AN ECONOMIC ANALYSIS OF THE LEGAL CONCEPT OF TRUSTEES' POWERS OF INVESTMENT

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1. INTRODUCTION

Economists are interested in the relationship between the financial sector and the real sector; rates of interest determined in financial markets affect decisions to save and invest and thus affect the level and composition of real economic activity. Financial institutions and financial markets do not exist in an institutional and legal vacuum; rather the operation of financial institutions and financial markets is influenced strongly by the legal structure relating to financial institutions and financial securities. In any economy there is a wide variety of laws and regulations affecting the establishment of financial institutions and the relative status of financial securities. Moreover, legal status of the financial sector is under periodic review with official inquiries into the operation of the financial system a common aspect of the economic environment.

Trustees' powers of investment have been regulated by legislation. For a long period in Australia, the legislation spoke of authorised trustee status which is a particular legal concept, designed for the specific legal purpose of giving guidance to trustees in the discharge of their duty of investment of trust assets especially in circumstances where the trust deed creating the trust and appointing the trustee is silent or incomplete. However, the concept of authorised trustee status has economic implications as it affects, first, the relative status of financial securities (and other assets) and, second, by implication, the relative status of the financial institutions which create the financial securities given authorised trustee status.

Economists are concerned to give and economic analysis of legal concepts to expose unintended consequences of those concepts. The legal concept of authorised trustee status is analysed to determine if the actual economic outcomes are those envisaged or intended. The analysis uses standard economic portfolio theory to determine if the concept of authorised trustee status can lead a trustee to an optimum portfolio. The analysis further considers the effects of authorised trustee status on the wider operation of financial markets particularly, where the legal concept of authorised trustee status differs between jurisdictions in the Australian Federation.

Recent legislative changes have provided a wider definition of trustees' powers of investment relying on the prudent person approach. This new concept is analysed and improvements to the concept are considered.

In this context the recent amendment of trustees' powers of investment made in South Australia is considered in the light of the previous discussion and analysis.

2. THE LEGAL CONCEPT OF AUTHORISED TRUSTEE STATUS

Trusts are legal devices[1] which separate legal and beneficial ownership of assets. Under a trust, the trustee legally owns the assets of the trust but is required to manage the assets for the benefit of the person or persons nominated by the legal instrument which sets up the trust. Trusts may be created in a variety of ways, the most common of which is the trust deed which also authorises the trustee to hold the trust assets in particular forms. Some trust instruments do not provide complete details of the trustee's powers of investment while other provide instructions which have been rendered inappropriate or inoperable by changes in the financial environment.

Trustees, who do not receive complete or contemporary instructions from the trust deed, may apply to the courts for relief. Because this is usually time consuming and expensive, governments have provided legislative relief by designating certain investments as being ones trustees are allowed to hold. Such legislatively approved investments are referred to as having "authorised trustee status".[2]

[1] A legal description of a trust is "A trust exists when the holder of a legal or equitable interest in certain property is bound by an equitable obligation to hold his interest in that property not for his own exclusive benefit, but for the benefit, as to the whole or part of such interest, of another person or persons or for some object or purpose permitted by law." Meagher and Gummow, *Jacobs' Law of Trusts in Australia*, fifth edition, Sydney, Butterworths, 1986, p7

[2] Further detail is given by R V Forgione, *An Examination of the Concept and Potential for Harmonisation of Authorised Trustee Status on Financial Institutions and Markets in Australia*, LLM dissertation, University of Queensland, 1993

3. DUTIES OF TRUSTEES

Trustees have certain duties[3] to perform in relation to the management of trust assets; these have been explained in the following way in an extract from the Model Code.

"In the exercise of his powers of investment the trustee shall consider:-

(a) the trust funds as a whole, the nature, composition and purposes of the trust and its anticipated duration;

(b) the needs and circumstances of the beneficiaries;

(c) the suitability of the investments held and of investments proposed;

(d) the need for diversification of investments;

(e) the administrative costs, including commission, fees, charges and duties payable, of making or varying any investment;

(f) the taxation consequences of making or varying any investment; and

(g) the possible impact of inflation or deflation."

The trustee is, thus, to take into account the particular circumstances and needs of the beneficiary and under certain circumstances the opinion and desires of the beneficiaries as well as the extent of the trust powers before deciding on the appropriate investments.

The duties of trustees are, in fact, to act as portfolio managers and to allocate trust assets to securities to further the goals of the trust. Some significance is placed on the fact that, as there are formal qualifications for a trustee, inexperienced persons not versed in modern financial practices may be appointed to act as trustees. The concept of authorised trustee status is thus seen as a device to provide some investment guidance to such trustees.

However, it would appear that in the broadest sense, mechanically selecting investments from a legal list would not discharge the duties of a trustee.

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[3] Further explanation of the legal basis of these duties is given in Ford and Lee*, Principles of the Law of Trusts*, Sydney, Law Book Company, 1990 and Lee (ed), Model Trustee Code for Australian States and Territories, Working Party, 1989

Generally, as a matter of practices, trustees are considered to have a "cast-iron" defence to allegations for failure to perform their duties if they can show that all trust assets were held in forms having authorised trustee status.

4. APPROACHES TO AUTHORISED TRUSTEE STATUS

There are three major approaches to the determination of authorised trustee status which can be indicated as follows:

1. the legal list
2. the credit ratings
3. the prudent person

The Legal List

The Australian States have traditionally used the legal list approach under which the relevant act (in Queensland it is the *Trusts Act)* specifies a list or schedule of assets which have authorised trustee status. In Queensland, the legal list comprises the following:

(a) in any of the parliamentary stocks, public funds or Government securities of the United Kingdom, of the Commonwealth, of any of the States of the Commonwealth, or of the Dominion of New Zealand;

(b) on first legal or first statutory mortgage of an estate in fee simple in land in any State or territory of the Commonwealth; or first statutory mortgage of Crown land held on perpetual lease in the State;

(c) in the purchase:

  (i) of land in fee simple in any State or Territory of the Commonwealth;
  (ii) of leasehold land in the State held for a term of forty years or more unexpired at the time of the purchase; or
  (iii) subject to the provisions of the Land Act *1962-1971* of any agricultural farm or grazing homestead freeholding lease of land from the Crown under the Act;

(d) in debentures or other securities charged on the funds or property of the Brisbane City Council or of any Local Authority in the State;

(e) in any more of the following, namely:

(i) on any interest bearing term deposit in any bank;

(ii) on the security of a certificate of deposit issued by any bank; and

(iii) on deposit in any savings bank;

(f) with any dealer in the short term money market, approved by the Reserve Bank of Australia, as an authorised dealer, who has established lines of credit with that bank as a lender of last of last resort;

(g) in any security in respect of which repayment of the amount secured and payment of interest thereon is guaranteed by the Parliament of the United Kingdom or Commonwealth or any State of the Commonwealth or New Zealand;

(h) in any of the stocks, funds or securities for the time being authorised for the investment of cash under the control or subject to the order of the Court;

(i) in any security authorised by, or under, any Act as a security in which a trustee may invest funds;

(j) in the common trust fund of a trustee corporation under the Trustee Companies Act 1986;

(k) in the purchase of shares in, or in the deposit of moneys with, a permanent building society approved for that purpose under the Building Societies Act 1985.

The guidelines in respect of building societies were contained in Regulation 33A which provides:

(a) the society shall have carried on business as a permanent building society without interruption for a period of five years immediately preceding the date of application, provided that where the society was registered as an amalgamated building society during that period it shall be sufficient if -

(i) at least one of the two or more building societies which were registered as the amalgamated building society carried on business as a permanent building society without interruption from the commencement of that period until the amalgamation; and

(ii) the society then carried on business without interruption up to the date of the application;

(b) the society (including, where the society was registered as an amalgamated building society, each of the two or more societies which were so registered) shall not at any time in the period of five years immediately preceding the date of application have been convicted of any offence against the Act or repealed Act;

(c) the society shall throughout the period of five years immediately preceding the date of application have achieved a sound financial position and performance. Where the society was registered as an amalgamated society during the period it shall be sufficient if -

(i) one of the two or more building societies which were registered as the amalgamated building society achieved a sound financial position and performance from the commencement of the period until the amalgamation; and

(ii) the society then achieved a sound financial position and performance up to the date of the amalgamation;

(d) the society shall hold resources (as defined in section 55(2) of the Act) equal to not less than 15 per centum of the total of the members paid up share capital and deposits held with the society;

(e) the repayment of all moneys owed to the society and secured by mortgage on freehold or leasehold land situated in the State shall be insured by a mortgage insurer.

The legal list approach is common among the States of the Commonwealth although the details differ between States; an indicative rather than a comphrensive comparison based on the classification of the Law Reform Commission of Western Australia is given below:

Investment:	NSW	Vic	Qld	SA	WA	Tas
Bank deposits	Yes	Yes	Yes	Yes	Yes	Yes
Bank certificates of deposit	No	Yes	Yes	No	No	No
Bills of Exchange Bank Accepted or Endorsed[4]	No	Yes	Yes	Yes	Yes	No
First mortgages	Yes	Yes	Yes	Yes	Yes	Yes
Commonwealth Government Securities	Yes	Yes	Yes	Yes	Yes	Yes
Semi-Govt securities	Yes	Yes	Yes	Yes	Yes	Yes
Common funds[5]	No	Yes	Yes	No	Yes	No
Shares	No	No	No	No	Yes	No
Unit trust schemes	No	No	No	No	Yes	No
Real estate	No	Yes	Yes	No	No	Yes
Purchase of a dwelling house for beneficiary	Yes	Yes	Yes	No	Yes	No

[4] Bill financing grew in importance in the 1980s and the commercial bills market is now a major private financial market in Australia. Bills, accepted or endorsed by banks, are low risk securities. Most bills on issue in Australia are bank accepted bills comprising about 85 per cent of the market. Bank endorsed bills are priced at a small discount to bank accepted bills reflecting a higher risk.

[5] Common funds are pooled investment funds of Trustee Companies which are established under State law and have special privileges. Common funds are similar to public unit trusts except that the role of manager and trustee is combined in common funds. An extended explanation is given in Jon D Stanford and Timothy G Beale, The Law and Economics of Financial Institutions in Australia, Sydney, Butterworths, 1995

In Western Australia, the Trustees Act has provided since 1962 that trustees may invest in equities subject to meeting all the following criteria:

(a) the equities are issued by companies incorporated in Australia;

(b) these companies have a minimum paid up capital of two million dollars;

(c) the equities are ordinary shares quoted on an Australian stock exchange;

(d) the shares have paid a dividend in each of the fifteen years preceding the year in which the investment is made.

This Act also provides that trustees may hold other securities issued by companies which satisfy the criteria above.

The rationale of the legal list approach is that the list indicates assets which have a low risk of default and which would be generally considered to be sound investments. The list includes securities which are issued or guaranteed by government and liabilities of banks which are subject to close official prudential supervision by the Reserve Bank of Australia. Freehold real estate and first mortgage on such real estate would command general support as a safe investment.

5. THE CREDIT RATINGS APPROACH

This approach give authorised trustee status to a security which has an approved credit rating from an approved credit rating company. This approach has evolved out of the practice followed in a deregulated financial market where portfolio managers routinely use credit ratings to define eligibility of securities for inclusion in portfolios. It is common for portfolio managers to adopt a blanket rule excluding from consideration securities which have a credit rating below a specified minimum.

The use of credit ratings of securities is now widespread and credit rating companies now issue sovereign credit ratings changes in which receive much publicity.

The two major credit rating companies, Moodys and Standard and Poors, have been active in Australia for some years and have achieved a strong market standing and credibility. The credit rating companies rate securities and their issuers by the probability that the security will make payments in full and on time. The most widely known credit rating system is the alphabetical one in which the highest rating is AAA then descending to AA, A, BBB and so on. A credit rating of AAA is top-flight representing a minimal risk while a credit rating of BBB is considered to be investment quality. (As an indication of the credit rating it can be noted that some Australian regional banks whose financial standing is unquestioned have a rating of BBB.)

6. THE PRUDENT PERSON APPROACH

In the United States of America[6], the prudent person approach has generally been adopted as the majority of States do not have a legal list. The principles underlying this approach are that sound diversification is fundamental to risk management so it is required of trustees in the ordinary course of their duty and that, as risk and return are directly related, trustees have a duty to analyse and make conscious decisions concerning the level of risk appropriate to the circumstances of the trust[7]. The prudent person rule has been considered to be a tautology as trustees have a general duty to be prudent while US courts have limited the generality of the approach by ruling certain investments to be "prima facie" imprudent. New Zealand has also adopted a prudent person approach.

The general trend in the USA has been to move away from the prudent person approach to a prudent investor approach under which the trustee is permitted to consider the whole portfolio as well as other funds held by the beneficiary. The prudent investor approach requires the trustee to consider a total return concept and to diversify risk as contrasted with the legal list approach under which a single stock could be retained if it were prudent or approved.

The approach to authorised trustee status in the UK differs from that in Australia. Under *The Trustee Act of 1925 (UK)* only a restricted power of investment (excluding land, for example) was given intending this as a safeguard for the beneficiaries against losses occasioned by

[6] Some small Canadian provinces have adopted the prudent person approach; New Zealand did so in 1988

imprudent investment of the trustees while, at the same time, protecting the trustees from liability from the beneficiaries for losses arising from their investment of trust funds. The criticism of this legislation was that it failed to make allowance for the far reaching changes in the economy there being no security in the capital of a trust retaining a paper value of ten thousand pounds if the real value of the pound has, as a result of inflation, been reduced to 50 pence[8].

Under The Trustee Investments Acts 1961 (UK) trustees are required to divide the trust funds into two parts referred to as the "narrow-range part and the wider-range part". Some investments eligible for inclusion in the narrow-range part, typically risk-free fixed interest securities whose capital value does not fluctuate, may be selected by the trustee without advice whereas the trustee may select other securities whose capital value may fluctuate (typically government long term securities, mortgages on freeholds or long leaseholds) only after first obtaining expert advice.

The trustee is not required to hold securities which are eligible for inclusion in the wider-range part (such securities are ordinary shares) but if such securities are held the trustee must obtain prior expert advice, which must be in writing, from a person believed by the trustee to be qualified. The trustee cannot repose blind faith in the expert advice because the trustee must act personally and cannot delegate such decisions.

7. ECONOMIC ANALYSIS OF AUTHORISED TRUSTEE STATUS

The role of a trustee is that of portfolio manager and as such the trustee has to consider the following general principles[9] of portfolio management in terms of the goals that would be sought by a portfolio manager:

1. maximum return on the portfolio;
2. maintenance of liquidity position;
3. capital gains;
4. security of portfolio;

[7] *Restatement of the Law of Trusts*, The American Law Institute, 1992, p15
[8] Pettit, *Equity and the Law of Trusts*, sixth edition, London , Butterworths, 1989 cited in Forgione, op cit.
[9] Jon D Stanford, *Money, Banking and Economic Activity*, Sydney, John Wiley, 1973, p34

5. limitation of debt position to that which can be services without strain[10].

In order to originate or implement a portfolio on behalf of beneficiaries, a trustee would be required:

(a) to give careful consideration to the beneficiaries's circumstances, needs and objectives, given the prospective maturity of the trust;
(b) to follow a logical process in establishing the beneficiaries's goals;
(c) to understand the basic principles of portfolio management;
(d) to have a knowledge of available financial assets and securities of beneficiaries;
(e) to determine a portfolio in the light of these previous considerations;
(f) to review the portfolio in the light of changing circumstances.

Beneficiaries' needs and objectives will be determined, in part, objective factors such as age, state of health, marital status, employment and financial circumstances apart form the trust. Younger people, for example, may be more concerned with longer term growth of assets than with immediate income; younger people are more likely to have dependent children; and to have more commitments. Older people generally would have a need for income and a lesser interest in capital growth of assets. In addition, there are critical ages at which beneficiaries may become eligible for social security and other benefits. The current and prospective state of health is important in determining the needs of beneficiaries. For instance, a beneficiary in poor health which is likely to deteriorate significantly to require a personal attendant or regular nursing has quite different needs to one in good health.

Marital status is a determinant of needs and objectives of beneficiaries; for example, married people have joint needs and commitments. Divorced people may have commitments to a former spouse and dependent children which are determined, and can be enforced, by the courts. Marital status also determines some taxation matters.

Whether beneficiaries are employed will determine their income; full time employment provides for a regular income and probably job related entitlements. Part-time or casual

[10] It would presumably be rational in an economic sense for a trustee to incur debt in some cases in, for example, investment in real estate for longer term capital gain. Whether this would be a "speculative" investment or otherwise would be allowable to a trustee is a legal question which will remain unanswered this paper.

workers enjoy fewer of these benefits as well as having lower and less certain incomes. Self employed people may have fluctuating incomes; some people, professional athletes are a good example, have high incomes for relatively short time periods.

The current balance sheet position, outside the trust, of beneficiaries is a determinant of the needs and objectives of those beneficiaries. Beneficiaries with wealth and little debt will have different needs to others with no accumulated assets but with debt outstanding.

The existence of all these considerations relating to the needs, circumstances and objectives of beneficiaries requires trustees to follow a logical process to arrive at an operational statement of the portfolio objectives. Certainly, determination of beneficiaries' goals and, thus, of the portfolio is not a mechanistic process; trustees must be alert to anything special or out of the ordinary and it would appear to be a reasonable requirement on trustees for them to maintain a checklist of items considered and some records to show the process by which they arrived at the goals.

The principles of portfolio management, which will be examined further below, are that a diversified portfolio, a collection of assets with different risk profiles, will carry reduced total risk to an undiversified portfolio. Hence we can say as a general proposition, which is examined more technically below, trustees would be required hold a diversified portfolio and would not discharge their duties by placing all the trust funds in any one single asset.

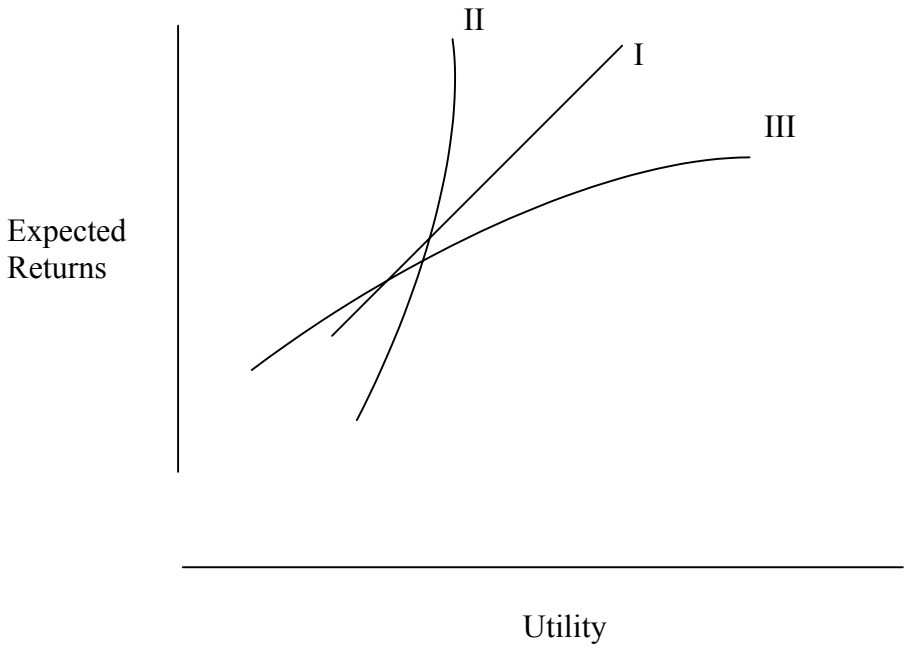
The trustee must necessarily have a knowledge of financial assets and securities in determining what assets are eligible for inclusion in the portfolio. The legal list approach bears directly on this matter by restricting the trustee's choice of eligible assets.

The process of portfolio management involves the steps of determination of the goals of the portfolio, based on the needs and objectives of the beneficiaries, matching of assets to meet these goals and the selection of a particular set of assets to comprise the portfolio. The portfolio further needs to be reviewed over time to ensure that it continues to achieve the goals. The need for portfolio review arises from the changes in needs and objectives and from the change in rates of returns available to financial assets. Changes to yields can occur as a result of counter-cyclical variations in interest rates and rates of return and variations in the yield curve.

8. PRINCIPLES OF PORTFOLIO SELECTION

The general approach to portfolio choice theory, originally developed by Markowitz[11] and Tobin[12], relies on the assumption that every portfolio manager is able to attach a subjective probability to future events so that the expected utility of any outcome can be determined. The expected utility of any outcome is a product of the expected return to any outcome and the probability distribution of that outcome. The three general forms of the expected utility function are shown in Diagram 1 where I represents constant marginal utility of expected return; II, diminishing marginal utility of expected return and III, increasing marginal utility of expected return.

Diagram 1: Three Forms of the Expected Utility Function

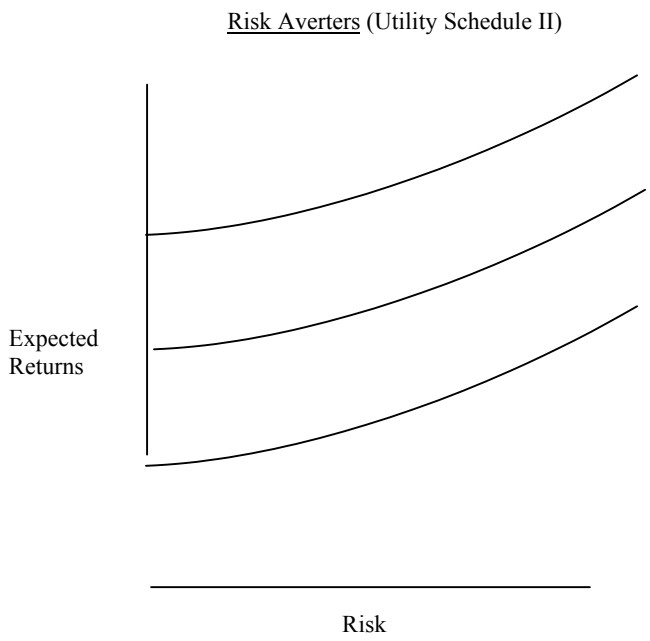


In this approach, the portfolio manager seeks to maximize expected utility subject to a wealth constraint, the total amount of funds available to the portfolio manager, and in the face of a set of given market prices of financial prices. It is further assumed that the general case is that

[11] H M Markowitz, "Portfolio Selection", *Journal of Finance*, 7, 1952, 77-91; H M Markowitz, *Portfolio Selection: Efficient Diversification of Investments*, New York, John Wiley and Sons, 1959.
[12] J Tobin, "Liquidity Preference as Behaviour Towards Risk", Review of Economic Studies, 25, 1958, 65-86

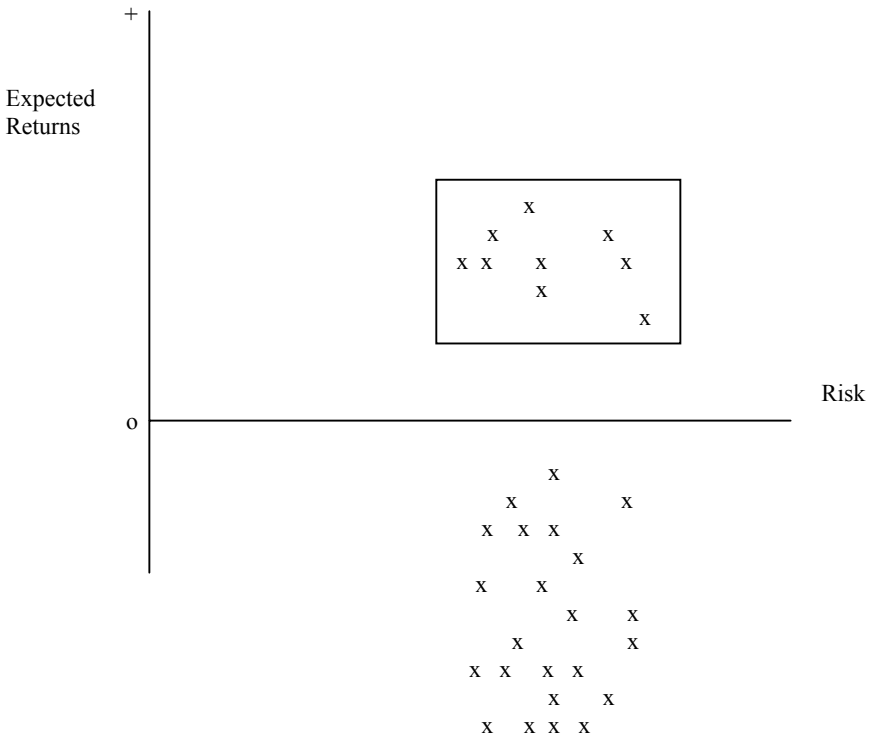
of risk averse portfolio managers, that is, with diminishing marginal utility. Such portfolio managers will accept greater risk only if compensated by increased expected return. This relationship is shown in Diagram 2 which represents the indifference curves (iso-utility curves) of risk averse portfolio managers.

Diagram 2: Indifference Curves of Risk Averse Portfolio Managers



The measurement of expected return is given by the mean or mathematical expectation of the return on a given portfolio. While the measurement of risk poses some severe difficulties, the Markowitz/Tobin approach measures risk by the degree of dispersion of the expected return of the portfolio around the mean, that is, by the variance. The set of feasible portfolios available to a portfolio manager is defined by the estimated return and risk combination and it is envisaged that there is a number of possible portfolios described by expected return and risk.

Diagram 3: Set of Feasible Portfolios

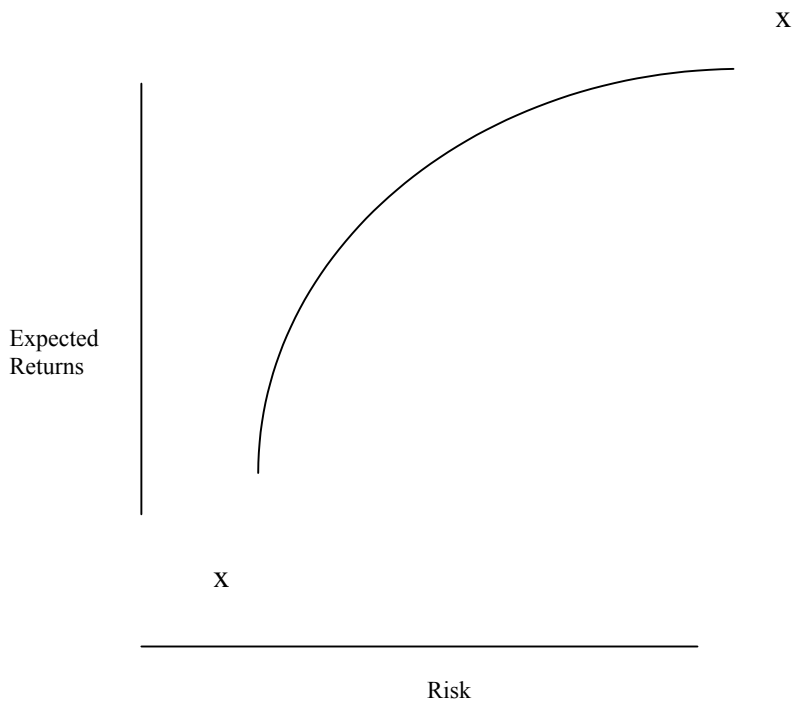


The principle of diversification asset holdings as a way to reduce can be stated as:

> If the probability distributions of the expected returns from individual assets are independent of each other, then the uncertainty of the collective return of a diversified portfolio will be less than the weighted average of the risks attaching to the individual assets comprising the portfolio.

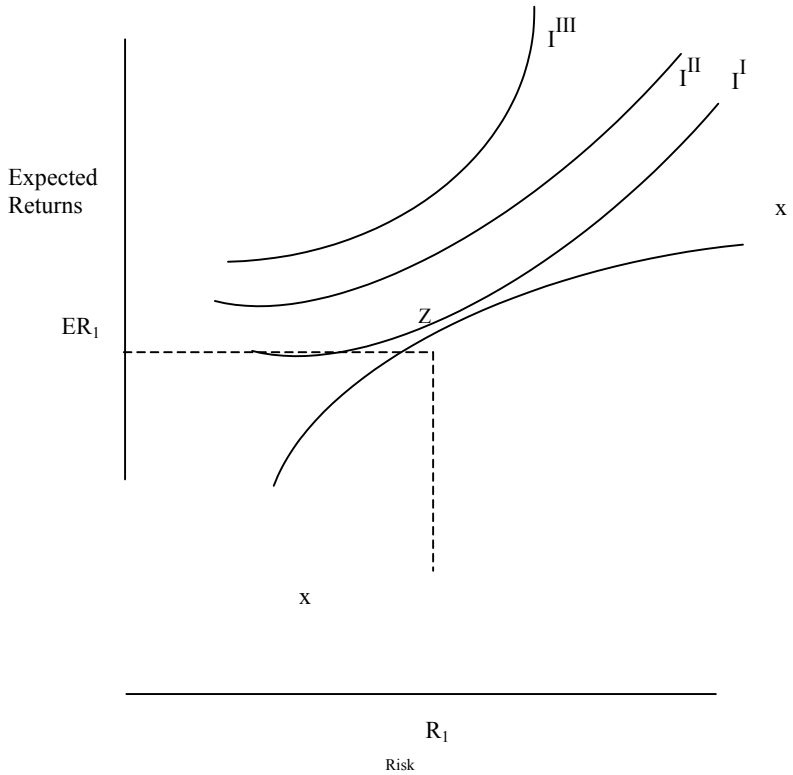
A portfolio manager will be concerned to select an efficient portfolio defined as a portfolio in which it is impossible to obtain a higher expected return with no greater risk, or to obtain greater certainty of return with no less expectation of return. The set of efficient portfolios is selected from the set of feasible portfolios by eliminating inefficient portfolios. Given the portfolio manager's wealth and given market conditions, the efficient opportunity frontier (which separates efficient from inefficient portfolios) is represented by the line XX below.

Diagram 4: Efficient Opportunity Frontier



The optimum portfolio is determined, diagrammatically, by combining indifference curves and the efficient opportunity function as shown below in Diagram 5.

Diagram 5: Illustration of Optimum Portfolio



The optimum portfolio is represented by point Z at which the portfolio manager selects a portfolio with an expected return of ER_1 and with a risk of R_1. The optimum portfolio will depend on the following factors:

1. the tastes and preferences of the portfolio manager;
2. the portfolio manager's subjective valuation of the probability of future events;
3. the market opportunities available to the portfolio manager.

9. CHANGES IN THE OPTIMUM PORTFOLIO

Changes in the optimum portfolio can be illustrated using the standard analysis developed by Tobin in which there are only two assets, one risk free and the other risky. Subject to an number of limiting assumptions the most significant of which[13] are that individual portfolio managers do not hold a definite view about the future market yield of the risky asset but can express their views in terms of an estimate of its probability distribution and that the expected future yield of the risky asset is independent of its current rate.

The expected return to the risk free asset is zero while the expected return to the risky asset is (r + g) where r is the coupon rate of return and g is the expected capital gain or loss. The risk attaching to the risky asset is given by Sg. The proportion of the portfolio in the risk free asset is A_1 and the proportion in the risky asset is A_2 such that $A_1+A_2 = 1$. The expected return to the portfolio as a whole depends on the proportion of the risky asset in the portfolio; similarly the risk attaching to the portfolio depends on the proportion of the risky asset in the portfolio.

Hence the return to the portfolio is given by $A_2*(r+g)$; since g is a random variable with an expected value of zero, the expected return (E_r) to the portfolio is A_2*r.

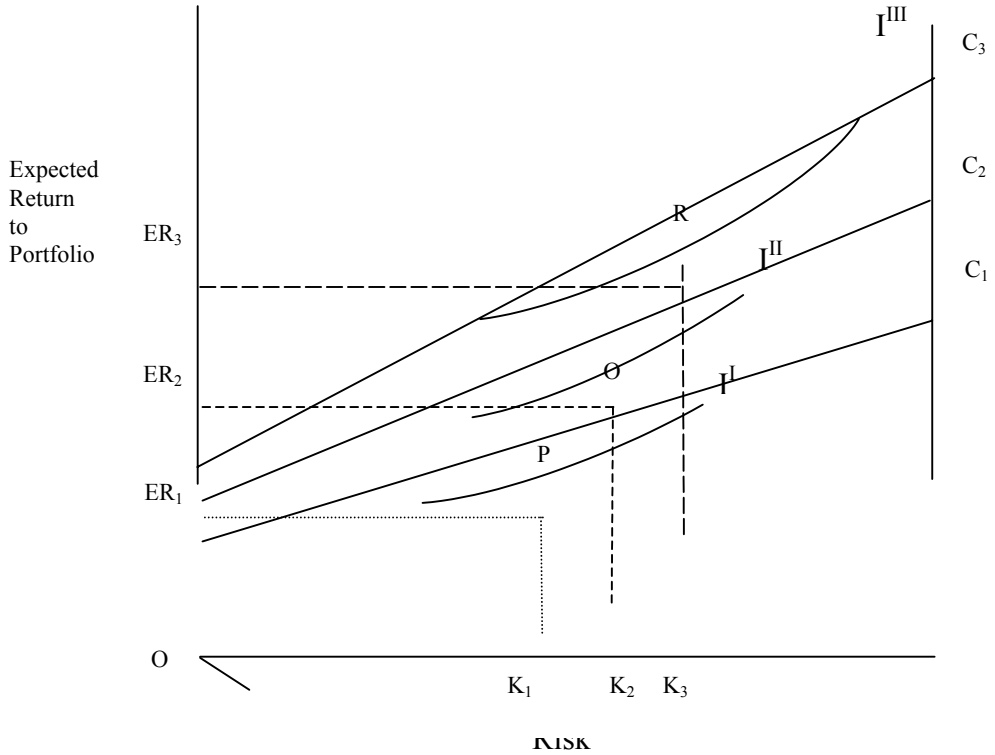
The risk attaching to the portfolio, S_r, is A_2*Sg ie the proportion of the portfolio in the risky asset by the risk attaching to the risky asset.

[13] Others are: the yield on the risk free asset is zero; the future yield of the risky asset is uncertain; the portfolio size is given; the proportions of the portfolio in held in the two assets does not depend on the size of the portfolio and cannot be negative. Transaction costs are ignored.

The determination of the optimum portfolio under three market conditions (the three conditions are where the nominal yield on the risky asset is r_1, r_2, and r_3 such that

$r_1 < r_2 < r_3$) is shown in Diagram 6 below. At a rate of return on the risky asset of r_1, the efficient opportunity frontier is OC_1, at r_2 is OC_2, and at r_3 is OC_3. At r_1, the optimum portfolio is represented by P (with expected return to the portfolio, ER_1 and degree of risk, K_1; at r_2, the optimum portfolio is represented by Q (with expected return to the portfolio, ER_2 and degree of risk, K_2; while at r_3, the optimum portfolio is represented by R (with expected return to the portfolio, ER_3 and degree of risk, K_3) such that $ER_1 < ER_2 < ER_3$ and $K_1 < K_2 < K_3$. Hence, the optimum portfolios are consistent with the assumption of risk averse portfolio managers.

Diagram 6: Optimum Portfolios under Three Conditions



Changes in Market Yields

A normal yield curve is usually regarded as the usual indication of the term structure of interest rates but the Australian experience suggests that a normal yield curve is not more prevalent than an inverse structure which is more common in economies experiencing inflation problems[14]. Inverse yield curves tend to occur in response to restrictive monetary policies. Interest rates are cyclical with short term rates being more variable than long term rates. However, the market price of long term securities are more variable than short term securities giving rise to capital gains and losses[15].

This behaviour of interest rates in Australia supports the proposition that changes in the relative yields of financial assets will occur over time and over the business cycle requiring portfolio managers to adjust their portfolios to take account of changing circumstances.

Analysis of the Concept of Authorised Trustee Status

The advantages of the legal list approach are that such a list provides an unequivocal guidance to trustees as to which particular securities ought to be considered in the portfolio choice and moreover directs the attention of the trustee to securities which are at the low risk end of the spectrum of financial assets.

The disadvantages of the legal list approach are numerous and taken in their entirety significant. First, the legal list can be out of date and fail to reflect current financial practices and current securities. This was a criticism of the Campbell Committee, while accepting that there was a need for State legislation to prescribe investments which are eligible where trust deeds are silent or particularly restricted as to investment powers, maintained that this legislation ought to have regard for modern instruments of financing and investment[16] and that there should be arrangements for periodically reviewing trustee securities to ensure that

[14] For an extended discussion of the behaviour of the yield curve, see B Hunt and C Terry, *Financial Instruments and Markets*, Melbourne, Thomas Nelson, 1993, especially Chapter 8

[15] Hunt and Terry note that, in general, interest rates are mean-reverting, that is, while they fluctuate from time to time there is a tendency to return to some long-run average rate so that an inverse yield curve is more likely to occur when interest rates are historically high. This experience violates one of the assumptions of the analysis of Tobin.

[16] Final Report, para 21.193

those which meet appropriate criteria are not excluded and that the retention of trustee status for others is desirable[17]. The Brady Committee criticised the legal list approach as being inflexible recommending the establishment of Trusts Investment Review Committee, comprising persons knowledgeable in finance, securities and trust law, to make recommendations to the Minister in respect of changes to the assets to be included in the list of authorised trustee status[18]. The South Australian government recognised both that maintaining an up-to-date list in the Act and Regulations requires substantial administration by the Government (in regular monitoring and review of, for instance, prescribed entities involving checking of their status, credit-worthiness and names changes and in review of requests for addition to the list) and that this was no, in fact, done[19].

The Brady Committee had recommended that a flexible legal list approach be adopted and that the list[20] include the following:

(a) land;
(b) first mortgage on land;
(c) securities or guaranteed by the Commonwealth or State of the Commonwealth;
(d) all deposits of banks;
(e) bills of exchange accepted or endorsed by a bank;
(f) deposits with authorised dealers in the official short money market;
(g) trustee company common funds which hold only authorised trustee investment as (a) – (f) and (h);
(h) any other investment which has a prescribed rating by a prescribed rating company.

In addition, the Brady Committee recommended that authorised trustee status should not be granted through Acts other than the Trusts Act and that a Trusts Investment Review Committee be established to make recommendations about changes to the list to the Minister.

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[17] Final Report para 21.194
[18] [The Brady Committee] Report of the Committee of Inquiry into Non-Bank Financial Institutions and Related Financial Processes in the State of Queensland, Brisbane, Government Printer, 1990, pp 135-6
[19] Second Reading Speech, Trustee (Investment Powers) Amendment Bill, House of Assembly, Tuesday, 11 April 1995, p 2260
[20] Report pp 138-9

The Brady Committee recommended that the minimum credit rating[21] as applying in respect of (h) above be the Standard and Poors rating of "A" or the equivalent rating of Moodys (both Standard and Poors and Moody being prescribed rating companies). This minimum rating was lower than the "AA" rating adopted by the New South Wales government but the Brady Committee concluded on the basis of evidence presented to it that its recommended rating of "A" would be a prudent standard for the determination of authorised trustee status and that this level of rating would adequately discriminate between securities.

In commenting on the Brady Committee approach, it can first be noted that the proposed flexible list would eliminate certain securities, deposits with building societies, secondary mortgage market securities[22], deposits with the Queensland Industry Development Corporation and deposits with the Queensland Treasury Corporation, QTC, a central borrowing authority of the Queensland government. This is in accordance with the views that authorised trustee status should not be granted to give favourable treatment to certain financial institutions or classes of financial institutions and that authorised trustee status should not be granted in Acts other than the Trusts Act. Deposits of the QIDC and the QTC would qualify for authorised trustee status under (c) above being securities guaranteed by the State of Queensland. It can be further noted that this flexible list approach introduces one anomaly in that some banks do have a credit rating below "A", although still of investment grade, and as such their deposits would not qualify for authorised trustee status under (h) but they do qualify under (d). This flexible list approach resolves some of the problems identified with the legal list approach but do not overcome the more fundamental objections to the legal list approach considered below.

Second, adherence to the legal list can lead to unexpected and unfortunate consequences. Two examples from the recent financial history[23] of Australia illustrate this only too well. It has been previously noted that the Western Australian legislation granted authorised trustee status to certain shares and to other securities issued by those companies which meet the test of eligibility. The existence of such a provision lead to the liabilities of Rothwells Limited, a merchant bank located in Perth, Western Australia, which failed amidst dramatic and

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[21] Report p138

[22] The Brady Committee made specific recommendations about the secondary mortgage market: Report pp 139-143

[23] The best general account of this period which examines some instances in detail is Trevor Sykes, The Bold Riders - Behind Australia's Corporate Collapses, Sydney, Allen and Unwin, 1994

controversial circumstances. Rothwells Limited, originally a company engaged in the business of menswear retailing in Brisbane, Queensland, had solid if unremarkable success allowing it to pay dividends for an uninterrupted period greater than 15 years. The directors of Rothwells Limited decided to close the menswear business and cease active operations whereupon Rothwells Limited became a shell. The shell was acquired by an well-known Western Australian entrepreneur, Mr Laurie Connell, who used the shell company as the launching vehicle for his new merchant bank, Rothwells Limited. Because the dividend history of Rothwells Limited in its former guise as a menswear retailer in Brisbane satisfied the eligibility criteria in the Western Australian legislation, shares of, and securities issued by, Rothwells Limited gained authorised trustee status in Western Australia. On the failure of Rothwells Limited[24] in its new format as a Perth merchant bank, depositors lost their funds.

The second example refers to the Pyramid Building Society in Victoria. Under Victorian legislation, deposits with, and "non-withdrawable shares" issued by, permanent building societies in that State were granted authorised trustee status. The exact status of "non-withdrawable shares" was not clear in the circumstances of the 1980s and were a remanent of the co-operative origins of permanent building societies in the last century. The Pyramid Building Society was an active marketer of "non-withdrawable shares" as part of its fund raising activities and later investigations revealed that the staff of Pyramid Building Society was not adequately informed of the status of "non-withdrawable shares" and did not convey to customers of the society any notion that "non-withdrawable shares" differed from deposits in the society. Technically, redemption of "non-withdrawable shares" was not automatic on the request of the customer but was contingent on the approval of the society after a period of notice determinable by the society. When Pyramid Building Society failed[25] due to imprudent and possibly unlawful lending[26]
holders of "non-withdrawable shares" were surprised and dismayed to find that what they held was not, as they implicitly believed and had been given to understand, equivalent to deposits in the building society. It was determined that "non-withdrawable shares" ranked with unsecured creditors in the liquidation of the Pyramid Building Society. In consequence,

[24] Details of the reasons for the failure of Rothwells Limited are given in the MCCusker Report: *Report of Inspector on a Special Investigation into Rothwells Limited, Part 1*, Perth, Government Printer, 1990
[25] Details of the collapse of the Pyramid Building Society and its associated societies are given in [The Habersberger Report] Farrow Group Inquiry Report, D.J. Habersberger Q.C, Melbourne, Government Printer, 1994
[26] One of the directors of the Pyramid Building Society is currently charged with a number of breaches of the Building Societies Act

holders of "non-withdrawable shares" have no possibility of receiving anything of the $120 million, in total, invested in "non-withdrawable shares"; depositors in the Pyramid Building Society have fared better but are still waiting to receive 100 cents in the dollar.

Third, the granting of authorised trustee status can confer special privileged status on the financial institutions which create the securities eligible for authorised trustee status. This can be used deliberately, at times, by government to give a special edge to certain financial institutions or financial securities. The Campbell Committee noted that the granting of trustee status to a security tends to create a special preferential market for it. This is certainly true for permanent building societies which have highlighted such status in their advertising and letterhead. Two examples of this practice can be found in Queensland. The Queensland Industry Development Corporation, QIDC, was a State government owned financial institution which was granted authorised trustee status explicitly to improve its competitive position as indicated by the following extract from the Second reading speech[27]:

> "As a further sign of our commitment to the QIDC, I can announce today that the Government has approved that the Trusts Act be amended to provide that moneys invested with the QIDC are authorised trustee investments within the meaning of the Trusts Act. This will enable QIDC to attract funds from a broader range of investors and should lower QIDC's borrowing costs."

Similarly, the Mortgages (Secondary Market) Act, 1984 gave authorised trustee status to secondary mortgage market instruments, because, as was stated in the Second Reading Speech[28]:

> "I have been advised that for an effective market to develop, any marketable security issued must have authorised trustee status. This status will be conferred by legislation for bills of exchange, promissory notes, bonds, certificates or other instruments which may be issued for the purposes of this market."

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[27] Queensland Parliamentary Debates,Vol 301, 1985-86, Queensland Industry Development Corporation Bill, p3455-3460.

[28] Queensland parliamentary Debates, Vol 295, 1984-85, p720-721

Fourth, there are anomalies in the definition of trustee securities between the States and one consequence of this is that securities which may otherwise have very similar risk and return characteristics are viewed differently by investors in different states. 332This may produce significant variations in the cost of capital in different states.. While the Committee saw no objection to the continuance of this practice, it did suggest that it is desirable that consistent and sound criteria be applied throughout Australia[29]. Attempts to put in train activity to harmonise authorised trustee status across the State of the Australian Federation came from the Special Premiers Conference in October 1990 which agreed to Heads of Agreement to reform State legislation for the supervision of non bank financial institutions[30]; consideration of a uniform approach to authorised trustee status was part of this brief but progress has been slow. The matter of authorised trustee status was placed on the agenda of the Council of Australian Governments, COAG, and the NBFI Working Group, comprising officials from all governments, was charged with the responsibility of investigating the matter. The NBFI Working Group provided an initial report in 1991 which was based on the premises that authorised trustee investments should provide guidance for inexperienced trustees with respect to the risk of potential investments and that regulation should provide some minimum measure of investment security. The NBFI Working Group[31] recommended that a single list of investments should apply across Australia. This list should be initially determined by, and kept under permanent review by State Treasurers and that, in order to minimise moral hazard, references to existing "Authorised Trustee Investments" in State legislation and regulations should be deleted and replaced by references to "Designated Investments". The Working Group further recommended that Designated Investments should comprise a minimum number of investments of defined status together with those which have a credit rating above a minimum standard. Those special Designated Investments were to be limited to those investments with high prudential security defined by the existence of government guarantees or the achievement of high national prudential standards established by the Reserve Bank of Australia or the Australian Financial Institutions Commission.

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[29] Final Report para 21.196

[30] Reform of the prudential supervision of state based deposit taking non bank financial institutions was completed with the passing of the Financial Institutions Act, 1992 and the Australian Financial Institutions Commission Act, 1992 being common and uniform in all States. Detailed examination of this legislation and the economic effects is given in Jon D Stanford and Timothy G Beale, The Law and Economics of Financial Institutions in Australia, Sydney, Butterworths, 1995

[31] NBFI Working Group, Authorised Trustee Investments - Proposals for Reform, Discussion paper, August 1993; Second Reading Speech, Trustee (Investment Powers) Amendment Bill, House of Assembly (SA), Tuesday 11 April 1995, p2258

In commenting on this draft approach, it can be said that the general thrust of the recommendations is towards a minimalist approach with a strong emphasis on avoiding risk. While this may satisfy some of the concerns about the use of the legal list to authorised trustee status, it does severely limit the investment powers of trustees to consideration of a restricted range of securities so that a portfolio constructed from these securities is unlikely to satisfy the needs of many beneficiaries. It also make a radical step from existing practice by eliminating real estate and first mortgages on real estate from the legal list.

The revised proposals by the NBFI Working Group, contained in its 1993 Discussion Paper, were that a single list of "Designated Investments" should apply across Australia[32] except for funds administered by Public Trustees and Trustee Companies and that this list of Designated Investments comprise a single limited list of designated investments limited to securities with a government guarantee, investments in bodies regulated by the Reserve Bank of Australia and the Australian Financial Institutions Commission as well as investments with a prescribed credit rating.

The comment on this proposal is that it really does not advance the position continuing to focus on government guaranteed or regulated securities although it would extend authorised trustee status to the deposits of credit unions which generally[33] have not been included in any legal list. The proposed list of Designated Investments will be overtaken by events when Trustee Companies are supervised by AFIC. The exclusion of real estate and first mortgages on real estate is justified by the claim that these assets are at the higher end of the risk spectrum. Concern about the exclusion of these assets was expressed by the South Australian government on the grounds that the exclusion will create difficulties in creating balanced portfolios[34]. In addition, this list places much more weight on the role of government as supporter of particular financial products and financial institutions. The intention of the systems of prudent supervision by the Reserve Bank of Australia of banks and the Australian Financial Institutions Commission of deposit-taking non bank financial institutions is not intended to guarantee the performance of these institutions or to guarantee their deposits; the overt aim of supervision is to protect deposits. Just what this means has not been made

[32] The reports of the NBFI Working Group have not been made public; details have been given in Second Reading Speech, Trustee (Investment Powers) Amendment Bill, House of Assembly (SA), Tuesday 11 April 1995, p2258.

[33] The New South Wales government had moved in 1995 to include credit unions in its legal list.

explicitly clear but such protection falls short of a guarantee and, indeed, the expression of anything like a guarantee for these deposits by government is to be discouraged.

Fifth, the legal list approach does not give adequate guidance to the trustee in selecting and maintaining an appropriate portfolio. This explained above in the section, Economic Analysis of Authorised Trustee Status.

Six, the concept of the legal list of investments of authorised trustee status has been extended to a position where it has outstripped its original design; the legal list approach cannot serve all the purposes which have been built on to it. In a modern financial sector, the problem of the prudent investment of trust funds to meet the particular needs of each set of beneficiaries cannot be resolved by listing a selection of investments selected on what must be seen at the margin to be arbitrary and ad hoc grounds. Nor can this problem be solved by restricting the activities of well meaning amateurs.

The credit ratings approach offers some advantages over the legal list in providing a more extended list of potential investments which does not require government action to update. Nevertheless, this approach contains some of the flaws of the legal list approach; it remains ultimately arbitrary in the selection of a minimum credit rating; it excludes some investments which might be necessary to achieve a balanced portfolio and most importantly it provide no guidance to trustees as to how to select and review a portfolio.

[34] Second Reading Speech, Trustee (Investment Powers) Amendment Bill, House of Assembly (SA), Tuesday 11 April 1995, p2258

SOUTH AUSTRALIAN LEGISLATION

In 1995, the South Australia parliament approved a new approach to authorised trustee status in that State by moving away from the legal list approach to a prudent person approach but made an important innovation by codifying the factors which should be considered by a trustee in exercising investment powers. The power of trustee to invest is expressed in the following way.

A trustee[35], unless expressly forbidden by the instrument creating the trust, may

(a) invest trust funds in any form of investments; and
(b) at any time, vary an investment or realise an investment of trust funds and reinvest money resulting from the realisation of any form of investment.

A trustee, if a professional manager of funds for other people, must exercise the care, diligence and skill that a prudent person engaged in that profession would exercise in managing the affairs of other persons or otherwise must exercise the care, diligence and skill that a prudent person of business would exercise in managing the affairs of other persons. A trustee must comply with the rules and principles of law that impose duties on a trustee to:

(a) exercise the powers of a trustee in the best interests of all present and future beneficiaries of the trust;
(b) to invest trust funds in investments that are not speculative or hazardous;
(c) act impartially towards beneficiaries and between different classes of beneficiaries;
(d) to take advice.

The trustee must pay attention to the following matters in exercising powers of investment. The trustee must have regard to:

(a) the purposes of the trust and the needs and circumstances of the beneficiaries;
(b) the desirability of diversifying trust investments; and

[35] Trustee (Investment Powers) Amendment Act 1995 (SA)

(c) the nature of and risk associated with existing trust investments and other trust property; and

(d) the need to maintain the real value of the capital or income of the trust; and

(e) the risk of capital or income loss or depreciation; and

(f) the potential for capital appreciation; and

(g) the likely income return and the timing of income return; and

(h) the length of the term of the proposed investment; and

(i) the probable duration of the trust; and

(j) the liquidity and marketability of the proposed investment during, and on the determination of, the term of the proposed investment; and

(k) the aggregate value of the trust; and

(l) the effect of the proposed investment in relation to the tax liability of the trust; and

(m) the likelihood of inflation affecting the value of the proposed investment or other trust property; and

(n) the costs (including commissions, fees, charges and duties payable) of making the proposed investment; and

(o) the results of a review of existing trust investments.

In carrying out their duties, trustees may obtain and consider independent and impartial advice reasonably required for the investment of trust funds or the management of the investment from a person whom the trustee reasonably believes to be competent to give the advice and to pay the reasonable costs of obtaining such advice from trust funds. In addition to some enabling features to allow the trustee to deal with securities affected by takeovers, mergers, schemes of arrangements, reconstructions and rights issues, the Act provides specifically that a trustee may purchase a dwelling house for a beneficiary to use as a residence. Furthermore, the Act provides that a court may offset gains and losses arising from investment of a trustee when there is an action for breach of trust against the trustee.

COMMENT ON THE SOUTH AUSTRALIAN PRUDENT PERSON

The new legislation of the South Australian government goes further than previously held concepts of the prudent person approach, which was regarded as being a tautology (trustees who have a duty to act prudently should behave as prudent persons in making investments) in spelling out the considerations which trustees must consider when undertaking investments of trust funds. The codification of these considerations makes it clear that the trustee is to act as a portfolio manager and in so acting has to exercise judgment and discretion which is not, and cannot be, specified in the legislation.

Where the new legislation falls short is in its failure to provide an objective standard by which to assess trustees performance relying on a case by case consideration when aggrieved beneficiaries commence an action against the trustee.

What is required to complete the prudent person approach is to link the trustees' powers of investment with the standard of conduct required under the Corporations Law of financial advisers and planners. The link would come in the following ways:

- trustees who are professionally qualified or who give investment advice or make investment decisions on behalf of others are required to base their investment decisions on no less considerations than would be required of a licensee or proper authority holder under the licensing provisions for security dealers and advisers; and

- trustees, who are not so qualified or experienced, in taking advice, may regard a licensee or proper authority holder under the licensing provisions for security dealers and advisers as being appropriate persons to provide such advice providing that that advice is given by following the conditions determined by the licensing authority.

Such a provision does not exclude the possibility that trustees may take further advice by way of a second opinion or on more specialised matters but it does complete the circle by providing

SECURITIES ADVISERS

A new structure for the national regulation of corporations was established in 1991 and the Australian Securities and Investment Commission is now the administrative body responsible for this regulatory regime. The new system has reformed the licensing of securities dealers and advisers. Dealers and advisers are participants in the securities industry who sell, or make recommendations about, securities to the public. The new approach licences the principal dealer or adviser (usually a corporation) and requires principals to assume responsibility for the conduct of their representatives and to be liable for the actions of their representatives. The new approach provides for the issue of proper authorities to their representatives of licensed dealers and advisers.

Under the licensing provisions of the Corporation Law, the conduct of securities dealers, investment advisers and authorised representatives of dealers and advisers is regulated. The securities regulated by the licensing provisions of the Corporations Law are shares, debentures and prescribed interests including superannuation products. Those subject to regulation are stock brokers, financial planners and management companies (securities dealers), financial planners, accountant and solicitors (financial planners) and proper authority holders of licensees. Agents or employees are not required to be licensed but licensees are accountable for the conduct of their agents and employees.

Licensees are granted by the Australian Securities Commission, the regulatory body, after consideration of the solvency, educational qualifications and experience, good fame and character, honesty, efficiency and fairness[36]. All licences are issued subject to conditions.

The Corporations Law imposes continuing requirements on how licenses should conduct their business with the main requirements relating to the making of security recommendations[37]. Advisers are obliged to disclose fees, commissions and other benefits and interests which are likely to affect adversely recommendations and to have a reasonable basis for any recommendation made. This requires advisers to consider the investor's investment objectives, financial situation and particular needs and to investigate and analyse the securities to be recommended to ensure they are appropriate for the investor's needs.

[36] Further details are given in Australian Securities Commission, ASC Procedures Manual - Securities & Futures Licencing, Melbourne, Centre for Professional Development, 1993

[37] These requirements are currently subject to review. See "Review of the Licencing Regime for Securities Advisers - Issues Paper", Melbourne, Licensing Review Task Force, Australian Securities Commission, 1995

CONCLUSIONS

Authorised trustee status is a legal concept which has economic implications; one of the major implications is that it assists in the direction of investment funds into particular securities and areas of the economy. The concept of authorised trustee status, while attempting to achieve specific outcomes for the beneficiaries of trusts cannot be relied upon to secure these results.

Australian governments have relied on the use of the legal list as a determinant of authorised trustee status but it is shown that the legal list is subject to many shortcoming and is basically arbitrary and *ad hoc* while at the same time not providing any real guidance to trustees in the discharge of their duty. In addition, the legal list approach has lend people to invest in securities which have resulted in loss to the investor. A flexible list approach removes some of the disabilities of the legal list approach but cannot resolve the question of guidance to trustees.

The prudent person approach to authorised trustee status in its general form suffers from the charge of tautology although its recognition of the role of the trustee as a portfolio manager is an important step forward.

Economic analysis of the role of the trustee maintains that this role is one of portfolio manager; a role which is complex but which is explicable in terms of definable procedures and practices. The role of trustee as portfolio manager is one which requires greater financial knowledge than can be assumed is possessed by all trustees. The trustee as portfolio manager is required to maintain a review of decisions make under powers to invest trust assets.

A solution to the problem of authorised trustee status is proposed. The solution takes two parts: the first is the adoption of the prudent person approach but with the codification of duties of the trustee and the explicit listing of the factors that a trustee should consider in using the investment powers. This approach has been adopted by the South Australian government in 1995 and other State governments have since moved to adopt similar legislation. This approach, by itself, is not complete as it does not provide an indication of the best practice approach to use of investment powers. The second part of the proposed solution is to link the investment powers of trustees to the best practice features of securities advisers

who are now licensed by a regulatory body, the Australian Securities and Investment Commission. Under this proposal, trustees who are experienced in financial matters would be required to adopt, as a minimum, the practices of securities advisers in making investment decisions about trust funds. Inexperienced trustees would be able to accept,
prima facie, that such security advisers were an appropriate source of expert advice without absolving them of their duty to make an independent judgment.

Harmonisation of authorised trustee status across all Australian jurisdictions had been a long held aim of economic policy and has now been achieved through the adoption of the prudent person approach to trustees' power of investment.