March 2023

Advisory

Trustee investments under the Ontario *Trustee Act*

In this Advisory, we present an overview of the principles of trustee investment under Ontario's governing legislation, the *Trustee Act.* As well, we provide a critical analysis of the main implications of the legislation for trustees, beneficiaries and advisors concerned with trust investment.

OVERVIEW OF TRUSTEE INVESTMENTS IN ONTARIO

Standard of Care

In July 1999, significant amendments to the *Trustee Act* regarding trustee investment came into force and those rules continue to govern today. By far the most sweeping change to the law governing trustee investment at the time was the introduction of a new standard of care incorporating the "prudent investor rule". Under prior legislation, if a trust agreement did not provide broad investment authority, a trustee was obligated to invest only in "trustee investments" set out under the *Trustee Act*, which were conservative and heavily fixed-income oriented. If a trust agreement provided broad investment authority, case law determined what were "prudent" investments for trustees, and focused on the nature of the individual investment, as opposed to the overall investment strategy.

Since July 1999, a trustee has been permitted to invest trust property in any form of property in which a prudent investor might invest, and must exercise the care, skill, diligence, and judgment any prudent investor would exercise in making investments. As a result, the types of investments trustees can currently invest in are considerably broader than under the former rules.

Authority to Invest in Mutual Funds and Common Funds

The legislation specifically authorizes trustees to invest in mutual funds, notwithstanding any rule of law in Ontario case law pre-dating July 1999 that prohibited a trustee from delegating his or her powers or duties.

Trustees also have express authority under the Act to invest in common trust funds if trust property is held by co-trustees and one of the co-trustees is a trust company. Common trust funds are pooled investment funds used by a trust company to consolidate the investment management of trusts and estates it administers as trustee.

Mandatory Investment Criteria

The Act sets out mandatory investment criteria which a trustee is obligated to consider in planning the investment of trust property, in addition to any others that are relevant to the circumstances. These criteria include:

- general economic conditions;
- the possible effect of inflation or deflation;
- the expected tax consequences of investment decisions or strategies;
- the role that each investment or course of action plays within the overall trust portfolio;
- the expected total return from income and the appreciation of capital;
- needs for liquidity, regularity of income and preservation or appreciation of capital; and
- an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

Diversification Requirement

The legislation also requires that trustees diversify the investments of a trust as appropriate having regard to the requirements of the trust and to general economic and investment market conditions.

Authority to Obtain Investment Advice

Trustees have express authority to obtain investment advice. The legislation specifically provides that it is not a breach of trust for a trustee to rely on advice he or she obtains if a prudent investor would rely on such advice under comparable circumstances.

Authority to Invest in Accordance with the Terms of the Trust

A settlor of a trust or testator of a will may, however, indicate specific investment provisions to which the trustee must adhere. The legislation states that a trustee is authorized to invest in a manner that is consistent with such terms of the trust.

Trustee Liability

The legislation provides certain protection to trustees for investment losses of the trust. A trustee is not liable for investment losses to the trust if the conduct of the trustee leading to the loss conformed to a plan or strategy comprising reasonable assessments of risk and return that a prudent investor could adopt under comparable circumstances.

IMPACT OF THE LEGISLATION ON TRUSTEE INVESTMENT PRACTICE

We have highlighted below how the legislation affects trust investments in general, as well as trustees' investment protocols and practices.

Better Returns for Beneficiaries

The current Act puts trustee investment practice in line with modern portfolio theory. With the flexible approach of the prudent investor rule and a standard of care which forces trustees to take a proactive approach to trust investment, beneficiaries benefit. Trust assets can be optimally invested to achieve higher returns, and in many cases, with less risk than under previous practices.

Increasing Use of Trusts

With the modernization of trustee investment practice and greater proactivity required of trustees resulting in better investment performance, trusts are attractive vehicles and increasingly popular as a result.

Broad Range of Investments

Under previous rules, various investments such as derivatives, futures and options were not considered prudent for trustees, and failing express authority under the trust instrument, could not be included in a trust or estate portfolio. The 1999 changes to the Act eliminated these restrictions. Where it is appropriate to do so, trustees may invest in these specialty investments, which in the right circumstances can be used to enhance investment return, and in some cases, reduce risk.

Legitimization of Mutual Funds and Pooled Funds

With their legitimization for use in trusts and estates in 1999, mutual funds have since continued to be a popular vehicle for investment of trust and estate assets. Mutual funds provide a vehicle to readily achieve the diversification mandated by the rules, including for small trusts and estates. The legislative amendment authorizing their use removed an outdated obstacle that trustees had faced in efficiently investing trust assets, in particular, for smaller trusts and estates.

Focus on Equities, Decline of "Fixed Income" Approach

The standard of care provided under the legislation requires trustees to take a proactive approach to investing. Trustees cannot simply invest in a narrow group of authorized investments and preserve capital. Particularly where a trust has a long-term horizon, trustees have to be more equity-oriented in order to act as a prudent investor would and to achieve appropriate investment returns.

Accountability Required of Trustees

Along with the standard of care, the requirement for diversification, and mandatory investment criteria discussed above comes a rather significant level of accountability required by trustees to beneficiaries.

Beneficiaries are in a position to scrutinize and assess comparative investment performance, and to challenge trustees where a trust or estate has inferior investment performance. Under the Act, an objective basis exists to assess whether trustees have properly discharged their investment role. Trustees must not only meet these standards, but also be in a position to demonstrate that they have.

Trustees need to establish clear written investment guidelines for a trust or estate which reflect the considerations they have taken into account and the rationale for their investment objectives, and must keep these guidelines up-to-date.

Trustees also must demonstrate that they have taken into consideration the mandatory criteria established under the *Trustee Act*, which requires proper documentation of their deliberative process and regular updating. Trustees need to liaise with beneficiaries on a regular basis to ensure the mandatory investment criteria are properly integrated into their investment planning.

Trustees also have to closely monitor their investment portfolios as may be appropriate based on the nature of the investments held and be able to demonstrate that such constant monitoring has been performed.

Diversification and Added Care Required if Original Assets are Retained

Under the Act, the obligation to diversify an investment portfolio is made subject to what is appropriate to the requirements of the trust and to general economic and investment market conditions. Trustees are required to carefully review original assets and appropriately diversify. Where it is advisable for the purposes of the trust to retain an original asset (for example, a family farm, large commercial property, or shares of a private company), as a defensive measure, trustees need to carefully document such decisions and where appropriate seek beneficiary approval.

Professional Investment Management

The legislation gives statutory blessing for trustees to seek professional investment advice. Case law in Ontario supports the position that investment counsel fees are a proper expense of an estate and are not deductible from trustee compensation. The legislation bolsters this position. No doubt all trustees, except those administering the most financially modest trusts and estates, are compelled to seek professional investment advice in order to fulfil the requirements of the legislation.

Corporate trustees should also seek specialized advice where the nature of the trust assets requires investment expertise not available in-house.