
**THE OTTAWA REGION
Charity & Not-for-Profit Law Seminar**

Ottawa – February 18, 2010

**Investment Decision Making
During Difficult Financial Times**

By Terrance S. Carter, B.A., LL.B., Trade-mark Agent

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1. INTRODUCTION

- The recent recession has resulted in some charities facing significant losses in their investment portfolios, e.g. 43% reported loss in the endowment fund of St. Francis Xavier University in 2009
- This has led the boards of many charities to become concerned about how best to invest charitable funds in a volatile market and what their personal exposure to liability might be

- Both of these concerns can be addressed by board members of charities:
 - Understanding their statutory investment duties under the *Trustee Act*
 - Ensuring that there is appropriate documentation in place to comply with the statutory requirements under the *Trustee Act*
 - Reviewing such documentation on a regular basis to ensure ongoing compliance with the *Trustee Act*.

- These issues will also be relevant to not-for-profits to the extent that they hold monies in trust for various endeavours, such as fundraising for charitable causes
- A not-for-profit when holding funds for a charitable purpose is deemed to be a trustee under section 1(2) of the *Charities Accounting Act*, and pursuant to section 10.1 of that Act the not-for-profit must comply with the requirements of the *Trustee Act*
- This means that the “prudent investor” standard of care under the *Trustee Act* discussed below will apply to not-for-profits in these situations

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- This presentation reviews what is legally required under the *Trustee Act* for investment decision making and how to practically comply with the applicable statutory requirements
- For more details, see Charity Law Bulletin #8 entitled *New Investment and Delegation Powers for Charities in Ontario*, at <http://www.carters.ca/pub/bulletin/charity/2001/chv1b08-01.pdf>
- Also see a Bulletin entitled “Investments by Directors and Trustees of Charities” at the website of the Public Guardian and Trustee <http://www.attorneygeneral.jus.gov.on.ca/english/family/pgt/charbullet/bullet7.asp>

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- 2. GENERAL APPLICATION OF THE TRUSTEE ACT TO CHARITIES**
- Subsection 1(2) of the *Charities Accounting Act* provides that charitable corporations are deemed to be trustees of their charitable property within the meaning of the *Act*
 - Section 10.1 of the *Charities Accounting Act* confirms that charitable corporations must comply with the investment decision making requirements in sections 27 to 31 of the *Trustee Act*
 - As well, property that is subject to a special purpose trust is specifically trust property subject to the *Trustee Act*

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- The *Trustee Act* will not apply where
 - The letters patent of a charity states that the *Trustee Act* does not apply
 - A special purpose trust in a will or in a gift agreement establishes a different investment power from that contained in the *Trustee Act*
 - There is a different investment power set out in special legislation creating the charity

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- 3. PROBLEMS WITH FORMER TRUSTEE ACT**
- The former *Trustee Act* (pre July 1, 1999) listed specific categories of legal investments, which categories were very limited
 - Debt issued by banks, governments, trust companies
 - Equities issued by Canadian companies but subject to a dividend test
 - Investments in mutual funds were not permitted
 - Delegation of investment decision making was also not permitted
 - Investment only permitted in the stated legal list
 - But there was no guarantee against negligence claims
 - Standard of care and prudence was still required

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- 4. NEW PRUDENT INVESTOR STANDARD**
- Effective July 1, 1999 – the prudent investor standard replaced the legal list of authorized investments
 - “A trustee may invest trust property in any form of property in which a prudent investor might invest”
 - No longer any restrictions on the type of investments
 - Standard of care required
 - “The care, skill, diligence and judgment that a prudent investor would exercise in making investments”

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- Investing in mutual funds is permitted
 - But no definition of mutual funds
- Investing in pooled funds is permitted
 - But no definition of pooled funds
- Investing in segregated funds is permitted
 - But no definition of segregated funds
- As a result of Bill 212 enacted in December 2009, the *Charities Accounting Act* has been amended to now permit charities to invest in real estate, provided that such investment complies with the prudent investment standard of the *Trustee Act*

5. NEW STATUTORY STANDARDS MANDATED

- Seven mandatory criteria must now be considered in making investment decisions
 - 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
- An asset’s special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries
- Mandatory diversification now required in making investment decisions
 - Duty to diversify to the extent appropriate to
 - The requirements of the trust
 - General economic and investment market conditions

- Neither of these mandatory lists is a complete code in itself, as they are minimum thresholds only
- Other investment criteria that are relevant in the circumstances must also be considered
- Can obtain advice and rely on advice in meeting mandatory requirements
 - Directors may obtain advice with respect to the investment of trust property and will not be liable for losses where trustee relied on advice, provided it is prudent to rely on such advice in the circumstances

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6. PREVIOUS “CATCH 22” SITUATION WITH REGARDS TO DELEGATION

- Amendments to the *Trustee Act* enacted on July 1, 1999 did not provide the authority to delegate investment decision making to qualified investment managers
- This created a “catch 22” situation for many charities
- Charities had to satisfy the “prudent investor” standard in investment decision making but were not able to delegate the necessary day-to-day decision making to qualified investment professionals

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7. DELEGATION NOW PERMITTED

- The *Trustee Act* was further amended as of June 29, 2001, as a result of an initiative taken by the Ontario Bar Association in order to authorize the practice of delegation of investment decision making
- The amendment permits the board of directors of a charity to delegate investment decision making to the same extent that a prudent investor could

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- This means that the board of directors of a charity can delegate investment decision making to a qualified investment manager
- However, the mandatory statutory requirements to be able to delegate must be carefully reviewed and complied with, as delegation is only permitted if the statutory requirements are met
- This is in addition to the existing right to, in effect, delegate investment decision making through mutual funds

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8. THE REQUIREMENTS IN ORDER TO DELEGATE INVESTMENT DECISION MAKING

A. Investment Policy

- Cannot delegate without an investment policy in place
- Investment policy is optional if no delegation but is recommended in any event
- The investment policy must set out a strategy for the investment of the trust property, comprising reasonable assessments of risk and return, that a prudent investor would adopt under comparable circumstances

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- The investment policy must be in writing and must take into account the seven (7) mandatory investment criteria and the mandatory requirements with regards to diversification
- Need to be careful that description of board duties in an investment policy does not increase liability for directors
- Will likely need to have specific investment policies for different funds
- As such, specific investment policies may be added as schedules to a general investment policy to reflect all applicable terms of references of the *Trustee Act*

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B. Best Interest of the Beneficiaries

- The trustee must be satisfied that the investment policy is intended to ensure that the investment decision making will be exercised in the best interest of the beneficiaries of the trust
- i.e. The investment policy must be in the best interest of the applicable charitable purposes of the charity and those who will be benefited by it as opposed to the requests of the donor or any other party

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C. Agency Agreement (Investment Management Agreement)

- The trustee must have a written agreement (commonly referred to as an investment management agreement) in the form of an agency agreement between the trustee and the agent (i.e. an investment manager)
- The agency agreement must include
 - The authority to delegate investment decision making
 - A requirement that the agent comply with the investment policy in place from time to time
 - A requirement that the agent report to the trustee at regularly stated intervals

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- In addition to the statutory provisions, an agency agreement should also
 - Include a definition of conflicts of interest for the agent and board members
 - Avoid the obligation to advise agent of change of circumstances
 - Be carefully reviewed to restrict indemnification of agent by the charity
 - Be reviewed by legal counsel for the charity before being signed where appropriate

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D. Prudent Selection of Agent

- The *Trustee Act* requires that the board of a charity has a duty to exercise prudence in selecting an agent, in establishing the terms of the agent’s authority and in monitoring the agent’s performance to ensure compliance with applicable terms
- The Attorney General may make regulations concerning who is qualified to act as an agent but no regulations have been made to date
- Pending adoption of regulations, it is essential to select agents who have appropriate professional credentials as investment managers

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E. Prudence in Monitoring Agents

- The *Trustee Act* requires that the board of a charity has a duty to exercise prudence in monitoring the agent’s performance to ensure compliance with the terms of the agency agreement, including:
 - Reviewing the agent’s report
 - Regular review of agency agreement and how it is being put into effect
 - Regular review of the investment policy and its revision or replacement if necessary
 - Assessing whether the investment policy is being complied with

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- Considering whether directions should be provided to the agent or whether the agent’s appointment should be revoked
- Providing, when necessary, directions to the agent or revoking the appointment of the agent
- The above mandatory list is not a complete code of what is required for due diligence and may therefore need to be supplemented as necessary
- As a result, the board of a charity needs to be pro-active in monitoring the agent

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9. DUTIES AND LIABILITIES OF AN AGENT (INVESTMENT MANAGER)

- An agent (investment manager) has a statutory duty to exercise a trustee’s functions relating to the investment of property:
 - With the standard of care expected of a person carrying on the business of investing the money of others
 - In accordance with the agency agreement
 - In accordance with the specific investment plan and the general investment policy to which it is attached, if applicable

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- An agent may not further delegate the investment decision making authority given to it by a board of a charity to another person or agent
- An agent should carefully review existing agency documentation (i.e. investment management agreements) to ensure that they comply with the mandatory requirements authorizing delegation under the *Trustee Act*

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- If a charity suffers a loss because of the agent’s breach of duty, then legal action may be commenced against the agent by
 - The trustees, i.e. the charity through its board of directors
 - A beneficiary, which would include the charity itself, and those who benefit from the work of the charity if the board does not bring action within a reasonable period of time
- As such, members of a charity and/or other individuals who receive a benefit from the charity could themselves initiate proceedings against the agent for breach of the agent’s duty if the directors of a charity do not do so

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10. LIABILITY OF TRUSTEES

- Relief from technical breaches of trust under the *Trustee Act* is not available for losses resulting from investment of trust property
- However, the *Trustee Act* does provide that a trustee will not be liable for losses from the investment of trust property if the conduct that lead to the loss conformed to an investment plan that a prudent investor would adopt under comparable circumstances

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- Failure to comply with mandatory requirements for delegation will preclude liability protection under the *Trustee Act* and will expose trustees to liability for breach of trust for unauthorized delegation of investment decision making
- Insurers for the charity should be consulted to determine if directors' and officers' insurance covers trustees' liability from investment losses
- However, the presence or lack of insurance does not affect the possibility that there could still be a finding of breach of trust

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- Damages could include not only losses but income that might have been earned if an investment was too conservative
- Other areas of exposure to liability for trustees relating to investments
 - The *Income Tax Act* in relation to non-qualified investments and excess business holding rules for private foundations

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– Special purpose funds, like endowment funds, building funds or scholarship funds must be invested separately from the general funds of a charity

– Co-mingling of special purpose funds for investment purposes must comply with the stringent accounting requirements pursuant to the new regulations under the *Charities Accounting Act*

- See Charity Law Bulletin No. 4 at <http://www.carters.ca/pub/bulletin/charity/2001/chv1b04-01.pdf>

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11. ESTABLISHMENT OF AN INVESTMENT COMMITTEE

- The establishment of an investment committee is not a statutory requirement, but is a prudent step to take if the full board does not have the time or expertise to oversee investments
- The appointment of an investment committee must be done in accordance with the terms of the general operating by-law for the charity

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- The composition of an investment committee should be made up of members of the board, but could also include non-board members, provided that the general operating by-law authorizes the establishment of an investment committee and appropriate investment expertise is sought for the committee
- Non-board members should generally constitute a minority of the composition of the committee
- The terms of reference for the investment committee needs to be clearly delineated, possibly as part of the general investment policy
- The investment committee needs to report back to the board on a regular basis

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12. REDUCING THE RISK OF EXPOSURE TO LIABILITY FOR INVESTMENTS

- Determine what investment powers apply to the charity and in which jurisdiction
- Consider taking the appropriate corporate steps to have the charity come under the investment power regime of the *Trustee Act*, particularly where the charity is wanting to delegate investment decision making to an investment manager

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- Take proactive steps to comply with statutory requirements of the *Trustee Act*
 - Establish and implement a general investment policy
 - Establish specific investment plans for separate funds, where appropriate
 - Where investment decision making is delegated, then establish and implement an agency agreement with the investment manager

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- All the documents should be reviewed on a regular basis, preferably each year, by the board of the charity
- Determine if other investment powers apply to special purpose funds and then comply with the applicable terms
- Obtain assistance from an investment committee of the charity, with the committee reporting back to the board of directors

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- Where the board conducts investment decision making themselves, consider retaining the services of a qualified investment advisor
- Alternatively, consider retaining the services of an investment manager, provided that an appropriate agency agreement is entered into
- Where a board member disagrees with an investment decision made by the board collectively, the board member should record his or her opposition and obtain independent legal advice to determine the appropriateness of resigning as a director

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