



SKELETONS IN THE CLOSET



Closet tracker funds have come under fire in Sweden, Norway and the US. They are widespread in the UK investment market, says **Saul Djanogly**, so it would be prudent for trustees and financial deputies to review their clients' investments

The financial services industry continues to be plagued by mis-selling scandals, from payment protection insurance to Libor and foreign exchange rate fixing. So far, these scandals have not affected financial deputies and trustees responsible for managing client investments. However, now there is a new storm brewing that directly affects such deputies and trustees: widespread investment in closet tracker funds.

Deputies and trustees' duties of care are set out under s1 *Trustee Act 2000*. Furthermore, remunerated and professional trustees are expected to meet higher standards than lay trustees.¹ It is also expected of attorneys and deputies that they live up to the standards set by the *Trustee Act 2000*.² On the basis that prevention is better than cure, deputies and trustees need to know what is in store for them and what action to take.

WHAT IS A CLOSET TRACKER FUND?

A closet tracker fund is, in essence, an investment fund that has been mis-sold to its investors. This is because it is marketed as a truly 'active' fund whose managers proactively seek to outperform their benchmark index, while, in practice, it almost entirely tracks or matches this index. These funds are known as closet tracker funds because their performance is almost identical to that of an equivalent tracker fund, but they charge the much higher fees associated with a far more active and hands-on investment policy. Closet tracker funds are widespread in the UK investment market – nearly 40 per cent of UK funds are vulnerable, with Hargreaves Lansdown estimating that GBP4 billion is invested in what it calls these 'dinosaur funds'.

Litigation has been started in Sweden by the Swedish Shareholders' Association against one of the country's largest investment funds for this kind of mis-selling.³ Meanwhile, the Financial Supervisory Authority of Norway has censured and issued a corrective order to a large domestic unit trust.⁴ It was ordered to either reduce its pricing or implement a truly active investment policy in line with its prospectus. A similar case went all the way to the US Supreme Court, which found against the trustees.⁵ The European Securities and Markets Authority said last year it was 'gathering information on the extent of the issue'.

RESPONSIBILITY LIES WITH TRUSTEES

While reviewing client investment portfolios for financial deputies and trustees, we found that the majority of their client portfolios contained significant exposure to closet tracker funds. The presence of these funds is clearly not serving their clients' best interests. Some trustees argued that, although this may be the case, legal responsibility lies with the advisors they have appointed rather than with themselves. In response, we sought opinion from counsel to clarify this point,⁶ as well as the other practical duties and responsibilities of trustees when it comes to managing their clients' investments. Counsel advised that a fiduciary has a duty to ascertain if there are any such funds in their client portfolios and to take corrective action if they are present.

CONCLUSION

Ignorance is no defence for fiduciaries when it comes to this potential exposure

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in their clients' portfolios. Financial deputies and trustees would be well advised to double-check whether they have any exposure to these potentially mis-sold funds. Whether they should rely on their advisors to do this, when in many cases it is the very same advisors who are responsible for investing in these problematic funds, remains a moot point. Deputies and trustees may wish to seek an expert, independent second opinion on this and other issues raised by counsel's recent opinion. In many cases, investment fees and charges are many times greater than all other professional costs. It may be but a matter of time before the Office of the Public Guardian moves its spotlight onto this area, which would be a welcome move.

- 1 *National Trustees Company of Australasia v General Finance Company of Australasia Ltd* [1905] AC 373
- 2 Judge Lush in *Re Buckley: The Public Guardian v C* [2013] EWHC 2965 (COP)
- 3 *Financial Times*, 'Sweden fights "the industry's dirty little secret"', 28 June 2015
- 4 Corrective Order 11.03.15
- 5 *Tibble et al v Edison International et al*, decided 18 May 2015
- 6 Michael O'Sullivan TEP, a Barrister at 5 Stone Buildings



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