PRACTICE TIPS

The Lawyer As Trustee: Working with Brokers, Investment Advisors and Financial Planners

Best Practice Standards

Recently, the American College of Trust and Estate Counsel published its long awaited "Guide for ACTEC Fellows Serving as Trustees" [ACTEC Notes Vol. 26 (2001), pp. 313-327]. The Fiduciary Matters Subcommittee advises that the guide is "not in any sense, a 'restatement of the law' dealing with trusteeships;" and acknowledges "it is addressed only to Fellows of the American College...and not to the legal community generally." Nevertheless, ACTEC standards, while not inflexible or monolithic, represent "best practice" for the profession and, for practicing lawyers, help define standards of reasonableness for fiduciary administration of trust assets.

Indeed, ACTEC allows for considerable variation in business practice models. Under some models attorneys act as a sole trustee, while under others they act as a co-trustee with beneficiaries or other commercial fiduciaries. Along the business services spectrum, the lawyer-trustee can provide a full range of investment and administrative services or can act as an "advisory fiduciary" that oversees other vendors as they provide requisite services.

Of particular interest, is the Guide's recommendations regarding investment of trust assets. The ACTEC position is noteworthy in several respects:

1) The lawyer-trustee should "adopt an investment plan that is suitable to the purposes of the trust." The plan should provide for the selection of appropriate investments, monitoring of performance on a continuing basis, and management of investment risks in order to minimize exposure to losses.
2) The plan, although based on the provisions of the trust document with respect to investment matters (including the status of beneficiaries and the relative importance of income and growth of principal) is separate from the governing trust instrument.
3) The investment plan should be in writing.

Once written investment policy is in place, the lawyer-trustee must then decide on how best to discharge the administration of the trust estate. Some firms have "a prudently self-contained investment function within the lawyer-trustee's law firm." Assuming that the trustee has competence and experience in the management of investments, and assuming that there are resources sufficient to maintain and monitor investments on a continuous basis, this trustee business model may work well. Indeed, this model characterizes trust service offerings of several large Boston firms.

For variations on the self-contained model, however, the watchwords are surveillance and monitoring. For example, the ACTEC guide discusses alternative investment models:

1) Use of professionally managed investments (bank pooled or common collective accounts and mutual funds) is a possibility when there are no restrictions in the trust instrument or local statutes. However, "the trustee must...select and monitor the funds with great care."
2) Utilize the services of a professional co-trustee possessing the necessary experience and investment expertise. "In that case the lawyer-trustee must keep track of the actions of the co-trustee: being sure that the investment plan is being carried out, monitoring the trading and checking on the performance of the account on a regular basis."
3) Employ a requisite level of care, skill and caution in selecting an agent for the purposes of delegating the investment function. However, the lawyer-trustee cannot delegate responsibilities for establishing the scope and terms of the delegation (i.e. written investment policy guidelines) and for "monitoring the agent's performance."

Most private trusts are currently managed without benefit of a written investment policy statement (IPS). Thus it comes as some surprise that the ACTEC Guide augments the importance of establishing sound written policy to the extent that it is now placed at the heart of fiduciary asset management activities. One can speculate that this evolution is due, in part, to the standards for general asset management promulgated since the early 1990s by organizations like the Association for Investment Management and Research (AIMR). AIMR calls for development and implementation of written investment policy regardless of whether assets are trust owned or personally owned. College texts in introductory investment courses now devote entire chapters to the rationale for, and use of written investment policy. Furthermore, the use of the written IPS is becoming increasingly common under the fiduciary asset management standards of ERISA.

Recent polls by the Institute of Management and Administration indicate that approximately 60 percent of defined contribution retirement plans with participant populations of over 1000 have an IPS. As the plan sponsor community moves from a defined benefit to a defined contribution/ 401(k) environment, it is not surprising that the IPS becomes more prevalent. Indeed, one recent ERISA decision suggests that the absence of written investment policy may be *per se* negligence [*Liss v. Smith*, 991 F. Supp. 278 (S.D.N.Y. 1998). Indeed, the Department of Labor expects that all defined contribution plans have a written IPS and the IPS is generally at the top of the document request list in any DOL audit.

One can also speculate that trustees of private trusts have been slow to hop on board because the legal implications of Restatement Third's repeal of the anti-delegation standards have not been clarified by local court decisions. As long as local courts focus either on community standards or "bright line" practices, trustees are unlikely to be surcharged for damages arising out of

a lack of written investment policy especially if a causal link cannot be established. Additionally, one can speculate that both the courts and commercial fiduciaries continue to struggle with the shift from a "legal list" investment environment based on evaluation of investments in isolation to portfolio-based standards reflecting modern portfolio theory's concentration on the evaluation of the risk/reward tradeoff of the trust's aggregate investment position.

Furthermore, one suspects that, for private trusts, the historically low U.S. divorce and remarriage rates mitigated the need for written IPS for all but the most dysfunctional families. As the traditional family model becomes applicable only to a minority of households, the antagonisms, animosities and competing interests of trust beneficiaries may increase. A written IPS is a tool for managing litigation risk in such an environment. It is not difficult to see why some investment product vendors exhibit reluctance to recommend a written IPS. If the salesperson assists the investment fiduciary to develop such a document, the salesperson might assume the legal status of an investment advisor or even co-fiduciary. From a liability control point of view, this is undesirable for the investment provider who would like to position the salesperson as merely an information source regarding available investment alternatives and as a facilitator for client order execution. Finally, until recently, the great bull market in domestic securities has undoubtedly provided a condition where a poor investment decision process could conceal its flaws under a warm and comfortable blanket of double digit annual returns.

Delegating Investment Functions

Brokers and financial planners often market their services under a variety of titles including investment counselor, investment representative, investment advisor and so forth. Often the quality of their recommendations is a key factors in the success or failure of the alternative trust business models outlined in the ACTEC Guide. In seeking to delegate certain investment functions (i.e. the generation of periodic investment return as opposed to monitoring and performance evaluation functions), the Guide is clear that the lawyer must employ reasonable care, skill and caution in seeking competent assistance: "Independent managers who are registered under the Investment Advisers Act, and regulated trust companies, are the obvious candidates as agents." Furthermore, the ACTEC Guide states "It is generally not recommended that a stockbroker be selected as a delegated agent under the UPIA [Uniform Prudent Investor Act]."

The explicit warning regarding delegation of certain investment functions to a stockbroker may be troubling insofar as many lawyer-trustees rely on sales recommendations made by such brokers. To make matters even more confusing, some brokerage firms (and, by extension, their sales representatives) have registered as independent investment advisors under the Investment Advisors Act of 1940. However, just as the SEC permits certain exemptions from registration for lawyer-trustees whose performance of investment advisory activities is solely incidental to the practice of their profession, so too, the SEC has proposed exemptions from the registration requirement for certain brokerage firms offering advisory services.

These firms are, in the main, the larger firms who, ironically, are positioning their sales agents as financial advisors compensated on a more traditional investment advisor model (fee or percentage of assets under management basis). Merrill Lynch, for example, entitles its website "The Personal Adviser" and advertises that "...services available to eligible clients include: The advice and guidance of a Financial Consultant." Brokerage firms, banks and insurance companies have traditionally been exempt from the provisions of the 1940 Act; and it is the SEC's current position that these types of "consultant" services should not trigger a need to register under the Act (as long as the broker does not exercise investment discretion over the assets in the account) because any investment advice remains incidental to sales activities and brokerage services.

The proposed SEC exemption of certain broker-dealers from the investment advisor act provisions apparently extends to solicitation and sales of wrap fee accounts. Wrap fees and compensation for wrap account sales are deemed to be compensation for sales and not compensation for investment advice. Needless to say, the SEC proposal has generated a firestorm of controversy among financial planners. Many financial planners are required to register as investment advisors either as state advisors (asset less than $25 million under advisement) or as federal (SEC) advisors.

Financial planners claim that brokerage transactions have become incidental to advisory services and, therefore, it is unfair to grant the brokerage firms an exemption from the duties that follow from registration. There is a small army of sales agents marketing services under titles suggesting objectivity and independence that are compensated for selling wrap fee accounts, hedge funds, insurance products and other programs that fly under the SEC's radar.

Ironically, however, the financial planning profession is itself undergoing a bitter internal debate regarding the Certified Financial Planner Board of Standards proposed rule 402. This rule calls for increased disclosure of the mechanisms used by planners to generate income (i.e. fees, commissions, etc.) and the level of that income. The October 2000 issue of *Financial Planning Magazine* quotes the opinion of CPF Board's Interim President that rule 402 was necessary because the ethics regulations that include disclosure requirements "...are often either misinterpreted or ignored by CFP licensees." Many financial planners maintain relationships with smaller broker-dealers and are subject to the same pressures to recommend programs with expenses and fees that may be unreasonable or inappropriate to the trust. Finally, coming full circle, certain financial analysis (CFA charter holders) regulated under AIMR Professional Practice Standards now stand accused of a variety of abuses regarding buy recommendations issued for companies whose stock the analysts own.

It is little wonder that ACTEC cautions the lawyer-trustee that delegation of the responsibility for generating investment returns is itself a task subject to fiduciary standards. It is also not surprising that the ACTEC Guide reminds the lawyer-trustee that:

- The return generation process must be monitored and evaluated in order to determine if current investment strategies are aligned with the investment policy of the trust; and that,
- Courts exercising equity powers sometimes over-ride broad-scope exoneration clauses.

These reminders highlight the two-fold function of a well drafted written Investment Policy Statement. It is the document that evidences a prudent decision making

process and, on the positive side, maximizes the probability of a long-term favorable outcome for trust beneficiaries. Conversely, it helps mitigate fiduciary liability, and allows the attorney to seek competent assistance without breach of trust for failure to attend to non-delegable duties through passive acquiescence to a salesman's recommendations. Therefore, it is critical to:

1) Draft and implement a well-conceived IPS; and,
2) Establish and conduct a prudent monitoring and surveillance program.

Investment Policy

A sound investment policy is one that is legally defensible, academically justifiable, and administratively feasible. Legal and/or academic complexities that tie the lawyer-trustee into administrative knots are as inappropriate as sales suggestions that poorly suited to the purposes, terms, distribution requirements, and other circumstances of the trust or that are offered without a thorough analysis of their impact on risk and return objectives suitable to the trust. Conventional trust administration developed under Restatement 2nd, held up the trustee as a "caretaker" of assets. The caretaker's job was to see that the property remained productive and that each investment exhibited a proper degree of conservatism so that no asset exposed the trust to a risk of a loss of principal. Restatement 3rd's Prudent Investor Rule substitutes a model of the trustee as a "caretaker" of policy where policy is defined as the exercise of reasonable care, skill, and caution in the context of the trust portfolio and as a part of an overall investment strategy that consciously articulates and decides on the risk/return tradeoff suitable to the trust. As caretaker of policy, the lawyer-trustee is concerned that the policy:

1) Evidences the prudence of the fiduciary's decision-making process;
2) Ensures that investment decisions are made from a long-term strategic perspective rather than from ad hoc reactions to broker tips or short-term market vicissitudes;
3) Establishes quantitative standards for investment selection, investment monitoring, and for expectations of investment performance.

A well-crafted IPS will outline:

- The rationale supporting the investment categories (risk/return exposures) represented by the trust portfolio's asset allocation decisions;
- The strategy to be employed in management of the trust estate (active v. passive investment management/ single security v. pooled account investments);
- Selection Criteria for evaluation of vendor product offerings (track record, risk parameters, load v. no load);
- Reporting procedures appropriate for ongoing monitoring and surveillance; and,
- Objective criteria for investment retention.

The IPS can then be handed to any investment product vendor (or set of vendors) in order to provide clear guidelines for the investment management process. It is the obligation of the vendor to recommend how returns can or should be generated within the policy guidelines. A typical guideline provision might, for example, inform a product vendor that the trustee deems it to be prudent to expose a reasonable percentage of assets to the risks and returns of the large company US market of stocks. Furthermore, it is the trust's policy to have a specified minimum level of diversification within the investment category. Investment recommendations must fit within policy targets designed to minimize investment charges, fees and expenses as well as tax mitigation targets. The product vendor can now search his or her menu of available offerings in order to bring appropriate selections to the trustee's attention and to discuss the merits and liabilities of each.

This policy-driven process stands in direct opposition to the common broker/ financial planner-driven process. In the latter process, the vendor offers the trustee a selection of good securities. For example, one Baltimore area lawyer-trustee annually invites three brokers to look at trust investment portfolios and to submit a written proposal based on his or her opinion regarding the best stocks to own during the forthcoming year. Each broker is given sufficient interview time to discuss the proposal with the trustee. Following this process, the trustee selects the proposal which, in his opinion, offers the best prospect of generating superior performance during the upcoming year.

The trustee relies on the "three bids" model of asset management without coming to grips with the logical dilemma of how many biased sales pitches does it take to constitute procedural and substantive prudence. After all, broker recommendations are not equivalent to fiduciary counsel because the vendor's job is to generate compensation through transactions. Such sales-oriented recommendations are not the same as independent, objective third party advice.

Irrespective of this logical difficulty, however, the trustee (and the brokers/financial planners who submit the proposals) operates under a "treasure hunting" asset management model that, although administratively feasible, is difficult to justify either legally or academically. The presenters are implicitly forced into eschewing broad-scope diversification with the hope (wishful thinking) that they have identified top performing securities. Instead of controlling risk, this process sends risk off the meter because, absent good performance, the presenter will not be invited to make future pitches.

Trustees, however, are rarely charged with the task of maximizing period-by-period returns. Rather, they are charged with the task of maximizing the probability of a successful long-term outcome at a level of risk appropriate to the needs of the beneficiaries and the level of trust capital available for investment. Academic literature (not to mention the popular press following the new economy meltdown) is filled with independent, objective studies indicating that "treasure hunt" investment strategies have a low probability of long-term success. Such an investment model fails to see that the investment decision making (policy) process is not same as period-to-period money management.

Following drafting and implementation of a well-crafted IPS, the lawyer-trustee retains the challenging task of surveillance and monitoring. Once again, however, the IPS will significantly reduce the effort and time commitment required for this task. Objective benchmarks can be specified as part of trustee asset allocation decisions. The vendor should be instructed to report not only raw performance data to the trustee, but also performance (after fees) v. benchmark; risk-adjusted performance relative to the benchmark's risk, and other useful information that will help the trustee evaluate vendor performance.

The IPS should specify both the type of information that should be forthcoming and the format in which the information should be presented. The objective of the

IPS should be to provide the vendor with a clear understanding of the standards against which investment recommendations will be evaluated and to provide the trustee with the insight necessary to determine whether the vendor's recommendations are adding or subtracting value from the trust estate. Monitoring is, as the ACTEC Guide suggests, at the core of fiduciary standards for the stewardship of trust assets. A full discussion of this topic is, however, beyond the scope of this essay.

In conclusion, lawyer-trustees wishing to continue relationships with brokers and financial planners should consider drafting a written IPS. Needless to say, they should seek competent assistance from a registered investment advisor who is independent of any vendor. Ideally, the registered investment advisor should not be a money manager and should not receive compensation for investment management activities or sales of investment products. Likewise, the independent advisor should not accept referral fees or other "soft-dollar" compensation from broker-dealers or investment managers.

The IPS should be administratively feasible to the extent that the trustee should be able to take it to any product vendor without unreasonably constraining the vendor's ability to offer quality products. Just as importantly, the trustee should be able to engage the services of any reasonably competent independent investment advisor should the trustee wish to outsource the monitoring and performance evaluation functions. The policy should not be a document that ties the trustee to any advisor or vendor with the result that the trustee is unable to discharge his or her non-delegable duties. Finally, the IPS should be communicated to all interested parties so that they can gain insight into how policy shapes a prudent investment decision making process that increases the likelihood of future investment success.

– Patrick J. Collins, Ph.D., CLU, CFA

Mr. Collins is affiliated with Schultz Collins Lawson Chambers, in Towson, Maryland.

A Lawyer's Word

Part One

Pinnochio demonstrated one penalty for failing to tell the truth. The penalty for an attorney affects his/her license rather than the proboscis. A sampling of what our Court of Appeals and those of other courts have said on this subject follows.

Vincent A. Indeglia, a Rhode Island attorney, accepted a settlement without the consent of his client. The settlement was paid to him in installments and when he attempted to disburse the proceeds to his client he was short $13,000 less than the sum due the client. He then fibbed to the client about the money's whereabouts and finally paid the client in full in just over a year. He was suspended for 90 days (a rather modest suspension I might add).

Emil J. Becker, Jr., an Indiana attorney, told the Disciplinary Commission that his client signed the client's daughter's name to a cash bond refund check. However, it was Mr. Becker who signed the check. For his "word" to the Commission he was suspended.

Eric B. Bolusky, an Oklahoma attorney, falsely stated in a deposition that a client had never requested return of the client file and told a client that a lawsuit had been filed when it had not and presented the client with a fabricated petition. He joined the ranks of suspended attorneys.

Nitor Egbarin, Connecticut, provided two federal income tax returns to home lenders without disclosing that he had not paid the tax obligations for either year. He, too, was suspended.

Pamela M. Espinoza, Colorado, inflated her hourly billings to justify the unreasonable retention of a retainer fee and then made false statements to the court. She was disbarred.

David W. Olivero, Illinois, filed a false disciplinary grievance against another attorney and lied about his conduct, under oath, to the disciplinary authority. He was suspended.

Jacqueline F. Ross, also an Illinois attorney, was suspended when she made material misrepresentations on two loan applications falsely certifying that she had no outstanding judgments against her and was not in default on any student loan.

Peter B. Walton, Alaska, created a false document attaching it as an exhibit to an unverified complaint. He, too, was suspended.

Anthony B. Lamberis, Illinois, was suspended for plagiarism in his thesis for a master's degree in law.

Theodore Hadzi-Antich, District of Columbia, was censured for submitting false information in a resume sent to a law school prospective employer.

Jason Mitan, Illinois, was disbarred for false statements on his application to the bar including failure to disclose a name change, his correct birth date, previous addresses, details of a divorce, attendance at law schools other than the one from which he received his degree, five previous employers, civil lawsuits, and arrests and convictions.

Stephen C. Haskell, Washington, altered bills to increase fees and was suspended.

Anthony Mason, Illinois, fabricated a settlement offer when he failed to file a