DRN-5111923

The complaint

Mr M complains that Northern Trust Global Services SE failed to meet its responsibilities as depositary of the Woodford Equity Income Fund (WEIF).

What happened

Mr M invested just over £148,480 in the WEIF in January 2017 via his SIPP and sold £10,000 later on. He also transferred some of these units to a SIPP Drawdown account.

Mr M remained invested in the WEIF when it was suspended in June 2019. Shortly after its suspension, the Authorised Corporate Director (ACD) of the fund, Link Fund Solutions, decided that it wouldn't be reopened. As the fund's assets were sold, small payments were released to investors who had direct holdings in the WEIF at suspension – no other redemptions or other disposals of units in the WEIF were allowed.

In early 2024 a Scheme of Arrangement was agreed between investors and the ACD which allowed payments to be made to investors and the fund to be wound up. I understand some if not all of these payments have been made.

Regulatory investigations

The Financial Conduct Authority (FCA) issued a Final Notice to Link on April 11, 2024. The notice required Link to pay restitution of £298,403,919 to the WEIF for the benefit of current unitholders. The FCA said this amount (which was the same amount as the Scheme of Arrangement above) reflected losses suffered due to Link not complying with the FCA's Principles for Businesses, specifically Principle 2 (skill, care, and diligence) and Principle 6 (fair treatment of customers).

The FCA found that Link failed to manage the liquidity of the WEIF appropriately, leading to its suspension in June 2019. This suspension prevented investors from redeeming their investments, resulting in significant losses. The FCA found that Link did not act with due skill, care, and diligence in its role as the ACD of the WEIF. Link's failure to manage liquidity and supervise the investment manager, Woodford Investment Management Limited, contributed to the fund's suspension. The FCA concluded that the suspension of the WEIF and subsequent liquidation meant that investors received significantly less than the value of their investments at the time of suspension. The FCA did not comment or make findings alluding to other potentially responsible parties (apart from Woodford himself) and so the role of the depositary, Northern Trust, was not examined.

Mr M's complaint

Mr M complained to Northern Trust in September 2020 and again in October 2020.

In summary:

- The WEIF had breached the relevant regulations that required it to limit its unquoted holding to 10% of its assets. He said that Northern Trust was tasked with overseeing Link and with ensuring the ACD and Fund Manager complied with relevant regulations and therefore had failed in its role.

- Valuations were of critical importance, and Northern Trust and Link were responsible for the pricing and valuation of unquoted stocks. Mr M said that "at all material times the valuations [of unquoted stock] were unrealistically high" and so the Fund was "grossly overvalued".

- He claimed he had suffered losses in excess of £64,428, as well as lost opportunity to invest elsewhere and distress and inconvenience.

Mr M also made some specific points to Northern Trust:

- Whether Northern Trust took any steps to ensure unlisted stocks were valued correctly;

- Woodford's investment style changed "dramatically" and was different to what the WEIF was supposed to be at the outset – namely a UK equity fund. Mr M said there was a "reluctance, unwillingness or inability to rein Mr Woodford in to prevent this seemingly increasingly reckless behaviour".

- Stock selection was poor and the fund became one of the very worst performing funds.

- What due diligence was carried out on which stocks Woodford was selecting when he was required to reposition the fund following its suspension.

- A "fire sale" took place following the suspension without the consultation or approval of investors, and this resulted in "significant professional fees being incurred by the Fund and assets being sold at below their true market value".

Northern Trust issued its final response letter in December 2020. It said:

- Initially, WEIF performed well and saw sustained inflows. However, its performance began to deteriorate, leading to increasing redemptions. In June 2019, a significant redemption request prompted Link to suspend the fund to protect all investors. This decision was made in line with the Prospectus and was agreed upon by Northern Trust.

- In relation to unlisted assets, Link was responsible for investment decisions, which it delegated to Woodford Investment Management (WIM). Northern Trust's role was to ensure Link managed WEIF according to FCA rules and the Prospectus, not to make investment decisions.

- WEIF was allowed to invest in unlisted securities under EU and UK regulations and the Prospectus. The Prospectus did not set hard limits on the percentage of holdings in specific sectors. Northern Trust identified and escalated three breaches of the 10% limit on unlisted assets to Link and the FCA between November 2017, and March 2018, fulfilling its oversight obligations.

- It didn't agree that it was responsible for pricing and valuation. Its role was to ensure Link had appropriate valuation and pricing policies and that WEIF units were valued according to the Prospectus and FCA rules.

- Unlisted assets lack a recognized exchange-based pricing source, posing valuation risks documented in the Prospectus. Northern Trust's task was to check that Link had suitable valuation policies for unlisted and less liquid listed assets.

- Link's policy included Fair Value Pricing (FVP), estimating the trade price between willing buyers and sellers. Northern Trust ensured Link had a Fair Value Pricing Committee (FVPC) with access to third-party valuation services.

- Northern Trust reviewed the pricing of assets subject to FVP, ensuring changes were supported by valuations and followed guidelines. This process was part of WEIF's annual audit by external auditors.

- Northern Trust was confident it took reasonable care to ensure Link managed WEIF's valuation and pricing activities according to FCA rules.

- Northern Trust ‘s role in liquidity oversight involved reviewing Link's risk management processes and responding to redemption pressures, fulfilling its duties in this area.

Mr M remained unhappy and referred his complaint to this service.

One of our investigators looked into Mr M’s complaint. He gave a detailed analysis and assessment, referencing the FCA’s Final Notice. In summary:

- Northern Trust identified breaches in WEIF’s exposure to unlisted assets and took steps to ensure compliance by liaising with Link and WIM. They encouraged actions to prevent future breaches and reported these to the FCA.

- Northern Trust attended meetings about WEIF’s liquidity profile. Link and WIM monitored liquidity daily, attributing issues partly to prolonged investor disinvestment. The FCA found that selling liquid assets to meet redemptions increased exposure to illiquid ones.

- The failure to adopt vertical slicing when meeting redemption requests exacerbated liquidity risks. Northern Trust’s remit did not include intervening in investment decisions.

- Northern Trust continued to ensure WEIF’s exposure to unquoted assets was appropriate. They noted no concerns about meeting redemption requests but did not discuss vertical slicing.

- Northern Trust’s oversight duties included ensuring Link and WIM monitored liquidity. They reviewed Link’s processes and were satisfied with the stress testing procedures in place.

- Northern Trust ensured Link had a rationale for using FVP. They relied on Link’s judgment regarding the valuation of illiquid assets and were not required to replicate stress testing.

The investigator also summarised the evidence provided to the service as part of his investigation. This included:

- Northern Trust examined the triggers for Link to review FVP and its ongoing oversight. Asset prices subject to FVP were reviewed every six months, regardless of the third-party company involved.

- The review was considered robust. The FCA did not find FVP use caused WEIF's collapse but noted it disguised liquidity deterioration. Northern Trust saw no increased risk from FVP use if stress testing was deemed adequate.

- From May 2018 to June 2019, Northern Trust continued addressing nominal breaches of holding limits similarly, despite WEIF's deteriorating liquidity. They participated in liquidity discussions but did not ask Link to revisit stress testing after April.

- WEIF's liquidity management was inconsistent. Link and WIM had differing views on liquidity limits and rebalancing needs. Link's analysis showed fluctuating liquidity assessments, with WIM disputing Link's findings.

- Northern Trust could have enhanced oversight by verifying stress testing applicability but guidelines did not specify how often it needed to carry out these checks. They likely would have received similar confirmations as in April.

- Northern Trust met its obligations as depositary. They ensured stress testing was in place and did not need to challenge FVP use or undertake independent analysis. Investment decisions on asset sales were outside their remit.

- Northern Trust's responsibilities were limited to ensuring prescribed processes like stress testing were in place. They were not responsible for re-performing Link's role.

The investigator therefore concluded that Mr M's complaint about Northern Trust's actions shouldn't be upheld. He said the evidence showed that Northern Trust and Link had separate agreements for depositary and administration functions, and no evidence suggested this had contributed to WEIF's mismanagement. He said that Northern Trust had no role in stock selection or investment decisions, which were made by WIM – and that poor stock selection would have led to fund failure regardless of Northern Trust's actions.

In relation to illiquid assets, he said that WEIF had been an all-equity fund investing in emerging companies, and listing illiquid assets was not inconsistent with the rules or the Prospectus. Until June 2019, following the redemption request of a large institutional investor, Northern Trust had ensured the fund could meet redemption requests. But Northern Trust was not responsible for monitoring professional investor withdrawals or their reasons for withdrawing and had acted fairly and reasonably in attempting to ensure the fund's risks were managed.

The investigator acknowledged the impact of the suspension on Mr M's investment and the losses this consequently caused him, but he concluded that Northern Trust was not responsible for the fund's mismanagement. The investigator said the evidence showed Northern Trust had met its obligations with reasonable care and therefore had discharged its duties appropriately.

Mr M and Northern Trust provided comments in response to the assessment.

<u>Mr M's comments</u>

Mr M didn't agree with the investigator's assessment. He provided a quote from the FCA that said that it had evidence suggesting depositaries took a "narrow view of their own role", whereas the FCA considered that its rules were "clear that their obligations go beyond that view" – for example, it said it wanted to ensure that "they are checking that a valuation process exists but also that it's robust and effective in a meaningful way and not just a tick box affair".

Mr M also set out what he considered were agreed facts. He said the FCA raised concerns about potential conflicts of interest between an ACD and a fund manager and concerns around the management of risks.

He said depositories played a crucial oversight role, ensuring robust and effective valuation processes, overseeing asset valuations and pricing, and monitoring liquidity.

He noted that Woodford had been involved in breaches that had led to a fine prior to him managing the WEIF, so there were some early warning signs.

Mr M also said that concerns over Woodford's interest in unquoted companies meant that he had been restricted to only FTSE100 and FTSE 250 companies by other firms, whilst concerns had been expressed in other quarters.

Mr M said that a major investor withdrew from the WEIF due to a shift from blue-chip to high-risk unquoted and small illiquid companies. WEIF's portfolio changed significantly, increasing its unquoted investments. There followed significant outflows, including this £1bn withdrawal, which reduced WEIF from £10.2bn to £3.7bn by 2019. Northern Trust, as depository, was aware of these outflows.

Furthermore, overvaluation of unquoted companies led to overpayment to withdrawing investors, increasing the fund's exposure to illiquid assets. WEIF breached the 10% limit on unquoted shares, circumventing rules by listing untraded companies on the Guernsey Stock Exchange.

Mr M said that by April 2019, only 8% of WEIF was in highly liquid stocks, with most holdings taking months to sell.

Mr M then asked questions that he said the investigator ought to ask Northern Trust as part of his investigation. In summary, his questions aimed to uncover the extent of Northern Trust's involvement and actions regarding the management and oversight of the WEIF. Mr M wanted to determine whether Northern Trust personnel worked for Link, shared resources, or had access to Link's systems, and if Northern Trust had any financial interests in WEIF beyond its fees. The questions also inquired about the organisations responsible for valuing unquoted and illiquid companies, the reasons for changes in valuation firms, and Northern Trust's communications with the FCA, investors, and brokers.

Additionally, the questions focused on Northern Trust's awareness and actions regarding breaches of the 10% rule on unquoted assets, the registration of companies on the Guernsey Stock Exchange, and the fund's liquidity issues. Mr M asked about Northern Trust's knowledge of the FCA's concerns and meetings with Link, the proposal to transfer unquoted holdings to Patient Capital, and the contractual commitment to invest in Rutherford Health.

The questions also explored Northern Trust's awareness of Woodford's relationships within another firm, the disconnect between that firm's promotion and withdrawal of investments, and the fund's liquidity management. Mr M sought explanations for significant downward revaluations and liquidity adjustments post-suspension, the sectors of unquoted companies, and Northern Trust’s response to critical media analysis.

Finally, Mr M sought further information about Northern Trust’s awareness of independent analysts’ valuation concerns, any independent valuations conducted by Northern Trust, and the decision-making process for asset sales to meet withdrawals.

Ultimately Mr M said that it was “convenient” for WEIF and Northern Trust to hold Link entirely to blame, but he considered that Northern Trust was complicit in the failings and ought to be held to account.

He said the collective responsibility of Link (the ACD) and Northern Trust (the Depositary) in overseeing the WEIF raised concerns about whether Northern Trust breached its duty of care to investors, potentially causing avoidable financial losses.

Mr M said that Northern Trust should have ensured a prudent spread of risk, especially given that all unquoted assets were in one sector. He said the assessment had narrowly interpreted the rules and guidelines applicable to Northern Trust, and instead he said that merely confirming the presence of valuations and stress testing them was insufficient. He said that ultimately, the investigator had found that Northern Trust did more by being involved in meetings with Link and WIM – this showed Northern Trust’s obligations must’ve gone beyond what it did and that it had opportunities to take more decisive action to protect investors.

Mr M said that Northern Trust had missed several red flags and that Northern Trust should have increased its oversight in response to these risks.

<u>Northern Trust’s comments</u>

Northern Trust agreed with the investigator’s assessment. It said that Northern Trust met its regulatory duties and was not responsible for re-performing the role of Link. It argued that any different view would require expanding Northern Trust’s regulatory duties or relying on hindsight, which it said wouldn’t be fair and reasonable.

Northern Trust said it did not breach its oversight duties and it fully complied with legal and regulatory obligations. It said it was not responsible for any financial losses, loss of investment opportunities, or distress suffered by Mr M.

As agreement couldn’t be reached, the case was passed to me to decide.

What I’ve decided – and why

I’ve considered all the available evidence and arguments to decide what’s fair and reasonable in the circumstances of this complaint.

I’d like to take this opportunity to confirm that I’ve read and considered all of Mr M’s detailed submissions – including those during the investigation and in response to the investigator’s assessment, which is what I’ve summarised above. I hope he doesn’t take it as a discourtesy that I have, however, only summarised his submissions – and that I won’t be responding to all the points he has made.

The purpose of my decision is to focus on the key issues in the complaint and so this is what I’ve done.

In reviewing all the evidence available to me, including the investigator’s detailed assessment of Mr M’s complaint, I’m satisfied that it wouldn’t be fair and reasonable to conclude that Northern Trust caused or contributed to Mr M's losses, or that it didn't comply with the relevant rules.

In the UK, the rules governing how depositaries discharged their functions in relation to a fund and an authorised corporate director (ACD) between 2014 and 2019 were primarily outlined in the FCA Handbook, specifically under the COLL (Collective Investment Schemes Sourcebook) and FUND (Investment Funds Sourcebook) sections.

The investigator has already quoted the relevant rules, so I won't replicate them here. But in short, Northern Trust was responsible for monitoring the fund's cash flows, ensuring the proper valuation of assets, and verifying that the fund's investments were in line with its stated objectives. It had to ensure the safekeeping of the fund's assets, which involved holding the assets in custody or verifying the ownership of assets held by third parties as well as ensuring that all payments made by investors were received and that all cash transactions were accurately recorded.

However, the fund management and especially the stock selection aspects of the management of the fund were the ACD's responsibility.

I make this point early on because I think that most, if not all, of Mr M's comments are fundamentally about how the fund itself was managed and how good or poor the individual stock selections and market calls Woodford made were. But Northern Trust's role wasn't to second guess those calls or to question the specific stocks that Woodford was choosing to invest in. It monitored how consistent Woodford's strategy was in relation to the Prospectus – and I'm satisfied the WEIF's prospectus gave Woodford a significant amount of discretion over what to invest in, which included illiquid or less liquid stock. But it wasn't Northern Trust's role to step in and influence or shape the actual management of the fund – that was Link's role which it had delegated to Woodford. Northern Trust was not responsible for the investment decisions themselves. And in my view, some of the issues that occurred within the WEIF were fundamentally related to Woodford's investment decisions and how poorly some of those decisions turned out to be.

I've seen insufficient evidence that Northern Trust failed to identify investments that were fundamentally incompatible with the stated aims of the fund or its prospectus.

Understandably, one of Mr M's key concerns is liquidity management – but it's clear to me that here too, Northern Trust was doing what it was required to do. It was monitoring the stress testing of the mechanisms to manage liquidity that Link had in place and insisting on regular updates and reporting. I've seen evidence of regular meetings at an appropriate level and the outcome of those meetings was routinely shared with the regulator.

In my view, Northern Trust was required to ensure that a process was in place to monitor the fund's liquidity and take action where necessary or if it had concerns – but its role was, in my view, one of oversight.

As part of the good practice outlined by the FCA from its liquidity monitoring visits, liquidity monitoring should be performed separately by the depositary – and I can see that Northern Trust did this.

Furthermore, the evidence I've seen shows that Northern Trust was taking an active role in relation to its duties, reporting the breaches it was aware of where necessary. I've seen evidence of certain breaches which Northern Trust picked up on, reported and monitored until remedial action was taken – and this information was shared with the regulator.

This occurred in relation to minor administrative breaches as well as the few occasions when the fund held more than 10% in unlisted stock. It's clear to me that as part of discharging its role, it closely monitored what was happening in relation to the makeup of the fund, took action when certain parameters were breached and reported them appropriately. Given that remedial action was taken on each occasion within a short period of time and the close engagement with the regulator, I'm not persuaded Northern Trust needed to do anything more than it did.

As part of monitoring the liquidity of the WEIF, I can see that it was also monitoring both the level of illiquid assets, as well as those that technically were not considered part of that cohort because they were due to be listed in the next 12 months. As Mr M might know, the 10% limit in COLL 5.2.8R didn't include "recently issued transferable securities" that included "an undertaking that application will be made to be admitted to an eligible market" and that "such admission is secured within a year of issue". This means that there may well have been investments that were due to be listed but did not in the end get admitted to an eligible market. I've seen evidence of Northern Trust questioning liquidity in the round, and not strictly focusing on what technically was included in the 10% limit.

At the same time, though, Northern Trust was reliant on both WIM and Link in their assessment of the individual firms they were deciding to invest in and who were announcing their upcoming listing. This wasn't something Northern Trust was responsible for second guessing or carrying out due diligence on – that would've been reperforming Link's role.

I'm not persuaded Northern Trust's role was to essentially re-perform the functions which were Link's responsibility. With hindsight it may be possible to identify areas where Northern Trust could've taken alternative actions – but that isn't my role. I'm not deciding the matter based on what I would've done as a depositary with the benefit of hindsight. I'm considering whether Northern Trust's actions, at the time and in light of the rules and obligations it was required to follow, were fair and reasonable.

On this note, I have taken into account the FCA's Final Notice against Link and the findings it made. The reason I've considered it is because in my view, it clearly identifies Link's lack of due skill, care, and diligence in managing the fund's liquidity and overseeing WIM. And it concluded that it was these failings that led to significant investor losses. Link's failure to manage liquidity appropriately, supervise the investment manager effectively, and ensure a prudent spread of risk was ultimately the reason why the fund failed and needed to be liquidated. I'm not persuaded, given the evidence available to me, that Northern Trust ought to be held "complicit" in these failings merely by virtue of its role as depositary – when it was in fact doing everything that was required of it in the circumstances and it had limited, if any, direct responsibility for the actions that led to the failings identified by the FCA.

The investigator obtained evidence of industry standards which showed that Northern Trust was discharging its role in line with those. Ultimately, Northern Trust's role included taking reasonable care that Link had procedures in place that were compliant with the applicable rules around liquidity management. This included ensuring that periodic monitoring was undertaken, which I can see Northern Trust had in place. The evidence suggests that it was not Northern Trust's responsibility to ensure that all checks undertaken by or on behalf of Link were compliant, but to ensure there were processes in place for those checks to be carried out appropriately. I agree this role needed to be more than merely perfunctory, but as I've said, it did not extend to carrying out Link's responsibilities itself.

I've given very careful consideration to Mr M's points, but I've seen sufficient evidence to conclude that, at the time, Northern Trust was testing Link's liquidity monitoring and requiring Link to periodically report to it.

It was clearly engaging with the regulator where relevant and questioning (and escalating where appropriate) key areas of the fund's management, for example around the valuation of less liquid assets and around breaches of fund limits.

I fully sympathise and understand Mr M's position and why he has made his complaint against Northern Trust. I accept that he faces significant losses arising from his investment in the WEIF. But in the particular circumstances of this case, I'm satisfied that Northern Trust discharged its responsibilities as depositary and was not responsible for the WEIF's suspension and liquidation.

My final decision

My decision is that I don't uphold Mr M's decision.

Under the rules of the Financial Ombudsman Service, I'm required to ask Mr M to accept or reject my decision before 14 March 2025.

Alessandro Pulzone
Ombudsman