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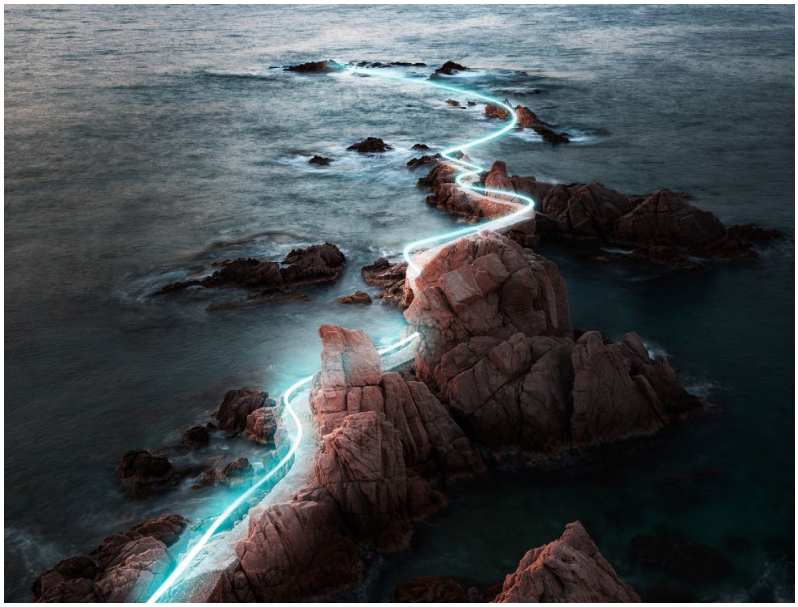
TRUST COMPANIES SURVEY
NAVIGATING TROUBLED WATERS

Inside:



2020

Introducing the Herbert Smith Freehills trust companies survey: Navigating troubled waters

In January 2020 we completed the research phase of our first survey of trust companies. We asked trust companies of different sizes, from a variety of onshore and offshore jurisdictions, with different ownership structures, questions about the most significant risk and compliance issues they face. The survey comprised 18 questions, with a randomised order of possible answers wherever this was feasible, to increase the integrity of the responses.

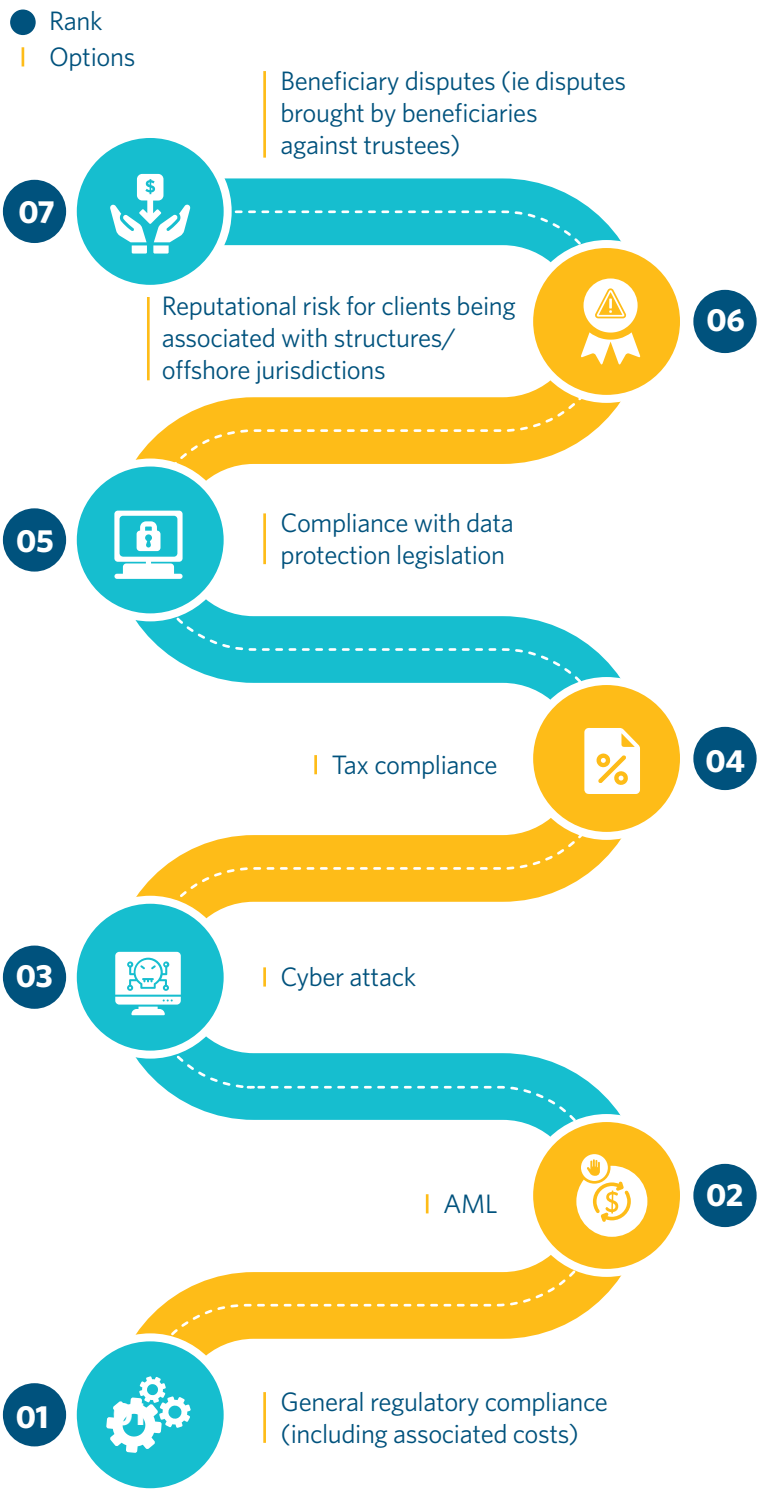
The one thing we did not ask people was the risks posed by major public health incidents. Coronavirus disease (COVID-19) subsequently became the biggest threat to countless businesses around the world. At the time of publication, different countries are at different stages in their fight against the virus. Some jurisdictions are slowly opening up following lockdown, others are not yet at that stage. Even if the possibility of a pandemic has been acknowledged for some time, the extent of the lockdowns around the world seems to have been unanticipated.

Does this all render our survey and its results irrelevant? Null and void? I don't think so. The ramifications of this will be felt for some time and may well change some of the ways that we work, but all through the crisis various businesses across the globe (by no means all of course) have managed to put in place their business continuity plans and found ways of carrying on.

I have contacted a number of people at trust companies during this time and the consistent message has been that things are busy. They may not have been able to travel the world, but their business life is adapting and going on. The themes of the survey remain as relevant as ever, as one commented: "Regulatory change has not stopped".

Over the next couple of pages we introduce the survey and then countdown from 7 to 1 the risks surveyed.

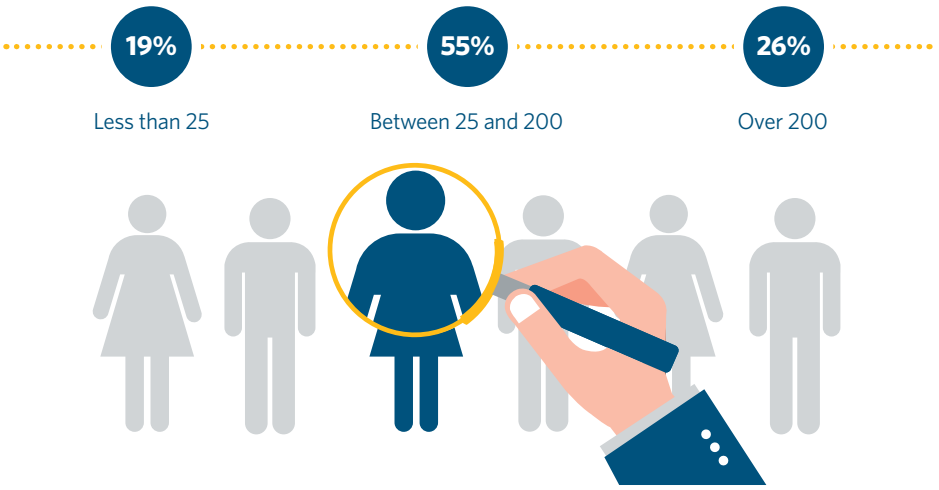
Which issues pose the greatest challenge to your business?



The respondents

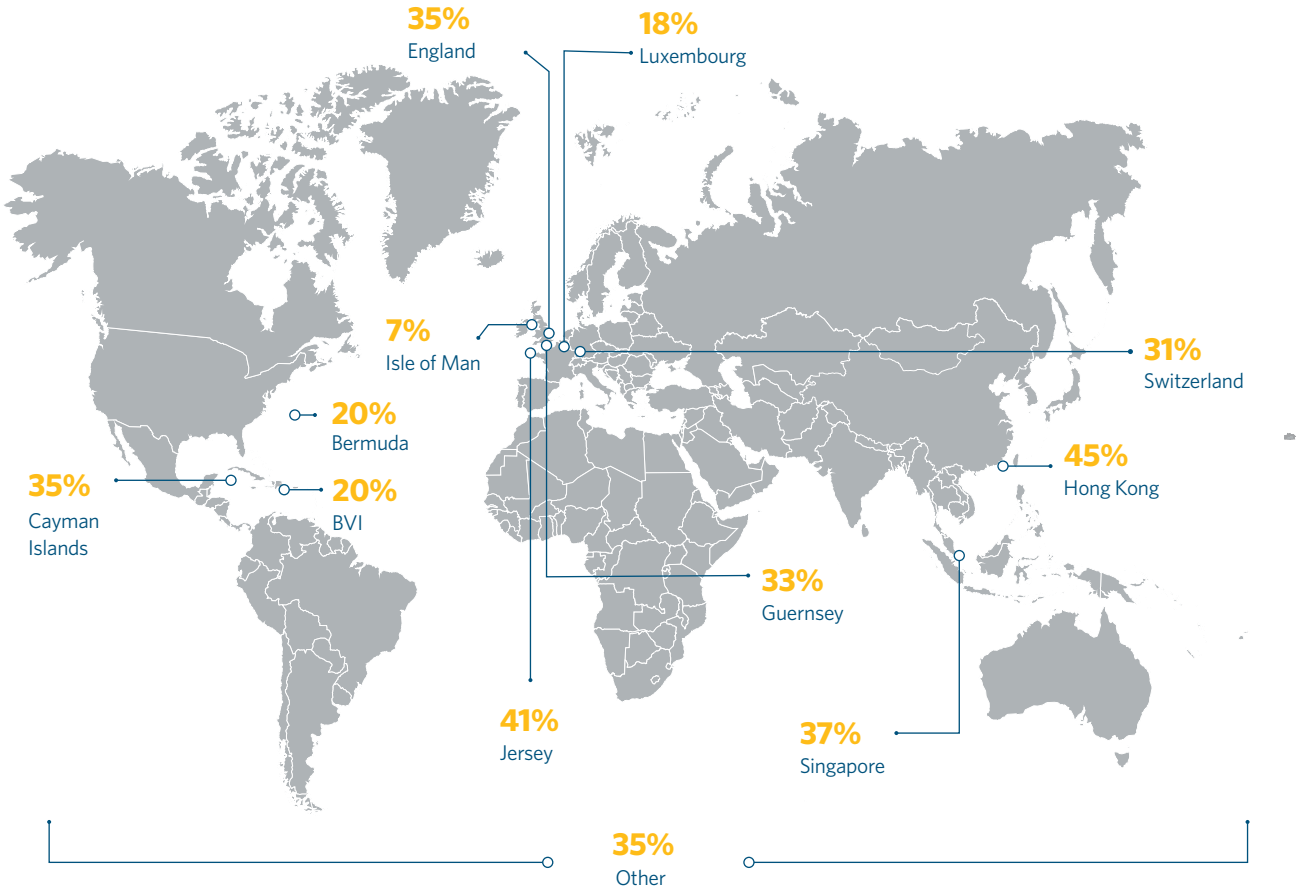
Around a quarter of the total number of responses we received were from smaller trust businesses (ie fewer than 25 employees), and a similar proportion from large entities (ie over 200 employees). The majority of respondents were medium-sized trust companies, with between 25 and 200 employees.

How many employees do you have in your fiduciary business?



In terms of jurisdictional spread, the respondent entities operate in all major International Financial Centres, such as Bermuda, British Virgin Islands, the Cayman Islands, Guernsey, Isle of Man, and Jersey, as well as some of the major onshore trust jurisdictions, including England and Wales, Hong Kong, Singapore, Switzerland, and Luxembourg.

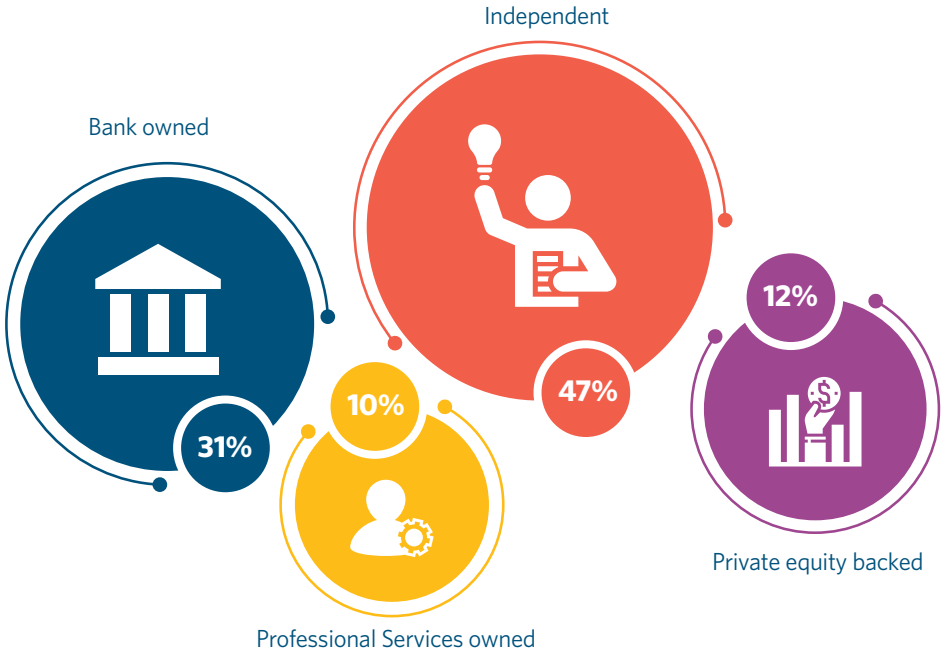
Which jurisdiction(s) do you operate in?



*respondents were able to choose more than one jurisdiction

The survey also covered a wide range of trust company ownership structures. Around 10% of the respondent businesses are owned by professional services firms and around the same proportion are private equity backed. Around 30% are bank owned, and just under 50% are independent.

What is your ownership structure?



Specific topics covered

Our survey covered the top risks trust companies face. In broad terms, the following pages will cover the following topics and will identify how significant a risk each of these is perceived to be by trust professionals:

Beneficiary disputes: Our survey reveals the most common sources of beneficiary disputes (ie disputes brought by beneficiaries against trustees) that trust companies encounter. We also consider the measures trustees might be able to take to minimise adverse consequences from such disputes.

Data protection: We have investigated what trust companies find the most challenging about privacy compliance, and provide practical guidance on managing the most difficult aspects.

Cyber Security: Our analysis covers what the main cyber security risks faced by trustees are; the types of cyberattacks trust companies tend to suffer in practice; and what trust companies are currently doing, and what they could be doing, to tackle the cyber security risks they face.

Reputational risks: We discuss the reputational risks for trust company clients arising out of being associated with "offshore" structures and jurisdictions.

Tax compliance: We cover what trust companies identified as the most burdensome tax compliance issues and the most helpful solutions for handling tax compliance within trust company businesses.

Anti-Money Laundering (AML): We discuss and analyse the most significant AML compliance challenges for trustees; how AML compliance issues have affected trust company businesses in the last year; how helpful (or otherwise) the trustees find the new guidance and more prescriptive Know Your Client (KYC) requirements.

Regulatory compliance: We map the most significant regulatory challenges faced by trust companies, as well as trust companies' views on whether regulatory intervention in their business is inevitable.

This market leading and thought provoking content will be equally helpful for (a) trust companies trying to navigate the increasingly complex and regulated risk and compliance landscape, and (b) others operating in the private wealth and trusts industries, with insights into the major issues trust companies are facing.

We were excited to embark on this journey and share our insights in this publication.

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Beneficiary Disputes

The respondents to our survey identified Beneficiary Disputes (ie disputes between the trustee and one or more of the beneficiaries) as one of the significant challenges trustees face. They nevertheless ranked it as the least pressing issue, when compared to other matters such as AML and regulatory compliance, tax, cyber, and data protection issues. We also asked what trust companies see as the most common sources of beneficiary disputes.

The results are in

A small minority of respondents (approximately 4%) considered the primary source of beneficiary disputes to be the difficulties caused by other office holders (eg protectors and advisory boards). Around 10% of the respondents considered the failure by the settlor to communicate the purpose and function of the structure to be the main issue, while a similar proportion of respondents identified fee disputes between trustees and beneficiaries as the main source of beneficiary disputes. A slightly larger proportion of respondents (12%) concluded that the breakdown of the relationship between trustee and beneficiaries was the primary source of beneficiary disputes.

By far the most significant proportion of trust companies surveyed thought that the principal source of beneficiary disputes was disharmony amongst the beneficiary group (64%). However, the numbers look quite different when we look at trust companies of different sizes and ownership structures.

While the responses from medium sized trust companies reflected the responses of the whole respondent pool (65%), only 34% of smaller trust companies identified disharmony amongst beneficiaries as the most common source of beneficiary disputes. The numbers seem to be skewed in the other direction in large trust companies, where 91% gave the same answer, which suggests that large, international trust companies are more often faced with disharmony amongst the beneficiary group.

What is the primary source of beneficiary disputes?

64%	12%	10%	10%	4%
Disharmony amongst the beneficiary group	Breakdown of the relationship between trustee and beneficiaries	Failure by the settlor to communicate the purpose and function of the structure	Fee dispute between trustees and beneficiaries	Difficulties caused by other office holders eg protectors and advisory boards

When we focus on the breakdown of results on ownership structure, the data also reveals some discrepancies in the prevalence of disharmony amongst the beneficiary group within different types of trust companies. Bank owned and independent trust companies' responses by and large reflect the whole respondent pool's views (with 69% and 55% respectively identifying disharmony amongst beneficiaries as the primary source of beneficiary disputes). This is in contrast to responses from private equity backed (83%) and professional services owned (80%) trust companies.

There are of course any number of explanations for these results (and it would be impossible to draw too many general conclusions). For example, professional services owned trust companies may have a greater appetite for risk and be prepared to take on structures which have greater potential for disharmony.

In light of these results, we will focus on what trustees and trust companies might be able to do proactively to seek to resolve disputes arising out of a conflict amongst the beneficiaries and prevent these from

escalating to a dispute between the trustee and beneficiaries. Here we will focus on situations where the breakdown of the relationship within the beneficiary group has already happened. There are many excellent resources on the steps trustees might be able to take to avoid such relationship breakdowns in the first place. The focus here is what trustees might be able to do to avoid the existing issues within the beneficiary group turning into proceedings against the trustee.

Why would beneficiaries bring proceedings against trustees?

Actions brought by beneficiaries against trustees often manifest themselves as claims for either breach of trust or breach of fiduciary duties. Sometimes such claims arise out of a genuine dissatisfaction on the beneficiaries' part about the performance of the trustee's duties or management of the trust. However, in other instances, beneficiary disputes can be a result of beneficiary group disharmony (for example within different factions of a family). In this situation the trustee can get caught in the middle of internal family struggles regarding how the trust should be administered, and might be sued by a dissatisfied faction as a result. This may be because there is no actionable legal claim against the other family members or because it is more palatable to sue a third party trustee rather than family.

If there were ever a map-based metaphor for these kind of family battles – people being close in one sense but also very far apart – the Diomede Islands in the Bering Strait are it. Big Diomede is Russian, Little Diomede is American. They also are only four kilometres apart, but fall on different sides of the international dateline and so are a day apart.

Disharmony amongst the beneficiary group, and what to do about it?

To intervene or not to intervene?

One of the first issues trustees will have to consider when dealing with disharmony within the beneficiary group is whether it might be helpful for the trustee to try to "mediate" the conflict between the beneficiaries and try to settle some of the disagreements. This may avoid the dispute escalating into one between the trustee and the beneficiaries, or certain beneficiary groups.

On the one hand there is an obvious danger in the trustee getting involved in the squabbles of beneficiaries, as this could lead to allegations of meddling, partiality or breach of fiduciary duties by a disgruntled beneficiary/beneficiary group. If not resolved, this can lead to a relationship breakdown between the trustee and beneficiaries/beneficiary group, and expensive litigation as a result of the trustee having placed itself "in the line of fire".

On the other hand, if the trustee does not make any attempt to resolve the dispute between beneficiaries, the trust could become increasingly difficult to administer as a result of ongoing animosity. Further, if the dispute remains unresolved, the trustee may in any event end up being sued by a disgruntled beneficiary/beneficiary group.

There are a number of factors trustees have to weigh up when making the decision about whether (and if so, how far) to intervene in a dispute amongst beneficiaries. Some of the reasons why some trustees might be reticent to get too involved include the following:

- **Impartiality** – The more involved a trustee gets in disputes between beneficiaries, the more difficult it might become for the trustee to remain impartial. And of course, the more the trustee knows about the internal workings and politics of the beneficiary group, the more decisions to act in the best interest of the beneficiaries become nuanced and complex.
- **Increased liability** – Trust instruments often include "anti-Bartlett" clauses, which operate to exclude the trustee's duty to enquire and supervise in relation to actions taken by a company in which the trust has a shareholding. However, such clauses may well not prevent liability arising if the trustee does in fact become aware of something indicating that they should use their powers of intervention. The danger here is therefore that if a trustee inserts herself/himself into an existing dispute between the beneficiaries, she/he might become aware of matters necessitating enquiry or supervision, which can negate the effect of the anti-Bartlett clause, and increase the trustee's risk exposure.
- **Traditional forms of relief may be unavailable** – One form of relief trustees are normally entitled to seek is to make a Beddoe application. This involves seeking court directions in relation to whether or not to bring, defend or continue proceedings by or against the trust, and obtain costs protection. In a beneficiary dispute situation, however, trustees are often not entitled to Beddoe protection like they would be in relation to third party disputes because the allegations made against them often involve breach of trust. Thus the court would need to resolve the underlying dispute between the trustee and the beneficiaries before deciding whether or not it should approve the trustee's involvement in the litigation in question and their entitlement to cost. The appropriate course in such cases is to resolve the underlying dispute first, rather than pursue a Beddoe application.
- **Insurance** – Increased trustee involvement could increase the likelihood of the trust company needing to claim on its insurance policy in the event of a beneficiary dispute. In this respect it will become increasingly important for the trust company to maintain clear channels of communication and a good working relationship with its insurers.

What can trustees do in practice?

We asked some of our colleagues at trust companies how they might deal with disharmony amongst beneficiaries in practice. Notwithstanding the considerations set out above, it was clear that those we spoke to prefer to get involved and take active steps to attempt to resolve conflicts within the beneficiary group, in order to seek to avoid further escalation. Sitting back in the hope that the beneficiary group will resolve the conflict amongst themselves was no one's preferred option.

The universal theme was that getting involved early, and communicating with the beneficiary group about the options to resolve their internal disputes in a frank and honest manner, can go a long way in preventing the escalation of disharmony within the beneficiary group. Grant Barbour of Ocorian explained "it is crucial to engage positively and immediately with the beneficiary group; trustees should get involved quickly and explain how corrosive disputes between beneficiaries can be, and there is no faster way to destroy a trust fund, than engaging in costly litigation."

In their communications with beneficiaries, trustees should remain impartial and emphasise their impartiality, as necessary. It may also be advisable to remind the beneficiaries that the trustee's obligation is to act in the best interest of the beneficiaries at all times, in order to keep these ideas at the forefront of the beneficiaries' minds.

In addition, trustees should consider practical, creative solutions to resolve disputes within the beneficiary group. In this regard, trustees could take guidance from the approach of Clare Usher-Wilson of Summit, who said of her interventionist

approach: "As trustees, we get very involved in beneficiary disputes, and we think there is a solution to every dispute, but these often require thinking creatively and outside the box".

Some of the tactics we have seen used in practice are as follows:

- **Resignation from board** – In a situation where some beneficiaries are represented on a private trust company's board, while others are not, consider whether it is worth encouraging the represented beneficiaries to resign to allow trustees to carry out their management role without the suggestion that the represented beneficiary faction has larger influence (perceived or real) than those not represented.
- **Representation** – Where there is a breakdown in the relationship within a family council of beneficiaries with a particular individual, the trustees may wish to consider appointing a neutral third party to represent that individual on the family council, to restore the functionality of that forum, and re-open effective communication channels with the entirety of the beneficiary group.
- **Respecting the natural order of the family** – To avoid aggravating the beneficiary group, trustees should try to respect existing family dynamics wherever possible. So for example if parents have particular wishes or restrictions on how, if at all, the trustees should be allowed to communicate with their beneficiary children, the trustees should be sensitive to those requests, even if the parents themselves may not be beneficiaries. In practice this may manifest itself as an agreement (whether a formal memorandum of understanding, or a more informal option) with the parents on the method, frequency etc. of communication with the beneficiary children.
- **Splitting the trust fund** – If it seems that certain members of the beneficiary group will never be able to see eye to eye and agree on matters, it might be worth considering splitting the trust fund to divide up the pot, and give the different groups more influence over decisions affecting their share.
- **Mediation** – Trustees are also able to recommend mediation to resolve a dispute within the beneficiary group. As with any informal dispute resolution mechanism, the advantage is that if a middle ground is found, the beneficiaries are likely to respect a more formal resolution arrangement. However, given the relative formality of the procedure, a mediation might encourage different factions to 'lawyer up' and crystallise or entrench their position more than a less formal dispute resolution mechanism might. Further, even though mediation is almost always cheaper than litigation, it is not without cost, which will likely be paid from the trust fund.
- **External advisors** – In order to avoid personally becoming entangled in the underlying beneficiary dispute, trustees might wish to consider engaging external consultants who might be able to negotiate a de-escalation amongst the family members. This may be a way of reducing the trustee's exposure in a conflict situation, but the benefits of that need to be weighed against the fact that appointing an external consultant to resolve a dispute will reduce the trustee's ability to control the situation.

Given the above, it goes without saying that good communication is crucial for trustees, and may also become an area in which trust companies wish to invest resources to upskill trust professionals' communication and mediation skills to be able to effectively deal with conflicts and disharmony amongst beneficiaries, without feeding existing fires.

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Reputational Risk

Our respondents identified reputational risks of being associated with offshore structures as the sixth most pressing threat to their business.

Reputational risk as a business challenge

Reputational risk for clients being associated with structures or offshore jurisdictions was identified as the second least challenging issue (out of a list of seven), behind other matters such as regulatory and AML compliance, data protection, cyber security or tax compliance risks.

Although it is impossible to identify a single explanation for this result, the following observations may go some way in explaining why trust companies identified the reputational risk for client being associated with offshore structures as a relatively low priority issue:

- This result may be surprising to those based in the UK, where the use of offshore structures has recently garnered some negative publicity. Negative perception is also an issue in Indonesia, where our experience is that the tax authority is generally suspicious about the use of trusts and offshore structures.

  As Lydia Essa of Trust Corporation International in Guernsey says "there has been a measure of global hostility towards the offshore finance industry in recent years, and the influence of the "court of public opinion" has been felt by some in the fiduciary industry. We have had conversations with clients around "onshoring" where the reputational risk of simply being associated with the offshore world is just too high, irrespective of the reputation of our jurisdiction or whether the structure is tax driven."

  Offshore investment structures came under intense (and negative) media scrutiny recently with confidential information leaks such as SwissLeaks, the Panama Papers and the Paradise Papers. Although there were examples of wrongdoing amongst some of these leaks, the more recent leaks in particular do not appear to have highlighted many examples of this and seem to have gained less traction in the public consciousness.

- Even if there could be said to be a negative view of offshore structures amongst the British public, trust company clients might not share that view. Some of these clients are from jurisdictions such as Hong Kong, Singapore and the Middle East, which are generally low tax environments in any event, and where offshore structures have been used commonly and openly for decades. As a result they have historically been viewed as legitimate wealth structuring tools, rather than the "dirty secret" they are often perceived as in the UK. The trust companies' clientele simply might not view offshore structures as a potential reputational risk, but perceives them as a legitimate wealth structuring option instead.

- It may also be that the idea of leading offshore centres being a hiding place for "dirty money" and a hotbed of tax evasion is simply considered to be an outdated notion particularly given increasing sharing of information and transparency. The offshore world can still very much appeal to those undertaking legitimate estate/succession planning, asset protection structuring or seeking structuring solutions when making investments outside of the UK. This could explain why trust companies do not seem to be particularly concerned about the reputational risk aspect of offshore structuring.

- Even if the reputational risk of being associated with offshore structures may be a concern for some, it is clearly not significant enough to discourage such offshore structuring in practice. According to a recent study that combines The Organisation for Economic Co-operation and Development (OECD) statistics on foreign direct investment with the IMF's Coordinated Direct Investment Survey, offshore investing accounts for almost $12 trillion worldwide, which is around 40% of all foreign direct investment in the world.[1] In fast-growing economies such as India, China and Brazil, this amounts to 50–90% of outward foreign direct investment, while in the UK and the USA, the proportion is still high, at approx. 50–60%.[2] Not to mention that 73% of the Fortune 500 operate one or more subsidiaries in offshore jurisdictions, including such companies as Apple, Pfizer and Microsoft.[3] The Paradise Papers identified the offshore activities of over 120 politicians and world leaders, including the British Monarch.[4]

- There are numerous legitimate reasons why trust company clients may to wish to use offshore structures. These (alone, or together) might outweigh any potential reputation risk of being associated with an offshore structure or jurisdiction. Just to name a few:

  - It may be unsafe for an individual to disclose substantial investments in certain emerging markets due, for example, to their high or public standing, or the political environment in certain jurisdictions. Using an offshore vehicle in such circumstances might be the safest solution.

  - Individuals located in different jurisdictions may be seeking to combine their investments in a neutral third-country in order to establish an investment fund or joint venture.

  - In certain jurisdictions, establishing an offshore company may provide an additional level of legal protection, including protection under various bilateral investment treaties, as well as increased efficiency of business operations, cheaper administrative costs and access to a better banking infrastructure and judicial system.

  - Some offshore jurisdictions have vehicles and structures such as purpose trusts, which simply do not exist in some onshore centres. Indonesia is a good example of this, where there is no local equivalent of a structure which offers the traditional advantages of a trust for succession planning. This can lead to an increased the demand for the use of offshore structures by Indonesian clients for succession planning.

1. Damgaard J., and Thomas E., "The Global FDI Network: Searching for Ultimate Investors." IMF Working Paper 17/258, 2017, International Monetary Fund, Washington, DC.

2. Damgaard J., Elkjaer T., and Johannesen N., "Piercing the Veil", Finance & Development, June 2018, vol. 55, no. 2, available at: https://www.imf.org/external/pubs/ft/fandd/2018/06/inside-the-world-of-global-tax-havens-and-offshore-banking/damgaard.htm

3. United States Public Interest Research Group, available at: https://uspirg.org/news/usf/study-73-fortune-500-companies-used-offshore-tax-havens-2016

4. BBC news, "Paradise Papers: Queen's private estate invested £10m in offshore funds", 6 November 2017, available at: https://www.bbc.co.uk/news/uk-41878305

The English High Court commented in a decision in April 2020: "The use of complex offshore corporate structures or trusts is not, without more, a ground for believing that they have been set up, or are being used, for wrongful purposes, such as money laundering. There are lawful reasons – privacy, security, tax mitigation – why very wealthy people invest their capital in complex offshore corporate structures or trusts."

Future changes

In recent years, the OECD and a number of jurisdictions have become particularly focused on increasing transparency of offshore investing, and are in the process of introducing more laws that may significantly increase regulatory scrutiny. These often include new reporting regimes and registers that record the names of ultimate beneficial owners, which may have a significant effect on potential reputational risks if anonymity is a major concern.

Enhanced transparency regimes and increasing disclosures of offshore holdings might have the effect of pushing reputational risk further up the risk scale for trust companies in future years, in jurisdictions where offshore investments are perceived negatively.

However, it is perhaps more likely that increasing transparency will demystify the offshore world, thereby having quite the opposite effect. Trustees report that the majority of their clients (and particularly the "next generation") are accepting of transparency and information exchange as features of the modern world and, increasingly, clients wish to align themselves with jurisdictions that have internationally recognised regulatory frameworks, sophisticated court systems and advisory networks and reputable fiduciary and corporate service providers.

This is the "flight to quality" that Lydia Essa reports to be more noticeable now than ever. Clients are, in her experience, generally attracted to those offshore jurisdictions which have a global reputation for quality, security, and meet international standards on transparency and information exchange, even if that comes at a slightly higher cost. Whether these enhanced regimes will assist in reshaping public opinion in time and reducing (or perhaps even eliminating) the reputational risk of an association with the offshore world is yet to be seen, but early signs are that certain jurisdictions may be well placed to thrive in these conditions, whilst others may well find the going a lot tougher. Only time will tell.

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Data Protection

We asked the participating trust companies what data privacy issues pose the greatest challenges to their business.

Privacy as a business challenge

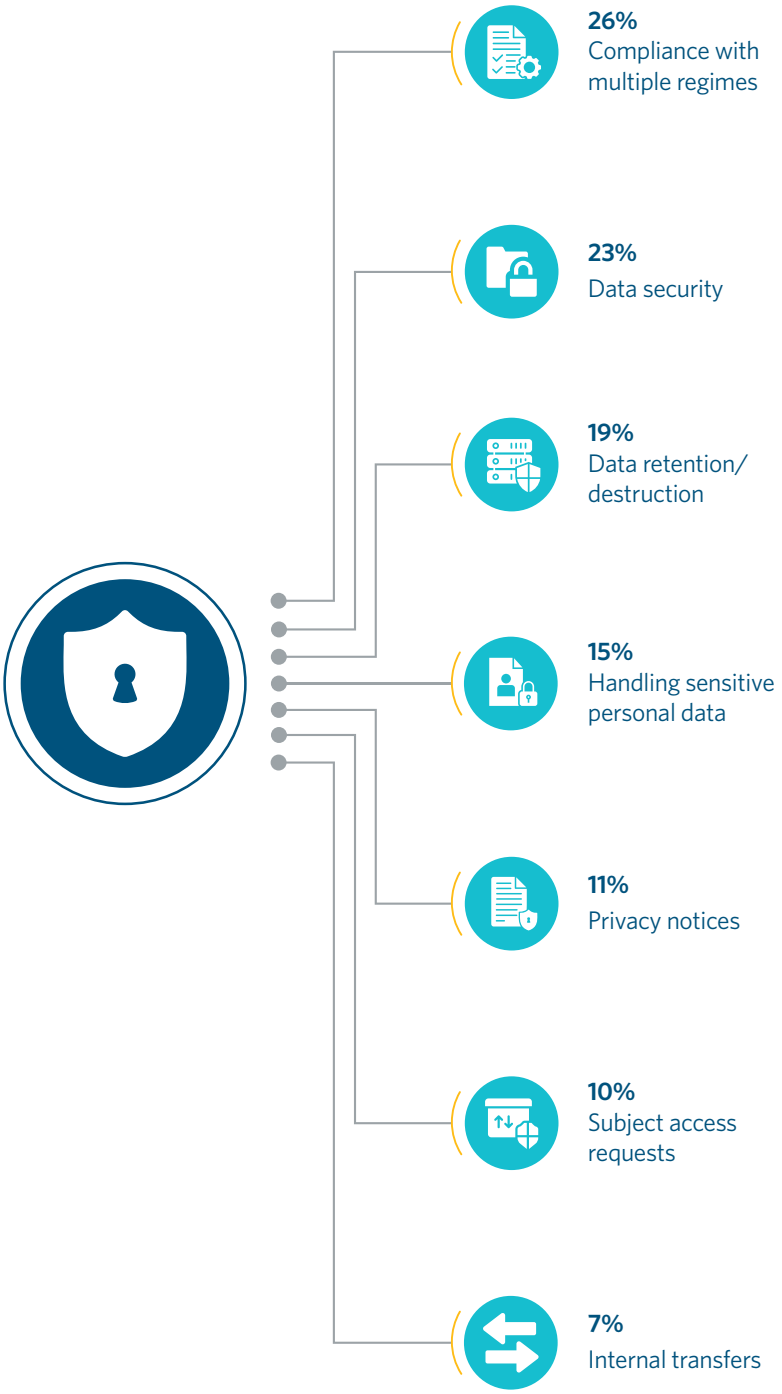
Interestingly, out of those surveyed, and despite the high profile implementation of General Data Protection Regulation (GDPR) in 2018, California Consumer Privacy Act (CCPA) in 2020, and multiple other data privacy laws around the world in recent years, compliance with data protection legislation only ranked fifth with the participants out of seven key issues posing the greatest challenge to trust businesses.

At first blush, this appears to contradict many FTSE 100 and similar lists of major international companies, which often cite data protection and cyber security risk as the two key risks to their business. The results also seem at odds with an industry usually in possession of large quantities of personal data, often including 'sensitive' personal data.

The survey itself did not delve into the reasons for this classification of data protection risk amongst participants and it is therefore left for us to speculate about this apparent difference in approach to data protection regulation. Upon reflection, there could be a number of reasons behind this potentially surprising result:

- **The geographical location of the trust companies surveyed** – The vast majority of the companies surveyed were located outside of the EU and the immediate reach of major data protection regimes such as the GDPR. Whilst the GDPR has extra-territorial reach in certain circumstances, its immediate effect is undoubtedly felt to a lesser extent outside of Europe.
- **Privacy fatigue** – In the short term aftermath of GDPR implementation, it is fair to say that many organisations are suffering 'privacy fatigue', having spent significant time and expense dealing with GDPR implementation. In the absence of significant enforcement action in the trust space, there may be little appetite to further grapple with data privacy issues.
- **Client confidentiality** – It is fair to say that the importance placed on client confidentiality for many trust companies means that data privacy legislation is less 'alien' and therefore less of a challenge for such companies than it is for many other organisations. Privacy is often already

What do you find most challenging about privacy compliance?



*respondents were able to choose more than one option

'built in' by design and confidentiality is fundamental to the business. A breach of client confidentiality would have significant consequences above and beyond any potential data privacy legislation sanctions.

Stuart Esslemont, Data Protection Officer at ZEDRA, echoes this analysis in relation to client confidentiality being a key pre-existing part of their business:

"Today's conversations on data privacy tend to focus on the risks associated with new technologies and digitalisation. Our longstanding focus on preserving confidentiality pre-dates technological advances and legislation like GDPR."

Privacy compliance issues

When asked what was most challenging about privacy compliance, the participants were broadly split amongst a number of key issues. Top of the issues list was compliance with multiple regimes, and given the geographic spread of many trust companies, this is hardly surprising. Whilst a lot of focus has been on GDPR in Europe, the last few years have seen a proliferation of new data privacy laws being implemented all over the world. Many of these bear similarities to the European regime but are not exactly the same and national concerns and interests are built in, making it challenging for multi-national organisations in particular to adopt a standard uniform approach to data privacy compliance globally. The increasing number of data localisation laws in particular creates challenges for companies looking to centralise systems and processes. Stuart Esslemont recognises that "there is no shying away from the fact that the multitude of legislation in different countries (with subtle variations on themes) and continual emergence of technologies present ongoing challenges to ensure that we continue to stay ahead of the game and keep personal (and all other) data safe and secure. COVID-19 is presenting novel data protection challenges which we are addressing on a daily basis in the 'new normal' environment in an effort to maintain our usual high standards on these matters."

Data security was another issue which ranked highly among privacy concerns, which again seems explicable given the potential consequences from both a regulatory and a business perspective which could flow from any data security breach.

Perhaps a more interesting issue coming out of the survey results is the placement of data retention/destruction as the third most concerning data privacy compliance issue. This possibly reflects the difficulties faced by trust companies having to navigate the complexities of competing data retention requirements in myriad regulations, on top of which is layered the GDPR requirement to not keep data longer than necessary. This often creates a tension between regulation setting out a minimum retention requirement versus privacy regulation seeking to impose a (subject) maximum retention obligation. Whilst historically we have not seen much enforcement action in this space, the recent decision of the Berlin Data Protection Authority to impose a €14.5 million fine against a real estate company for its over retention of personal data suggests that data retention and destruction could be an issue on the radar of not only trust companies but also now the regulators.

Key takeaway

For the trusts industry, it is clear that data and privacy remain a concern and there are a number of practical challenges with data privacy compliance. However, for now, the advice remains to ensure that appropriate resource is directed at privacy compliance, have in place up-to-date policies and procedures and ensure that personnel are adequately trained so that such policies and procedures are rigorously followed.

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Tax Compliance

The respondents identified tax compliance issues as the fourth most significant challenge.

The survey mapped which specific tax compliance issues trust companies struggled with the most. A fairly even share of the vote for most pressing issues (15–17%) was taken by each of (1) managing tax compliance issues arising from the daily operation of existing structures; (2) identifying and dealing with tax compliance issues arising from new structures, and (3) inheriting non-compliant structures, as the most pressing issue. However, the front-runners emerged as keeping up with legislative changes in tax law (24%) and the management of historic (and potentially contentious) tax issues arising in relation to existing structures (28%).

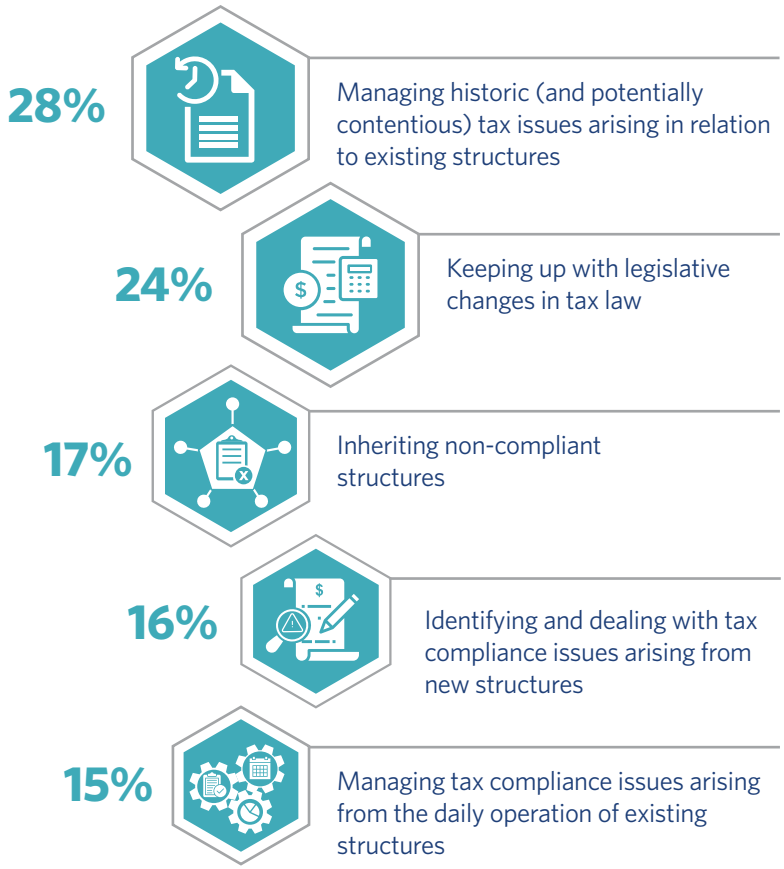
This is perhaps to be expected given current trends in tax compliance and transparency, resulting in the surfacing of historic tax issues. Transparency is, of course, here to stay, and this year (2020) sees the introduction of the following regimes:

- Reporting of cross border arrangements (pursuant to sixth EU directive on administrative cooperation, "**DAC 6**"). As most readers will be aware, DAC 6 requires intermediaries (that is, anyone who designs, markets, manages, organises or makes available for implementation) to report cross-border arrangements which bear certain hallmarks.
- Augmentation of trust registration requirements (pursuant to the fifth EU money laundering directive, "**5MLD**"). Among other things, 5MLD requires registration of all UK express trusts and non-UK express trusts which acquire UK real estate or enter into a business relationship with a regulated person in the UK (including registration of controlling interests in non-EEA entities).

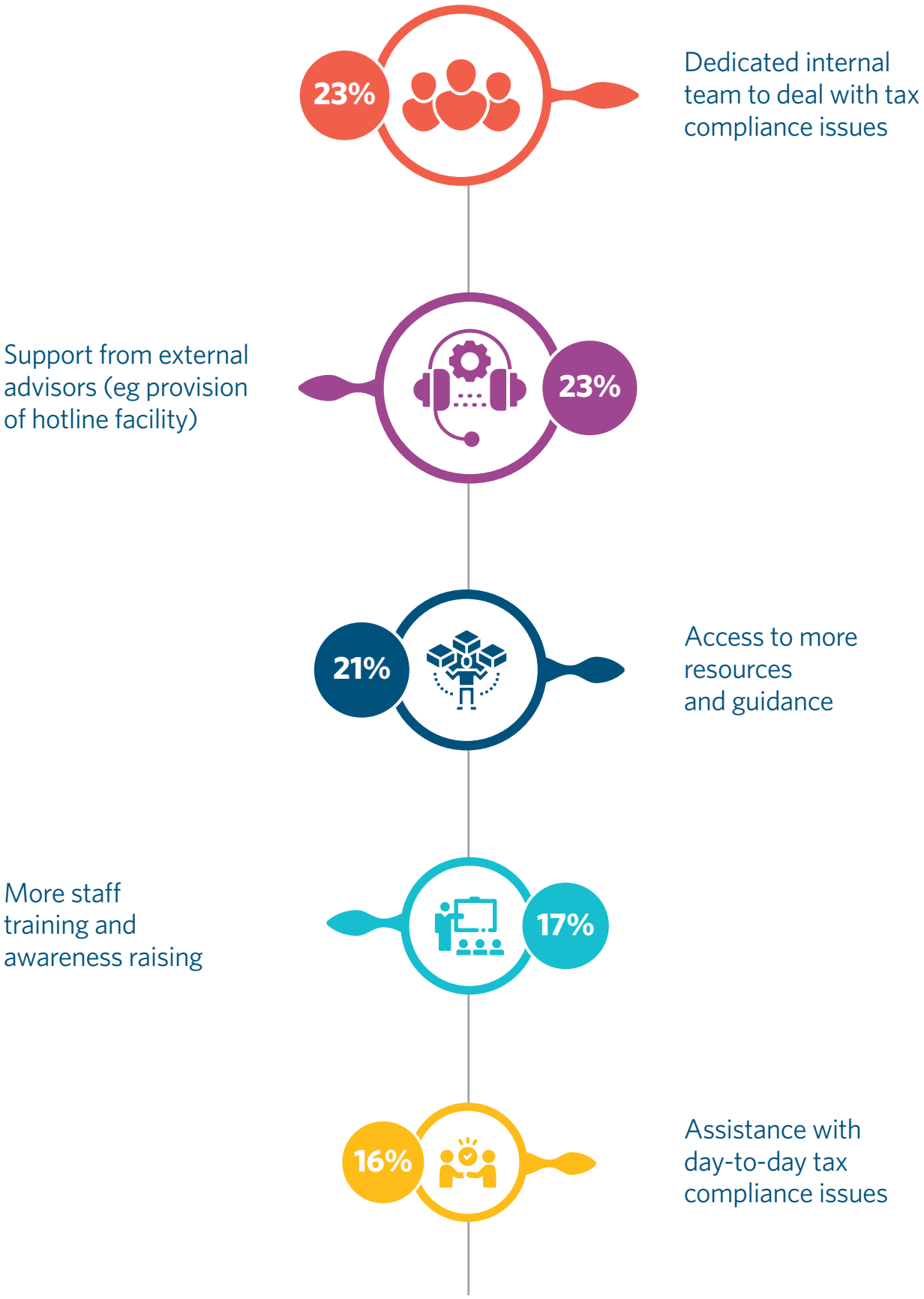
Based on experience, particularly that which emerged from the "requirement to correct" process in the UK ("**RTC**"), many of the historic tax issues arising for trust companies were caused by (i) reluctance on the part of clients to provide full disclosure of relevant facts and analysis (particularly in relation to domicile status) and (ii) difficulty in keeping up to speed with tax rule changes (which, in our survey, registered as the second biggest challenge for trust companies). In relation to the RTC, we are now seeing HMRC starting to assess and enforce the significant penalties promised in that legislation of up to 300%.

- As regards the marshalling of facts, certainly post-implementation of CRS and the RTC, we have seen trust companies revisiting their terms and conditions and new business intake processes in an effort to reconsider (i) what information is required; (ii) how that information is verified; and (iii) how tax risks are allocated between the parties.

What do you find most challenging about tax compliance?



What would be most helpful in handling the tax compliance issues in your organisation?



- As regards legislative change, in order to assist the reader with issue spotting and horizon scanning from a UK perspective, we set out below some of the most relevant recent and future developments relating to UK trust taxation.

It is also now known that HMRC are considering approximately 30 cases in relation to the (relatively) new strict liability corporate criminal offence of failing to prevent the facilitation of tax evasion (the "**CCO**"). In summary, that offence is committed where an associated person of a corporate/partnership (whether or not UK resident) facilitates another person to evade tax (whether foreign or UK), and the relevant corporate/partnership cannot demonstrate that it had in place "reasonable prevention procedures".

Given this increase in enforcement activity, it is more important than ever that businesses ensure they have conducted an appropriate risk assessment; implemented appropriate policies and procedures to address any risks identified; and ensured staff and associates (particularly those within populations identified as being high risk) have received adequate training. HMRC's actions make clear that they are taking seriously the new regime, and are serious about targeting advisors and service providers as well as non-compliant taxpayers themselves.

Recent changes

- **Remittance basis** – Since tax year 2017/18, the remittance basis of taxation has been unavailable to (i) any individual after they have been UK resident for 15 out of 20 years; and (ii) any individual who was born in the UK with a domicile of origin within the UK. (See our blog here for the latest on the UK's statutory residence test in light of Covid-19.) In each case, such an individual is now "deemed domiciled" within the UK for income and capital gains tax purposes (the deemed domicile rules for inheritance tax purposes have also been changed, and are subtly different). As such, they will be taxed on an arising basis on benefits received from UK trusts (as well as on personal income and gains), and any trusts established by them will be within the scope of UK inheritance tax.
- **Trust protection and tainting** – In parallel with the deemed domicile changes, rules were implemented to ensure that non-UK trusts (established prior to the settlor acquiring deemed domicile status) can still be used as tax efficient roll up vehicles within the UK provided that (broadly) (i) the wealth remains in the trust, and (ii) no property is added to the trust by the settlor.
- **Anti-recycling rules etc** – From tax year 2018/19, rules prevent the avoidance of tax by routing trust payments to UK resident beneficiaries via non-UK residents. These rules will not generally apply where the payment to the UK resident is made more than 3 years after the original distribution. At the same time, rules were enacted to (i) tax settlors where certain trust payments are received by close family members and (ii) to prevent income and gains being "washed-out" by distributions to non-UK resident beneficiaries (prior to distributions to UK resident beneficiaries).
- **IHT relating to UK real estate** – From April 2017, interests held by non-UK trusts in certain companies and partnerships have been within the scope of UK inheritance tax if and to the extent the value of those interests derives from UK residential property (or, in certain cases, the proceeds of disposal of the same). Complex rules also apply to create charges where monies are used to finance or the secure the purchase of such property.
- **CGT relating to UK real estate** – From April 2019, complex rules apply to ensure that non-UK residents are chargeable to capital gains tax on the disposal of both directly held and indirectly held interests in UK real estate (in the latter case, only where the holding is substantial, and the relevant entity is property rich).

Future changes

- **Trust taxation** – The UK Government launched a wide ranging consultation on the reform of trust taxation. Although the consultation period closed almost a year ago, the Government's response is still awaited, so the likely scope of any reforms remains unclear. A Government response to a review it commissioned of the UK's inheritance tax regime is also awaited (the review, conducted by the UK's Office of Tax Simplification, concluded that wide ranging simplification was advisable).
- **Compliance** – Prior to re-election in December 2019, the UK Conservative Party published a manifesto pledging (among other things) new increased sanctions for tax avoidance and evasion law; a "beefed-up anti-tax evasion unit in HMRC"; and consolidation of the UK's existing anti-avoidance and evasion measures and powers. The development and deployed of these pledges is still a work in progress.

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Cyber Security

Our survey shows that trust companies consider cyber attack to be one of the greatest challenges they face.

The results show that trustees consider phishing, impersonation and malware to be the main cyber security risks they face. Some 33% of respondents said they saw phishing as the main risk whilst 22% identified impersonation as a main risk and 14%, malware.

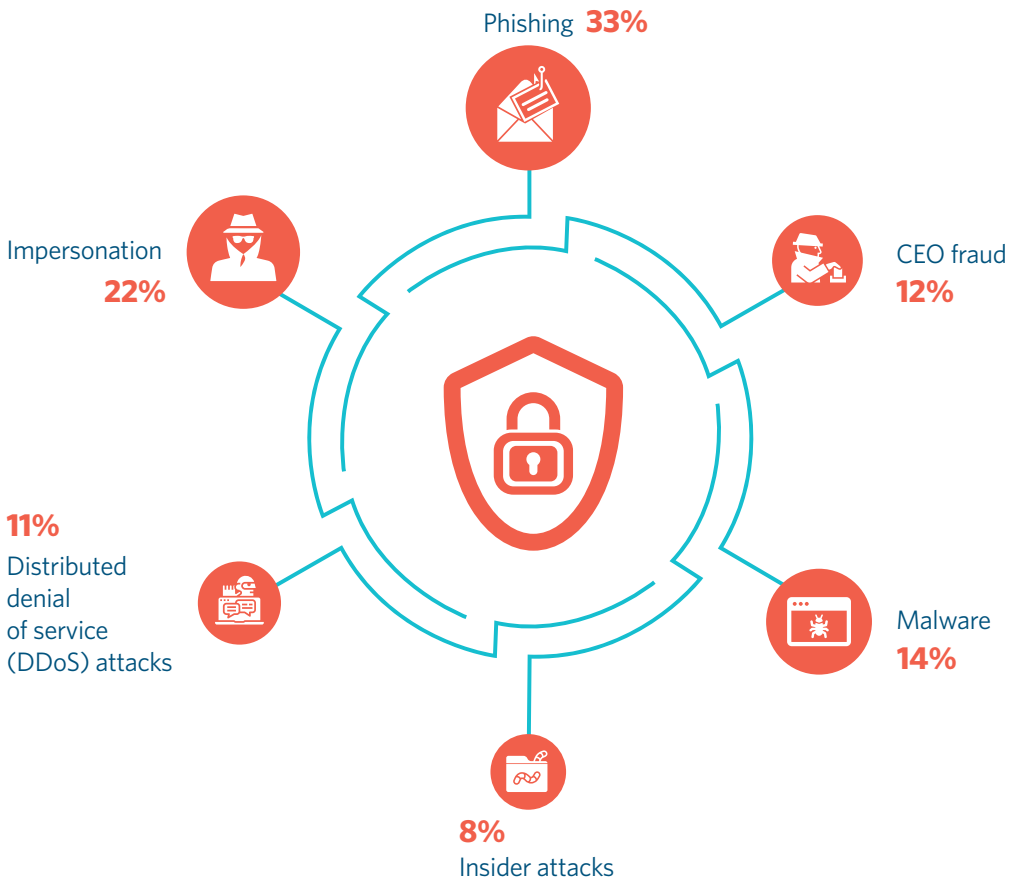
What are the main cyber security risks faced by trustees?

This is perhaps unsurprising as many cyber attacks – even highly sophisticated nation–state attacks – need an initial entry point and this is commonly one or more of these three. The scale of this problem is enormous – the National Cyber Security Centre, for example, estimates that 1.5 million new phishing sites are created around the world every month.

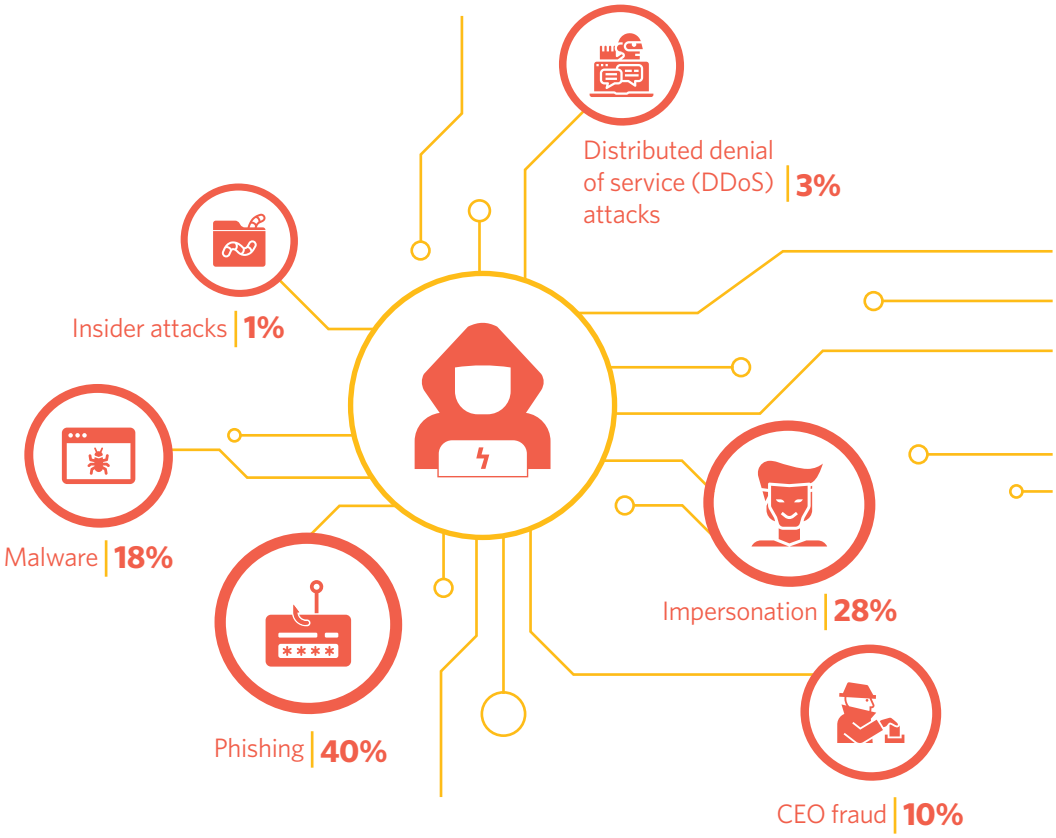
Phishing is a fraudulent attempt to obtain sensitive information such as usernames, password and credit card details by masquerading as a trustworthy entity in email, text or social media. Phishing attacks can install malware (software which is specifically designed to disrupt, damage or gain unauthorised access to a computer system), with a view to infiltrating systems or stealing intellectual property or money.

Impersonation, sometimes in conjunction with phishing or spear phishing attempts, involves the hacker pretending to be someone trusted (the friendly IT support person, a customer services representative from a bank and so on) with a view to tricking the victim into voluntarily doing something. In the trust company world in particular, impersonation might come in the form of emails purporting to be from beneficiaries asking for distributions from the trust fund. Paul Hodgson of Butterfield Trust in Guernsey mentioned their experience that the small number of phishing attempts that their business sees result from successful attacks on beneficiaries and settlors which are then used to create sophisticated template emails which require a combination of a high level of training to ensure that relationship managers identify them, call backs to known contact numbers to combat them and a dedicated cyber security team that detect and respond to attacks.

What are the main cyber security risks faced by trustees?



Which of the following types of cyber-attacks have you suffered?



Perception of the main risks was born out by reality. Some 40% of the trust companies surveyed said they had suffered a phishing attack and 28% an impersonation attack. Some 18% had experienced a malware attack. CEO fraud and distributed denial of service were far rarer, with only 10% and 3% of trust companies experiencing attacks of this kind. Only 1% had suffered an insider attack, which is perhaps indicative of rigorous screening of personnel both prior to and during employment.

Bob Rodger, the Head of Information Security at Butterfield Trust, commented that ensuring high standards of cyber security is a business imperative – they regard the ability to deliver fiduciary services in a secure way as a critical component of their relationships with settlors, beneficiaries and the range of third parties, with whom they deal.

So, how can trust companies defend themselves? Training people to spot attacks of this kind is an important part of defence and 44% of respondents said that they were doing this.

However, there are many other "hard basics" that can be deployed using a layered approach to bolster your security defences further.

One layer might involve making it harder for attackers to reach users. This might involve filtering or blocking incoming emails, implementing anti-spoofing controls and reducing the amount of information you make public on websites or social media. For example, hackers can often discern a significant amount of information about the systems, software and data centres used by a business, simply by looking at the LinkedIn profiles of their IT support staff.

There are also steps you can take to protect your organisation from the effects of undetected phishing emails. You might use two factor authentication, which makes it harder for attackers to access accounts, ensure that authorisation gives privileges only to people who need them and install endpoint monitoring and protection software to try to intercept or detect malware. You can also help protect your users from malicious actors by use of a proxy server – a server which screens incoming and outgoing web communications – and ensuring that browsers and other software are up to date.

Much of this was borne out by the survey results. Some 41% of respondents said they were investing in security, with 38% saying that they ensured operating systems are updated and patched, 38% saying they blocked access to restricted sites, 36% saying they disabled access to external media and 28% saying they prevented downloads.

Trust companies were active in threat detection, with 36% saying they constantly monitored systems and 31% carrying out penetration testing to identify vulnerabilities and see whether their defences could withstand attack.

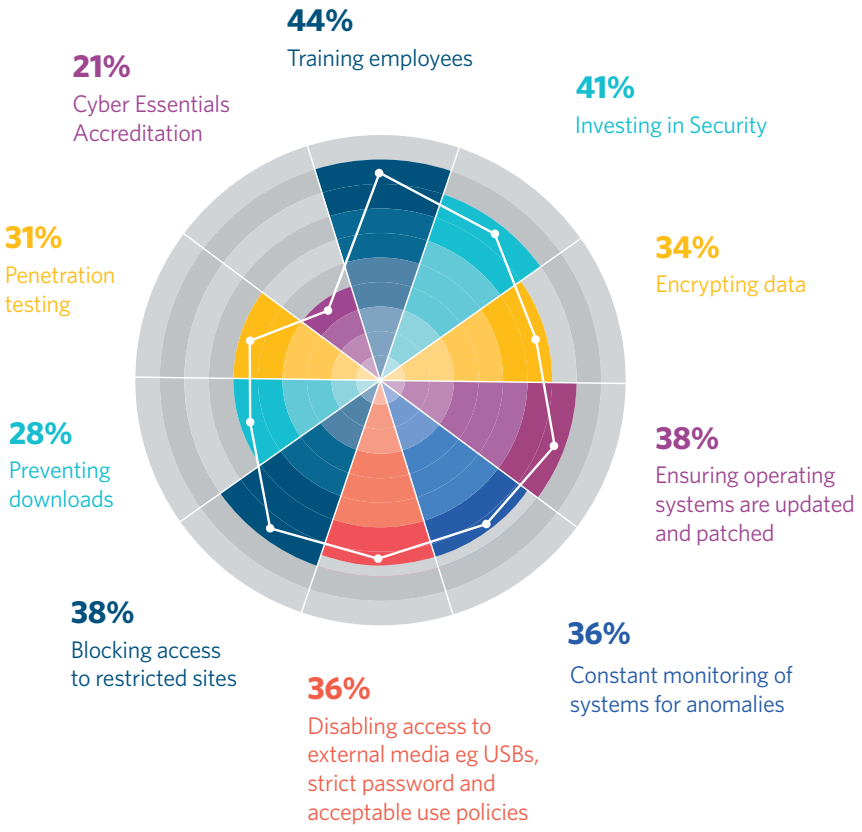
Only a third of trust companies (34%) said they chose to encrypt data, which may reflect the challenges of implementing some types of encryption (such as on-disk encryption) without interrupting business as usual.

These types of measures are also contemplated by various accreditations such as Cyber Essentials and Cyber Essentials Plus. A fifth of those surveyed were adopting Cyber Essentials accreditation, a government-backed scheme to ensure a minimum level of cyber resilience.

What are you doing to tackle the cyber security risks faced by trustees?

Regulators expect organisations to prevent attacks and it is prudent to obtain up-to-date legal advice on the regulators' expectations and how they are developing in line with rapidly evolving technology. The GDPR reflects that the security one implements should take into account "the state of the art". Seven of the ten top fines by data protection regulators in Europe last year were for inadequate technical and organisational measures under the security of processing provisions of Article 32 of the GDPR. The Information Commissioner's Office (ICO) in the UK has recently powerfully emphasised the importance of "hard basics". It has recently issued two fines following personal data breaches at the top level allowed under the pre-GDPR regime – £500,000 – for inadequate technical and organisational measures. In one case, the ICO specifically mentioned failure to attend to network segregation, firewalls, software patching, regular vulnerability scanning, penetration and vulnerability testing, application whitelisting, systems for logging and monitoring, updating software, point to point encryption, secure domain administrator accounts and adopting standard builds for all system components. In the other, it noted that the entity had failed to satisfy four out of five of the National Cyber Security Centre's basic Cyber Essentials guidance.

What are you doing to tackle the cyber security risks faced by trustees?



*respondents were able to choose more than one option

Key takeaway

Given that even the most secure organisations can still suffer successful attacks, there is an increased emphasis on organisations' ability to respond to, recover and learn from attacks quickly. Financial Services regulators are asking firms to ensure that they can deliver operational resilience in their important business services. Accordingly, rapid detection and containment of any cyber incident is essential and any measures to protect your organisation should include a way to deliver prompt and effective incident response, which can do much to mitigate the harm any attack might cause and may reduce the likelihood of regulators taking enforcement action against you.

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Anti-Money Laundering

Background

Money laundering and terrorist financing risk has been a key area of focus for regulators across the globe for some years – and this trend is only likely to continue. Exposés such as the 'Panama Papers' and 'Paradise Papers' have, rightly or wrongly, put offshore wealth in the cross-hairs of regulatory, Non-Governmental Organisation (NGO) and law enforcement scrutiny, and the 'laundromat' scandals have drawn attention to the need for closer supervision in some jurisdictions and more joined-up cross-border regulatory cooperation.

Trust companies have been at the centre of many recent developments in this space, including the continued push for greater transparency of company and trust beneficial ownership. Under the EU's Fourth Money Laundering Directive ("**4MLD**"), for example, regulated entities (which include trust and company service providers ("**TCSPs**")) came under an obligation to report beneficial ownership information regarding certain taxable trusts, to be stored on national trust ownership registers accessible by certain public authorities. This obligation was significantly expanded under the Fifth Money Laundering Directive ("**5MLD**"), which broadened the type of trusts required to report beneficial ownership information, and extended the range of persons who may access it – a development which will be of particular importance in affected common law countries, such as the UK, Cyprus and Ireland. 5MLD also imposes an obligation on regulated entities to report discrepancies between beneficial ownership information they obtain during Know Your Client (KYC) processes and the information stored on the relevant national register.

Many other jurisdictions intend to – or are being encouraged to – adopt additional transparency measures. The UK Crown Dependencies of Jersey, Guernsey and the Isle of Man, for example, have recently announced their intention to provide, within the next couple of years, public access to their corporate ownership registers.

Given this context, it is unsurprising that AML ranked within the top three issues faced by trust companies for over 75% of our survey respondents.

The most significant AML compliance challenges for trustees

In order to understand the areas in which trust companies perceive the greatest AML-related challenges to their business, we asked two questions: 'What are the most significant AML compliance challenges for trustees?' and 'How has AML compliance most affected your business over the past 12 months?'.

Our respondents reported that the most significant AML-related challenges they faced were as follows :

What are the most significant AML compliance challenges for trustees?

37%

Understanding and verifying journey to wealth/source of funds

24%

Understanding/ verifying complex ownership structures

8%

Dealing with PEPs

26%

Effective monitoring of client activity

18%

Effective staff training and awareness raising

8%

Basic identification and verification of those in the structure

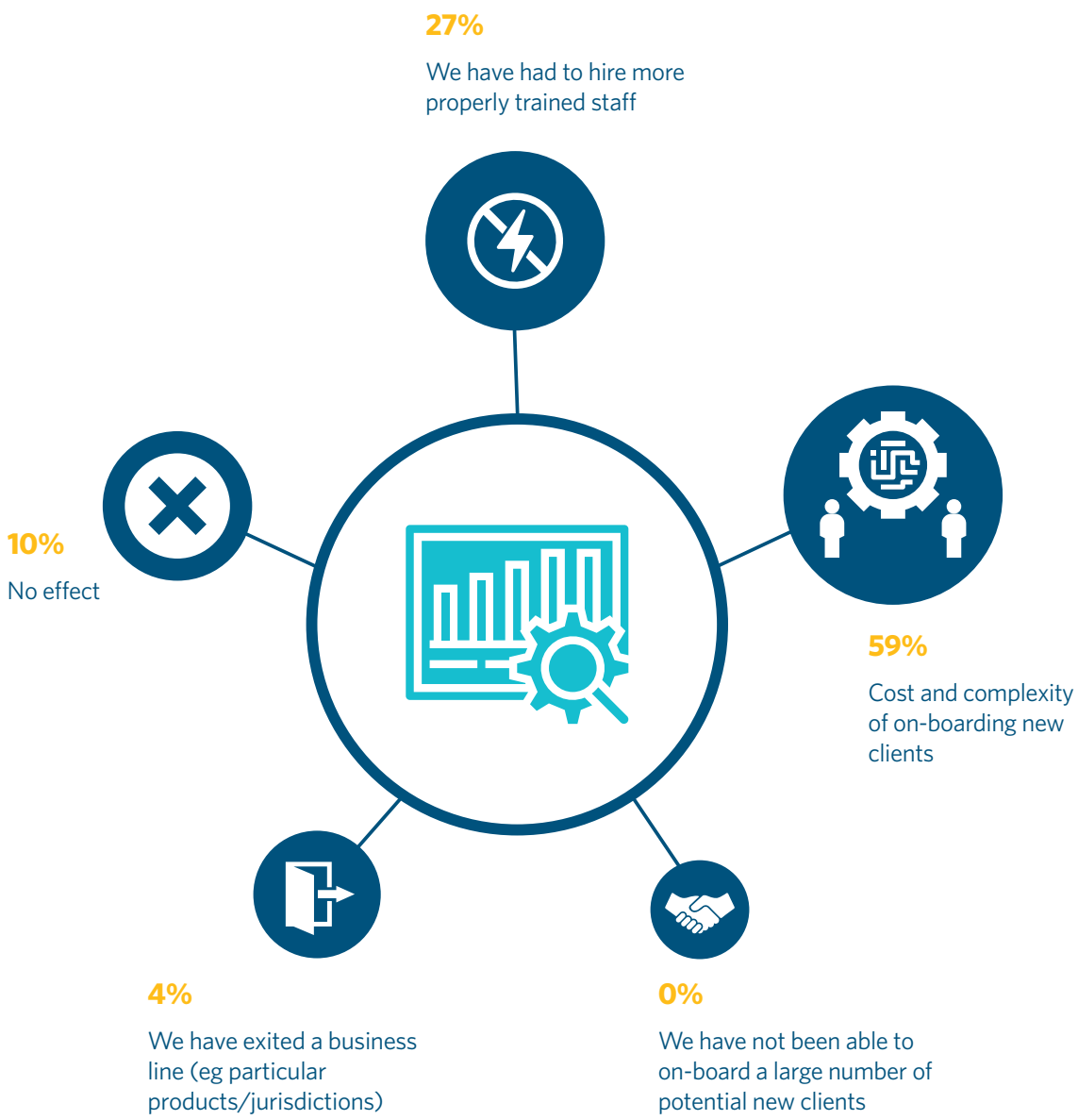
*respondents were able to choose more than one option

This is relatively unsurprising – despite the fact that obtaining an understanding of the source of funds and source of wealth of clients is a key means of mitigating the risk of money laundering, it is an area in which, in many countries, there continues to be limited practical guidance on the verification measures that should be taken. It is one thing for guidance to assert that a client's source of wealth should be understood, but another to clarify when and how, in practice, it should be verified.

It is however interesting to note that, in a context where complex ownership structures are to be expected, 24% of firms found it challenging to verify such structures. Perhaps respondents had in mind the difficulty in understanding or verifying the rationale for such structures; this is often a more difficult task in the context of private wealth, where legitimate rationales such as tax planning and privacy can sometimes be difficult to distinguish from the more nefarious reasons why clients might wish to use a vehicle with complex and obscure ownership features.

In relation to the area of respondents' businesses that have been most affected by AML compliance measures:

How has AML compliance most affected your business over the past 12 months?



Although it is at the lower end of responses, the figure of 4% is striking – to exit an entire business line in light of AML risk (or AML compliance costs) is of course a very significant step, underlining the very real impact that new regulation, and increased enforcement action, has had in this space.

Measures to address AML risk

The fact that trust companies are facing challenges with respect to AML compliance generally, and that a majority of respondents have been impacted by the cost and complexity of on-boarding new clients, raises the question of what further steps regulators could take that may be helpful for trust companies.

We asked respondents whether more guidance and/or more prescriptive requirements in relation to KYC measures would be helpful for trust companies. In recent years there has been a continued trend towards a risk-based approach to AML compliance; this of course has many benefits, but poses its own challenges in terms of clarity for firms as to their obligations; particularly smaller firms whose compliance resources are more limited, so we asked about this specifically. In response to this question:

Would more guidance and/or more prescriptive requirements on KYC be:

43%

Helpful in providing more clarity for trustees on their requirements?

18%

Unhelpful because it could lead to a 'box ticking' approach rather than a focus on mitigating AML risk?

39%

Both

The survey respondents operate across numerous jurisdictions, so these responses may reflect a level of dissatisfaction with the guidance or requirements of particular AML regimes. Nevertheless, the very mixed view is interesting. Perhaps the answer would be additional practical but non-binding guidance – including, for instance, good and best practice examples for firms of varying risk profiles – certainly, it seems that clearer requirements alone are unlikely to provide the solution, but that the current position is also unsatisfactory.

Views on beneficial ownership register obligations

As mentioned above, the EU under 4MLD and 5MLD has imposed additional requirements on trust companies in an attempt to address a perceived area of greater AML risk.

It is apparent that the industry is fairly evenly divided on the potential utility of these measures in the fight against money laundering, but a large majority agree that they will be burdensome.

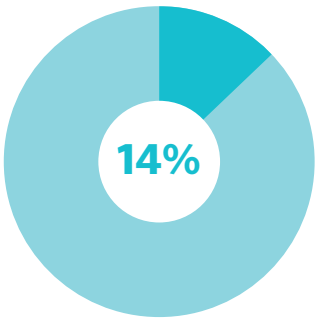
Of course, even if these measures have the potential to be useful, much depends on the steps relevant authorities take to investigate any information reported pursuant to these new obligations, and the impact of 5MLD is still largely unknown given that EU member states are at various stages of implementation. It is to be hoped that an evidence base regarding the impact of the new requirements is developed in due course, which other countries could weigh in the balance when considering whether to impose similar measures, given their significant compliance burden.

We also provided an opportunity for respondents to share any further views they may have on the subject-matter of the survey. One respondent expressed the view that many third party firms, when dealing with trust companies based in comparable AML jurisdictions, are unwilling to rely on the customer due diligence ("**CDD**") / KYC measures already undertaken.

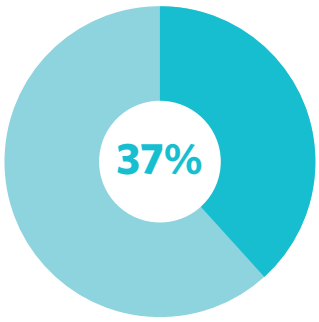
In the UK, there are several reasons why firms may be reluctant to use the 'reliance' provisions under MLR 2017. First, seeking to rely upon the suitability of 'third country' AML regimes (ie those outside of the EEA, which would be the category assigned to most of the jurisdictions in which our respondents operate) requires a degree of analysis as to the equivalence of AML standards. Given there is no EU 'white list' of equivalent regimes, this analysis (which

is rarely a straightforward one) typically falls on the relying party. Second, local practices or regulations (for example, confidentiality or data protection laws) might prevent the exchange of CDD information that is required by the provision. Third, as the relying firm remains liable for any failure by the counterparty to comply with the CDD/KYC measures, this is a risk that many firms are only willing to assume after reviewing and assessing the suitability of the counterparty's AML procedures, which can also be a time-consuming and costly exercise and so it is often only undertaken where there is a clear commercial rationale for doing so.

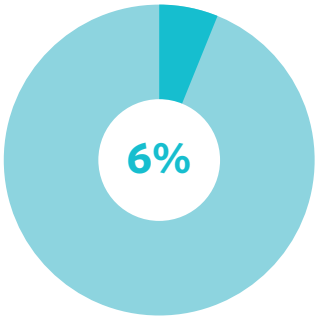
Do you think the introduction/enhancement of requirements on trustees relating to reporting information to beneficial ownership registers (for example, the challenges that will be implemented in the EU under 5MLD) will be:



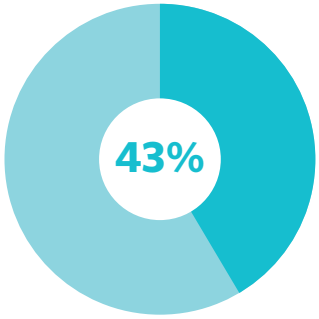
Useful in the fight against money laundering



Useful in the fight against money laundering but burdensome for trustees



Not useful



Not useful and burdensome

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Regulatory Compliance

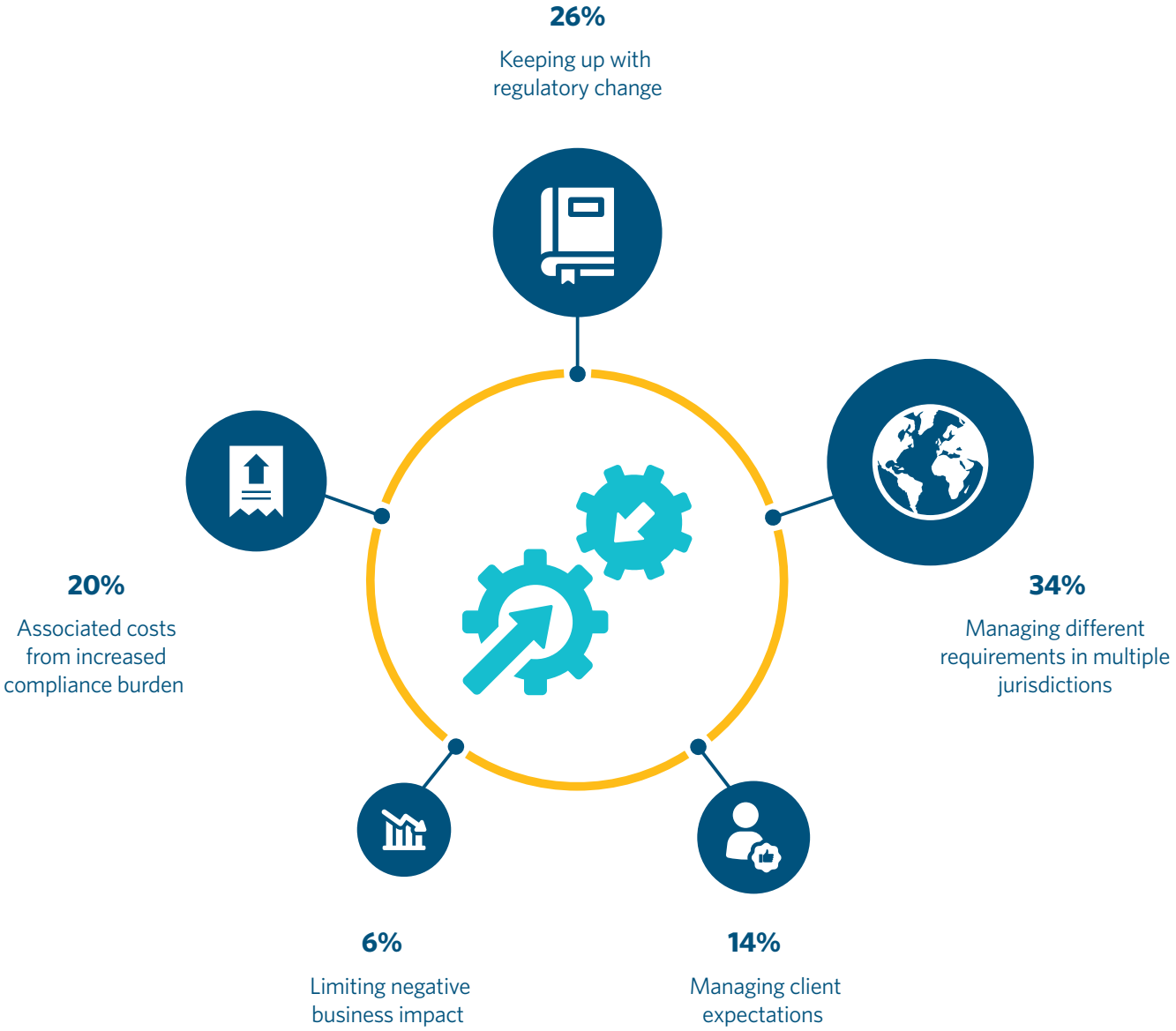
Our respondents identified regulatory compliance as the biggest threat their trust company faced.

The multiplicity of laws to be complied with if trust and company service providers (**TCSPs**) operate in various jurisdictions, and the ever-changing regulatory landscape more generally, can make it difficult for TCSPs to navigate and keep on top of their regulatory compliance obligations. Consistent with this, a clear majority of survey participants cited "general regulatory compliance (and associated costs)" over the likes of AML, "cyber attack", "data protection compliance" etc, as the issue that poses the greatest challenge to their business. Furthermore, 34% of respondents cited before and after and 26% before and after as the most significant regulatory compliance challenges that organisations are facing.

Of the 20% of survey participants that considered "associated costs from increased compliance burden" to be the most significant regulatory compliance challenge facing their organisation, 60% were independently owned. The remaining 40% were split evenly between being bank owned or private equity backed. No one jurisdiction stood out as more concerned about associated costs from increased compliance burden than any other, with all of the jurisdictions evenly represented in the results.

Only 6% of survey participants considered "limiting negative business impact" to be the most significant regulatory challenge that their organisation is currently facing. This could reflect a shift from organisations focusing on the potential burdens of

The most significant regulatory compliance challenge your organisation currently faces is:



regulatory compliance (eg added costs, slowing down decision making, restricting business etc) to regulatory compliance being recognised as a contributor to the governance of the organisation and even a business enabler, for example, by instilling confidence in customers. With many regulators increasingly focused on board and senior management accountability and oversight, and large fines being levied for AML/CFT failures, a robust compliance framework can provide protection from prosecution and personal liability, and avoid reputation–damaging headlines.

Of the 14% of survey participants that considered "managing client expectations" to be the most significant regulatory compliance challenge facing their organisation, 70% of them were bank owned, while the remaining 30% were independently owned. It is possible that bank owned TCSPs might find it harder to manage their clients' expectations if they have to also comply with the stricter regulatory compliance obligations that apply to banks.

Finally, 61% of survey participants responded in the affirmative when asked "whether regulatory intervention in their business was inevitable". This is a fair expectation given regulators around the world are increasing their regulatory reach and supervisory remit in respect of the TCSP industry. Take, for example, the licensing regime and AML/CFT regulatory framework for TCSPs that came into force in Hong Kong in 2018. This survey result may also reflect that even the best run businesses are at risk of regulatory intervention, and as such it is important that regulatory compliance is taken seriously.

Is regulatory intervention in your business inevitable?

Key takeaway

Compliance as a core business value

The Financial Action Task Force has issued guidance to the effect that it is the responsibility of the senior management of a TCSP to foster and promote a culture of compliance as a core business value. In our view, this would almost certainly assist the TCSP to effectively navigate the challenges referred to above. It would also help to ensure that those who are tasked with implementing the TCSP's regulatory compliance framework are well supported. This is important as the regulatory compliance landscape will continue to evolve and the repercussions of any enforcement action can be significant.

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Thank you for reading our report on the Herbert Smith Freehills trust companies survey

This report has examined some of the most pertinent and obvious risks faced by trust companies, but is not exhaustive of the multitude of challenges they are faced with. In addition, trust companies face further uncertainties, such as:

- **Geo-political challenges** – Separate from obvious threats posed by changes to international fiscal regulations and the imposition of sanctions or 'blacklisting' measures against individual jurisdictions where trusts are commonly established and managed, companies offering trust services are also susceptible to other aspects of political risk. This can be extra-territorial – for example, the possibility of adverse changes to legislation governing wealth management in a key client origination market – or domestic, as recent political instability in Malta has highlighted. Extreme weather events similar to the British Virgin Islands' traumatic experience with Hurricane Irma in September 2017 should also not be discounted.
- **Talent attraction and retention** – Although they do not typically experience consistently high turnover comparable to other professional services providers, trust and corporate services providers can face a range of talent pressures – the impacts of which can be exacerbated where succession planning may be limited in scope or amid deteriorating morale in individual offices experiencing protracted adversity. The supply of specific skillsets – in particular, risk and compliance – can be constrained and expensive in what are often small and competitive local labour markets, especially during periods of escalating demand when regulation is strengthening, making poaching to plug key gaps and loss of knowledge in its wake credible risks. Tightening labour laws in many markets meanwhile impose long lead-times to fill vacancies with expatriate candidates.
- **Mergers & Acquisitions** – Acquisition to increase market share, access new jurisdictions or tap into new customer verticals has long been a preferred pathway to growth in the trust sector. Risks here include identifying the right targets at the right time in a crowded terrain stalked by other players in purchasing mode, conducting sufficiently rigorous due diligence to ensure an accurate valuation and identify possible compliance liabilities in the client portfolio of superficially attractive plays, and achieving post-deal integration that truly realises synergies across constituent parts that often have very varied origins, leadership styles and operating models.
- **Reliance on third parties** – Utilising non-affiliated counterparties to provide complementary services to multi-national clients across jurisdictions where the trust company does not have its own footprint presents a range of delivery and reputational exposures. In a sector where a significant proportion of new business originates via intermediaries including legal, accounting and banking firms, over-reliance on individual 'rain-maker' relationships can also be detrimental when these change unexpectedly. With a consistently sizeable proportion of data leaks, tax evasion and corruption incidents (among other regulatory breaches) attributable to errors and misconduct by third parties, keeping up with evolving regulatory requirements in jurisdictions where 'eligible introducers' remain permitted and continue to be utilised represents a further – and significant – compliance challenge.
- **Competition** – In a sector where it is widely accepted that customers rarely change service providers before liquidation, winning the business initially becomes all-important – as the point above on avoiding complacency around risks associated with key referrals channels emphasises. Standing out from the crowd is increasingly important, especially online where searches and due diligence are increasingly focused, and in the teeth of intensifying rivalry from larger competitors buoyed by the strategic coherence and professionalization of accompanying targeted sales and marketing activity that private equity backing and international expansion/consolidation can confer. Bottom-up margin erosion from smaller challengers aware that baseline price comparisons form part of the new client evaluation process likewise has to be considered. And in what is usually a relatively 'small world' with a revolving door between and frequent dialogue amongst family offices and funds, service providers and the regulator, a reputational misstep can inflict lasting damage on market position, and over time market share.

Herbert Smith Freehills have experience advising trust companies on a full spectrum of risks, technical and legal issues across all major offshore and onshore jurisdictions; please reach out to a member of our global team (found overleaf) if you would like to continue the conversation and find out how we can help your trust company.

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