecting trustees in a selected range of jurisdictions;

ii) to provide the Executive Committee with sufficient information and recommendations to formulate a policy on Hong Kong's Trustee Ordinance (the "Ordinance") to be put to the Association's membership in the second quarter of 1994 for discussion and, if approved, for adoption; and

iii) subject to the Association's adoption of a policy on the Ordinance, to provide a basis for the Association to make submissions in mid-1994 to the Hong Kong Government on amending the Ordinance to conform it with modern law and practice both in Hong Kong and internationally.

1.2 The Sub-Committee met on 10 occasions during 1992 and 1993 to review the entire scheme and perceived limitations of the Ordinance. As a result of the Sub-Committee's review, it recommended to the Executive Committee of the Association that this Report be commissioned.

1.3 This Report is prepared under the instructions of, and pursuant to a Resolution made the 21st October 1993 by, the Executive Committee of the Association.

2. STRUCTURE OF REPORT

2.1 This Report is divided into 3 parts:

Part A Regulation of trustees in Hong Kong: should the provision of trustee services be regulated and if so, in what form?

Part B Investment powers of trustees: should they be continue to be primarily regulated by reference to a statutory list of permissible investments; or primarily by reference to a new test of what a "prudent person" would do?

Part C Rules of equity and miscellaneous provisions: should outmoded English rules of equity be retained; should existing rules on how trustees make decisions, and on trustees' powers of delegation, be retained; should rules on the "proper law" of a trust be codified?

2.2 Each Part contains a comparative survey of the laws of other jurisdictions relevant to that Part. Those jurisdictions in turn are classified as

- jurisdictions which generally have just one body of business laws applying to residents and non-residents, e.g. New Brunswick;

- "offshore financial centres" whose business laws are divided into those dedicated to use by non-resident persons and those dedicated to use by residents, e.g. the British Virgin Islands;

2.3 Each Part also contains its recommendations for amending the Ordinance, based on the comparative survey and on modern trustee practice. No formal draft amendments to the Ordinance are included in this Report, pending the formulation of a policy on the Ordinance.

2.4 The basis of review of English rules of equity, in force in Hong Kong, is that certain of those rules are redundant in practice. Part C of this Report summarises such of those rules as the Legislation Sub-Committee considers redundant; and recommends their abolition.

PART A

REGULATION OF TRUSTEES IN HONG KONG

Should the provision of trustee services be regulated and , if so, in what form?

3.1 The Different Methods of Regulation

1. Hong Kong trustee law is derived almost entirely from English rules of equity and statute law. Those rules have been continuously developed from their origins (to do with title interests in English land and the benefits and burdens of such interests) over 600 years ago. For most of that time, trustees have been regulated primarily by the Courts rather than by governmental agencies.

2. As a general principle (which Hong Kong law and governmental policy has followed) regulation of trustees outside the Court system has been confined to the credentials of certain classes of trustees, rather than the general body of trustee law. An important exception to this general principle has been the imposition of statute law over the past 100 years on the question of permissible investments by a trustee. That is dealt with in Part B of this Report.

3. The classes of Hong Kong trustees specifically regulated by governmental agencies are those who

   - are corporations acting as executors of deceased estates; or

   - are managing pooled investment moneys publicly subscribed by persons whose only common link is the fact that they have subscribed to the same pool; or

   - derive their legal status or powers from a process of registration such as by the

Registered Trustees Incorporation Ordinance; or by an Ordinance dedicated to a specific trusteeship; or

- are required to register to permit them to act as trustees such as by the Occupational Retirement Schemes Ordinance.

4. From these features of Hong Kong law one can propose that:

regulation of all trustees, as such, has never been regarded in Hong Kong as a special area of public interest requiring trusteeship itself to be placed under the regulatory control of a governmental agency; and

it is desirable to leave trustees and their beneficiaries to regulate themselves under Court supervision where they are not already regulated by existing Ordinances.

5. One can contrast these proposals with the fact that both Hong Kong and overseas companies are compulsorily regulated - under the Companies Ordinance - which leads one to conclude that in Hong Kong:

it is the legal form of ownership, control and management of investments and business transactions which determines whether the entity represented by that legal form is required to be regulated; but

if the legal form does not require regulation, then only a limited range of activities carried on by the entity will themselves require regulation; and

if the activities do not require regulation then the law is fully satisfied.

6. These conclusions are the same under the law of the following jurisdictions (see also paragraph 2.2 above):

all of the Australian States and New Zealand;

all of the Canadian Provinces, except for British Columbia which has special laws for registered trustee corporations conducting trustee activities external to

Canada, for clients outside Canada;

all of the United States of America;

Singapore, Malaysia (except for the Labuan territory) and India; and

the United Kingdom.

7. these conclusions are, however, not the same under the laws of the following jurisdictions (see also paragraph 2.2 above):

Jersey and Guernsey (but not Alderney) of the Channel Islands;

the Bahamas, the British Virgin Islands, the Cayman Islands and Turks and Caicos Islands (but not Anguilla, Antigua, Belize, Montserrat or Nevis) of the Caribbean members of the Commonwealth;

The Netherlands Antilles, Liechtenstein, Luxembourg and Monaco; and

Vanuatu and the Cook Islands

all of which have varying forms of legislation which, as noted in paragraph 2.2 above, distinguish between use by the resident and use by the non-resident; but which also regulate all trusteeships by imposing a general requirement to register, with exemptions granted from that general requirement.

8. One can therefore further conclude that:

jurisdictions with specific business laws for non-residents doing external business and specific business laws for residents doing domestic business; will require registration of, or will regulate, all trusteeships.

3.2 The Purpose and Benefits of Regulation

1. The jurisdictions listed in paragraph 3.1.6 above see no benefits in regulating all trusteeships. They apparently do see benefits in regulating some: in particular the administration by trustee corporations of deceased estates; the getting-in and management of pooled publicly-subscribed investment money; and special-status

trusteeships for a particular purpose or objective.

2. It can be said that the purpose of such regulation and therefore the discernable benefit is to provide a statutory scheme of protection for trustees and their beneficiaries. There is no other discernable benefit to anyone.

3. By contrast, the jurisdictions listed in paragraph 3.1.7 above do see benefits in regulating all trusteeships. They cite the need for protection of trustees and beneficiaries, to be sure. They also frequently impose a statutory set of rules and tests for the credentials and behaviour of trustees, which supervene the (usually English) rules of equity otherwise prevailing in varying degrees. Those rules of equity in turn are dependant constitutionally on when each jurisdiction came into existence.

4. Throughout the Caribbean British Dependent Territories and Commonwealth jurisdictions
(except for Jersey which is not an equity jurisdiction) the variation in when the rules of equity first came to be adopted is some 300 years, Bermuda being the earliest; closely followed by Barbados and Jamaica; with the Bahamas in due course becoming a Commonwealth in its own right, 300 years on in the 1970's. This means that one needs to pick one's "offshore" equity jurisdiction with care.

5. It can be said that one benefit of regulating all trusteeships, and especially those respecting foreign property and non-resident beneficiaries, is that the regulator can disregard the problem of the extent of the rule of equity, for the regulator has a simple method of determining the full extent of trusteeships legally under his jurisdiction.

6. The usual consequence of such a registration system for trustees is judicial recognition of the situs of the underlying trusts of the trustee. This is the method used in the Cook Islands which also has a register of trusts themselves. If a trust is registered then the statute ousts any other jurisdiction and requires the Court to apply Cook Islands law, which includes recognition of the trusteeship.

7. By contrast, Belize does not require regulation of trusteeships but provides an optional registration of trusts themselves. But once on the register a trust will attract Belize law as the proper law of that trust to the exclusion of any other.

8. It can be seen from the Cook Islands and Belize approach to trusts and their trusteeships that a registration system of a trust can be designed to confer the benefits of local law on that trust, to the exclusion of the possible adverse consequences of the law of a foreign jurisdiction. This is in answer to problems that arise when a foreign (e.g. Cook Islands or Belize) trust law is not granted full recognition and applied in the civil law systems. But it is also designed to specifically oust any other jurisdiction.

9. The hope, so the theory goes, is that a foreign court will recognise a statute where it

disregards equity or a trust instrument. This theory is the basis of marketing the legislation internationally to persons seeking to shelter foreign assets from claims usually in the Courts of the jurisdiction where those assets are sited. Such persons do this by settling trusts not for tax reasons but to make it legally difficult for a claimant to recover from the trustee - which often is legal owner of the disputed assets.

10. In the end, though, the Cook Islands or Belize approach to conferring benefits on a trust carries a pre-condition: that the trustee or his trust pay a registration fee. The benefits are "purchased" by payment and those benefits can be, on the face of it, very attractive to the customer seeking a secure home for his assets, far from problems of the "proper law"; "forced heirship"; creditor claims and disclosure to foreign regulatory and tax authorities.

11. The advantage of such an approach is that where, as is the case with so many such jurisdictions, there is little depth to their legal and judicial infrastructure, a Code on trusts will provide instant and comprehensive guidance to the local Court and to the foreign lawyer, not otherwise likely to be available to the extent it is in for instance Hong Kong.

12. A major feature in the difference in approach to regulation of trusteeship between those jurisdictions in 3.1.6 and those in 3.1.7; is that the governments of the latter category rely, as an instrument of fiscal policy, on the revenue collected from registration fees paid by various enterprises (including trustees) registered in one legal form or another with the subject governmental agency.

13. In other words, regulation of trusteeships is a wide-spread and recognised form of taxation by the levying of registration fees, in turn by demanding compulsory registration in varying classes of trusteeship Registration is not intended, in the main, for use for domestic business or investment.

14. It is a fair view that such governmental revenues will be protected first and a delinquent trustee's beneficiaries second, if the latter wished to issue Court proceedings within the jurisdiction in which the trust was held domiciled or in fact registered.

15. The opposite result would appear true for those jurisdictions listed in 3.1.6, and also for Hong Kong.

SUMMARY OF COMPARATIVE APPROACHES

The purpose of regulation of trusteeships in the Hong Kong tradition is primarily to provide a scheme of protection for trustees and their

beneficiaries.

The purpose of regulation of trusteeships in "offshore financial centres" is primarily to create a new field of servicing offshore trust business which produces revenue and employment but also provides a strictly statutory framework of standards which those trust businesses must meet.

3.3 Regulation of Persons in Business as Trustees

1. The Ordinance is based on the Trustee Act 1925 (United Kingdom). The scheme of regulation of trustee corporations (and individuals as trustees) has continued essentially unchanged since then. This the same in the jurisdictions in 3.1.6 except for the United States of America and in Victoria, Australia (because of the failure of a trustee company). The scheme in Hong Kong is confined to specific cases of trusteeship. A registered trust company in empowered to carry out objects in s.81(1) of the Ordinance, and can charge fees for its services. There is no requirement to register and no regulation of trusteeships in other areas some of which overlap s.81(1). The Ordinance makes no distinction between an unpaid private trusteeship and a trusteeship by a corporation whose business is to make a profit from acting as trustee.

2. The law in most jurisdictions is that an unregistered trustee is barred from being remunerated for his trusteeship. It is not recommended that that law be changed in Hong Kong. A trustee can, however, in fact profit if the ruling trust instrument empowers him to levy fees or charges on top of the trust's administration expenses which are incurred in the name of the trustee, as a personal liability, able to be recouped out of the trust property, but at a profit.

3. If an unregistered trustee company is part of a group of companies or related businesses, the trusteeship itself can be conducted unpaid but another group company

or business can act as a delegate administrator (under s.25 of the Ordinance) and charge the trustee fees for acting as administrator. It is moot whether the trustee has a conflict of interest in paying his delegate in such circumstances. The Ordinance is silent on the point but in the absence of a power in the ruling trust instrument to levy fees, the better view seems to be that the trustee is a party to a conflict of interest, causing the trustee to apply trust property indirectly for the benefit of persons other than the beneficiaries. That is, there is a breach of trust.

4. If a person is in business per se as a trustee in Hong Kong the above analysis holds good whether the trustee is incorporated in Hong Kong or not. It follows that some legislative mechanism would be need to be devised to permit such a trustee to overcome the rule on no-reward and the ever-present problem of conflict of interest, so that his business can be conducted without the need for uncertain devices to circumvent those two formidable legal problems.

5. It also follows that because registration under the Ordinance is unnecessary for many trusteeships by foreign companies conducted in Hong Kong (even though e.g. in the British Virgin Islands the foreign trustee may be required to register in its place of incorporation) the Ordinance effectively provides "optional" registration. There appears to be no easy and logical regulatory basis to distinguish between trustees "in business" and those who are not.

6. The logical distinction to be drawn, if any, is that between trustees responsible for managing and investing money drawn from "private" as distinct from "public" sources. This area is already regulated and applies to any trustee in Hong Kong. It follows that regulation of trustees "in business" or of "professional" trustees will add little practical substance to the existing regulatory regime. That is, it is what a trustee does, rather than the mere status of the trustee, that is already regulated. This would seem sufficient in a large and well developed investment market such as Hong Kong's with good legal and judicial infrastructure and active regulatory bodies.

7. There is however a practice in Hong Kong which, taken to its logical conclusion, can undermine the concept of regulation of corporations acting as trustees. Where a foreign company doing business here includes "trust" in its name, unlike Hong Kong companies, it must be registered by the Registrar here with that name unless "the Registrar is satisfied" [a process liable to judicial review] that the criteria in s.337B of the Companies Ordinance are met. Amongst those criteria is intent to use a deceptive name or to pass-off the foreign company as associated with another, or a local company. So long as there is no real evidence before the Registrar that that might happen (a very low standard for him to meet) any foreign company with "trust" in its name, can register.

8. The consequence is that registration (as described) under Part XI of the Companies Ordinance is the sole regulatory contact with the foreign "trust" company. Where a door to profit is open to any businessman competent, honest or otherwise, he will walk through. It seems odd that any person in Hong Kong can incorporate his "trust" company in a suitable foreign jurisdiction and register it in Hong Kong to achieve what he cannot by incorporating locally.

9. Banning the word "trust" is no answer because good or bad is not found in a name alone. The real issue, in my view, is where foreign "trust" companies registered under Part XI of the Companies Ordinance, not only hold themselves out as "trustees" but claim business competence and substance to do so, as Hong Kong trust companies must. That is, the law permits them to accrue their credentials by implication first with actual competence and substance an ill-defined and somewhat distant second.

10. A separate issue is whether the very basis of the puny regulation of foreign "trust" companies I have described is itself adequate. The test is whether, in law, a foreign company has "a place of business" here. This is a different test to one of "carrying on business", and different again to tax tests on "permanent establishments" or even liability to Profits Tax under the much-debated common law on "source" of income. It is possible for a foreign "trust" company to claim that it has no "place of business" here and yet do business here, by agency or advertising. Letterhead is one inexpensive sheet but can speak volumes to the lay reader of the word "trust" in the company name.

11. I have no easy legislative solutions to offer for these conundrums so for the present I merely note them and state that subject to recommending further study of these comments I propose no changes on laws on regulation of trustees per se.

SUMMARY OF PART A

1. Hong Kong trustees have never been regulated, as trustees alone. The regulatory laws do not distinguish between trustees who are "paid" or "unpaid"; "in business" or "private"; or "professional" or "non-professional".

2. The existing regulatory laws provide for:-

   i) "optional" registration of Hong Kong corporations which, once registered, empower them to carry any objects in s.81(1) of the Ordinance;

   ii) registration of all other corporations under the Companies Ordinance so long as they remain as trustees of money from "private" and not "public" sources.

3. Subject to review of the law on registration of foreign companies under the

Companies Ordinance, there is no compelling need for change in the regulation of persons acting as trustees.

PART B

INVESTMENT POWERS OF TRUSTEES

"legal list" or "prudent man" ?

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4. Comparative Approaches to Laws Governing Trustee Investment

In this section of my paper, I propose to outline the general approaches to trustee investment which have been adopted in a number of comparable jurisdictions, and to refer to some recent developments both in those jurisdictions as well as in "offshore financial centres". This is a subject which has already been well documented see especially Ontario Law Reform Commission, Report on the Law of Trusts (1984). I do not think there is any need for an independent or detailed discussion here, but a summary may be found useful.

4.1 **England**

1. As noted in paragraph 3.3, the present Hong Kong approach derives from rules previously developed in England, and any examination of this subject starts from there. It seems that, as principles of trustee accountability were being developed, the courts in England made no attempt to control trustee investments until the South Sea Bubble collapse in the early eighteenth century. Thereafter trustees were permitted to invest only in Bank of England Consolidated Annuities. A very limited list remained until 1859, when Parliament passed legislation to broaden the investment power of trustees, a process which gradually continued through the nineteenth and twentieth centuries, by the addition ad hoc of various securities.

2. A change in pattern was introduced by the Trustee Investments Act 1961. There were three classes of trustee investments: "Part I investments" (limited classes of government stock and bank deposits), "Part II investments" (other government or local authority stock, building society deposits, mortgages and rent-charges), and "Part III investments" (company and building society shares and unit trusts). No more than 50% of the trust funds may be invested in Part III investments; and the trustee may invest in Part II investments only after obtaining proper written advice. The trustee is required to have regard to the need for diversification of the trust investments, and the suitability of particular investments to the needs of the trusts: section 6(1). The legislation is generally one of the "legal list" type, but it imposes very few restrictions on company securities as trustee investments.

3. The legislation was reviewed by the Law Reform Committee in its 23rd Report (Powers and Duties of Trustees), 15-17. The Committee observed that the Act had become irrelevant to modern conditions, and had proved "tiresome, cumbrous and expensive in operation". It therefore recommended that the scheme of division of the

trust fund for investment purposes be abandoned. Instead, the trustee should be able to invest any part of the fund in Part III investment after taking proper advice; and the Committee recommended that advice no longer be required for Part II investments.

4. The Committee considered, as an alternative, a proposal along the lines of a "prudent man" rule but rejected it in these terms:

"Although a general freedom to invest within the framework of what may loosely be described as a duty of care has its attractions and might reflect current practice where the present law is excluded, we think that such a solution would create considerable difficulties, particularly for smaller trusts. Further, we think that in any event the law should continue to provide some guidance and indeed protection for trustees......"

4.2 **New Zealand**

1. Prior to the passing of the Trustee Amendment Act 1988 (which introduced a "prudent man" rule) the New Zealand legislation followed the "legal list" approach, the list having been extended well beyond government issued or officially backed securities with various special criteria being attached to different categories of investment. These special criteria took various forms, examples of which are:

i) Guarantee of payment by government;

ii) Size of company in which investment made;

iii) Stock exchange listing;

iv) Subscriptions must be fully paid up;

v) Dividend history;

vi) Proper advice;

vii) Valuer's report and security margin on loans.

Like Hong Kong now, 10 years ago in New Zealand the addition of further investment categories, and changes to the criteria for some existing categories, was proposed (by the Property Law and Equity Reform Committee in its Second Report on Trustees' Powers of Investment (1984)), and these proposals had they been adopted would have added further complexity to the legislation.

2. The possibility of replacing the "legal list" with the "prudent man" rule was considered by the Committee in its Report on Trustees' Statutory Powers of Investment (1970), but rejected on the ground that it offered "too little guidance to

trustees who are not experienced in investing money". The method in fact adopted, in the Committee's view, provided "flexibility while at the same time laying down guidelines which if followed would exempt a trustee from liability for any loss" (p5). When the Committee returned to this issue in its Second Report (1984), pp2-3, it noted some particular features of the New Zealand financial system which might throw doubt on the desirability of continuing with the approach, namely (i) the practice of relating institutional investing (particularly of quasi-governmental authorities) to the requirements of the Trustee Act; (ii) the economic advantage that some investee institutions might gain by attaining trustee investment status, while equally worthy organisations were unable to meet particular safeguards laid down in the legislation.

3. It is also of interest that in its 1970 Report, the Committee considered the English provision requiring the trustee to have regard to the need for diversification. It did not recommend the inclusion of a similar provision in New Zealand legislation since, "in some cases diversification might be unwarranted and even unsuitable" (p10). In general, it was thought that this fell within a trustee's general duty to act prudently and so no specific provision was necessary. In 1986 a Working Party study was published on "prudent man" rule. My Report has relied heavily on that study for the content of this Part B.

4. In 1988 as a result of the Working Party's study, the Trustee Act was amended to introduce a "prudent man" rule which essentially imposed a standard on all trustees that they take account of:

- The need for diversification of investments
- The need to maintain the real value of the fund and the effects of inflation
- The level of risk of depreciation and the potential for capital gain
- The liquidity of the investments
- The tax efficiency of the investment strategy
- The need to take professional advice

Higher standards are demanded of professional trustees (which is in line with case law - see Bartlett v. Barclays Bank Trust Co. [1980] Ch. 515) but statutory relief is available where a proper investment strategy and appropriate diversification of investments has been adopted.

4.3 Australia

1. The Australian jurisdictions follow the "legal list" approach. Of particular interest are developments in Western Australia, whose provisions were taken as a model by the New Zealand Australian legislation does, however, include provisions requiring

diversification, and the consideration of the suitability of each investment for the trust, adapted from the English legislation: Trustees Act 1962, s16(5). A similar approach has been adopted has been adopted by the Law Reform Committee of South Australia, in its 40th Report (Powers of Investment of Trustees).

2. The Western Australia Law Reform Commission considered the prudent man rule in its Report on Trustees' Powers of Investment (Project 34, Part V) (1984). In its Working Paper, the Commission had previously pointed out that the prudent man rule allowed trustees greater flexibility to respond to changing economic circumstances, and made it less likely that an honest and diligent trustee would commit a breach of trust by accident (through overlooking technical safeguards laid down in the legislation). On the other hand, it noted that the rule may not provide sufficient guidance to inexperienced trustees. The Commission inclined towards retaining the legal list approach, a conclusion it confirmed in its Report. Among the factors which weighed with the Commission were (i) lack of support for the prudent man rule in responses to the Working Paper; (ii) it had not been adopted elsewhere in Australia or New Zealand; (iii) the apparent freedom of investment permitted by the prudent man rule might in practice be limited by conservative judical decisions.

3. The Commission went on to consider and reject three alternative methods of modifying the "legal list" approach so as to meet some of the difficulties inherent in the existing law, while accommodating the need of the inexperienced trustee for official guidance when investing. The suggestions were:

(i) A list of investments could be made which are deemed "prudent", so the beneficiary could not challenge the trustee's selection on the basis of want of due care. This was rejected because trustees, in selecting from the list, must have proper regard to preserving the capital against inflation and there would have to be some standards of prudence in making this selection. It will be noted this assumes trustees in Western Australia have a duty to pay regard to the effects of inflation when making investment decisions. In New Zealand at least, there is as yet no clear judicial pronouncement that trustees are bound to do any more than preserve the nominal value of the trust capital. The position appears to be the same, juding by information available to the Working Party, in most American jurisdictions where the "prudent man" approach applies and indeed this is seen by some as a weakness in that approach.

(ii) A narrow list of investments could be enacted, with a provision permitting trustees to go outside the list if they considered themselves skilled enough to do so. This approach was too close to the "prudent man" rule for the Commission's liking, and carried with it the risk that an inexperienced trustee might be tempted to speculate with trust funds.

(iii) Greater investment powers could be given to skilled, than to unskilled, trustees. Such a proposal would create difficulties of classification, and could be seen as penalising beneficiaries where the trustees were unskilled.

4. The Commission did suggest minor modifications of the legal list approach, including a statutory reference to the trustee's duty of prudence and impartiality, extension of the

existing obligations to obtain expert advice, and various procedures to enable the list to be updated. The Commission also suggested that the Court be given power to extend the categories of investment for those trustees who make specific application.

4.4 Canada

1. Canadian jurisdictions have followed in the same tradition of a statutory list of permitted investments, the list being gradually extended. In 1970, however, the Conference of Commissioners of Uniformity of Legislation in Canada approved a Uniform Act which would enact the prudent man rule. This proposal has been adopted so far as I can determine, in New Brunswick, Manitoba, North West Territories, Yukon and more recently in Nova Scotia and British Columbia, but not in the remaining provinces.

2. The Law Reform Commission of Manitoba, in its Report on Investment Provisions Under "The Trustee Act" (1982), supported the adoption of the "prudent man" rule on the grounds that a "legal list" is static and requires legislative amendment to change; the inevitable delay can cause hardship. While the "legal list" approach is designed to preserve the capital intact, it may give insufficient weight to the need to generate income. Moreover, the Commission received representations from charitable and professional trustees who would welcome the "prudent man" rule so that they could achieve a realistic investment portfolio, and adapt that portfolio to meet the special circumstances of each trust. The best and safest method, according to these groups, is to have a good mix of debentures and stock; a "legal list" is merely a hindrance. The Commission pointed out that apparent advantage given to the trustees by the legal list (immunity from claims for poor investment, as compared with liability under the "prudent man" rule if the investment turned out badly) was based upon erroneous legal presuppositions. Canadian judicial decisions indicated (a) that a trustee who invested inappropriately in "legal list" investments could still be liable for lack of prudence; and (b) trustees who invested reasonably under a "prudent man" rule would not be made liable merely because the investment turned out badly.

3. The Commission referred to the difficulties that could arise with the "prudent man" rule, where trustees may have differing degrees of expertise. Should this be recognised by legislation, so that there would be no one objective standard of "reasonableness"? The Commission favoured the approach adopted by the American Law Institute 1 Restatement of the Law of Trusts (2nd ed 1959), namely that a trustee who held himself out as having a special degree of skill would be held to that standard. Otherwise, "ordinary prudence" would be fairly flexibly defined to meet the circumstances of the individual case. It would also be helpful, in this connection, to set out a list of criteria which the trustee might consider when making investment decisions. A significant point made by the Commission was that a statute is not the place in which to set out guidelines for the lay or inexperienced trustee. Instead, a trustee's handbook and guide should be prepared to advise trustees on their duties and possible areas of investment. As a last resort, the equivalent of our Trustee Ordinance, (section 60 permitting a court to excuse a trustee who has acted honestly and reasonably) might be invoked in approximate cases.

4. The Ontario Law Reform Commission, while conceding that there were strong arguments

5. for either side, came to the same conclusion, finding that the balance of advantages lay with the prudent man rule: see 1 Report on the Law of Trusts (1984), 214-222. It considered the variations on the "legal list" approach which had been proposed elsewhere in the Commonwealth, but did not regard them as satisfactory. Allowing the list to be updated by Order in Council, rather than legislation, did not necessarily alleviate the inherent difficulties and delay experienced in settling appropriate amendments to the list. Requiring the trustee to take expert advice before investing involves him in expense, and also presupposes that the trustee has the expertise to distinguish between good and bad advice. To extend the list of investments beyond government or "officially" backed securities (as has been done in New Zealand (prior to 1988) and Western Australia by authorising investment in shares) encourages trustees to put undue reliance on statutory guidelines when their actions will be tested against the general duty to take reasonable care. To broaden the list further still would permit investments which may well be, of their own nature, unsuitable for the smaller private trust.

5. The Commission saw the basic advantage of the "legal list" approach as being to give private trustees, who are often selected for their personal qualities rather than investment skill, the assurance of a standard list, with set criteria, enabling them to avoid both the temptation of speculation and the risk of being charged with improper investment. But it also saw disadvantages. A legal list encourages trustees (even if they are given wider powers by their trust instrument) to "play it safe" by confining investments to the categories in the list. The Commission thought that trustees should instead be encouraged to diversify their investments, and to guard against such common investment risks as the erosion of purchasing power, maintaining a proper balance of interest between life tenant and remainderman. As the Commission saw it, a consequence of the list approach might be that "trust beneficiaries may be exposed to a real risk of non-recoverable loss when the statutorily authorised investments are employed in unsuitable economic times" (217).

6. The Commission was of the view that these difficulties can be overcome by adopting the "prudent man" rule. But that rule itself has been criticised on these grounds:

(i) The concept is perceived as placing an undue emphasis on preservation of the real value of the principal, without giving due regard to the needs of the income beneficiaries, who are also hurt by inflation (though, as the Commission points out, this is not a necessary corollary of the prudent man rule). In fact, this perception is probably inaccurate as studies of the American jurisdictions where the rule is in force do not point to any general judicial recognition of a duty for trustees to preserve real rather than nominal values for capital.

(ii) Abandoning the legal list causes difficulties for trustees of many private trusts, who then have to seek advice which is either costly or simply not available to them (though the Commission observed that if trustees need such advice to function effectively in

the modern investment world, they ought to take it, and the settlor should consider carefully who the trustees ought to be, and which of the trustees should have investment responsibilities).

(iii) Trustees may have to guess in advance, it has been suggested, what investments will be regarded by the Court as appropriate (thought it is thought that this suggestion is not wholly borne out by the North American experience, where the judicial approach has been to examine each investment decision on its own merits, and the ultimate possibility of judicial review is something which may enter any trustee investment decision).

In coming to a conclusion in favour of the prudent man rule, the Commission emphasised the illusory protection afforded by any form of legal list which might be suggested, the extensive use of wide investment powers in trust instruments, and the need to place any investment decision against the broader context of the trustee's other duties in administering the trust, including the duty to act impartially between different classes of beneficiary. Of particular importance was the experience of over four-fifths of American jurisdictions which had adopted the rule, and the absence of any appreciate comment to the effect that it has serious defects in practice.

4.5 United States of America

1. The "prudent man" rule is traced back to the decision in Harvard College v Amery, in 1830. The formulation which has been quoted above was influential in other United States jurisdictions as well, but as the nineteenth century progressed the investments open to trustees were in practice severely diminished by court decisions on what a "prudent trustee" (as opposed to a prudent investor) might do with funds for investment. These court-made lists were often inflexible and restrictive, and (as in the Commonwealth) State legislatures intervened to extend the permissible range of investment. These lists became discredited after the stockmarket crash of 1929, and pressure mounted for a system which would enable trustees to make their own investment decisions, unfettered by a legal list. This movement grew, and now I believe that at least forty-two State jurisdictions adopt some version of the prudent man rule. This development has been associated with inflation and high tax rates, coupled with a recognition of the stability of modern securities markets, sounder structures of corporate management, and the development of mutual funds and common trust funds.

2. Whether the inhibitions imposed by older versions of the "prudent man" rule have been entirely shaken off in those jurisdictions adopting its modern form, may perhaps be open to question. The reader of 3 Scott on Trusts (3rd ed 1967), para 227, might find in that text a certain reluctance to endorse purely speculative investments, bonds being sold at a heavy discount, new and untried investments ("derivatives" in the current jargon), trade or business investments, investment in land with a view only to profit-taking, second or equitable mortgages, unsecured loans, and mingling of trust money with other people's money in a combined investment. Some commentators

who have looked specifically at the application of the "prudent man" rule in the United States are in general confident that the position of a trustee who acts reasonably in selecting his investments is satisfactorily protected even though they are critical of the rule in other respects: see e.g., "Trustee Investment" (1974) 23 ICLQ 748. Others refer to the "cumbersome restraints embodied in the Prudent Man Rule": see, e.g. "Trustee Investment" (1978) 126 U Pa L Rev 1171, 1195. Moreover, the rule seems to carry with it the implication that expert advice is necessary for the unskilled trustee. The practical success of such a rule is usually tested by whether it brings better returns back to the beneficiary. That in turn depends on (a) a predominance of investor trustees who are skilled and knowledgeable enough to take advantage of the flexibility afforded by the rule; and (b) courts who are prepared to support them even when investments turn out badly.

3. Those commentators who are critical of the rule attack it because it does not go far enough in encouraging trustees to undertake a broad investment strategy. Limitations still imposed by the rule (as modified by the courts) are regarded as inappropriate to long term "dynastic trusts", an expression used to describe trusts where the primary objective is to preserve the real value of the trust assets throughout successive generations of beneficiaries. These may be contrasted with "maintenance trusts" where the objective is to provide for the support or welfare of one beneficiary or one class of beneficiaries with any remainder passing on to others. In this type of trust, investment skills and the preservation of real values for capital are usually less important aspects of the administration of the trust.

4. The rule in its usual form may not be sufficient to promote a "portfolio" approach to reducing investment risk, because (a) some investments in the portfolio taken on their own might be imprudent in terms of the rule, even though deliberately included primarily to counterbalance perceived risks for other and possibly clearly prudent investments which operate in a different or contrary direction and the overall effect is that the risk of the portfolio are will balanced and minimised; (b) a loss on a single imprudent investment, if it amounts to a breach of trust, may not be able to set off against gains from other investments - the "anti-netting" rule. These criticisms go, of course, to the courts' application of the prudent man rule rather than its substance. Another possible difficulty is that one may be leading inexperienced trustees towards units or mutual funds. There is some evidence in the United States that such funds, even though professionally managed, produce a lower return than that obtained by the ordinary depositor investing his own money, though understand this to be disputed particularly given the current popularity of mutual funds. But, assuming that the mutual fund does better than the unskilled trustee could achieve by his own unaided efforts, the beneficiaries are at least that much better off.

5. A difficulty which is sometimes raised is that the mere fact of being a trustee imposes prudential duties which do not have to be observed by an ordinary investor. Because they are obliged by law to "play it reasonably safe", trustees thus find themselves in a market in which they are more restricted than ordinary investors who are not so inhibited. This has interesting implications which have not been fully explored. For example, it could be used to develop an argument that the trustee investment law

should be broadened out widely to the point where trustees become liable to beneficiaries only if they depart from that standard of conduct they exhibit in dealing with their own personal affairs; they would then be freed from the normal restraints on trustees. All investors (whether trustees or not) have their own priorities in investing which may preclude particular investments and make others highly desirable; trustees are not peculiar in this respect and this implies that any investment criteria should be sufficiently flexible to accommodate the various priorities.

4.6 **Offshore Financial Centres**

1. There is a remarkable conformity (if not "clinging-to" of old ways) amongst the jurisdictions listed in paragraph 3.1.7 (the "offshore financial centres") in their approaches to the law of trustee investments. They all, in some manner, remain committed to the "legal list" approach. These centres heavily promote so-called "asset protection" or " creditor-proof" trusts for non-residents, relying on well-drawn trust instruments rather than the law for the underlying trustee investment powers. A recent chance to introduce the "prudent man" rule in Belize was passed up in 1992 when their new Trust Law repeated the legal list approach with a Schedule of permissible investments but with the option of allowing a "contracting out": in other words the essential concept that Hong Kong has now. This conformity is underlined, for the Caribbean members of the list in paragraph 3.1.7, by the fact that (a) their domestic companies legislation (e.g. for Anguilla and the British Virgin Islands) is up to 100 years old and (b) their various modern "International Trusts" Ordinances and Laws and so on are focused on everything but the law of trustee investment. This is usually to supposedly enhance the jurisdictions' attractiveness for tax or creditor-avoidance reasons. It is fair to say that tax and creditors have been a predominant motivation and stance in the development of such laws, resulting in a particular slant in them.

2. I myself assisted in the drafting of the first version of the International Trusts Act 1984 (Cook Islands). The law of trustee investments underlying that Act was not considered a suitable topic for extensive revision. Indeed there was a view prevalent - perversely - that if we just rid the Cook Islands "offshore" jurisdiction of inconvenient old rules of equity that no one liked; we ought nevertheless stick with the problematic remainder on the practical basis that at least the lawyers knew where the "pot-holes" were and how to avoid them.

3. I feel that many lawyers in Hong Kong and elsewhere would find it uncomfortable to have their trustee investment law problem-solving capacity eliminated by a Code or a more conceptual approach. This, in my view, is a very good reason for retaining "old ways" in "offshore financial centres" whose legal infrastructure is often minimal. This is not an aspersion on the abilities of professionals in such places: it is a recognition that such persons simply do not have much first-hand domestic experience of trustee investment issues under their own law because the level of domestic trustee investment activity is low - in line with the size of their economies. It therefore is of great assistance to have a standard system with reference to a checklist - the "legal

list" - without resort to the inherent legal difficulties of a conceptual approach such as "prudent man" rule.

4. This is the English approach noted in paragraph 4.1.4. Cayman for instance is quite clear on this approach by adopting a view that what is good enough for England is good enough for Cayman. Their "legal list" approach is similar to that of England's.
I have found therefore that despite many valuable and innovative features in modern trustee statutes of the "offshore financial centres" there is a definite theme of retention of the "legal list" approach. So we in Hong Kong can learn little, I conclude, from such places so far as the law of trustee investments is concerned.

Summary of comparative approaches

1. There seems little doubt that the North American jurisdictions are based on the premise that the "legal list" approach to trustee investments may lead to less satisfactory investment performance even assuming that trustees have appropriate skills in investment strategy. This is an important consideration where investment performance is a significant objective as it will usually be for private trusts of the "dynastic type", for some "fiduciaries" such as managers of pension funds, and institutional investors who happen to be tied by statute to the statutory trustee investments. Of course, it lies in the hands of those who establish such trusts or institutions to confer wider investment powers than those provided by a list, though the existence of an approved statutory list of investments has the tendency to "lead" even experienced trustees towards limiting themselves to the listed categories of investment.

2. No satisfactory method has yet been found of amending the law so as to give free rein to skilled investor trustees, without causing problems for trustees of the private trust of the "maintenance" type. Their selection as trustees may well be the result of considerations such as personal knowledge of the affairs of the beneficiaries, or general wisdom and judgement in human relationships with investment expertise or performance being a secondary factor. Considerable ingenuity has been expended in some countries on amending the "legal list" approach, but (when compared with the "prudent man" rule) these have to be seen as complex compromises which may well impose substantial extra costs on trusts without any countervailing benefits. In changing economic conditions, the apparent "safeguards" of the list approach, exemplified by the Hong Kong Trustee Ordinance, can be illusory, and in any event guard only against certain risks (loss of the nominal value of the capital) and, not necessarily, effectively against others (e.g., erosion of purchasing power through inflation). Nevertheless, there is something to be said for the view that the close personal attention non-professional trustees given to the general administration of at least the "maintenance" type of private trust is more valuable and more attuned to the real objectives of settlors of those trusts than distant professional management that achieves maximum investment return at the risk of exacerbating family differences.
This is not to say, however, that it is not possible to strike a balance between these two extremes.

3. The "offshore financial centres" have generally kept to the "legal list" approach, allowing
"contracting out", and have little domestic trustee investment activity on which they can draw for experience to develop their own laws further.

4.5 THE PURPOSE OF A LAW OF TRUSTEE INVESTMENTS

1. It is generally accepted that the list of authorised investments in the Trustee Ordinance is a list of "prudent" investments and thus permissible for trustees. I submit that the Association should have reservations about a law of trustee investment which is conceived as a mere "backstop" to the powers which would normally be included in a well-drawn trust instrument. Legislation so conceived would provided a list of (relatively) "safe" types of investment, but would make no attempt to cover all forms of investment a trustee might properly undertake, or to protect beneficiaries from inefficient investment policies. I submit the better legislative solution (if it can be achieved) is one which lays down a generalised standard for trustee investment, recognising nevertheless that at least for the normal private trust the creator i.e., the settlor or testator should be free to specify different standards, or particular forms of investment, in their trust deeds and wills.

2. Despite e.g. New Zealand's statutory approach, I can see no basis for differentiating, in the general standards required of trustees, between professional trustees and so-called "non-professional" trustees. The distinction is difficult to make logically and I recognise that nearly all trustees will have expertise in some area, and be selected for that reason. As a matter of general principle, subject to the right where appropriate of the creator of the trust to select a different regime, anyone who undertakes trusteeship should observe proper and objective standards for all facets of their management and administration of the assets entrusted to them. To the extent they lack expertise in particular areas trustees should seek professional guidance or advice. Additional costs to the trust may be involved although these must be balanced against the losses which may result from ill-considered acts or omissions flowing from deficiencies in expertise or judgement.

3. If there is any distinction to be made at all, it should only be between the paid and unpaid trustee. This is alluded to in paragraph 3.3 on regulation of trustees. Under the law as it stands trustees are not entitled, without express provision or court approval, to remuneration for their time and trouble for so acting. It is outside my brief for Part B of this Report to explore the relationship between the extent of the duties imposed on trustees either now or following my recommendations and their reward, with all its implications for fee structures and a review of the general right of trustees to remuneration. For the present I simply note that whether or not a trustee is entitled to remuneration is one of the factors presently taken into account by the courts on being asked to excuse trustees from liability for breach of trust under section 60 of

the Ordinance. I do not suggest any change in this respect.

4. I recognise that, quite apart from the normal private trust, there are particular groups of trust investors who have in the past been linked with the general law of trustee investment, but to whom special considerations apply. One such group is the company pension scheme which is already governed and limited by the provisions of the Occupational Retirement Schemes Ordinance ("ORSO"). Another is the "quango" or other organisation whose power to invest is limited to authorised trustee investments by its empowering legislation. In the case of pension schemes their investment powers are primarily definitive and may not be amended or expanded. ORSO's effect may therefore be more restrictive than the provisions in the Trustee Ordinance where creators of such trusts at least have the right to go beyond the "legal list" and specify in the trust deed different regimes or standards. All such restrictions on investment imposed by existing legislation will require re-examination in light of the principles discussed briefly in this report. The Registered Trustees Incorporation Ordinance excludes "the acquisition of gain" from the objects of trustees wishing to incorporate. It is problematic whether a "prudent man" rule with all its trappings will free or further restrict such trustees. But they would be affected by any change.

5. While I consider trustee investment law should be based on a general standard of prudence and lead to improved returns for beneficiaries by encouraging trustees to look beyond mere matters of security when investing, I do not go so far as to recommend that the law should require trustees to expressly formulate and/or record overall investment strategies or impose on them defined standards of investment performance. But there is a case to be made that trustees need somewhat clearer guidance on their duties in selecting and making investments than is to be found in the typical legislative formulation of the "prudent man" approach. I think this need can be best met by specifying (without being exhaustive) the broad considerations trustees may wish to take into account at that point. Trustees also have somewhat ill-defined general duties of care in monitoring investments from time to time and considering whether those made or held should continue to be retained. I do not think that these general duties should be added to by the imposition of statutory performance standards which might, as a result of ex post facto comparisons of the results actually obtained with those which might have been obtained by different investments or from some other investment strategy, lead to trustees becoming virtual insurers of ongoing investment performance. The imposition of new or wider performance standards is best left for the courts to consider from time to time in the light of contemporary developments in the general law concerning duties of care.

6. While the law of trustee investment is an important area of law which should respond broadly to the needs of society, there should be no scope for governmental or special interest intervention which would result in the preference of one equally satisfactory investment over another, solely on the ground that it is a form of economic activity preferred by the government of the day. It is in the public interest (a) that beneficiaries of trusts are protected by trustee investment rules which will lead to an appropriate return on the trust funds; and (b) that all investors make their own choices as to the investments most suited to their needs, within an economy which is basically

"neutral". The law of trustee investment should not be used to distort that neutrality, however worthy the objectives which might appear to justify such a use.

7. In developing the recommendations which follow, I have taken the view that it is preferable to frame a general law of trustee investments which will lead to the best return for beneficiaries, rather than accommodate the law to the immediate needs of those who currently administer trusts. I accept that, if my recommendations become law, there will be some trustees, particularly those responsible for small private trusts or the small pension funds, who will need to re-appraise their current practices and perhaps seek independent advice or management of the trust fund.

4.6 "LEGAL LIST" OR "PRUDENT MAN" APPROACH?

1. I am of the view that the difficulties with the legal list approach are sufficiently serious to justify abandoning it in favour of a principle which, though less precise, is more suited to modern investment conditions in Hong Kong. The only substantial argument in favour of retaining the legal list, in my view, is that difficulties may be caused to the trustee of the smaller trust if the possible range of investment is not suitably delineated, and no sufficient expertise or advice is available. While I appreciate that it may be very convenient for a trustee to rely on a statutorily authorised list, this is not necessarily in the beneficiaries' interests, and there is no evidence that persuades me that it will be impossible for impractical for the trustee of the smaller trust to meet the standards required under the "prudent man" approach.

2. I can see little advantage in the approach which adopts the "prudent man" rule but adds a statutory list of examples or broad categories of investments This proposal seems to suffer from all the disadvantages of both approaches, and few of the advantages. With respect to the argument that the trustee be under no general duty of care in investing, but solely the duty of honesty and good faith (so he would be liable only for losses caused by investments that he would not have made with his own personal funds), I can find no serious ground that such a change in the law is appropriate, at least at this time, and I am not disposed to pursue it.

3. I am therefore of the view that legislation based on the so-called "prudent man" approach should be adopted in Hong Kong. I do not believe, however, that trustees should be obliged as a matter of law to take any particular consideration into account if that seemed to them inappropriate to the needs of their own trust, nor do I believe that the stated considerations should be treated as exhaustive. There is the reservation that in time, a set of considerations which seemed useful to trustees of the 1990s might become outmoded as investment practices develop in new directions. Nevertheless, I see this as primarily a drafting problem, and recognise that no matter what form of words is adopted, lawyers in future generations will seek to draw restrictive inferences from statutory phrasing which the draftsman did not intend. If the stated considerations are found in due course to have become out-of-date or inappropriate, then they could be reviewed.

I think that the established law reform procedures will be able to accomplish that

much more readily than under the present system, where each new form of investment has to be included in the "legal list", with little prospect of it ever being removed once it has become an authorised investment.

4.7 CHANGES IN OTHER ASPECTS OF TRUSTEE LAW

1. My brief in Part B of this Report is to consider whether the "prudent man" approach is to be preferred to the "legal list" approach, and having reached the conclusion that this is so, further comments I make on other desirable amendments to trustee law are strictly speaking outside that brief. In some cases also, I can only draw attention to a difficulty, without being able to provide a legislative solution. Nevertheless, it is in my view impossible to make a full assessment of the present law of trustee investment without taking these issues into account. While I do not say that the suggestions which follow are an essential corollary of the recommendations on the matters within my brief it is my view that these issues are causing serious difficulties and some distortion of trustee investment decisions and are deserving of immediate consideration and early legislative reform.

2. **Duty to diversify.** The practice of diversifying trust investment among a number of different institutions or different fields of economic activity, will often be a desirable one if the size of the trust funds permit it. However, the proposal that a duty to diversify be written into the trustee investment legislation in my view carries a good idea too far.

   It would be appropriate, however, to include the possibility of diversification as one of the considerations a trustee might take into account in selecting and making investments.

3. **Diligence in investing** - see paragraph 4.5.2 above.

4. **Inflation.** The available literature makes some reference to the legal issue whether the trustee is obliged to try to maintain the real value of the capital of the trust or only its nominal value, in which latter case the life tenant may in effect benefit from the diminution of the real value of capital to the extent, for example, the rate of return on a fixed capital investment although nominally and legally belonging entirely to income, reflects and is intended to compensate for that diminution. There is also discussion of the trustee's general duty to act "even-handedly" as between life tenant and remainderman, a duty which is generally assumed, but I do not think that I should recommend the enactment of any such obligations, since the issue requires study in its own right and should not be dealt with by way of an aside in a Report on the prudent man approach. Nevertheless, I can see advantage in including this, again, as one of the considerations which may be taken into account by the trustee in selecting investments.

5. **The anti-netting rule.** There are two aspects to this issue which require separate consideration.

(a) Under the "legal list" approach, the ambit of enquiry, whether by the trustees in selecting and making investments or by the court in subsequently adjudicating on their propriety, tends to be quite narrow. All investments must come within one of the classes authorised by the list and this necessarily concentrates attention on the particular characteristics of each individual investment proposed or made. It has been suggested, with a good deal of accuracy I believe, that this may militate against adoption by trustees of a portfolio strategy for investment. The essence of such a strategy (which has been the basis of investment education for many years) is to choose a set of investments which minimises the risks for the target level of return being sought. Where an overall investment strategy, shown to be sensible and prudent, has been adopted, the prudence of selecting or retaining particular investments ought not to be judged, I think, only by the characteristics of those investments each viewed in isolation, but their setting within the overall strategy ought also to be taken into account. Adoption of a 'prudent man' approach offers an opportunity to move away from the tendency shown until now by both trustees and the courts to test liability by reference solely to factors relating to each investment taken individually. I would hope that in the future an investment would not, irrespective of its outcome, necessarily be categorised as negligent, and the trustees thus exposed to personal liability, by an enquiry confined to that investment alone. I hesitate to suggest that trustees be automatically entitled to relief from the consequences of making an investment which, although part of what may be otherwise an unexceptional investment strategy, is clearly imprudent for trustees.

Nevertheless, I think a wider approach to the test of prudence is justified and would be encouraged if amongst the considerations a trustee might properly take into account, the legislation includes the overall balance and thrust of the investment portfolio.

(b) Even adopting this wider approach to prudence, it is still possible for trustees to invest negligently, so that they are liable for losses the trust suffers on that account. Under the present law, the so-called "anti-netting rule" may impose undue losses on them. Thus, if they adopt an imprudent investment strategy involving six separate stocks, and five are successful while one fails, the trustees may be liable to repay the trust for the loss of the sixth investment without receiving any credit for the gains on the other five. This is a departure from the ordinary rules for assessment of damages, under which a defendant should put the plaintiff in the position the plaintiff would have been in if the defendant's duty had been performed. In the example given, if the trustees had not acted in breach of trust, they would not have invested in the successful shares either, so that the trust would have made neither the gains nor the windfalls. The rule imposes an unnecessary penalty on the honest trustee who is trying to do the best for the trust, and is by no means invariably applied: see eg Bartlett v Barclays Bank Trust Co Limited [1980] Ch 515, 538. Its continued recognition symbolises the traditional legal over-emphasis on the importance of each individual investment, at the expense of an overall assessment of the investment portfolio as a whole, and it could be abrogated or considerably modified by statute.

6. **Life tenant and remainderman**. Whether a particular receipt is income or capital,

so as to belong to the life tenant or the remainderman, is a matter of strict law in which the trustee has no discretion. By judicious choice of investments, however, the trustee can influence the respective gains of each, though the arts of prediction required will usually make it impossible fully to control what happens. There are arguments in favour of giving the trustee wider powers to allocate particular receipts to life tenant and remainderman. This issue is directly linked with the matters on inflation discussed in paragraph 4.7.4 above. Serious difficulties are caused to trustees, with the result that they may decline to invest in assets which bring such difficulties in their wake. They have a considerable potential to distort the investment pattern of trust moneys.

7. **Delegation of investment powers and common funds.** A noticeable feature of recent investment patterns has been the formation of "pooled funds" which are professionally managed, and where the investor's money is placed in a much larger "pool" of which he takes an appropriate share. There is an assumption made by many trustees and mutual fund managers that this is not an appropriate trustee investment, unless specifically authorised. Further investigation has laid the assumption open to doubt, and it is conceivable that if the "prudent man" approach were adopted this type of investment would be available to a trustee. Again, it is necessary to distinguish two different situations:

(a) The trustee places part of the trust funds on investment in a common fund or unit trust. Under a "prudent man" approach to investment, there should be no special difficulties with these funds as an investment by trustees in them should be justifiable by considerations other than merely the kind of investments made by the fund itself. The quality of the management of the fund ought to be an equally important factor. I note that in this respect there is no essential difference between investment in a "pooled fund" and buying shares in an investment company which in turn holds interests in a number of different enterprises.

(b) The trustee delegates the entire responsibility for selecting and holding investments to a manager. This would appear to be beyond the trustee's statutory powers of delegation unless the delegate were a registered trust company (see Trustee Ordinance ss.25 and 81(1)(d)).

The second of these two situations would seem to call for separate study (perhaps by the existing Working Party which is reviewing the Second Schedule and Part VIII of the Trustee Ordinance); before there was any departure from the general rule against delegation. There would need to be careful consideration of the circumstances in which a general delegation of the investment power was appropriate, and the respective obligations and liabilities of the trustee and the fund manager, both as between themselves and towards the beneficiaries. The question of delegation is developed further in Part C of this Report.

8. **Contracting out**. Like the "legal list" if the new rule were introduced, there must be a legal method for a trustee to adopt a standard different to that laid down by statute.

So I recommend that a trustee can "contract out" of "prudent man" rule under a statutory formula. This might also help the Registered Trustees Incorporation Ordinance problem mentioned in paragraph 4.5.4; as much as the bold settlor who wishes to maximise his trustees' powers.

SUMMARY OF PART B

My recommendations are:

(a) Legislation be adopted enacting the "prudent man" approach to the definition of trustee investments;

(b) The legislation include various considerations which a trustee may properly take into account when investing, provided that these are not to be treated as exhaustive;

(c) Among the considerations which would be included are:

  i) The safety and investment potential of the holdings of the trust, seen as a whole;

  ii) Whether there is need to diversify the investments held by the trust;

  iii) Whether there is need to maintain the real value of the capital or income of the trust during the period of its operation;

(d) Specific legislation provision be made:

  i) Empowering the trustee to take into account the overall balance of the investment portfolio so that particular investments may be regarded as "prudent" if they are an integral part of a total investment strategy which is itself prudent;

  ii) Abolishing the so called "anti-netting" rule, thereby empowering the court (where a trustee has adopted a total investment strategy which is not prudent) to balance the overall losses and gains when ordering that trustee to make good resulting losses sustained by the trust;

(e) Early consideration be given to the urgent need for reform of the law of income and capital, and the legal problems involved in maintaining the real value of trust capital;

(f) Consideration also be given to whether it is appropriate to extend the trustee's power

to delegate investment of the trust fund to a fund manager.

(g) Trustees should have available a statutory formula empowering them to "contract out" of the standards imposed by the new "prudent man" rule.

PART C

RULES OF EQUITY
AND MISCELLANEOUS PROVISIONS

abolition of old laws; delegation; proper law

5.1 Abolition of old laws

1. Trustees in Hong Kong are affected by many rules of equity very few of which are codified or available for ready reference in any one list or authorative compendium. In many cases, those rules were developed in English courts to cope with settlements of title to land and interests in land.

2. It is trite that rules such as that against "double possibilities" are little known to most trust practitioners and unknown to the general public. They appear to have little application in the Hong Kong context and can conveniently be abolished. Because they are occasionally statutory (such as those arising under the administration, property law and conveyancing ordinances) and because they are scattered in the equity cases, the best method is to bring their abolition together in a Part of a "Trustee Amendment Ordinance" which would not need to be reproduced in the resulting new Ordinance since they would not, per se, be amending the existing Ordinance.

3. The simplest method of identifying those rules proposed for abolition is to list them:

- the rule against double possibilities
- the rule against accumulations
- application of the rule in Saunders v. Vautier
- the rule presuming a voluntary settlement to be revocable; and
- the rule against perpetuities

4. This last is the most commonly misunderstood rule and, in my view, serves no special purpose in Hong Kong since it was intended, originally, to promote vesting of landed interests and to prevent an indefinite trust period. I would recommend its replacement with a rule that simply states that a trust shall be required to vest in a natural person or a corporation and if the trust cannot do so (through a deficiency in the trust instrument or through a lack of remaindermen) then the trust property shall be deemed bona

vacantia and devolve accordingly. That is, Hong Kong trusts would have no "perpetuity period".

5. I must re-emphasise the need to carefully examine the property and conveyancing statutes to conform them to the above proposed amendments.

6. I reject introducing the concept of "purpose" trusts in Hong Kong since they can in reality undermine a significant body of trust and commercial law in their practical application. I have seen little real need for them which cannot be served by other legal mechanisms such as incorporated societies. The "purpose" trust is all too often associated with the need to avoid the law rather than promote it and I feel that the Association should not go down that path.

5.2 Delegation

1. This area is very unsatisfactory since a trustee may not delegate at all unless empowered specifically, by trust instrument or statute, to do so. I have previously referred to doubts about the legal efficacy of delegation. I recommend that s.25 of the Ordinance be amended to permit any trustee to delegate any trusteeship responsibility, save for the trusteeship itself, arising under the trust's administration. There is compelling practical need for this. The disaffected beneficiary may always have recourse to the negligent delegating trustee's personal liability as a balance to this proposal. There does not seem to me to be a need to continue to restrict a trustee. This would also assist custodian fiduciaries who wish to appoint sub-custodians.

2. In other words, trustees are so commonly caught by the restriction on delegation, it should be converted to a power to generally delegate but, as noted in paragraph 4.7.7 there would need to be a careful review of the circumstances in which this power can be exercised. I recommend that a separate study of this be undertaken since it is major step for the Association to promote and it is very difficult to obtain helpful views from other jurisdictions which might apply in the Hong Kong context.

5.3 Change of Proper Law

1. The proper law of trusts is one of the most debated areas of trust law and is ignored in many circumstances because it is misunderstood or unknown by too many. There are two views:

   i) trustees should be content with the "law on change of the proper law" as it stands;

   ii) the rules should be codified to give trustees a statutory formula which they must adopt should they (or any other person having the requisite authority) choose to cause a change in the proper law of a trust.

2. For the reasons given in paragraph 5.3.1 above, I favour the second view and

recommend that the Ordinance be amended to give the trustees the stated formula. so long as they comply with the formula, a lot of dispute and doubt - particularly on transactions involving change of jurisdiction of trust administration - will be resolved. I have in mind the special problems of custodian trustees and fiduciaries of securities traded internationally through sub-custodian account holdings. The issue there is to differentiate between the situs of administration of a fiduciary relationship and the situs of the trust property. The concept of the proper law of a trust has developed in line with the political and juridical concept of the nation state's jurisdiction and is now a hindrance to commerce, not an asset, so the rules ought be changed. This is an uncontroversial recommendation but one which will remove many jurisdictional problems and questions about trustees' authority over their trusteeships.

5.4 Comparative Approaches

1. Part C contains such a patchwork of legal miscellany that any jurisdictional comparisons are not very helpful save that many "offshore financial centres" have taken the path recommended in paragraph 5.1 except, inexplicably, for the recommendations on abolishing the perpetuity period for a trust.

2. Delegation and change of proper law have received intense attention in recent years in commercial cases, surprisingly, in New York and London. In the end it is a matter taking a policy stance that delegation is desirable; that trustees (and others) should be able to change the proper law; and promoting the amendments without recourse to complex analysis of what other jurisdictions, with different circumstances, might have done or not done in these areas.