Final decision	
Complainant:	Mrs G
Firm:	Firm IJK
Complaint Reference:	RV/28
Date:	21 June 2007

1. The following represents my final decision in the complaint brought by Mrs G against IJK ("the firm"). I issued a provisional decision on the complaint on 1 February 2007, in which I indicated, with reasons, that I was minded to uphold the complaint. Mrs G accepted my provisional findings. The firm did not, and made various submissions asking me to re-consider those findings.

2. In summary, the firm raised certain objections to my general approach to dealing with splits complaints, although some of those objections were not directly relevant to this complaint. Thus, the firm did not agree with my provisional, general approach to the assessment of professional liability and to my use of the FTSE350 High Yield Index as a benchmark for calculating redress. And the firm disagreed with my use of 8% per year simple interest on crystallised losses and to my 'whole portfolio' approach to redress for managed portfolios. I also received a number of submissions from other complainants about my provisional, general approach to complaints about splits.

3. The firm also made some further submissions specific to the complaint. In summary, the firm considered that I had given insufficient weight, in my provisional decision, to the firm's own definition of a 'lower risk' portfolio, as agreed with the complainant. The firm also said that Mrs G's investment objective – a balance between income and capital growth – necessitated the inclusion of an equity element in her portfolio. And ordinary shares in conventional investment trusts, as well as unit trusts, should not generally be assessed (as the Financial Ombudsman Service appeared to assess them) as medium risk investments, as this ignored the diversification of risk that these investments achieved. The firm also clarified its sources of research before recommending investments, and said that my proposed redress method, using ten-year par government stock, was inappropriate to the case, and that I was penalising the firm by ignoring funds that Mrs G chose to withdraw from the portfolio.

Complaint

4. The complaint I am asked to resolve is between Mrs G and IJK. The firm had been discretionary manager of Mrs G's portfolio since June 1997. Mrs G says that in 1999 the firm bought investments for the portfolio that were too high risk, which pushed it above the agreed risk profile (low risk).

5. The investments which Mrs G primarily referred to were ordinary shares in three splits, as well as shares in Cable & Wireless Plc. They all went on to perform poorly.

6. The firm says its advice was appropriate and has declined to offer compensation. As the parties cannot agree, the matter falls to me to determine.

7. As I have made clear, I have treated the complaint as being one that Mrs G, as a result of the firm's advice and management, came to hold a portfolio of investments that was unsuitable for her when viewed overall.

Introductory remarks

8. In many ways the dispute between Mrs G and the firm is a straightforward matter much like many other thousands of disputes this Service is asked to determine about the suitability of investment advice and/or the management of investment portfolios.

9. This final decision forms part of our handling of over 6,000 complaints relating to advice by this and other firms to invest in splits, or in collective investments themselves invested in splits. Most of those complaints have now been resolved - in a few cases I or one of my ombudsman colleagues have issued a formal decision to determine the matter but in more cases my adjudicators have successfully mediated a settlement. Some cases that were initially referred to this Service have subsequently been resolved in other ways. Several customers accepted an offer from Fund Distribution Ltd (administering the fund to which many firms contributed following discussions with the regulator). And some firms against which complaints were made have foundered and have become unable to pay claims. Complaints against those firms have been passed to the Financial Services Compensation Scheme, the statutory "fund of last resort".

10. Around 300 "splits" cases remain to be dealt with by this Service, the majority of which relate to this firm and eight other stockbroking firms all represented by a city law firm (Barlow Lyde and Gilbert). This means that significant elements of the evidence and arguments that the firm has raised in response to this complaint are common, not just to this case I am dealing with today, but to all the other splits cases that this Service is considering in relation to this firm. In all, the firm's legal and other advisers have sent us seven reports and two opinions of Counsel.

11. Whilst there may be common elements to the complaints and I naturally seek to decide similar cases in a similar way, it is my duty to consider disputes on the basis of what is fair and reasonable in the particular circumstances of the case. The widespread concerns surrounding the events in the splits sector, the significant numbers of splits complaints received, and the broadly similar issues underlying many of the cases[1] have all prompted me to consider the common elements, but I must still treat each complaint as requiring an individual decision. If, when considering each case on its own particular merits, I encounter so-called 'generic issues' affecting a particular firm – in other words, splits-related issues that bear upon this case as well as others involving the same firm - I must decide to what extent those issues should be relevant to my findings in the particular case. My aim is to be fair and consistent in dealing with the generic issues, whilst taking full account of the facts and issues which distinguish one case from another.

12. It is to be hoped that the approach I decide to take in resolving this complaint about the firm will be helpful in resolving other cases involving the firm, where there are sufficient similarities. The actual outcome of each case will, however, depend upon its facts.

13. As far back as May 2004 we published a briefing for intermediary firms describing the 'high level' approach that we were adopting in relation to complaints about zeros. We applied

[1] As the firm's own evidence has demonstrated

a related approach to the other main share classes about which we received complaints – income shares and ordinary shares.

14. As far as I am concerned, the approach as described represented the starting point for our investigation of splits cases, based upon our knowledge and experience of such cases up to then, and it contained sufficient flexibility to allow for the facts of individual cases, for example the specialist knowledge about splits that certain firms possessed.

Structure of the rest of this decision

15. I have set out the main issues in five sections. My formal final decision is set out in section 3.

- The first section is scene-setting in nature, describing in outline the investment that is at the heart of this dispute. I also describe the market for splits and the problems that were experienced after late 2001 in the splits market. I summarise the FSA and Treasury Select Committee enquiries into these matters that took place after the events and note the arrangements for Fund Distribution Limited under which payments were offered to certain customers.
- In section 2 I describe my approach to assessment of this case.
- In section 3 I set out my findings on the facts of this case in so far as they relate to the circumstances of Mrs G.
- In section 4 I examine approaches to redress.
- In section 5 I set out the specific redress in this case.

But first I summarise my findings and decision in this case.

Summary of findings in this case

16. In the present case the firm acted as discretionary manager of Mrs G's investment portfolio, under an agreement which had existed since June 1997. Mrs G's risk profile for the portfolio was agreed as low, with a balanced return from income and capital growth.

17. In 1999 the firm bought certain investments for the portfolio which Mrs G says resulted in the risk level of the portfolio increasing above the agreed level. The investments consisted of 'ordinary shares' in three split capital investment trusts: Gartmore Shared Equity Trust, Gartmore British Income & Growth Trust and Jupiter Enhanced Income. Mrs G also complained about the firm's decision to buy shares for her portfolio in Cable & Wireless Plc.

18. All three sets of ordinary shares in splits had prior ranking shares at the time of purchase. The firm should have taken the risk implications of these prior ranking shares into account and concluded that the ordinary shares of all three splits were higher than medium risk at the time of purchase, on account of their subordinate ranking and the gearing effect produced by the prior ranking shares.

19. Having regard to the composition of the portfolio as a whole, the ordinary shares in splits combined with other investments that were higher than low risk formed a sufficiently

high proportion (over 60%) to ‘unbalance’ the portfolio above low risk, making it unsuitable for the complainant from December 2000 onwards.

20. Compensation should be paid by reference to how Mrs G’s portfolio would have performed from December 2000 to the date of disposal in line with ten-year par government stock plus 1%, allowing for the income that Mrs G had actually received from the portfolio and capital withdrawals that she had made. Interest would then be payable on the loss as calculated, to the date of payment.

SECTION 1: The Split Capital Investment Trust sector

21. In this section I describe in outline the products generally known as Splits which are at the heart of this dispute, describe briefly the problems experienced by many splits and the sector in general in 2001 and note the main enquiries undertaken into these matters by other authorities.

About Splits

22. Split capital investment trusts are, like any other investment trust, limited companies with shares independently listed on the Stock Exchange. Generally initiated by a fund manager or a broker, investment trusts invest in other shares and give private investors a way of investing indirectly in the stock market with potential advantages of diversification within or across sectors. They are therefore in broadly the same market as such collective investments as unit trusts. Unlike unit trusts the value of the investment (represented by the share price) does not directly reflect the underlying asset value, but may be at a premium or a discount to it.

23. Originally the usual structure of a split was to divide the investment return between income shares which were entitled to all of the income, and capital shares which were entitled to all of the capital growth. The main purpose for the capital shares was to provide an investment attractive to high marginal rate tax payers (since the growth was taxed as a capital gain only). Income tax exempt investors, such as pension funds, formed the main market for income shares.

24. Over time modifications began to appear, such as the introduction of further gearing in the form of unsecured loan stock, or variations in the division of income and capital appreciation.

25. The first splits to include zero dividend preference shares ("zeros"), in addition to capital and income shares, were launched in 1987. High capital growth in the 1980s meant that that the gearing effect of income shares on the capital growth reduced during the trust's lifetime. Zeros offered investors a fixed target return on capital at redemption (taxed as capital growth). And for investors in capital shares, zeros gave a form of gearing that would not be eroded by the growth of capital shares as a proportion of total assets in the same way as gearing through income shares alone.

26. Subsequent developments included:

- The issuing of ordinary income shares instead of capital shares. These participated in income (as geared by the zeros) but also included participation in any residual capital growth above the fixed growth accrued to the zeros.

- Gearing through bank borrowing as an alternative to zeros, with interest (at a lower rate than the necessary yield on zeros) rolled up and charged to capital.

- Investment policies that included investing in income and ordinary income shares of other splits in order to achieve an attractive yield on the first split's own income shares.

27. Significant development in the sector took place in the late 1990s. As the Treasury Select Committee noted:

28. "Split capital investment trusts began to develop significantly in the 1960s, and by 1987 several dozen such trusts had been launched. 1987 saw the launch of the first splits which had 'zeros' as part of their capital structure. By the end of 1998, over 70 further splits were on the market, the vast majority of which included zeros. In the period 1999 to 2002 there were a further 81. Many of these splits were of the so-called 'barbell' type, with the assets of the trust concentrated at opposite ends of the income/growth spectrum with relatively little in the middle."[2]

29. However, financial conditions and market sentiment during 2000 and 2001 triggered a sequence of events which culminated in the collapse of a number of splits. The technology market collapsed, share values in the UK and globally fell. Shares in many splits were suspended. Investors in others suffered losses.

30. So this complaint concerns investment vehicles which had been developed in novel ways in the recent past, resulting in significant structural change. In addition, where the complaints involve zeros, they concern a share class that was relatively new to the investment community and about which there had been increasing enthusiasm across the community in the run up to the relevant advice.

The Treasury Select Committee's enquiries

31. As a response to the losses in the sector, the Treasury Select Committee took evidence and issued the report quoted from above. Its findings can fairly be described as uncomplimentary to the sector. In particular, as relevant to the issues brought to the Financial Ombudsman Service the Committee said:

32. On risk:

> *"(b) We strongly believe that the splits sector should indeed have 'shouted louder' about the changing nature of the sector. The key point is that any bank gearing made zero shares in splits significantly more risky in falling markets and, the higher the level of borrowing, the greater the danger. It is clear that significantly higher levels of gearing were common in splits launched from around 1999 compared to those in the early 1990s when the major expansion in zeros first began. Virtually all of the holders of zeros were in the dark about the levels of borrowing (paragraph 20).*
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> *(c) The increased use of cross-investments in other splits made the shares in splits a much more complex investment than they had previously been. They were potentially more volatile, often more highly geared than was apparent, and certainly more difficult to understand and to monitor. In some cases, it amounted to little more than a sophisticated form of pyramid selling, which we deplore (paragraph 24).*
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> *(d) Many zeros launched in the late 1990s (and subsequently) were structured in such a way that, in adverse market conditions, the zeros were not low risk products. They were in effect different from earlier zeros and were now complex derivative products. Even their designers appear not to have fully understood how they would react to falling markets; we regard this as a significant lapse in responsibility. They held particular risks*

[2] House of Commons Treasury Committee, Split Capital Investment Trusts, Third Report of Session 2002-03, HC 418-I

in the event of a significantly falling market; and the fact that such market conditions were not in historical terms likely does not justify them being sold as low risk (paragraph 29, (a)(d))".

33. On mis-selling:

"(g) It seems clear to us that those primarily responsible for the development of the 'newer' splits—the board members themselves, some trust fund managers and some sponsoring brokers—did not take the steps they could and should have taken to bring the true nature of the risks in zeros to the attention of the wider investment community. We deplore the fact that many investors in the 'newer' zeros were not adequately warned by trust fund managers of the risk to their investment, especially as the managers subsequently increased that risk by substantially increasing gearing (paragraph 41).

(h) We accept that not all individual investors in zeros over the last five or more years are automatically entitled to compensation, even if their investment was made using some form of adviser or intermediary. The circumstances of each case must be examined—initially by the adviser or company concerned but if necessary by the Financial Ombudsman Service—but we are in little doubt that there is a wide range of cases in which it will be found that compensation is justified (paragraph 42).

(i) The statements of risk in the promotional material must be assessed in the wider context of the way in which clients were led to believe that zeros were, overall, a safe investment. The greater was the general belief among inexpert investors that investments were 'low risk' when they were not, the greater was the onus on those advising them—or on those designing the products and promoting them through advisers—to make clear what the risks were. It was insufficient for the warnings to be little more than small print (paragraph 42)."

The Financial Services Authority's enquiries

34. The FSA undertook its own investigations. In late 2001 it consulted on regulation of the sector and responded to that consultation in May 2002. At the end of 2004 it announced details of a settlement reached with some splits managers and brokers to contribute £194m to a distribution fund (Fund Distribution Ltd) to which investors in zeros could apply. Payment covering partial loss would be made without the consumer needing to establish fault by the firm.

35. Around 500 consumers who had previously complained to the Financial Ombudsman Service have accepted a share in the distribution, in exchange for which they have withdrawn those complaints in whole or in part as a condition of acceptance. The eligible applicants will have received 50.663p in the pound of their losses, after taking into account monies they may have received from other sources.

36. I am of course required to investigate complaints and reach findings independently of other bodies' investigations. The work done by the Treasury Select Committee and the Financial Services Authority is of background interest, but cannot be the basis of my findings. In the following section I describe my approach to this case.

SECTION 2: My approach to deciding this case

37. In this section I set out the approach I have taken to resolving this splits case involving the firm, incorporating consideration of representations that have been made by the parties (primarily the firm through its legal advisers) about this.

General observations

38. The Financial Ombudsman Service is called upon to resolve large numbers of disputes about whether or not various investments were "mis-sold". The central issue in many is whether or not the investment was "suitable": that is whether it was a reasonable match for the circumstances of the customer when the advice was given.

39. The assessment of what is or is not suitable includes an understanding of what the customer's investment objectives were and places considerable weight on an understanding of investment risk, that is the appetite of the complainant for investment risk and the risk involved in the particular investment under consideration. Problems will arise if either the customer's appetite for risk has not been properly assessed or if the assessed risk does not match the product that is bought. If the firm recommended or selected a product that was not suitable then it is likely to be liable for the losses the complainant has experienced in consequence.

40. Usually customers will take an active part in the assessment of their own appetite for risk and to describe their own investment needs – and although firms too have responsibilities here, this assessment is not generally at issue in these cases.

41. By contrast, the adviser typically has the leading role in assessing the suitability of a product or products to meet those needs within the assessed risk level. In the splits cases the core issue relates to that leading role: that is, whether the firm correctly assessed the degree of risk associated with the investment as suited to the customer's agreed appetite.

42. The circumstances under which the splits investment came to be selected and held can vary widely. There may have been several splits investments held in a portfolio, and that portfolio may have been held under trust, or be designed for pension provision as a self-invested personal pension. The firm may have had an advisory role, or may have been given discretion to buy and sell investments. The firm may have had a duty to monitor the suitability of the investments. Most commonly the investment or investments will have been one of zero dividend preference shares, income shares or ordinary shares, sometimes a combination. In this case, Mrs G a 'discretionary' portfolio, part of which was invested in 'ordinary' shares.

43. Similarly firms have told me that they adopted at different times widely varying approaches to assessing the risk of the splits products they recommended. Many made general assumptions about the level of risk associated with splits, some relied on the descriptions given by splits providers, whilst others conducted some analysis of the sector and a few of individual products. But of course any such analysis was carried out at different times and firms have not generally been able to document the particular enquiries, if any, that they carried out.

44. As complainants have pointed out, a critical issue is whether the analysis carried out by the individual firms was adequate to assess the risks of splits products. The firms say that they did not expect that what did happen in the splits sector, would. Consumers tend to view this as a collective failure: the enhanced risks of the products were clear and well known

(they say), or at least should have been to the firms. Indeed some customers would argue that there was a “magic-circle” of financial firms in the know about the true risks associated with splits who nonetheless actively recommended splits to their clients. Firms say that they should be judged by the standards applying to reasonably competent advisers: that they, like many of their peers, were acting competently and that the risks were either unforeseeable, or not such that they ought to have been foreseen. They also say that their assessments of risk and suitability were reasonable when considered against the standards of the day.

45. The assessment of the suitability and risk of a financial product is not a precise science. There is not for example a universally accepted description of different levels of risk, let alone a generally agreed methodology for assessing the risks of products. A financial adviser is expected to exercise reasonable judgement bearing in mind the legal and regulatory responsibilities. Inevitably given the nature of financial markets and the analysis of risk, genuine differences of view will emerge about both the appropriate methodology for undertaking assessments and, more important, the level of risk that ought properly to be ascribed to a particular product.

46. In resolving disputes between advisers and customers it is not my role to substitute my own judgement for that of a reasonably competent adviser. But equally I cannot stand back and simply assume that the adviser in question has advised competently.

47. The question I need to resolve is whether or not a particular sale of a particular product (or a particular portfolio) was suitable for the particular client. In addressing that question I have taken into account what the firm has said about how it assessed the risks of splits investments (and portfolios of which they formed part). However, what I must decide is whether the risk profile that the firm attributed to the investment (or the portfolio) properly reflected the risk factors that ought fairly to have been known to the firm at the relevant time. (I say more about ‘portfolio complaints’ later in this decision.)

48. My approach therefore has been to consider how I should assess whether or not the firm’s conclusion about the risks associated with a particular splits investment was mistaken, and in consequence the particular product at a particular time was suitable or unsuitable for the customer. This will take into account the firm’s varying levels of knowledge and/or experience at different times as well as the fundamentals of the products in question. So I must form a view on what risk factors this particular firm should have taken into account at a particular time when assessing a particular splits investment, and what conclusions about the risk profile of the investment the firm should have drawn.

49. The starting point for forming such a view may well be the sort of risk factors of which, by particular times, I consider a financial firm like this firm should have fairly been on notice. But I must additionally consider what, if any, specialist knowledge the firm also possessed.

50. Inevitably this results in some sharp dividing lines being drawn. For example, it may be fair for me to distinguish cases involving the firm based in part on the time that the advice was given, because I think it reasonable that understanding of the risks associated with products and the assessments that the firm should have been expected to make should have developed over time. Later recommendations may be more difficult to sustain than early ones. The effect can appear arbitrary. Advice given on one day may in accordance with such an approach be seen as appropriate whereas the same advice on the next day would be viewed as unsuitable.

51. I have therefore needed to think carefully about where these lines should be drawn in relation to this firm. I have in fact chosen these points cautiously. That is, for example, to identify not the first point where concerns might have been raised but the point where it is reasonably clear that the firm's level of awareness of an issue was (or should have been) such as to raise questions whether earlier analysis had been sufficient and appropriate.

52. The submissions I have received have been, in large part, intended to persuade me that my proposed approach is inappropriate. This document is a decision in an individual case. However, it will help if I explain my approach and the justification for it at some length, taking into account all the submissions that I have received.

53. This is not a debate, with the Financial Ombudsman Service arguing one view against the position put up by the firms involved and/or their advisers. Our independent and impartial role is investigative, inquisitorial and, ultimately, to act as arbiter. We sit in the middle of two sides, the firm and the consumer. Where one side is more vocal than the other (as the firms have been in these cases) the reality may be obscured that there are two disputing parties, with a quasi-judicial ombudsman service making a decision on fair and reasonable grounds as to whether the firm is at fault and, if so, what the consequences were for the consumer.

Approach to this decision

54. At the risk of some simplification, many firms have told us that they had a generalised approach to assessing the risks of splits. Splits were a relatively specialist product so there was no agreed approach to assessing risks. Typically, however, they considered zeros to be low risk products as they were sheltered from the market by the other share classes over which they had preference and no zero had yet failed to pay out its target value. And many firms were accustomed to recommending ordinary income shares in splits as medium risk investments.

55. Set against this approach was a gathering body of comment and evidence that pointed to particular potential problems with splits products and in particular to certain elements of the product. As that wider understanding developed I find that the firm should have included in its assessment of the product a consideration of some of the factors that had been highlighted as giving rise to particular risks. Given that developing understanding, it was no longer prudent for the firm to assume that all splits, or all shares within a particular class of splits shares, could simply be treated as a group.

56. So, bearing in mind the developing understanding of the splits products, what would proper enquiries by the firm have disclosed? To reach a view on this I consider various indicators to distinguish one split from another bearing in mind the risks that were being increasingly understood. In summary I consider in particular:

- any relevant marketing material (the statements made by splits providers)
- asset cover (for zeros and certain income shares)
- the level of bank borrowings of the split and any structural gearing
- the level of investment by the split in other investment trusts

57. I take into account how understanding of the risks developed over time and how that would fairly have been reflected in increasingly in-depth risk assessments. I also take into account the extent of expertise and knowledge available to the firm.

58. So the effect of this approach is not that the firm ought suddenly to have been stringent in its risk assessments – nor, to put it another way, that if the firm had been more stringent, it would necessarily have reached a conclusion as to risk different from the one it in fact held. The effect is that, with the passage of time, applying the knowledge accessible to the firm and the expertise it could reasonably have been expected to have, it would have reached increasingly informed views about risk, so concluding, by certain points in time at the latest, that particular investments were not suitable for some of its customers, given their established risk appetites.

Portfolio complaints

59. Many complaints involve a portfolio of investments that was constructed according to the firm's advice and/or managed by the firm in line with a particular risk profile and objective; for example, a low risk portfolio or medium risk portfolio, with an objective of producing income or capital growth. In nearly all such cases the agreement between the firm and the customer was that the portfolio overall should satisfy those criteria, but subject to that, individual investments/products within the portfolio might differ from them.

60. So in such cases it was normally not enough for the firm just to assess the risk level and characteristics of a particular investment on its own – although that should always be the starting point. The next stage should then be to assess the risk profile and characteristics of the portfolio overall, which involved assessing all the investments/products in the portfolio and what their respective risk levels and features added up to.

61. References in this decision to "suitable" and "unsuitable" investments or products should be understood with these points in mind, where the splits investments formed part of a wider portfolio. In such cases, it was not the individual investments or products that were suitable or unsuitable in isolation, but the portfolio as a whole. But the starting point was still to assess the risk level and other characteristics of the splits investments.

Considerations in deciding my approach

62. Overall, in deciding my approach to this firm's complaint, I have:

- collated commentaries made by observers both in the specialist and general arenas before and at the time of the events complained of
- researched and reviewed the prospectuses and marketing literature of the splits concerned
- reviewed the views expressed by the regulator at the time
- carefully considered submissions made directly by the firm, the complainants, and by their representatives

63. In addition, I have, of course, been able to draw on the Financial Ombudsman Service's considerable experience in investment matters across the Service, since broadly investment related complaints have historically formed a significant proportion of the

complaints dealt with by the Financial Ombudsman Service and its predecessor organisations.

64. The reports with which I have been provided run to many hundreds of pages. They have been read and considered in detail, and what follows includes consideration of the issues in the light of them. It would neither be helpful nor practicable to deal with them piecemeal in this document. But, to be clear, the documents that have been taken into account are:

A report on market practice and splits by a market practitioner

A splits expert's report on the nature of zeros and other split capital shares

The same expert's report on publications about splits

The same expert's commentary on splits

The same expert's response to the Financial Ombudsman Service's comments about his report on the nature of zeros and other split capital shares

An academic's analysis of risks associated with splits

The same academic's report on the Financial Ombudsman Service's approach to calculating redress for income shares in splits

A legal opinion on redress for splits

A further legal opinion on redress and related issues, relating to splits

and the miscellaneous submissions made on the firm's behalf by its solicitors.

65. In the remainder of this section I set out the central matters that I have considered in formulating my approach to this complaint. Some of the evaluation and conclusions reached are included here, or given particular emphasis, because they have been specifically raised in the submissions referred to above. However, I am not required to deal with every submission in the same degree of detail – and in general my assessments are made in the light of submissions rather than as point by point observations on them.

66. I look at:

(a) How understanding of splits and the underlying risks developed over time, to decide whether and when the firm should have responded to that understanding in its risk assessments, concluding that there are two points at which, at the latest, the firm should have reconsidered its approach. This results in three periods:

- before 1 December 1999
- 1 December 1999 to 30 April 2001
- 1 May 2001 and after

(b) the understanding and assessment of risk, in general and as applied to splits, to decide what conclusions the firm could have reached, had it responded when I consider it should, in making investment decisions and recommendations for its customers.

I then make some observations about

(c) whether the firm can be regarded as having more knowledge about splits than other firms

(d) a particular objection; namely that the fact that the regulators did not identify these matters as systemic and then step in, is argued to imply that the firm need not itself have responded to changes in the sector.

(e) submissions made by splits complainants who read the three representative provisional decisions posted on the Financial Ombudsman Service website.

(a) the developing understanding

67. I considered, in formulating my approach, when the firm should have been on notice that when assessing risk it needed to consider carefully the particular issues in the splits sector, rather than adopt more generic approaches.

68. Complainants have tended to argue that the particular risks of splits were (or at least should have been) evident from very early on. In contrast firms may argue that particular issues in the sector only became evident to them when problems emerged and could not have been evident beforehand.

69. As mentioned above, the Financial Ombudsman Service has researched contemporary articles and other publications. They are summarised, with comment, in a document published on our website[3]. In response I have been supplied with a report prepared by a splits expert (but the views expressed are the expert's own) about publications on splits.

70. The material summarised on our website is not intended to be a representative sample. Any information in the public domain that warned or cautioned about splits was relevant. The question is when, prompted by the background noise if nothing else, the firm's risk assessments ought to have changed to a fuller examination of the particular investments. While the adverse or cautionary material was outweighed in quantity for much of the time by material that was neutral or supportive that does not mean it should have been ignored.

71. Some of the adverse/cautionary commentaries refer specifically to ordinary or income shares, as distinct from zeros. However, observations about the risk of such shares are relevant to complaints about zeros too, since they constituted warnings about assets. In any trust with zeros, as net assets fell there was a greater risk that the zeros' redemption value would no longer be covered.

72. As well as the material we have published, some of the splits expert's comments (in Section 3 of his report) can be taken to support the view that by a certain time the firm would

[3] http://www.financial-ombudsman.org.uk/publications/guidance/splitsguide-annex.pdf

have been aware of risk factors such as asset cover, gearing (financial and structural) and holdings in other investment trusts. He notes in several places that it was accepted that:

- it was well established that gearing is a risk factor with positive and negative effects;
- geared shares performed poorly in falling markets - although he also says (particularly in relation to the breaching of debt covenants) that the probability of an extreme market was very low.

73. He also, in distinguishing between zeros and income shares/ordinary income shares, notes that the latter were "always marketed as high risk".

74. I have taken into account the publicly available material, and had regard to the pricing points made above as well as all of the submissions on the issue of knowledge and understanding.

75. So at what point was the background such that this firm should have looked more deeply into individual investments before making its recommendations?

76. In looking at the information available at the time, I have identified the latest points at which I consider the picture changed. Some firms may have taken particular factors into account earlier (and where I know that they did so I will consider whether their conclusions were appropriate). But I have concluded, after a careful review of all of the available material, that December 1999 and May 2001 are significant points by which this firm's approach to risk assessment ought to have changed, at the latest. It is the sum total of material rather than individual documents that leads me to those dates, but, to highlight some of the significant material:

- Going back to 1992 the material shows an ongoing debate amongst practitioners about how splits shares should be risk assessed. It is also evident that practitioners considered there were increased risks from gearing and investment by splits in splits at a fairly early stage, but there was no consensus on how to quantify those risks.
- The 12 November 1999 issue of Investors Chronicle contained a survey entitled "Investment Trusts: Turning somersaults" – "The split capital trust sector has come full circle again and is now enjoying an extremely high profile. But there are still some participants who are worried by the thought of cross holdings". It said:

  '…there can be no denying that many HGO's (highly geared ordinary shares or income & residual capital shares or ordinary income shares) would be vulnerable on the capital front if world stock markets took a protracted downturn. The income support will diminish as redemption or roll over approaches and the share price could plunge if the zero dividend preference shares seem set to claim an unexpectedly large share of a shrinking capital cake. Trusts investing in income shares, could have a diminishing share of a series of shrinking portfolios, so despite their professional managers and growing diversification they must be extra vulnerable.
  But anyone investing in geared shares, be they in a conventional trust, a split or a split capital fund of funds, must understand that they will be badly

hit by a sustained bear market. Investors should only be tempted by the high yields if they believe in a strong medium term equity market.'

- By Spring of 2001 there were significant concerns expressed by some professionals. Cazenove & Co referred to applying 'healthy scepticism' in their Annual review dated 10 January 2001. In addition to the January 2001 Cazenove & Co Annual review and the April 2001 Professional Investor report entitled "For whom the barbell tolls…" there was a report "Can risks really be reduced to a zero?" in The Times newspaper of 21 April 2001. Extracts of some of comments are as follows [the extracts are not necessarily directly connected]:-

  'Certainly, some zeros are far riskier than others. As always, it pays to kick the tyres and check beneath the bonnet before buying. Sue Whitbread, investment trust expert at Chartwell Asset Management, the independent adviser, says that any assessment of a zero should begin with the underlying portfolio. 'You want a well-diversified blue chip portfolio,' she says. For such information, it is best to lay your hands on the trust's annual report. Failing that you can scrutinise a fund's top ten holdings on any number of Internet sites'.

  '*beware of funds that invest in other split trusts. This is piling risk upon risk, and dilutes cover.'*

  '*At Exeter, Mr Craig also urges private investors to avoid the zeros of splits with a high level of exposure to the income shares of other splits'.*

  '*Such has been the depth of concern about the risks associated with this crop of zeros that one fund management company recently sold off its holdings and re-invested the proceeds in an earlier generation of zeros. The company preferred a cut in yield rather than risk a dent in capital'.*

  '*The near collapse earlier this month of Framlington NetNet, and a handful of other technology split capital investment trusts, has done nothing to soothe fears that the web of interlocking splits could start to unravel – and set off a chain reaction throughout the £12 billion sector.*

  'Ironically, neither Framlington NetNet nor any of the Aberdeen funds which have come close to breaching their banking covenants has any zeros, relying instead on the banks for their leverage. This has not helped their plight.'

  'While zero holders have to sit tight until wind-up, bankers can demand their money back if the fund's coverage slips beyond agreed limits.'

77. It has been argued[4] that the pricing of shares in the market did not indicate that the market perceived that risks were increasing and/or that the change in the structure of splits – including gearing via bank borrowing – created substantial risks. There was, it is said, no significant risk premium. The point being made is that if there had been such a premium it would have indicated to practitioners that there was a hitherto unrecognised risk that needed to be taken into account. There is a somewhat circular argument here: in effect it is said there needed to be an identifiable risk premium set by the market in order for the market to identify risk.

[4] In, for example, the market practitioner's report

78. But anyway, market prices are not necessarily a reliable indicator of risk profile, because they reflect not only the anticipated risk but also the anticipated reward. A medium-risk high-yield investment can attract a higher market price than a low-risk medium-yield investment. That is especially so because market prices are largely set by and for market professionals – who are well able to assess the trade-off between risk and reward. Additionally, in practice sentiment – such as misplaced enthusiasm in a sector - can simply mean that pricing is "wrong", whether over- or under-valuing shares. If there was no significant risk premium, that could easily have been because the risk had been underestimated.

79. I have taken into account the publicly available material, and had regard to the pricing points made above as well as all of the submissions on the issue of knowledge and understanding. My overall conclusion is that, given that knowledge and understanding were developing over time, the firm should have responded to changing perceptions initially in some way by 1 December 1999 - and made a further adjustment of approach by 1 May 2001. I repeat that these are the latest points. Many firms will have made an appropriate response to events sooner, and complaints against them may therefore not succeed.

80. Next I explain how I have decided to assess the likely outcome for customers of the adjustments in approach that I consider the firm should have made. To do that, I need to reach conclusions about risk and how the firm ought reasonably to have assessed it in relation to splits.

(b) understanding and assessment of risk

81. As I said earlier, it would not be sufficient simply to try and assess what the firm did, in relation to each transaction, based on the firm's own risk assessment methodology. I have instead to decide on an approach that fairly reproduces risk assessments that are no less accurate than assessments I consider the firm's customers ought to have benefited from at the relevant time.

Risk and suitability

82. The purpose of the risk assessment of the product is to match it with the customer to ensure its suitability. So it is necessary to be clear about the parties' proper understanding of risk.

83. In some of the representations I have received it has been put forward that "risk", as a term of art in the investment world, applies to the uncertainty surrounding both good and bad outcomes. However, to most people "risk" relates to adverse outcomes only. The opposite side of the coin is reward. In this document the word "risk" is taken to have been intended and understood in the ordinary sense – that is, as applying to the degree of possibility of adverse outcomes alone.

84. There are well recognised difficulties in quantifying and describing risk. Descriptions such as "medium risk" or "low risk" mean different things to different people. And of course they are on a continuum, there being no clear dividing line between different risk levels. Common terminology amongst practitioners might typically be to classify the risk attributes of a particular investment as "low", "medium" or "high"[5]. But, like points of the compass, where there are theoretically infinite points in between the cardinals, there are gradations of risk in

[5] The market practitioner's report predominantly uses a three-point scale.

between the commonly agreed terms. Unlike the points of the compass there is no absolute consensus as to what even the main terms mean, though there may well be a great deal of common ground.

85. The splits expert, in Part 1 of his report on the nature of zeros and other splits capital shares makes a series of observations about perception and assessment of risk, most of which are consistent with the observations above. There is one significant point on which he appears to differ. He says that risk can be measured objectively and that "…risk statements contained in published documents should not be interpreted by what any one individual investor might understand, as different investors interpret it in different ways." That statement must be right, because of the emphasis on "one individual investor". The interpretation of risk statements should be based on what its intended audience in general would have understood. But in looking at an individual case one cannot exclude what the particular individual reasonably and predictably would have understood in the light of his or her own experience and needs, and any discussions surrounding the investment decision.

86. In this case and similar ones the complaint can only succeed if the actual risk ought to have been recognised as higher than the risk that the consumer agreed to or ought to have been invited to take, with allowances for some imprecision in the definitions and their interpretation at the margins. So it is not helpful to engage in discussion of whether some artificial line has been crossed between, say, "medium" and "high", or between "medium" and "medium high". If the actual risk should have been identified at the time, making allowance for marginal imprecision, as higher than the acceptable level then that is enough.

Assessment of risk in splits investments

87. As I have previously said, the following features are most obviously potentially relevant to assessing the suitability of investments in 'splits':

- any relevant marketing material (the statements made by splits providers)
- asset cover (for zeros and certain income shares)
- the level of bank borrowings of the split and any structural gearing
- the level of investment by the split in other investment trusts.

88. I consider that in deciding what risk assessments the firm would have reached acting properly, these are the features I should have regard to. There could be arguments about the relevance of other features – and about whether these particular features will always give a consistent and reliable picture of risk. However, the starting point is that these features undoubtedly bear upon the risk level of investments in splits, and they were referred to in general and specialist literature about splits to which the firm can fairly be assumed to have had access (newspaper articles, trade and investment journals and so on).

89. The first feature is specific to the particular investment. This is how I consider the final three features listed above impact on the risk assessment of specific splits.

1) Asset cover

Asset cover is an accepted factor in assessing risk. At any given point the market is as likely to fall as to rise and over a long period the market, or more particularly the

underlying portfolio, could fall, recover and fall again. These fluctuations will be reflected in the asset cover at any point in time and affect risk. So it is not the case, as might be argued, that having asset cover of at least 100% is only significant if the trust is due to wind up. The increased risk is not just notional. And if the trust's assets have fallen to the extent that its debt covenants are breached, there is a risk that it may go into immediate liquidation even if it is not due to wind up.

There was (and still is) no one particular way of measuring the asset cover for zeros. I am aware that different firms have used different methods and the same firm may have used different methods at different times to reflect a changing perception of the factors that affect the asset cover.

For example, the Association of Investment Trust Companies (AITC) calculated the asset cover in a particular way until November 2000 for its monthly statistics report. It slightly changed the method from December 2000. In July 2001 it introduced an additional measure of evaluating the asset cover. It called that the 'debt cover method'.

The formula I consider appropriate for use in deciding these cases to determine the asset cover of zeros – acknowledging that the other methods exist, is:

$$\frac{TA - PC}{ZRV}$$

Where: TA = Total Assets; PC = Prior Charges; ZRV = Zeros total redemption value.
This was the method most firms used at the relevant time. It was, and still is, the method used by AITC[6].
However, the method does not specifically allow for the effect of borrowings or holdings in other investment trusts. For example, consider this trust:

TA = £100m; PC = £50m; ZRV = £30m.
Applying the formula, the zeros' asset cover would be 167%. This might seem to indicate that the zeros were substantially covered. However, if we take into account all 'debts' including borrowings, there are only 25% excess assets. The method does not give a complete picture where borrowings need to be taken into account.

One way to allow for this would be to include the borrowings in the denominator instead of subtracting it from the total assets. This is the 'debt cover' method used by AITC from July 2001. But this still does not allow for the effect of indirect gearing introduced through holdings in other investment trusts.

I consider that the effect of prior charges and holdings in other investment trusts should be taken into account separately from asset cover. They are discussed below.

[6] From December 2000, the AITC slightly modified this formula to allow for estimated future expenses. This was done by deducting the estimated future expenses from the total assets in the numerator. This has the effect of slightly reducing the asset cover. However, not all trusts subscribed to AITC and hence firms would have to estimate future expenses themselves if not available in the AITC report. Bearing in mind the practical difficulties of doing so, especially for the smaller firms and given its limited impact, I have decided not to modify the formula to include future expenses - even for calculations after December 2000.

In summary, I consider that asset cover must form part of the firm's risk assessment after a certain date, given its potential significance to investment outcomes. As part of the risk assessments in this decision I consider that adequacy of asset cover should be considered in the context of a substantial, but not impossible, fall in assets.

What this means in practice is that I consider that asset cover should have informed the firm's risk assessment of zeros from 1 December 1999 at the latest. I consider that, from that time (at the latest), a zero with asset cover of less than 125% (i.e. its target value is not capable of withstanding a 20% fall in assets) should have been regarded by such a non-specialist firm like the firm as a higher than low risk investment. But a zero with asset cover of 125% or more was not necessarily low risk, if the firm ought to have taken other risk factors, like bank borrowings, into account as well.

And I consider that an income share, possessing a target value and prior-ranking zeros, with asset cover of less than 154%[7] (i.e. its target value is not capable of withstanding a 35% fall in assets) should have been regarded by such a firm as a higher than medium risk investment. But an income share with asset cover of 154% or more was not necessarily medium risk, if the firm ought to have taken other risk factors, like bank borrowings, into account as well.

2) Bank borrowings and structural gearing

All splits involve a structure that means some classes of share get a higher capital return and some get a higher income return. This 'structural gearing' is inherent in the nature of a split.

Whilst zeros are a type of structural gearing, structural gearing does not have to involve the use of zeros and zeros are not inherent in the nature of a split capital investment trust company.

Some splits chose to borrow in the hope of producing increased returns - 'financial gearing'. Unlike structural gearing, borrowing is not an inherent feature of a split. It is not, in risk terms, equivalent to zeros. A zero holder's entitlement to full repayment can be affected by whether a split capital investment trust company's gearing is wholly through zeros or part zeros and part bank borrowing.

If the gearing is wholly by zeros, the zeros come equal first. Even if there were some shortfall, the zeros would at least share between themselves what assets there were. If the gearing is partly by borrowing, the zeros come second. The borrowing might eat up some or all of the assets, before the zeros got anything.

If the underlying investments appreciate, the non-zero shareholders will reap the greater benefit from any borrowing, while the zero holders' gain will be restricted to the predetermined maturity value.

If the underlying investments depreciate, the borrowing will impact first on the non-zero shares. But, in such circumstances, it increases the prospect of wiping out the value of the non-zero shares, and so increases the prospect of the zeros being affected. So, from the point of view of a zero holder, bank borrowing has clear potential disadvantages in the bad times, but no clear benefits in the good times.

[7] Significantly higher than 125%, to take account of the structural gearing produced by the zeros.

So gearing through bank borrowing needs to be taken account of as a risk factor. However, I consider that for a non-specialist firm like the firm it should only be taken into account in considering investment decisions and recommendations made from 1 May 2001 onwards. I consider that by then at the latest, such a firm ought to have made a further adjustment to its thinking. Having regard to gearing in addition to asset cover, is in my view a fair proxy for that adjustment.

In deciding quite how the firm should have taken account of it, I have considered the effect of a range of percentages of financial gearing.

- At 20% gearing, that percentage of a split's underlying portfolio is financed by borrowing. The actual amount of the borrowing is fixed and therefore is constant but the value of the underlying portfolio is variable. Consequently, the percentage of debt gearing varies inversely with the value of the underlying portfolio.

- With financial gearing of 20% a fall in the underlying portfolio value of an investment trust would manifest itself in the net asset value of the investment trust's ordinary shares - ignoring any other gearing which may be present through structural gearing (prior ranking zero dividend preference shares, income shares etc.) – thus experiencing a fall 25% greater than would an un-geared ordinary share.

- A 30% fall in the value of the underlying portfolio would result in a fall in the net asset value of 37.5%. Furthermore the investment trust is no longer geared at 20% but at 28.57% giving a compounding effect to any further weakness in the underlying portfolio.

- Bearing in mind that the ordinary shares of a split capital investment trust would be further geared by the structural gearing resulting from prior share classes this would make them more vulnerable to falling stock market conditions than the ordinary shares of an un-geared conventional investment trust. It also means that the impact of falling markets on the other share classes would be more pronounced than in an un-geared trust.

So, at 20% debt[8] gearing I consider the potential level of risk magnification significant enough to raise the risk rating of an investment in a split. If it would have been low without gearing, I consider the firm should regard it as higher than low with such gearing.

At 40% gearing I consider the gearing magnification effect sufficient to increase the risk profile of the share classes further.

Structural gearing – that is, gearing via prior-ranking share classes, typically zeros - is relevant to assessing the risks of subordinate share classes in splits, typically 'ordinary shares', sometimes called 'ordinary income shares', and 'income shares'. Ordinary shares and income shares will be riskier than zeros in the same split. So, in addition to the effects produced by structural gearing, the risk factors relevant at any particular time to zeros will also be relevant to ordinary shares and income shares.

[8] I have carefully considered market practitioner's opinion on the significance of 30% gearing.

3) Investment by the split in other investment trusts (IT's)

Diversification as a general strategy can reduce risk. But investment by splits in other IT's can have opposite effects.

First, holdings by one split in a relatively small number of other IT's can cause liquidity problems if one or more large holder wishes, or is forced, to sell.

Second, investment stays concentrated in the investment trust sector. So although the trusts invested in may themselves focus on different classes of investment or different sectors, the split is vulnerable to difficulties within the investment trust sector.

Third, holdings in other IT's can affect the level of gearing carried by the zeros and/or income shares of a split, if the IT's in which it invests have significant levels of borrowing.

Fourth, several layers of holdings - IT's investing in IT's investing in IT's etc. - can make it difficult to see a potential shortfall in the value of the underlying assets. So:

- If split A buys zeros in split B, whose zeros are trading at a premium to the value of the underlying assets, the value of split A's assets is based on split B's share price rather than the value of its underlying assets.

- And if split B's underlying assets include zeros in split C, whose zeros are trading at a premium to the value of the underlying assets, the value of split B's assets is based on split capital investment trust company C's share price rather than the value of its underlying assets.

- As AITC put it to the Treasury Committee, there could be premium piled on premium, which might prove unsustainable. As AITC said – "Total asset values of some funds therefore depend upon the market price of others."

Given these factors, I am clear that the firm ought to have taken into account the extent of investment in other IT's in reaching a proper risk assessment.

As with financial gearing, in my judgment, for a non-specialist firm like the firm, investments in other IT's should only be taken into account in considering investment decisions and recommendations made from 1 May 2001 onwards. And as with financial gearing, in deciding quite how firms should have taken account of investment in other IT's, I have considered the possible effects of such investment.

90. It is difficult – because of the interactions described above - to establish an exact risk effect of any particular percentage of investment in other investment trust companies by a split capital investment trust company. But that fact itself, in adding to unknowns, increases the risk involved. However, I consider the potential adverse effects of a percentage investment in other investment trusts as being at least equivalent to the potential adverse effect of a similar percentage of debt gearing.

91. Given that the effects can be taken to be broadly equivalent, it is reasonable, for the purposes of my proposed approach, to amalgamate the two influences. Thus, for example, I regard debt gearing of 30% as equivalent to debt gearing of 15% combined with 15% investment in other IT's.

(c) the knowledge and expertise of some firms

92. In seeking to establish the extent of the firm's responsibilities to a complainant, I have considered what were the practices of the profession at the time. At law, the firm would be required to exercise the ordinary skills of an ordinary competent professional carrying on that particular activity at that particular time. That said, where a significant number of firms have failed to act with reasonable care, the law may conclude, and I think it is only fair and reasonable, that individual firms should be judged by how they ought reasonably to have operated, rather than by how that significant number operated, having regard to the individual firm's level of specialism.

93. I have found that some firms clearly had more knowledge and understanding of splits than other firms operating in the same market. In effect, they were specialists. So, firms that were sponsoring brokers of split capital investment trusts must, by virtue of that role, reasonably be taken to have possessed special expertise in splits and to have acquired or been in a position to acquire an earlier knowledge of certain risk factors – in particular the significance of bank borrowings and of investments in other investment trusts. Such firms, as specialists, are to be judged by the standards of other such specialist firms. Their responsibilities therefore were greater than those of other non specialist firms.

94. In this case, I have not found the firm to possess any special knowledge or expertise greater than that possessed by the generality of firms that advised on splits. So I have not treated the firm as a specialist firm.

the regulators

95. The firm has suggested[9] that it should not be blamed for not recognising risk factors that the regulators themselves did not recognise or regard as sufficiently serious at the time.

96. The regulatory responsibility for firms advising on splits lay with IMRO, the SFA and (for some intermediaries) the Personal Investment Authority (PIA). Later the Financial Services Authority (FSA) took its statutory powers, replacing these self-regulatory organisations.

97. In certain respects my approach to this complaint finds some support in what the regulators were doing. For instance:

> *Gearing and asset cover as risk factors*
>
> Information about asset cover and gearing were included in prospectuses launching - or amending the capital structure of - split capital investment trusts, indicating that the FSA as listing authority was aware of them as risk factors.
>
> *Cross holdings as a risk factor*
>
> In February 2001 IMRO was sufficiently concerned about cross holdings as a risk factor to set up a project. This project was to assess the risk concentration in the

[9] For example, via its solicitors

holdings of splits and the possibility of a collapse in the sector being caused by, in isolation, cross holdings. This culminated in a report dated April 2001.

In the light of IMRO's concerns the PIA issued a regulatory update in March 2001 which included a warning on 'income shares' in splits. The regulatory update warned that "it is important that the structure of these products and the risks involved are carefully explained to customers before they commit themselves".

98. It was the FSA that took the most active steps in relation to splits. On 8 November 2002 the FSA published a note entitled "Further memorandum from the Financial Services Authority". It records that risk warnings in the prospectuses issued even before April 2001 specifically identified the risks of gearing and the potential impact of the failure of one trust on others invested in it.

99. In the memorandum referred to above, the FSA looked at two subjects: the information they received from the Guernsey regulator about splits, and the role of the UK Listing Authority in approving prospectuses for listing. I consider it is of questionable value to take this relatively confined area of work and extrapolate findings (or the absence of them) to other areas such as the adviser's responsibility towards individual investors.

100. In particular the FSA was looking to see whether there was a systemic risk from the risk concentration in the holdings of splits. The memorandum referred to above said that the FSA considered "systemic risk" to mean a threat to the stability of the financial system and that problems in the splits sector were not expected to be a risk in this sense – and they have not turned out to be.

101. The memorandum notes that the IMRO project on splits concluded in April 2001 that the risk concentrations did not indicate a problem for the splits sector as a whole. It also seems from Mr Tiner's comments to the Treasury Select Committee that investigations carried out in early 2001 might have specifically looked at the concerns about the supposed magic circle allegations at the time. (I do not have special knowledge of what FSA in fact did.)

102. So FSA's investigations were focussed primarily on the impact on the stability of the financial system and to the splits sector as a whole (perhaps with particular reference to the magic circle allegations). That they did not take any action does not mean that in an individual split the extent of holdings in other investment trusts were not a risk factor to be taken into account.

103. In fact, according to the memorandum, in October 2001 the FSA had analysed the interaction of gearing and cross holdings and had concluded that there was risk to the splits sector as a whole due to crossholdings. But the report concluded that the market would have to fall further for large number of funds to become insolvent. The FSA's concern was about the potential for large scale insolvencies in the splits sector and not about some individual zeros being unable to pay their stated target values. Their activity is quite different from the Financial Ombudsman Service's determination of risk levels inherent in particular transactions in the context of the objectives and risk attitude of individual investors.

104. I have taken into account what the regulators themselves did, and the views they expressed. It would not, however, be right to take their activity and observations – or the fact that they did or did not act at any particular point - as defining the reasonable knowledge of a firm at the time, or as giving tacit approval to firms' approaches. It is not an exact

analogy, but if an authority having responsibility for road speed limits were to review a limit and decide it was right for a particular stretch, it would remain the driver's responsibility to drive within the limit and with due care. The firms themselves were charged with fulfilling regulatory obligations as to suitability. It was their direct responsibility, not the regulators', to do that.

105. The regulators would not normally be expected to know as much at any given time as did the firms actually transacting business. Anything that the regulators might have done would be essentially after the event and based on what they themselves could establish in their investigations. Finally, none of what the regulators said or did was expressed to be conclusive.

106. For these reasons I do not consider that the fact that the regulators did not step in until somewhat later than the dates I have identified should cause me to reconsider those dates. Indeed, it may be that a time lag before regulatory action is more likely than not in such circumstances.

(e) other complainants' submissions

107. I wrote to all complainants with unresolved splits complaints that involve the nine firms represented by solicitors Barlow Lyde & Gilbert, drawing their attention to the three representative provisional decisions dated 1 February 2007 posted on the Financial Ombudsman Service website and inviting them to make written submissions if they wished.

108. I received submissions from 12 such complainants, which I copied to Barlow Lyde & Gilbert. Six of the 12 submissions related to the specific facts of the complainants' cases and had no relevance beyond those individual cases.

109. Four of the remaining submissions disagreed with my provisional treatment, for risk assessment purposes, of zeros for which the complainant accepted payments from Fund Distribution Ltd (FDL); this treatment was evident from 'provisional decision A' on our website. I was minded to treat such zeros as suitable for the complainant's investment portfolio, as payments from FDL had to be accepted in full and final settlement of any complaint involving the relevant zeros.

110. The complainants mainly argued that this was unfair to them as, when they were required to decide whether or not to accept the FDL payments, they did not yet know what decision the Financial Ombudsman Service would ultimately make on their complaint. If they had known this earlier, as they felt they could legitimately expect, they would not have felt obliged to accept the FDL payments.

111. Whilst I can see that complainants faced a hard choice and I therefore sympathise, I do not think it fair or reasonable to ignore the legally binding promise that they freely made when they accepted the FDL payments. A significant number of complainants did indeed reject their FDL offer and so their complaints could continue to be investigated by us unaffected.

112. Another complainant thought he could tell from the provisional decisions that the proportion of higher risk splits investments in a portfolio had to be at least 40% before I was minded to find the portfolio 'unbalanced' and uphold the complaint. But that is wrong. Each case depended on its facts and on the precise composition of the portfolio.

113. Another complainant considered it unfair that her complaint should be affected and therefore delayed by my consideration of the general issues concerning splits. Again I sympathise, but I have not seen how I could make fair and reasonable decisions on complaints involving splits investments without careful consideration of these issues.

114. Finally, one complainant, whilst accepting my general approach to assessing the suitability of an investment portfolio[10], queried whether certain zeros were not always unsuitable, regardless of the overall risk profile of the portfolio. The complainant argued the point well but ultimately I have not been persuaded to change my approach. The issue is at what point I can fairly and reasonably decide that a breach of duty has occurred. The duty in question - the bargain struck between the parties - was in relation to the portfolio as a whole, not individual investments within it.

[10] which is to assess the suitability of the whole portfolio, not individual investments within it

SECTION 3: Mrs G's complaint against Firm IJK

Complaint

Mrs G's complaint concerns the firm's management of her discretionary portfolio account. She says that she required a low risk portfolio, but she came to take the view that many of the investments included in the portfolio were too high risk for a low risk portfolio. She considers that the firm should have operated a 'stop loss' policy to limit the losses she suffered on some holdings. She also says that the firm failed to explain to her that some investments were higher risk.

Mrs G has referred in particular to her holdings in the Gartmore Shared Equity Trust (ordinary shares), Gartmore British Income & Growth Trust (ordinary shares), Jupiter Enhanced Income (ordinary shares) and also her investment in Cable & Wireless Plc.

I have considered:

i. whether the firm owed Mrs G certain responsibilities
ii. what was the nature of those responsibilities?
iii. did the firm fail somehow in carrying out those responsibilities?
iv. has Mrs G suffered loss as a result of those failures on the firm's part?
v. is it fair and reasonable in all the circumstances of the case for the firm to be held responsible?

Circumstances

Mrs G signed a discretionary management agreement with the firm on 24 June 1997. This agreement stated that she required a low risk portfolio which would aim to achieve a balance between income and capital growth.

Between April and October 1997, Mrs G transferred five holdings into the portfolio and invested £28,055 in further holdings. She invested further lump sums in February 1999 (£8,500) and June 2000 (£40,000).

The exact dates of purchase for the shares in split capital investment trusts are as follows:

Jupiter Enhanced Income ord shares	£8,295	01/02/99
Gartmore British Inc & Growth Trust ord shares	£4,200	20/07/99
Gartmore Shared Equity Trust ord shares	£4,023	20/07/99

Mrs G withdrew £1,000 as a lump sum from the portfolio in May 1999, and received a total of £24,516.91 in income payments (up to December 2004). She made further capital withdrawals of £19,593.62 in June 2004 and £11,400 in November 2004.

The firm's submissions

The firm rejected Mrs G's complaint that the investments she named were too high risk for her portfolio or that it had failed to manage her portfolio competently. It made the following points in response to the complaint:

- The justification behind the investment in the ordinary shares of the three splits was that the investments would be returned at redemption if there were only relatively modest levels of market growth. However, instead the market fell dramatically.
- The investments complained of were not the only holdings of this type in the portfolio – investments trusts were used as part of the investment strategy for Mrs G's portfolio.
- In the three months before purchase, the value of the Gartmore Shared Equity trust had risen by 7.4% and over five years it had risen by 37.4%. The investment also aimed to match, as far as possible, the performance of the FTSE All Share Index.
- According to Gartmore, the ordinary shares of both the British Income & Growth Trust and the Shared Equity Trust were 'average' risk at the time of recommendation.
- At the time of purchase of Gartmore Shared Equity Trust ordinary shares, only 8.5% of the portfolio's assets were held in other investment trusts. None of Gartmore British Income & Growth Trust's assets were held in other investment trusts.
- Cable & Wireless was one of the UK's leading blue chip shares at the time of purchase and nothing adverse was known about the company at the time or the purchase would not have been made.
- The firm aimed to provide its clients with bespoke portfolios, so no two portfolios, even with the same investment objectives, would be the same. The firm did not operate a 'model portfolio' regime. Therefore even though the firm issued guidelines to portfolio managers about asset allocations, together with recommended stocks and funds, it was up to the portfolio managers how they managed a particular portfolio. There was no obligation on them to adhere strictly to the guidelines.
- The firm did not offer a 'stop loss' facility as the individual fund manager was given discretion over whether to buy or sell a particular holding.

The firm also made the submissions in response to my provisional decision of 1 February 2007 which I have summarised earlier in this decision.

Findings

Having carefully considered the evidence and the facts of the case, I am satisfied that the firm had assumed a responsibility to Mrs G to take all reasonable steps to provide her with and maintain a portfolio which satisfied her agreed requirements. In undertaking this responsibility the firm was obliged to act with reasonable skill and care.

I am satisfied that Mrs G's risk profile for her portfolio was still low when the firm purchased the three holdings in splits in 1999 and also the holding in Cable & Wireless in 2000. There is no suggestion that the low risk requirement stated on the agreement she signed in 1997 had changed by this date. In fact the client profile updated on 31 July 2000 show that Mrs G's required risk profile was low and her investment objective was 'balanced', i.e., she required a balance between income and capital growth.

As to what was meant by 'low risk', if, as in my view there clearly was, there existed a conflict between 'low risk' and 'lower risk' in the firm's forms, that conflict should be resolved, in the usual way, in favour of Mrs G, the person who did not draft the forms. And Mrs G's specification of 'low risk' could be taken to indicate a "specific strategy that does not fall within [the] firm's investment and risk definitions", as referred to in the firm's letter of 21 February 2007, which gave rise to a specific contract to that effect, i.e. that she required a low risk, not 'lower risk', portfolio.

Mrs G gave the firm absolute discretion over the management of her portfolio, including discretion as to when to buy and when to sell particular holdings. I have therefore considered the suitability of Mrs G's portfolio for the agreed risk profile and investment objective.

I consider that the earliest suitable date to check whether the firm provided Mrs G with a suitable portfolio to be 29 December 2000. I say this because by this time all the investments which Mrs G has specifically named were purchased. Also, in June 2000 Mrs G made a substantial payment of £40,000 into the account and by December 2000 the portfolio was fully invested, including this payment.

The rough percentage breakdown of the portfolio at 29 December 2000 by market value is as follows:

Treasury stock, other Fixed Interest securities and cash	33%
UK Equities	43%
Ordinary shares in three Splits	15%
Conventional Investment Trusts	9%

All three splits in the portfolio had issued prior ranking shares at the time of purchase. I consider that the firm should have taken the risk implications of these prior ranking shares into account and concluded that the ordinary shares of all three splits were higher than medium risk at the time of purchase, on account of their subordinate ranking and the gearing effect produced by the prior ranking shares.

I acknowledge that Gartmore rated the ordinary shares of both the British Income and Growth Trust and the Shared Equity Trust as "average risk". But I do not think that the firm should have relied solely on this information. The firm held itself as competent to advise on splits investments and should have carried out its own risk assessment. Mrs G went to the firm for advice, not to Gartmore. It was then for the firm to decide what precise sources of research and information it should use.

Conventional investment trusts issue only one class of share, ordinary shares. Therefore there are no share classes which will have a prior ranking call on the assets, other than any bank loan taken by the trust. I think that this makes them, in principle, lower in risk that the ordinary shares of splits, where there will be prior ranking shares. However, because there are no other share classes, the ordinary shares of conventional trusts bear all the equity risk of the portfolio. Therefore I consider that they should normally be viewed as higher than low risk.

Even if, which I do not on balance accept, the firm's definition of a 'lower' risk portfolio was relevant, which definition included holdings in investment trusts and leading UK companies, I do not think that the firm should have assumed that all investment trusts or all UK leading companies were lower risk investments simply because they fell within this definition. I think that the firm should have carried out its own risk assessment of a holding before recommending it.

But in any case on any reasonable view, at the relevant date, more than half of the portfolio was invested in securities that were higher than low risk. This, in my view, is an excessive percentage for a portfolio that was meant to be low risk overall. Although I accept that a certain proportion of a low risk portfolio can be held in higher than low risk investments,

including equities, this was too high a percentage for the portfolio to be described as low risk overall at the relevant time.

As discretionary managers, the firm were responsible for the ongoing suitability of the portfolio. Looking ahead, I do not find that the proportion of higher than low risk investments held in the portfolio reduced sufficiently for the portfolio to be considered low risk.

So I find that Mrs G's portfolio was unsuitable for her low risk profile from 29 December 2000 onwards.

It follows that I conclude that the firm failed in its responsibilities to Mrs G in that it established and managed a portfolio which did not match her stated requirements. I consider it reasonably foreseeable that this failure would cause Mrs G loss. Accordingly, my decision is that it is fair and reasonable to uphold the complaint against the firm.

SECTION 4: Approaches to redress

115. As well as formulating an approach for deciding the merits of this complaint, I have had to decide on an approach to providing fair compensation for the loss suffered in this case, which may then be appropriate for other similar cases involving this firm. I also have in mind the need for consistency across all of the cases dealt with by the Financial Ombudsman Service.

116. My power to award redress is provided for by statute in section 229(2) of FSMA. Section 229(2)(a) provides me with a wide discretion to make an award "….of such amount as the ombudsman considers fair compensation for loss or damage…". I have had regard to the firm's legal opinion as to what this section means and its implications for how I should operate. My decision on the merits of the case is made on a fair and reasonable basis, taking into account, among other things, the relevant law (DISP 3.8.1R). Similarly, in considering issues of redress, it is fair and reasonable to have regard to the relevant legal principles and other relevant factors in deciding what I consider to be fair compensation in all the circumstances of the case. But I am not limited by section 229(2) (a) to awarding what would be awarded at law. Rather, it is an award of what I consider to represent fair compensation, subject to the limits of reasonableness. This means that where I find that a consumer was misadvised, I will usually aim to place him, as nearly as possible, in the position that he would have been in had he been properly advised, subject to fairness and the overall statutory objectives of FOS. Balanced against that I recognise that it would not normally be fair to pay compensation for loss which is too remote from the firm's acts or omissions.

117. I will have found that the splits investment or the portfolio to which it belonged was unsuitable for the individual consumer. If, instead of the unsuitable splits investment or portfolio, there was a clear suitable alternative that the consumer would on the balance of probabilities have invested in, then redress should be based on that. However, in practice it is rarely the case that there was a broadly equivalent but suitable alternative under discussion at the time. So I have to decide what the return from such an investment or portfolio might have been, and to do that I have adopted certain yardsticks or benchmarks.

118. They have been, until now:

For consumers taken to have wanted a low risk investment:

1% a year above the return on ten-year par government stock held to maturity

For consumers taken to have wanted a medium risk investment and capital growth:

the FTSE350 Total Return Index

For consumers taken to have wanted a medium risk investment and income:

the FTSE350 High Yield Index

119. If I decided that the consumer's risk requirement was between medium and low, and/or the consumer wanted a balance of income and capital growth then I would normally use these proxies in equal proportions (50/50).

120. These are, of course, not the only possible yardsticks. In particular it has been suggested that the FTSE350 indices are inappropriate because they are insufficiently diversified (at sector and stock levels) and consequentially represent a higher degree of risk than "medium". In addition it is said that the index return is in practice unachievable since it disregards the expenses of real investment.

121. The reasons that I chose these particular yardsticks are as follows.

- *Government stock* is a low risk investment. Like even a good-quality zero, if that is what the consumer thought they were getting, government stock carries the risk that the value can fluctuate with interest rates. But, unlike such a good-quality zero, government stock does not realistically carry even a low risk that the issuer will default. The difference in risk should be reflected in the reward, hence the additional 1% return.

  The use of a ten year term is sufficient to allow for the fact that the portfolio was 'ongoing' without a specific end date. It does not imply that the expected term of the portfolio was ten years.

- *The FTSE Indices*: Instead of selecting either a little known or obscure index/benchmark or an index/benchmark used primarily within the investment industry, I have concluded that it would be more appropriate to use one of the FTSE indices with which all firms and the vast majority of investors - including unsophisticated investors - were familiar.

  It has been suggested by some firms that the FTSE All Share index would be appropriate but I concluded that this index would give far too wide a representation and give some weight to company shares which would seldom – if ever – be represented in medium risk portfolios.

  Most complainants and all firms would be readily familiar with the FTSE 100, FTSE 250 and FTSE 350 indices. The FTSE 350 index incorporates the companies comprising the FTSE 100 index and the FTSE 250 index. I consider that this index (FTSE 350) offers a more representative spread of investments comparable to a well diversified medium risk portfolio and includes a good proportion of what could be considered 'blue chip' shares.

  Furthermore, historically FTSE 350 shares underpinned much of the investment undertaken by split capital investment trusts.

122. For the reasons I have given, I remain persuaded that the FTSE350 High Yield Index (where the main objective is income), and the FTSE350 Total Return Index (where the main objective is growth), are fair and reasonable benchmarks to use for redress where it is solely or predominantly splits investments, and not the whole portfolio, that are being compared with the benchmark, in cases where the portfolio should have a medium risk profile. (In 'low to medium' cases, a FTSE 350 index would continue to be used in conjunction with a Gilts-related benchmark, on a 50/50 basis. And if a 'balanced' objective between growth and income applied, the FTSE350 High Yield index and the FTSE350 Total Return index would continue to be used together, on a 50/50 basis.) Although the FTSE350 High Yield index features some sectors more than others, it seems to me to be a very well suited benchmark where income production from equity investment is required.

123. But I am now persuaded that the FTSE 350 indices will not normally be appropriate benchmarks for redress where it is the whole portfolio that is being compared with a benchmark (again, in cases where the portfolio should have a medium risk profile). This is because in such a case the splits constituents of the portfolio do not comprise the whole portfolio. So what should be the alternative benchmark in such cases?

124. The firm has suggested the use instead of the IMA (Investment Management Association) Equity and Bond Income index as a benchmark. As I understand it, this index is intended to represent a 'fund of funds' comprising funds which invest at least 80% of their assets in the UK, between 20% and 80% in UK fixed interest securities and between 20% and 80% in UK equities, with an aim of achieving a yield of 120% or more of the FTSE All Share Index.

125. Having regard to the complainant's portfolio I do not consider that a 'peer group' index like the IMA index is appropriate. As IMA states, the primary purpose of the index is to provide a benchmark for "g*roups of similar funds whose performance can be fairly compared by consumers*". So in my view, this index would be more appropriate for any individual fund within that sector and not for the type of portfolio the complainant had.

126. APCIMS[11] indices on the other hand are derived from a combination of popular Gilts and Equity indices which are reasonably familiar. They are not 'peer group indices' and so their performances would not be affected by very bad or very good performers within the group. In other words, the risks undertaken by individual fund managers (whether lower than average or higher than average) would not play a part here, in contrast to the IMA index.

127. So I consider that an APCIMS index would be a suitable benchmark for a medium risk, 'whole portfolio' situation, and within the APCIMS indices, I consider the most suitable one for a complainant who had an income objective would be the APCIMS Income index, while the APCIMS Growth Index and the APCIMS Balanced Index would suit those respective objectives.

Portfolio issues

128. In many cases the firm is managing a portfolio of investments, with complete discretion as to what investments are actually held, subject only to the portfolio matching a particular level of risk. In such cases, the firm has an obligation to its customer to establish and maintain a portfolio consistent with its customer's agreed risk profile.

129. The firm's advisers have provided me with legal opinions on the question of how redress should be determined in such cases[12], and they have responded to my provisional decisions by saying that my provisional approach to awarding redress in such cases is wrong. I have read and considered the views expressed in these opinions and letters. Essentially it is argued that I should only find a firm at fault if the risk level of the portfolio as a whole is out of balance. However, when calculating the loss I should only consider the loss that relates to the individual investment(s) that I have identified as having caused the 'imbalance'. Whilst I agree with the first proposition, I continue to take a different view from the firm's advisers on the second, for the reasons that follow.

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[11] The Association of Private Client Investment Managers and Stockbrokers

[12] I.e. the legal opinions referred to earlier in this decision

130. It is on the face of it fair that if liability is decided by reference to the whole portfolio, redress should be decided in that way too. So I consider the onus is firmly on those who argue the contrary to produce compelling reasons for departing from what would otherwise be a consistent approach. And such reasons would help to dispel the impression of simply wanting 'the best of both worlds'.

131. I am obliged by statute and by DISP (the rules which govern the operation of the Financial Ombudsman Service) to reach a determination on liability by reference to what is, in my opinion, fair and reasonable in all the circumstances of the case. In considering what constitutes a fair and reasonable determination of a particular case, I am required to have regard to, amongst other things, the relevant law. When considering what constitutes appropriate compensation in a particular case, statute provides that I may award such compensation as I consider "fair". In assessing what is fair I have had regard to, amongst other things, the common law and the fundamental legal principles (including causation and remoteness) which are used by the courts to assess damage. These have provided me with helpful guidance. But neither I nor the firm's advisers have been able to find any decided court case precisely on the point which supports the proposition that redress in the case of managed portfolios should be calculated in the way the firm suggests or should not be calculated in the way that I calculate it.

132. The firm's obligation to its customer is to take all reasonable and proper steps to provide a portfolio which satisfies the customer's requirements, including his agreed risk characteristic. Aside from any more general obligation, this was in fact a stated regulatory requirement for this firm (which, at the time of the events to which this decision relates, was subject to the rules of the Securities and Futures Authority ("SFA")). In addition to there being a requirement to make individual suitable decisions, Rule 5-31(3) of the SFA's rules said:

"(3) A *firm* which acts as –

(a) an *investment manager* for a *private customer* ….

must ensure that the customer's portfolio or account remains suitable, having regard to the facts disclosed by that customer or other relevant facts about the customer of which the *firm* is, or reasonably should be, aware."

133. Similar requirements appear in the Financial Services Authority's rules. The rules, and the doubling up of the suitability requirement to apply to individual investments and the portfolio as a whole, reflect the reality – that the suitability of individual investments is dependent on the suitability of the portfolio as a whole.

134. The contract between the firm and the consumer is to provide a portfolio of the agreed risk level. The firm is not required to account to the consumer for its individual investment decisions in the sense that it need not obtain prior permission from the consumer for individual transactions. The firm has certain reporting requirements, to keep the consumer informed about transactions affecting the portfolio, but at any given time the consumer may not be immediately aware – and certainly has no obligation to make him or herself aware – of the content of the portfolio.

135. The consumer has given the firm discretion to invest and so usually cannot successfully complain that any single investment decision is unsuitable, other than in the context of the other decisions affecting the portfolio. A consumer may put the complaint as "xyz shares were too risky". But if I were to consider the complaint exactly as framed I would

have no way of identifying the particular shares as more or less suitable than any other holding in the portfolio. The complaint would be bound to fail.

136. A high risk investment is not automatically unsuitable for a medium risk portfolio. If the investment is small, the portfolio may remain balanced (i.e. medium risk overall) even if there is no counterbalancing low risk investment.

137. If the high risk investment is sizeable, the portfolio may be 'unbalanced' (i.e. above medium risk overall) unless there is a low risk investment that provides an adequate counterbalance.

138. But if there is no counterbalancing low risk investment, it is necessary, and sufficient, only to conclude that the portfolio overall was unbalanced and thus unsuitable. There is no clear answer to the question which of the investments in the portfolio was unsuitable: was it the high risk investment, or was it one or more of the medium or lower risk investments contained in the portfolio that might instead have been a low risk counterbalance to the high risk element?

139. I have an investigative role. Unlike the Courts, the vast majority of complainants to the Financial Ombudsman Service are unrepresented and not advised on how best to state and particularise their complaint. I am not limited to dealing with complainants' "pleadings", as a court might be. Consistently with my obligations under statute to resolve complaints fairly and with a minimum of formality I look to identify the essence of the complaint. In these cases – although few complainants would express it in quite this way – the essence of the complaint is whether the firm committed a breach of duty, which in context means whether the firm failed to keep the whole portfolio in balance. So I interpret the complaint in the best way that it can be given practical meaning – that the portfolio as a whole was out of balance. That will mean that I do not always restrict my assessment to the investment decision or decisions that the complainant has referred to in the complaint form. If I did so, I could be accused, rightly, of interfering with legitimate exercise of discretion. I would be ignoring the firm's regulatory responsibilities and its primary obligation to its customer. And the consequences for the parties could vary significantly depending on the mere chance that a complainant had worded the complaint in one way or another.

140. Nor, for the reasons I have given, is it the case that I decide that a particular investment or investments is/are solely responsible for the portfolio being out of balance. My decision is always in substance that the whole portfolio was out of balance (if such was the case). And I do not think it fair to make a general assumption that, if the firm had not recommended or used the particular splits investments but had resorted instead to other investments, the rest of the portfolio would have been identical or largely the same. The composition of the whole portfolio may well have differed significantly if the firm had not used the particular splits investments and so had been denied (for example) the particular levels of growth or income that these originally provided.

141. Where liability is judged by considering the portfolio as a whole, so, usually, should loss be. The issue I must decide is what loss the firm's breach of duty caused. The relevant breach of duty is the failure to keep the whole portfolio in balance. So it is only fair and reasonable, in my view, to compare how the whole portfolio actually performed with how it would have performed in line with a suitable benchmark, which should reasonably reflect general market and performance fluctuations.

142. So typically, I compare the actual performance of the portfolio with how it would have performed in line with a benchmark index that reflects the portfolio's agreed risk profile. The

benchmark reflects the sort of return that in my view the complainant could reasonably have expected from the portfolio from the time it became unsuitable, if the firm had not breached its duty. And I consider it a fair and common sense way of stripping general market losses out of the redress calculation, as the firm should not in principle be liable to compensate for those.

143. The choice of benchmark does not involve any use of hindsight, so there is no question of my choosing a benchmark purely (or at all) because it results in a better or worse financial outcome for either party by comparison with the actual performance of the portfolio.

144. Nor will it be the case that the medium risk benchmark, which is applied to the value of the whole portfolio, would be a suitable benchmark of performance for each constituent investment in the portfolio if taken individually, as any portfolio can legitimately contain investments of differing risk levels. So there should be no surprise if some of the investments in the portfolio performed markedly better or worse than the benchmark.

145. And since hindsight plays no part, I make no adjustments if the medium risk investments in, say, a medium risk portfolio actually under-performed the medium risk benchmark. There should be a portfolio effect even if the portfolio was unbalanced, and the factors producing the under-performance may have had compensating effects elsewhere in the portfolio.

146. In my view the general approach that I have described above is fair and reasonable for cases where the firm has complete discretion over the management of the investment portfolio. But I do not rule out adjusting this general approach if the particular circumstances of a case require it.

147. I am likely to adopt a different approach, restricting the redress methodology to a smaller range of investments within the portfolio, where for example there is a non-managed advisory relationship and the firm may not be regularly and routinely in a position to take remedial action. In such a case the constituents of the portfolio, as they change from time to time, are not necessarily the firm's choice or recommendation. Clearly this will depend on the circumstances and may vary from case to case.

Interest

148. In many cases there will have been an event causing the loss to crystallise (such as the sale of the investment). Compensation for damage caused by the firm's wrongful acts or omissions is calculated up to the date of that crystallising event. However, in addition there must be some adjustment for the time between crystallisation and payment of compensation.

149. In effect the complainant has been deprived of access to funds between crystallisation and the date of my award or later payment. Interest is due, but at what rate? I have considered the firm's legal opinions, both of which express their views as to the appropriate method of calculating interest in such cases. I set out below my approach to this issue.

150. I have a discretion to award interest by virtue of section 229(8)(a) of FSMA. However, the section does not specify the method by which interest should be calculated. I have carefully considered whether interest under section 229(8)(a) should be calculated on a simple or compound basis. I have noted the position of the Courts on this issue. Section 35A of the Supreme Court Act makes specific provision for the payment of interest on awards of damages. It provides the Courts with a number of discretions - including the rate

which may be used and the period for which interest should be payable. However, it stipulates that interest should be calculated on a simple basis. Thus, interest on damages (as opposed to interest as damage) should be calculated on a simple basis. I have adopted this approach to the calculation of interest on the post-crystallisation award.

151. Section 229(8)(a) does specifically provide me with the power to specify the rate of interest. I have carefully considered what would represent an appropriate rate under section 229(8)(a). The objective is to compensate the complainant for having been kept out of his money, rather than to seek to put him back into the position he would have been in but for the wrongful act of the firm. But it is not always straightforward to assess this. With the benefit of hindsight complainants might have wished they had put in place any number of beneficial investments. They might also claim they had to borrow funds from elsewhere to cover the shortfall in their funds pending payment of the award. But I have to guard against hindsight. In most cases the actual effect on the complainant's finances will not be ascertainable without making speculative assumptions. I need to see a clear alternative use of the money before I believe it would be right to take this into account. Nor is interest intended to penalise the firm.

152. In the absence of such clear evidence, I look to the approach of the Courts to this issue. There is no completely clear and consistent approach. There are different rates applicable in different circumstances. The rate applicable under the Judgments Act 1838 as interest on Court judgments after judgment is currently 8% simple and has not changed since 1993. This rate is sometimes used to calculate interest on post-crystallisation damage, but perhaps more commonly now, certainly in the Commercial Courts, base rate plus 1% is used (as a simple rate). The rationale appears to be that this is intended to represent a commercial borrowing rate. However, the borrowing rates available to consumers are typically higher than for commercial customers. And the tax treatment is likely to differ – with a consumer, unlike a commercial customer, being unable to treat interest paid on borrowing as an allowable expense for tax purposes.

153. In their Consultation Paper on Compound Interest, the Law Commission sought to address some of these issues. It proposed that there should be a single rate, applicable in all cases. The rate proposed there (which it was proposed would apply to compound and simple calculations), was to be the commercial rate, set by reference to bank base rates. In the absence of persuasive evidence to the contrary, a consistent rate has real attractions for me. The rate is intended to achieve the same purpose - namely to compensate the complainant for having been out of his money. Firms would be subject to additional uncertainty if they did not know the rate which was to be used. This might prove detrimental to attempts to resolve the dispute at the earliest possible stage, consistent with the statutory objectives of the Financial Ombudsman Service pursuant to section 225 of FSMA.

154. So, unless there is a clear alternative use of (or cost of) the money in the individual case, I am likely to award interest at 8% a year simple – from which the law requires the firm to deduct lower-rate tax and on which some consumers may have to pay higher rate tax also. In the absence of particular circumstances in any specific case which might suggest that it was fair to act otherwise, I consider this approach to represent a fair and reasonable starting point and to have the advantages of consistency, predictability and arithmetical simplicity.

155. The use of a fixed simple rate has obvious advantages in making it easier to apply in a calculation – and easier for the complainant to check. A compound variable rate cannot be

checked without access to the historical record of rates from time to time, and requires a degree of mathematical ability.

156. It also means that the calculation is not made yet more complex by having to distinguish between interest on the loss between crystallisation and decision, and interest on delayed payment after decision. Whatever the rate for the former, the rate for the latter would be likely to remain at 8% simple, in line with the judgment debt rate.

SECTION 5: Specific redress

In assessing what would be fair compensation, I consider that my aim should be to put the complainant in the position she would have been in if she had not been inappropriately advised by the firm. I must next consider what loss was caused to Mrs G by the firm's failures and what would amount to fair compensation. If the firm had fulfilled its responsibilities to Mrs G properly, I am satisfied that it would instead have bought investments which resulted in Mrs G holding a low risk portfolio with a balanced income/growth objective. In calculating Mrs G's actual loss, I aim to put her into the position she should have been in but for the firm's failures.

I consider that the most appropriate approach to determine whether or not Mrs G has suffered a loss as a result of the risk level of her portfolio would be to compare the performance of the portfolio with a 'yardstick'. I think that the most reasonable yardstick to use would be 1% a year above the return Mrs G would have obtained if her portfolio had performed in line with ten-year par government stock – as shown on the Bank of England website– held to maturity.

I choose that yardstick because I am satisfied that Mrs G wanted a low risk portfolio. Like even a good-quality low risk investment, government stock carries the risk that the value can fluctuate with interest rates. But, unlike even a good-quality low risk investment, government stock does not realistically carry even a low risk that the issuer will default. That difference should be reflected in the ratio between risk and reward, which is why I intend to add 1% a year to the return on ten-year par government stock.

I stress that I am using a yardstick or benchmark which serves as a proxy for a low risk return. I am not thereby saying that Mrs G's portfolio would instead have consisted, wholly or in part, of ten-year par government stock.

I think that it is fair and reasonable to apply the yardstick comparison to the entire portfolio. This is because I normally view the portfolio as a whole, not individual holdings, and because the firm was discretionary manager of the portfolio and had ongoing responsibility for its composition.

My calculation will take account, as it did in my provisional decision, of the withdrawals that Mrs G made from the portfolio.

Applying that yardstick:

- Mrs G's portfolio was worth £94,467 on 29 December 2000.

- I understand from Mr G that the account was transferred to another manager in June 2006. The exact valuation at that date is not available but Mr G was able to provide the value as at the latest available valuation date. Accordingly, the portfolio was worth £60,281 as at 5 April 2006. It appears that by this time all the securities were disposed of and the account was due to be transferred. So I have taken this value and the date as the disposal value and disposal date.

- Accordingly, had the sum of £94,467 performed in line with the yardstick to 5 April 2006, it would have been worth £127,748.

- Mrs G has received income payments from her portfolio to date. This has to deducted from the value derived above. I understand that she received a total of about £27,070.

- I have not taken into account the withdrawal Mrs G made from the portfolio in May 1999 as this is before the date from which I am calculating redress (December 2000).

- Mrs G withdrew £19,593.62 from the portfolio on 4 June 2004. Had this sum performed in line with the same yardstick to date, it would be worth £21,876 at the disposal date.

- Mrs G withdrew a further £11,400 from the portfolio on 9 November 2004. Had this sum performed in line with the same yardstick to date, it would be worth £12,320 at the disposal date.

- Thus the redress payable to Mrs G would be £127,748 less £116,547 (£27,070 + £21,876 + £12,320 + £60,281). This works out to £6,201 at the disposal date.

- From the date of disposal, I award interest on this loss to the date of actual payment. Interest is at 8% per year simple (which is around £600 to date).

So I order the firm to pay Mrs G £6,201 plus interest as specified. Should any dispute or query arise about my calculation before this redress is paid or accepted, it should be referred to me for resolution.

Roger Yeomans
Ombudsman