THE INVESTMENT POWERS OF TRUSTEES

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THE INVESTMENT POWERS OF TRUSTEES

Law Reform Commission of Saskatchewan
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The Law Reform Commission Act:

"The Commission shall take and keep under review all the law of the province, including statute law, common law and judicial decisions, with a view to its systematic development and reform, including the codification, elimination of anomalies, repeal of obsolete and unnecessary enactments, reduction in the number of separate enactments and generally the simplification and modernization of the law."
EXECUTIVE SUMMARY

The Saskatchewan *Trustee Act* constrains trustees to invest only in securities of types approved by the Act. Approved investments include government bonds, first mortgages, and some preferred shares. Common shares are not included. Only one other province, Newfoundland, retains such a restrictive list of approved investments.

The "legal list" approach to regulating the investment powers of trustees has long been subject to criticism. Some provinces have expanded the list, but there is a broad consensus that even reformed lists do not reflect the current realities of securities markets and financial planning. In particular, the legal list approach does not encourage a balanced portfolio approach to investment. Not surprisingly, many trusts are now drafted to avoid the legal list requirement by giving broad discretionary powers of investment to the trustee. In the result, statutory over-sight of trustees' investments has been undermined.

The Commission has considered two approaches to reform of statutory regulation of powers of investment. The Uniform Law Conference and some Canadian Law Reform Commissions have recommended abolishing the legal list and adoption of a "constrained prudent man" rule modelled on American law. In England, the legal list has been modified to permit investment in a wide range of equities if written advice is obtained and no more than 50% of trust funds are so invested. The English Law Commission has proposed broadening the Wide Range list further, and removing the 50% cap on equity investment.

The Commission rejects the constrained prudent man approach. American experience has shown that it fails to direct trustees toward a balanced portfolio approach to investment, and suffers in practice from many of the defects of the legal list. The English approach is preferable. Trustees would remain under the general duty to invest prudently long recognized in equity. Statute law would provide direction, encouraging balanced investments and requiring that adequate advice is obtained. After surveying the opinions of investment councillors, the Commission has also concluded that the English Law Commission was correct in proposing that no statutory cap be placed on equity investments.
I. INTRODUCTION

The principal duty of a trustee is to manage trust property and invest trust funds for the immediate or eventual benefit of the beneficiaries. In Saskatchewan today, as in other provinces, investment rather than management is usually the trustee's most important duty. The settlement trust, in which an estate is kept intact and managed by the trustee to protect future generations, has never been popular in Saskatchewan. A will may require the trustee to retain a family business and operate it during the lifetime of the testator's widow or until children come of age, but even this kind of trust arrangement is relatively uncommon. Most private trusts in Saskatchewan are intended to provide a capital fund for the maintenance of minor children and the surviving spouse. Estate property not subject to specific devises and bequests is liquidated to create the fund, and it is invested by the trustee to achieve the purposes of the trust.

Investment of trust funds is perhaps the most difficult task imposed on trustees. Trustees are under a duty to act with the diligence that (as one of the classic authorities on the standard of care expected of trustees put it) "a man of ordinary prudence would exercise in the management of his own affairs". But because investment of funds is always a risky proposition and the future security of beneficiaries often depends upon it, English and Canadian trust law has supplemented it with an additional safeguard to protect the trust capital. The Saskatchewan Trustee Act provides that, in the absence of an instruction to the contrary, trust funds can only be invested in securities permitted by

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2Most private trusts in Saskatchewan are created by will. Typically, the will stipulates that a sum of money is to be held in trust, in which case it must be raised from sale of estate property. Alternatively, the trust is imposed on the residue of the estate after specific bequests and devises have been met. In this case, the rule in Howe v. Dartmouth (1802) 32 E.R. 56 provides that, in the absence of express or implied intention to the contrary, the residue is to be converted to investments rather than held in specie. The rule has proved difficult to apply, with the result that carefully drafted wills usually avoid it. Nevertheless, it incorporates what has long been the usual policy of testators, and most wills that avoid the rule with a specific direction do so by expressly requiring conversion of the residue.

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the Act. The Act contains what has come to be known as "the legal list" of permitted classes of investments.

The list is restrictive, including only what have been regarded as the safest investments:

1. Bonds of the Government of Canada, or guaranteed by the Government of Canada, including subsidy bonds;

2. Bonds of any province, or guaranteed by any province, including subsidy bonds;

3. Bonds of municipalities in Saskatchewan, or guaranteed by a municipality;

4. Bonds of the Governments of the United Kingdom and the United States, or guaranteed by them;

5. Guaranteed investment certificates of a trust company approved by Regulation;

6. First mortgages on Canadian real estate;

7. Debentures of mortgage loan companies with paid-up capital of at least $500,000, and a reserve fund of at least 25% of paid-up capital;

8. Preferred shares of corporations incorporated in Canada, or listed on any "recognized stock exchange", that has paid the dividends required under the terms of the stock issue during the preceding five years, or has paid dividends equal to at least 4% of the value of common stock during the same time period;

9. Bonds issued under The Rural Telephone Act, The Hospital Act and of cooperatives registered under the relevant provincial statutes;

10. Bonds of a Cooperation incorporated in Canada secured by a trust deed on assets or debentures and "other evidences of indebtedness", and which has paid dividends on its preferred shares as stipulated in 8 above;

11. Deposits in Chartered Banks, Credit Unions incorporated under The Credit Union Act or by provincial statute, and trust companies with membership in the Canadian
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Deposit Insurance Cooperation or approved by Regulation. ¹

The legal list approach to regulation of investment by trustees was devised by the courts and the British Parliament in the nineteenth century. ² It may have represented prudent investment advice when it was conceived, but it has come under increasing criticism since the World War II. Various specific criticisms of the legal list as a mechanism for controlling trust investment have been made. Some of them will be discussed below. The crux of the matter, however, is doubt that the list represents a sound investment strategy for trustees.

A trustee must pursue several goals when trust funds are invested. First, security is vital. The trustee has an obligation to preserve the fund for its intended purposes. Speculation, even if well-meaning, is not appropriate unless the settlor of the trust has specifically sanctioned it. Usually the trust fund is expected to provide a continuing source of income for a beneficiary, or to accumulate for a specific purpose such funding the education of the beneficiary. Speculative risk is not compatible with the goals of trusts of this type. Second, the trustee must seek an adequate return on investment to fulfil the purposes of the trust. Almost without exception, trust funds are set up with the expectation that investment income will be earned, and become available as it is needed. A trustee who invests so conservatively that the trust cannot achieve its purposes has failed the settlor and the beneficiaries as surely as a trustee who looses trust funds in bad investments. Third, the trustee must invest funds in such a way that income and capital is available when it is needed. Long-term investments are appropriate if trust funds are not required in the short-term; a trust expected to provide frequent pay-outs to beneficiaries must have at least enough assets in liquid, short-term investments to meet the demands made on it.

Investments on the approved list are unlikely to be lost. Since the list includes both long-term bonds and more liquid assets, it does not impede investments scheduled to pay-outs of trust funds. The list does not, however, include a full range of the investment vehicles now available for that purpose, nor does the list do anything to encourage proper diversification and scheduling. Most importantly, the investments on the legal list will often fail to produce a rate of return that will accumulate income as rapidly as a prudent investor unconstrained by the list could achieve. If interest rates are lower than expected when the fund was established, it is very likely that the income

¹The Trustee Act, R.S.S. 1978, c. T-23, s.3 (as amended 1981).

²See below.
produced will be inadequate to fulfil the purposes of the trust.

The problem with the list is not just that does not include equity investments that would achieve a higher rate of return. It is based on a conception of investment that is no longer appropriate. It was conceived at a time when adequate rates of return on government-backed interest-bearing securities were high enough, relative to other options, to provide the basis for a sound investment strategy. That is no longer true. Investment advisors today recommend a portfolio approach that balances growth and security. Common shares provide growth and reasonable rates of return when interest rates are low; bonds and guaranteed investment certificates provide security and good returns when interest rates are high. The Saskatchewan legal list, with its emphasis on interest-bearing investments and dividends, makes it virtually impossible for trustees to adopt a portfolio approach. In the result, trustees constrained by the list are unable to balance investments or plan effectively to deal with changes in market conditions.

Dissatisfaction with the legal list has made it commonplace to relieve trustees of the obligation to comply with it. Waters reports that 90% of contemporary trusts contain investment clauses that permit the trustee to "invest as they in their discretion think best".6 The figure may, however, be somewhat lower in Saskatchewan, where many relatively small trusts are established by will and administered by trustees with no formal investment expertise. An informal survey conducted by the Commission suggests that many lawyers and some trust company officials who advise on estate matters in Saskatchewan do not routinely recommend a discretionary investment clause, despite the fact that the Saskatchewan legal list is one of the most restrictive in Canada. Nevertheless, the trend is toward routine inclusion of discretionary investment clauses. In part, this reflects the fact that national trust companies are now more inclined to set policy at head office than in the past. Even locally-headquartered trust companies that did not recommend discretionary investment clauses a few years ago now do so.

All provinces that retain a legal list except Saskatchewan and Newfoundland now permit restricted investment in common shares and some other classes of investment not allowed in the traditional list.7 A more fundamental reform was recommended by the Uniform Law Conference of Canada in 1970. The model Trustee Act adopted by the Conference jettisons the legal list entirely. It is place, the Act provides that, unless otherwise constrained by the terms of the trust, a trustee may

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6Waters, above, at 766.

7The restrictions will be discussed below.
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...invest trust money in any kind of property, real, personal, or mixed, but is so doing he shall exercise the judgement and care that a man of prudence, judgement and intelligence would exercise as a trustee of the property of others.  

This formula is apparently intended to be more restrictive than the general duty of care imposed on trustees. It is based on American precedent, where the legal list approach was rejected in the nineteenth century. Because it refers to the prudence that a prudent person would exercise in managing "the property of others", it has been held to dictate a more cautious investment strategy than would be appropriate when investing one's own funds. The Uniform Act echoes a leading American decision on the meaning of the rule:

A trustee has not unlimited authority to invest as an ordinary prudent man would invest his own; he must take risks only as an ordinary prudent man would take who is a trustee of the money of others.

This approach has aptly been characterized as the "constrained prudent man rule". In the Uniformity Commissioners' opinion, it provides enough restraint to provide adequate protection for beneficiaries. Variations on the rule have been adopted in New Brunswick (1970), the Northwest Territories (1970), the Yukon (1980), and Manitoba (1983). The Ontario Law Reform Commission has recommended a somewhat expanded version of the rule.

Waters suggests that "it seems likely that in the forthcoming years the prudent man rule will replace the present legal lists in one Canadian jurisdiction after another." Since most (the Saskatchewan experience notwithstanding) trusts drafted in Canada today avoid the legal list in any event, it could be argued that little harm could result from formally laying it to rest. No catastrophic consequences have been reported in those jurisdictions that have adopted the prudent man rule.

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9In Re Buhl's Estate 178 N.W., 651 (1920).


12Waters, above, at 775.
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There can be little doubt that the legal list as presently constituted is no longer an effective protection for beneficiaries. Nevertheless, the Commission is not convinced that the concept of a list of permitted investments should be dispensed with, or that the prudent man rule is an adequate substitute.

Testators with large estates who appoint trustees in confidence that they will obtain the best available investment advice or who are content to authorize a less cautious approach to investment than is usually deemed appropriate for trustees, do not need the protection of legislation. For them, an investment clause tailored to their specific requirements is the logical course of action. Even the constrained version of the prudent man rule will usually be too restrictive for their needs. 13

Statutory regulation of trusts investments is useful as a guide to trustees of small trust funds who lack investment experience and cannot justify the time and expense required to aggressively manage trust funds. That many of them may now have discretionary investment powers is, in the Commission's view, no argument for repealing the list. Many testators have been advised to dispense with the list because it is inappropriate, not because no guidance for their trustees is desirable. In fact, as the unsettled financial markets and unpredictable interest rates of recent years have demonstrated, sound investment plans are more difficult to devise than in the past. As Waters notes

[T]hough the stability and security of "equities" has increased immeasurably since Victorian days [when the legal list was adopted], the risk element was not something to be forgotten as if the Victorian conception of the reliability of government stock and the unreliability of "equities" was now suddenly reversed.

Experienced investors and investment councillors recognize the danger in sacrificing security to growth:

"Put all your eggs in the 'equity' basket and watch the basket" was not a precept trustees felt applied to their circumstances, especially when they were concerned with income and capital beneficiaries. 14

The legal list errs in the other direction, requiring trustees to invest in interest-bearing investments even when rates of return are so low that income falls short of need. But in the absence of the

13 See below.

14 Waters, above, at 771.
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constraint of the list, it is all too easy for an investor to persuade himself or herself that a bull market will continue, or that rates of return on guaranteed investments and bonds are too low to justify leaving any substantial funds in them— and they will find no lack of confirmatory advice. The prudent man rule provides little concrete protection against this kind of well-meaning misguidance. It gives the courts an after-the-fact criterion for determining whether a breach of trust has occurred, but it does not give practical guidance to trustees.

A different approach to redefining trustees' investment powers has been developed in England. *The Trustee Investment Act, 1961* was intended to direct trustees toward prudent, balanced investments without dispensing entirely with the legal list concept. The Act divides the legal list into two sections. The "Narrow Range Investments" stipulated by the Act are similar to those contained in traditional legal lists. The "Wide Range Investments" contained in the new list include many that were deemed too speculative under the old regime, including common shares of companies with proven ability to pay dividends. Trustees subject to the legal list can invest up to 50% of trust funds in the Wide Range category. The new list thus recognizes the principle that trust investments should balance growth and security, a proposition that is further strengthened by an express direction to trustees to have regard to the need for diversification "in so far as is appropriate to the circumstances of the trust". Finally, the Act requires that written advice be obtained before Wide Range investments are made.

In the Commission's opinion, *The Trustee Investment Act* embodies a more satisfactory policy in regard to trustee's investments than the prudent man rule. It provides guidance to trustees rather than merely enacting a criterion for judging their performance. Moreover, it directs trustees toward a diversified portfolio approach to investment and recognizes the need to obtain expert advice. Neither the traditional legal list nor the prudent man rule as effectively incorporate these keys to prudent investment.

Unfortunately, despite its attractive characteristics, *The Trustee Investment Act* has not proved to be entirely successful in operation. In 1982, the English Law Reform Committee reviewed the legislation, and concluded that it is too restrictive. The Committee recommended that the Narrow Range list be kept, but only for the purpose of identifying investments that can be made

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159&10 Eliz. 2, c.62. See below for further discussion.
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without advice.16

The Commission is of the opinion that Saskatchewan legislation regulating trustees' investments should follow the general approach of The Trustee Investment Act. In addition, the Commission accepts most of the proposals made by the English Law Reform Committee to improve the model. The Commission agrees that the Wide Range list is too restricted in scope, and that the distinction between the Narrow and Wide Ranges of investment should function primarily as a mechanism for ensuring that trustees receive adequate advice.

In recommending an approach that differs from that proposed by the Uniformity Commissioners and adopted in several provinces, the Commission is cognoscente that uniformity of laws is usually desirable. However, statutory regulation of trustees' investments will have its primary impact on relatively small trust funds established by will and involve few interprovincial complications. Moreover, since the list will apply only in the absence of an express term of the trust to the contrary, it will not operate as a constraint on testators and settlors who seek to conform to another model.

II. THE LEGAL LIST AND THE PRUDENT MAN

1. The Rise and Fall of the Legal List

Restrictions on permitted trust investments in Britain and Canada originated in the policy of the Court of Chancery in the first decades of the Nineteenth Century. In an era when most trusts took the form of settled estates, only a small portion of trust property was available for investment. Regulation of trust investments was not, therefore, a matter which attracted much attention from the courts or Parliament. Chancery invested funds under its control in 3% Bank of England Consolidated Fund Annuities, securities that came to be known as the soundest of investments under the popular name "Consols". When trustees applied to the court for advice on investment decisions, Chancery recommended investments similar to those it made itself. Prior to 1859, only Consols and first mortgages on land were available investment options for English trustees.17 This, it has been

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suggested, was the beginning of the "legal list".18

Most trust property in the eighteenth and early nineteenth centuries was in the hands of the landed classes. Chancery's conservative approach to trust investment reflected the gentry's bias against investment in commercial enterprises, all most all of which were regarded by them as highly speculative ventures, particularly after many of them had been ruined by the infamous "burst" of the speculative "bubble" of the South Sea Company in 1710. In the aftermath of this scandal, incorporation of joint stock companies other than by Act of Parliament was curtailed. In fact, at the time Chancery's embryonic list of permitted investments began to take shape, there was no legally-recognised means of investing in any but a handful of private companies except as a full owner or partner. As the commercial wealth of England expanded during the nineteenth century and commercial fortunes began to surpass those of the landed aristocracy, attitudes changed. Gladstone's Corporations Act of 1849 signalled the change, giving legal recognition to joint stock companies, and creating a new form of investment.

Almost inevitably, the list of approved investments was expanded. But extension of the list proceeded cautiously. Although the number and size of trust funds increased after midcentury, the landed settlement continued to drive the evolution of trust law. In 1859, in the first Trustee Investment Act, Parliament confirmed Consolidated Annuities and first mortgages as permitted investments, and cautiously added bonds of the Bank of Ireland and the East India Company. Subsequent legislation expanded the list to include restricted investment in railway bonds, securities guaranteed by the British Government, and, under The Colonial Stock Act, 1900, securities issued by colonial governments. By 1900, the legal list in recognisable modern form had taken shape. When a new Trustee Act was adopted in 1925, the recommendation of a Parliamentary committee was followed, and trustees' investment powers left largely unchanged.19

Saskatchewan received the law regulating trustees' investments as of 1870, probably including the first Trustee Investment Act. In any event, the Saskatchewan Trustee Act was modelled on

18Waters, above, 767.
19Waters, above, at 769.
nineteenth century English precedent. Other Canadian provinces similarly followed the English lead with a few innovations. Ontario, for example, permitted investment in trust and loan company securities in 1879.

As Waters observes, "the whole thesis of the pre-1939 era was that secured loans at a fixed rate of interest were ideal for trust purposes". So entrenched was this idea that the courts were reluctant to find that a settlor had relieved his trustee from the constraint of the legal list. In Spratt v. Wilson, for example, it was held that a trust provision permitting the trustee to make investments "at his discretion" only allowed choice between the options contained in the list. It is perhaps surprising that this philosophy withstood post-World War I inflation and the speculative climate of the 1920's. Critics of the conservatism of the legal list should take note that it was fortunate for many widows and children that the list was not repealed or expanded. In the result, trust funds were at least partially spared the effects of the crash of 1929. The legal list did no more than reflect what was regarded as sound investment policy designed to safeguard the resources of typical trust beneficiaries. It was only after World War II that the rules of the game began to change.

The effects of inflation, weak currencies and rapid growth in the first three decades after the war drastically changed conventional wisdom about what constitutes sound investment. Bonds and government securities declined in value, and interest rates failed to compensate for price inflation. Waters aptly summarizes the dilemma for a trustee tied to the legal list:

[With] the erosion of purchasing power of currencies... [what] the trustee needed was a hedge against inflation, and the only thing which could provide this was "things" as opposed to money loans at interest. Even when a debt obligation security was redeemed, the trustee was paid the same capital sum which he had invested years before when the issue was new, and in the meantime, the purchasing power of the

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20 On the history of trust legislation in Saskatchewan, see the Commission's report on English Statute Law in Saskatchewan.

21 On the history of the legal list in Ontario, see The Ontario Law Reform Commission, above, at 194. Because Ontario did not receive nineteenth-century English trust legislation, provincial statutes reproduced the legal list in 1869 and 1879 Investment of Trust Funds Acts.

22 Waters, above, 769.

23 (1890), 19 O.R. 28.
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currency had lessened, sometimes as dramatically as the prices of government stock had fallen. There were, therefore, two factors cutting away the capital value of all trustee investments on the legal list; the inherent slide of the prices of government stock, and of the purchasing power of the currency.24

The obvious solution to the problems outlined above was to permit equity investments. During the post-war era, economic growth has led to a steady secular growth in the value of equities. Stocks, and particularly common shares that might realize capital gains, became the cornerstone of even cautious investment strategies. Settlors increasingly abandoned the legal list after 1945, and the courts facilitated the flight by adopting a more liberal interpretation of investment powers contained in trust documents.25

Legislative reaction was slower, but the notion that the list should be expanded to include at least some equity investments took hold. In Canada, the work of the Uniformity Commissioners between 1951 and 1957 chronicles the change in attitude. A 1951 draft Trustee Act retained the traditional list with few changes. It was not adopted by the Conference. Instead, a series of redrafts during the next six years experimented with expansion of the list. Both common and preferred shares were included in subsequent drafts, but only a restricted authorization to invest in preferred shares survived in the uniform Act adopted by the Conference in 1957. Despite the hesitancy of the Uniformity Commissioners, most provinces that adopted legislation based on the Uniform Act included a restricted power to invest in common shares. The Ontario common share provision is typical. It permits investment in common shares of companies only if the shares are fully paid up and the company has paid a dividend of at least 4% on its common shares in each of the preceding seven years.26 Saskatchewan, almost alone among the provinces that based amendments to the law on the Uniform Act, followed the official text. The Saskatchewan legal list is drawn from the Uniform Act, and like it, permits restricted investment in preferred, but not common, shares.

Despite inclusion of a restricted power to invest in equities in the list of most provinces, the legal list approach remained under critical scrutiny. As a practical matter, reform of the legal list in the late 1950's and early 1960's must be regarded as a failure. The list is of value only if it is deemed reasonable enough to be accepted by settlors; otherwise, they will continue to place their trustees

24Waters, above, at 770.
25Waters, above, at 776.
26R.S.O. 1980, c. 512, s.27(1)(e) (adopted in 1960).
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beyond its grasp. Inclusion of restricted investments in common and preferred shares in Ontario in 1960 did not induce settlors to return to reliance on the legal list, and the experience in most other jurisdictions was probably similar.

Critics of the legal list argue that even after reform, it is not a satisfactory mechanism for encouraging good investment practises by trustees. It may even encourage uninformed trustees to believe that their responsibility to invest prudently has been satisfactorily discharged merely by the fact that trust funds have been placed in approved securities. The Manitoba Law Reform Commission suggests that many trustees may be under the misapprehension that compliance with the list relieves them of liability for imprudent investment decisions. Yet, a trustee who places trust funds in long-term interest bearing securities of the sort that eminently meet the requirements of the list may be doing a grave disservice to the beneficiaries of the trust in a period of high inflation. Because the investments on the list are sound in the sense that the capital investment is usually safe, it is sometimes suggested that it prevents trustees from making a mistake. But surely an investment that deprives the trust of needed income by trading growth for security can be a serious mistake.

The most serious difficulty with the legal list as presently constituted is its inflexibility. The limited power to invest in equities recognised in most provinces may have addressed the most obvious shortcoming of the list, but it does not confirm to modern investment advice. In particular, it lacks the flexibility required to create a portfolio of investments that will balance the need for security with the need for growth over the life of the fund. The investment goals of the trustees of most family trust funds are similar to those of an investor planning for his or her own retirement. At present, low interest rates make investment in guaranteed investment certificates (G.I.C.'s) unattractive. On the other hand, economic uncertainty and volatility on the stock markets dictates against over-investment in equity mutual funds or shares of common stock. The safest course of action is to invest in both. Councillors advising clients on the purchase of Registered Retirement Savings Plans are currently suggesting that

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27 see comments by J.A. Nesbitt in 65 Canadian Bar Papers 173 (1965).


30 Manitoba Law Reform Commission, above, at 10.

31 Manitoba Law Reform Commission, above, at 6.
about 1/3 of funds should be invested in equity funds, the remainder in short-term investment certificates. The flexibility to do so exists for an individual investing in an RRSP; it does not exist for a trustee constrained by the Saskatchewan legal list.

Jeffrey Gordon observes that

Modern portfolio theory can be understood as making the following claims: Investors care about risk and return of assets: Indeed, they prefer the greatest return for the least risk and insist on being compensated in proportion to the risk. The risk from owning any particular asset can be lowered if the investor also owns other assets the returns on which respond to different firm-specific and general economic factors. In a familiar simple example, the risk from owing stock in an umbrella manufacturer is lower if the investor also owns stock in a suntan lotion manufacturer; abnormally sunny or rainy weather will enhance one firm's profits even while it hurts the other firm.32

The legal list eliminates the risk of "speculative" investment in equities, but forces the trustee to put all his eggs in one basket nevertheless.

2. The Prudent Man Rule

When the Uniform Law Conference adopted the prudent man rule in place of the legal list in 1970, it was responding to the failure of reform by extending the list. If few settlors are content to rely on the list, there is no effective statutory regulation of trustees’ investments. It was believed that what the prudent man rule lacks in specificity, it will make up for if it is acceptable to settlors and their legal advisors. The Manitoba Law Reform Commission appears to have adopted this point of view in its Report on Investment Provisions Under the Trustee Act. The Commission at least tacitly accepted the proposition that nothing more than minimal regulation of trustee's investments is feasible, commenting that "An incompetent trustee is an incompetent trustee and remains so regardless of what legislation prevails in his jurisdiction".33 On this analysis, the constrained version

32Gordon, above, at 54.
33Manitoba Law Reform Commission, above, at 10.
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of the prudent man rule contained in the Uniform Act is useful because it sets a somewhat higher
standard than the general duty imposed on trustees, but it should not be expected to provide much
guidance to trustees.

Other advocates of the rule, including the Ontario Law Reform Commission, expect
considerably more from it. The rule has been in place in the United States since 1830, when the
Massachusetts courts expressly rejected the restrictive approach adopted by the English Court of
Chancery,34 and has been adopted by decision or statute in 39 states and the District of Columbia.
During the last century the rule has been refined, interpreted and expanded. Definitive form was given
to it in the influential Restatement of Trusts (1935) and Restatement (Second) of Trusts 1959.35 The
Ontario Law Reform Commission meets the objection that the rule "requires the trustee to guess in
advance the kind of investments the court may later determine to be suitable...if an action for breach
of trust is commenced" by pointing to the guidance provided by the American authorities.36 The
Commission notes that "Over the past forty years, considerable literature has been published in the
United States on the operation of the prudent man concept in a wide range of investment
circumstances."37

The Ontario Law Reform Commission is of the opinion that the prudent man rule as it has
developed in the United States will provide satisfactory guidance for trustees. There can be little
doubt that the rule has in fact avoided the most serious shortcomings of the traditional legal list. In
particular, the commentary appended to the first Restatement suggested that restricted investment
in common shares is appropriate. It was probably in large part for that reason that a major shift from
the legal list approach to the prudent man approach occurred in the United States in the 1940's.38 On
the other hand, the rule has not been interpreted as a justification for speculation or excessive risk
taking. There is, however, growing doubt in the United States that the rule permits trustees to adopt
investment plans that meet contemporary needs in the most effective fashion.


35Shattuck, "The Development of the Prudent Man Rule for Fiduciary Investments in the
United States in the Twentieth Century", (1951) 12 Ohio St. L.J. 491.

36Ontario Law Reform Commission, above, at 218.

37Ontario Law Reform Commission, above, at 209.

38Shattuck, above, at 501.
Contemporary criticism of the rule dates from the early 1970's, motivated by an apparent failure of the courts to adapt the rule to encompass new investment strategies. Langbein and Posner, for example, have demonstrated that the rule is antagonistic to the portfolio concept. In 1987, Gordon was able to summarize the critique that had emerged over the previous decade:

Legal academics have persuasively argued that the constrained Rule is founded on a narrow conception of risk and safety that has been superseded by contemporary understanding of markets and investments. In particular, they argue that modern portfolio theory presents a better account of risk and safety, and thus a better guide to prudent investment.

Criticism of the rule has not been confined to academic circles. A survey in 1986 of fifty large institutional investors found that these institutions "regard themselves as significantly constrained by current legal standards of prudence from pursuing optimal investment practices".

Gordon identifies three aspects of the prudent man rule as it has been interpreted and expanded as the root of the problem. All three trace to the Restatement and the official commentary on it prepared by a leading American expert on trust law, A.A. Scott. Scott's first innovation was to equate prudence with "preservation of the estate." Thus, according to Gordon,

An investment strategy designed to preserve principal will presumably be more cautious than one aimed at permanent disposition, which would include a buy-and-hold portfolio of common stocks at a higher level of risk and expected return. Moreover, in inflationary times, a mandate to preserve the estate becomes confounding; to preserve the estate in nominal terms may well defeat the testator's object of transferring wealth to the next generation...


40Gordon, above, at 54.


42Gordon, above, at 60.
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Second, it was Scott who "constrained" the prudent man by insisting that a prudent trustee must act differently than a prudent person investing for himself or herself. This formula was not contained in the original version of the rule, and was not universally accepted until after the first Restatement was issued. Gordon writes that

Scott tells us that a prudent trustee may not pursue...[investment] goals in ways acceptable to a prudent investor. Scott's dubious distinction confuses the setting of appropriately safe investment objectives with the process of investing. The confusion creates a special problem for a financial model like portfolio theory, in which investments (and investment techniques) designed to achieve greater safety may nevertheless appear risky viewed in isolation.43

Finally, and most importantly in Gordon's view, Scott formulated a set of rules intended to prevent speculation that are now inappropriate. Gordon notes that

On the forbidden investment list are, for example, margin purchases of securities, "speculative" stock, discount bonds, securities in new or untried enterprises, and second mortgages. "Speculative stock" seems to refer to all companies except those "with regular earnings and paying regular dividends which may reasonably be expected to continue."44

Scott's list of forbidden investments looks very much like the converse of the legal list in place in most Canadian jurisdictions. If the prudent man rule is widely adopted in Canada, and content is given to it by referring to American precedent, very little will have been achieved. If, on the other hand, our courts do not turn to the American experience, we will be left with a virtual tabla rosa. In the worst case, the result would be de facto abandonment of any serious effort to provide guidance to trustees. Our courts might, of course, fill the void by evolving an appropriate interpretation of the rule that differs from the American model. In any event, adopting the prudent man rule would be less than exercise of law reform than a mechanism to pass the ball to the judiciary. Such a course of action could be justified only if no viable alternative exists.

43Gordon, above, at 60-61.

44Gordon, at 61.
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III. REFORMING THE LEGAL LIST

1. The Trustee Investment Act

The origins of the English Trustee Investment Act trace directly to the initial post-war dissatisfaction with the legal list's emphasis on government securities and interest-bearing investments. Although the Act was not passed until 1961, the dual list concept it embodies was first proposed by the Nathan Committee report to parliament on reform of trust law in 1952. The Committee recognized that changing economic and market conditions made it increasingly desirable to balance equity and debt securities to achieve both security and sufficient growth to counter inflation. The dual list reflected this portfolio philosophy of investment. Since the legal list already provided ample opportunity to invest in interest-bearing securities, the most immediate practical effect of adopting the dual list was that it permitted trustees to make limited investments in equities. In one respect, then, The Trustee Investment Act achieved much the same purpose as the contemporary Canadian legislation permitting investment in equities.

The type of equity investments allowed under the Trustee Investment Act are very similar to those permitted under Canadian legislation. Thus the Wide Range investments permitted under the English Act includes company stocks (including, in the English usage of the term, debentures), building society shares, and trust units (equivalent to mutual funds), but only if the company has issued and paid-up capital of at least £1,000,000, and has paid dividends in each of the five years preceding the date of the investment. Ontario, by way of comparison, permits investment in common shares of corporations that have paid dividends (of at least 4%) during a seven year period preceding the investment, and in preferred shares if dividends have been paid in the preceding five years. Since a prudent investor of trust funds would not likely put much more than 50% of a trust fund in equities even if allowed to do so, the practical effect of the English and Ontario provisions on investment options is much the same.

The difference between the English approach and the expanded legal lists adopted in Canada is nevertheless significant. The Canadian reform was merely permissive. Apart from signalling that prudent investment of trust funds need not be confined to debt instruments and government guaranteed securities, it implied no notion of what sort of investment strategy is appropriate for trustees, and contains no mechanism for guiding trustees to a prudent course. The Trustee Investment Act, on the other hand, is designed to encourage good investment practises. Limiting equity investment to 50% of the fund is the most obvious method of achieving this end, though not necessarily the most important.
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Trustees are expressly instructed by the Act to have regard to the need to maintain a balance between the income and capital requirements of the trust when making investments. Although this provision was probably included out of concern that trust funds be managed so as to protect the interests of both income and capital beneficiaries, it also serves to encourage a balanced portfolio investment strategy. Failure to more explicitly embody the portfolio theory in the provision reflects the fact that it was conceived in the 1950's, before modern portfolio theory had been fully developed. In any event, the section provides protection for the prudent investor who has sought to build a balanced portfolio by including some higher risk securities to generate potential growth. It has been noted above that under the prudent man rule as interpreted by the American courts, an investment may be regarded as improper because of the risk it entails even if it is part of a portfolio designed to balance growth and security. The same objection may be made to the expanded legal lists adopted in Canada. Under the English Act, investments are not examined in isolation to determine whether a breach of trust has occurred. It is the over-all investment strategy that must stand or fall if impropriety is alleged.

The English Act also recognises that the task of a prudent trustee is more difficult than it was in an age when a trust fund invested in Consols was a virtual guarantee of financial security. It therefore requires trustees to obtain advice in writing before investing in securities on the Wide Range list. While this requirement may be superfluous in cases in which the trustee is an experienced investor, it is an entirely appropriate provision. Experienced investors will obtain advice in any event; those who might be tempted to act without advice are forestalled.45

2. Reconsidering the English Approach

In the Commission's opinion, the basic approach of The Trustee Investment Act is more satisfactory than either the traditional legal list approach or the prudent man rule. However, the English Act cannot be regarded as a successful reform. Like its Canadian counterparts that authorized limited investment in equities, it did not significantly affect the trend toward trust provisions conferring discretionary investment powers on trustees.46 The reasons for the Act's failure to re-impose effective statutory control of trustees' investments were investigated by the English Law

45See the comments of the English Law Reform Committee, above, on this point.

46See Waters, above, at 772.
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Reform Committee in 1982. Although it recommended significant change to the Act, it proposed retaining most of its basic features.

The Act has been criticized on a number of grounds. The mechanism for dividing trust funds between Narrow Range and Wide Range investments is, in the English Committee's view, unnecessarily complicated. Before making Wide Range Investments, the trustee must split the fund into two parts, and each must henceforth be administered as separate funds. Just what purpose this serves is unclear. Presumably, it is intended to prevent losses from Wide Range investments from becoming liabilities chargeable against the Narrow Range fund. However, the Wide Range investments permitted by the Act are not likely to produce significant liabilities as opposed to losses. The Committee recommended abolishing this requirement, though it is unlikely that it is sufficiently cumbersome to have accounted for the Act's lack of appeal to settlors. The advice provisions have also been criticized, but the Committee believed them to be useful, and recommended retaining them. In both respects, the Commission agrees with the conclusions reached by the English Law Reform Committee.

The Committee concluded that the 50% "cap" on investment in Wide Range securities is too inflexible. The Act permits Treasury to increase the limit to 75% by order-in-council, but this power has never been used. Some critics proposed that the courts should be empowered to increase the proportion of Wide Range securities in individual cases. The Committee, however, recommended a more drastic alteration of the legislation. It proposed dropping the cap entirely. The two-list structure of the Act would be retained, but only for the purposes of the advice requirement and to give substance to the direction to diversify investment between the Narrow and Wide range categories. The English Law Reform Committee also recommended removing the limitations contained in the present Act on the type of permitted equity investments. Thus, the reformed legislation would permit investment in equity shares of companies that do not pay dividends.

The Commission agrees without reservation that there should be no restrictions on the type of equity investments in shares of publicly-traded corporations permitted to trustees. This approach is necessary if it is to restore statutory control of trustees' investment decisions. It is likely that the unpopularity of the legislation with settlors and their advisors can be traced largely

47 In addition to the report of the Law Reform Committee, see Waters, above, at 771-72, and the Ontario Law Reform Commission, above, at 220-221.

48 This is Water's opinion, above, at 771.
to the limited range of equities included in the Wide Range list. Many attractive equity issues do not pay regular dividends. If share value increases as a result of the performance of the company, investors will be content to realize capital gains on their investment (and the favourable tax treatment it entails) rather than expect dividends. When expanded legal lists where first mooted in the 1950's, there was a closer connection between a corporation's prospects and its dividend-paying record than at present. As the Law Reform Committee noted, companies now make the decision to pay dividends or re-invest profits on grounds that have more to do with interest rates and long-term corporate strategy than with the solvency of the firm. The limitations on equity investment in corporate shares contained in both The Trustee Investment Act and Canadian trustees' legislation no longer reflects the realities of financial markets.

However, in the Commission's opinion it would not be appropriate to permit all forms of equity investment. Investment in share capital does not involve the trustee in management of a public corporation. In addition, the liability of the trust fund is limited to the value of the shares. These features make them appropriate investment vehicles. Unless the terms of the trust provide otherwise, a trustee is required to invest the trust fund in securities, and an executor is expected to liquidate the assets of the estate he or she administers and invest the proceeds. A trust is not ordinarily a mechanism for carrying on or purchasing a business, and the risks involved in doing so are not acceptable unless the terms of the trust expressly direct such a course of action. Therefore, the legal list should continue to be confined to debt and equity securities of publicly-traded corporations and secured loans. However, the Commission is also of the opinion that it would be desirable to permit trustees to apply to court for permission to make otherwise unauthorized investments. While such investments are usually not justified, there may be good reason for permitting them in individual cases.

The Commission has, somewhat reluctantly, concluded that a cap on equity investments is unnecessary except for purposes of the advice provisions in the legislation. In some respects, a mandatory limit on equity investments has much to recommend it. It would protect at least a portion of the trust fund from speculative losses and over optimistic views of the state of the market. A prudent investor will not usually place the entire fund in equities. While a 50% cap is necessarily arbitrary, it is probably not far from the limit a prudent trustee would impose on himself or herself in a majority of cases. Particularly in a jurisdiction in which most trust funds are administered by nonprofessionals, the basic guidance provided by a cap is attractive. Nevertheless, the Commission has concluded that a mandatory cap would impede sound investment strategies.

49See above.
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The investment strategy appropriate for most trust funds is similar to that appropriate when an individual invests for retirement. Therefore, contemporary advice to individuals investing in Registered Retirement Savings Plans (R.R.S.P.'s) provides a good analogy to the advice that would given to trustees permitted a wide range of investment options. Almost without exception, the expert advice to people saving for retirement is to balance equity investments (usually equity mutual funds as an R.R.S.P vehicle) with secure interest-earning investments such as G.I.C.'s. A 50% cap on equity investment would often be appropriate, but there are too many variables involved in making investment decisions to make it a workable mandatory limit. When interest rates are high, a smaller proportion of equity investments is good practice. But when interest rates fall, as they have in the last few years, most advisors suggest sharply increasing equity investments. Moreover, the proportion of equity investment that is appropriate also depends on the length of time the funds will be invested. A young person planning for retirement can afford to ride the ups and downs of the stock market in pursuit of a higher rate of return. A person approaching retirement age cannot gamble that the market will be performing well when retirement income is required, and would be well advised to shift funds into G.I.C.'s when a good capital gain on equity investments can be realized. A trustee should similarly be guided by the time that will elapse before trust funds must be paid out.

An authoritative guide to mutual funds published by *The Financial Times* provides this general advice to investors:

As far as risk is concerned, you have two basic strategies from which to choose, one that is active and one that is passive. The active strategy is to constantly change the mix of mutual funds within your R.R.S.P., moving into growth [equity] funds when they offer the best values and into income funds and money market funds when the outlook is for equities is cloudy.... The passive strategy reflects the view that your age dictates the type of mutual funds you hold- the younger you are the more risk you can take.\(^50\)

The Financial times guide suggests that 80% equity investment might be appropriate for an investor of thirty years of age. By fifty years of age, however, the proportion in equities might prudently be reduced to 40%.\(^51\) Investment advisors at Co-op trust in Saskatchewan have adopted a similar policy in advising investors in its mutual funds. For a person under 35 years of age, from 50% to 100%

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\(^{51}\) p. 74.
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investment in "mixed" funds that include both equities and interest-earning securities is recommended. For investors older than 35, 35-50% in mutual funds, with the remainder in G.I.C.'s is advised. Mutual funds are usually not recommended for investors over 55 years of age. Independent investment councillors contacted by the Commission were less inclined to suggest formulae, suggesting that in giving advice, "risk tolerance" and age were primary considerations. All suggested that RRSP contributions over the last two or three years should have been weighted toward equities because of low interest rates. None, however, would ordinarily advise more than 50% of total retirement savings in equities for any but younger investors.

Sound investment of a trust fund probably requires a slightly more conservative approach than saving for retirement. A young person saving for retirement can ride the ups and downs of the market, as can a trustee who is able to make long-term investments. But a young person saving for retirement can also usually afford to sustain some losses, since the rate of investment in the fund can be increased in later years to off-set them. A trust fund, on the other hand, has no source of new funds to compensate for losses. It is doubtful, then, that the 50% cap is responsible for the Act's failure to secure the adherence of settlors. Nevertheless, it is difficult to escape the conclusion that a 50% would not afford enough flexibility to meet changing needs and market conditions.

In the Commission's view, mandatory advice rather than a mandatory cap on investment in equities and other relatively risky investments is appropriate. It is unlikely that an investor who follows advice of the kind outlined above will suffer serious losses. If it was reasonably certain that trustees would seek and receive proper advice before investing trust funds, no statutory regulation of trustees' investments would be necessary. However, because most trustees are not professional money managers or experienced investors, there is good reason to believe that mandatory advice requirements would provide useful protection for trust funds. The Commission informally questioned institutions selling mutual funds about the advice sought and received by investors. It was found that practice varies widely at present. Some institutions offering R.R.S.P.'s do no more than ask clients if they are prepared to take the risk of an uninsured investment. One trust company representative justified such a policy by noting that "we do not do financial planning". In other cases, guidelines such as those outlined above are used to assist clients. Some institutions and independent advisors attempt to gauge the "risk tolerance" of clients by considering their means and circumstances. Particularly at a time when low interest rates are leading to increased interest in equity investments even by investors

52Waters, above, at 772, questions whether the balance between equity and debt securities obtained by trustees with discretionary investment powers "differ very much from the statutory 50:50 division".
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for whom security is a primary consideration, it is desirable to ensure that trustees obtain professional advice before investing trust funds.

Mandatory advice when trust funds are invested in equities and other high risk securities is, in the Commission's opinion, the most important of its recommendations. However, because many trust documents presently oust the provisions of The Trustee Act governing investments by trustees, the impact of the advice requirement would be minimal if it is not applied to trustees who have been given discretionary investment powers. Although the list of approved investments would be of no application in such cases, the Commission believes that all trustees should obtain advice before investing trust funds in equities and other securities carrying a similar risk.

IV. SUMMARY OF RECOMMENDATIONS

The trustee investment provisions in the Saskatchewan Trustee Act are no longer in accord with prudent investment planning, and are out of step with the realities of contemporary financial markets. Reform of trustee investment legislation is necessary if effective statutory regulation and guidance of trustees is to be maintained. In the Commission's opinion, the components of an effective policy are:

1. Recognition that prudent investment of trust funds must provide as much security as possible while maintaining growth and income levels consistent with the purposes of the trust.

2. Assurance that trustees will obtain expert advice before investing.

3. Legislation that provides guidance to trustees rather than providing an after-the-fact judgement of investment decisions. If a breach of trust is alleged, the equitable standard of prudence is an adequate standard. Legislation should supplement it by directing trustees in a prudent course. Reformulation of the standard applicable to determine whether the trustee is liable for breach of trust is neither necessary nor desirable.

The Commission has concluded that these goals will best be served by retaining a list of approved investments, but modifying it to permit trustees to create balanced portfolios of debt and equity securities.
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1. Investments approved for trustees governed by The Trustee Act should consist of two classes:

   (a) Government (municipal, provincial, federal, and selected foreign securities) now included in the list of approved investments under the Trustee Act; first mortgages and securities secured by first mortgages or trust indenture; Insured Deposits in financial institutions; Securities guaranteed by governments.

   (b) All other publicly-traded securities and securities approved by Regulation.

2. Trustees should be directed to invest funds, having regard to the nature and purposes of the trust, to maintain an appropriate balance between income and capital, and to meet the needs of the trust for security and growth.

3. A trustee should not be permitted to invest in class (b) securities without obtaining the advice, in writing, of a recognised financial advisor. This recommendation should apply to trustees who are permitted to make investments not included in the approved list, and to trustees who have been given discretionary investment powers.

4. A trustee should be permitted to apply to the court for permission to make an investment that is not otherwise approved.