complaint

Mrs A invested in the Keydata Secure Income Bond on the recommendation of AWD Chase de Vere ("the IFA"). She believes she invested too much of her capital in this product and therefore her exposure to the fortunes of Keydata was too large. Even after being compensated by the Financial Services Compensation Scheme (FSCS) she has outstanding losses.

background

The adjudicator was of the view the complaint should be upheld for the following reasons:

- Mrs A had retired by the time of the advice in 2006 and was looking to take an income from her investments. She had agreed to a cautious to moderate risk profile.

- With the Secure Income Bond, the adjudicator was of the view this was unsuitable because it represented a significant risk to Mrs A's capital. This was because the underlying investments were in traded life policies and relied on a financial model to predict the maturities of these policies to produce the return of capital and income within the relevant timeframe. The investments involved and relied on several separate and unrelated businesses all providing different undertakings to ensure the product was monitored and administered correctly and properly. As such, the adjudicator felt the arrangement was sophisticated and complex and the risks were similarly complex.

- In explaining why he was of the view the Keydata fund represented a significant risk to Mrs A, the adjudicator made reference to the Final Notice from the Financial Services Authority (FSA) and the financial penalty it imposed on Norwich and Peterborough Building Society for its failure to give its customers suitable advice in relation to Keydata products. The adjudicator felt this revealed a number of distinctive features to the life settlement fund and was doubtful whether such a fund could be suitable for all but the most experienced of retail investors.

The IFA disagreed with this assessment because of the following reasons:

- At the time of the advice Keydata was a highly respected product provider and had won several industry awards.

- The Keydata bond helped diversify Mrs A's investment portfolio. Not only was this because the bond was a new and different asset type (from fixed-interest securities and cash) but also because it allowed an exposure to the US rather than a dependency on the UK and Europe. Mrs A was also recommended a commercial property fund, a fund of funds and an investment bond.

- The suitability report included extensive and prominent risk warnings that would not have been missed by Mrs A.

- Mrs A and her husband had a substantial investment portfolio which they had held for a number of years. Therefore they cannot be considered naïve in terms of investment experience or be absolved from any blame if they chose not to read the risk warnings or failed to seek clarification.

- It is with the benefit of hindsight that the supposed esoteric nature of the Keydata bond is now overemphasised. Although the functioning of the bond was dependent on a financial model and this was new to Mrs A, the fund's eventual failure was not for this reason or the nature of the traded life policies. The misappropriation of the funds that damaged Keydata was not foreseeable as was also the case according to the FSA with the collapse of Lehman Brothers.

- The IFA appreciates that because Mr and Mrs A were both retired they could not take significant risks with their money. But, it does not believe the Keydata bond represented a significant risk. Not every investment needs to exhibit exactly the same level of risk for the overall portfolio to meet the required level of risk and to maximise the client's returns.

- Mrs A has not said the investment was unsuitable, but rather that too much was invested in the bond. The IFA appreciates the ombudsman has the remit to look further than the matter being complained of but this should only be applied to instances where the consumer has a lack of financial awareness. Mrs A was an experienced investor who held a sizeable and diverse portfolio.

- Mrs A and her husband have confirmed that the amount invested with Keydata was 14.1% of their capital. According to FSA guidance for the limits of one structured product provider this should not exceed 10% of the portfolio. This means 4.1% which is £2,013.10 could have been wrongly advised. Therefore, if the ombudsman does not accept its arguments concerning suitability he or she should only be concerned with this amount in excess of the 10%.

After receiving a copy of the correspondence, Mrs A made the following comments:

- Mrs A and her husband do consider themselves naïve concerning finance and investments which is why they used the IFA in the first place.

- Mrs A said that she thought of herself as more of a cautious investor rather than the cautious to medium risk profile that belonged more to her husband. She said she made this clear to the adviser during the discussions.

- Mr A confirmed that he was not pursuing a complaint as he is satisfied with the compensation he has received from FSCS.

I must decide this case on its individual merits. However, as the adjudicator has explained, we have considered complaints about Keydata bonds before and published a decision which sets out our general approach to such complaints on our website. The decision is in the investment section of our online technical resource which can be found by clicking the publications tab.

my findings

I have included above only a brief summary of the complaint background, but I have read and considered all the evidence and arguments available to me from the outset.

When considering what is fair and reasonable, I am required to take into account relevant: law and regulations; regulator's rules, guidance and standards, and codes of practice; and, where appropriate, what I consider to have been good industry practice at the time.

I am therefore mindful of the general legal position including: the law relating to negligence, misrepresentation and contract (including the express or implied duty on professional advisers to give advice with reasonable skill, care and diligence); and the law relating to causation and foreseeability.

There is no dispute that this was an advised sale of an investment product where the IFA assessed the suitability of the product for Mrs A. As the IFA gave advice about regulated investments, I have taken account of the regulatory regime that applied at the time which includes the relevant FSA principles and rules on how a business should conduct itself.

Taking this into account it seems to me that the overarching question I need to consider in this case is whether the recommendations given were suitable for Mrs A in her particular circumstances.

In doing so I need to take into account the nature and complexity of the investments and Mrs A's financial circumstances, needs and objectives; understanding and relevant investment experience; and tolerance to investment risk.

In January 2006 Mrs A transferred her existing PEP worth £54,000 into the Keydata Secure Income Bond (issue 4) and took out a separate ISA in the same product. The issuer of the bond was Lifemark, which was a Luxembourg based special purpose vehicle.

It is important to note that although this element of advice concerned an investment made by Mrs A alone, it formed part of the overall advice given to both Mr and Mrs A. I have therefore considered their overall joint circumstances.

From the available information it does not appear that a record was made of Mr and Mrs A's personal and financial circumstances at the relevant time in 2006. However, such a record was made in September 2004 which indicates that they were in their sixties, with Mr A being retired and Mrs A semi-retired. Their income was comprised of a combination of earnings from employment, pension and interest. They held joint savings of £137,000 and investments of £296,000. Their attitude to risk was recorded as cautious to moderate (four on a scale of one to ten).

The IFA sent a report to Mr and Mrs A on 17 January 2006. The adviser wrote that they wanted to take an income of £2,500 a year from their investments to pay for holidays. It was stated their attitude to risk was still cautious to moderate. This meant there would be an "emphasis on stable returns" but they recognised there would be an increasing percentage of their capital in equities to provide real growth.

It was noted in the IFA report that Mr and Mrs A had £100,000 on deposit and were prepared to invest all but £20,000 of this. It was also said they had an investment portfolio of £491,000 with 31% of this being in equities and the balance in fixed-interest securities, cash and property. The adviser recommended the transfer of Mrs A's PEP into the Keydata Secure Income Bond because their portfolio was considered to be overweight in fixed-interest securities and cash for their risk profile. Mr and Mrs A were also both advised to subscribe to a new ISA for that tax year in the same Keydata bond.

The Keydata bond was recommended in the IFA report because it paid a "secure and high rate of return". Because it was uncorrelated to other asset types it provided diversification. It was also said that the bond met Mrs A's attitude to risk of five out of ten. Further recommendations were made to invest in an overseas equities fund which was compatible with their cautious to moderate attitude to risk, and a property fund which met their moderate attitude to risk.

It appears to me the objective was to rebalance Mr and Mrs A's portfolio such that the proportions held in fixed-interest securities and cash were reduced so the overall portfolio complied with their cautious to moderate risk appetite. The aim was also to generate an income of £2,500 a year. Subsequently, this rebalancing would lead to a corresponding increase in overseas equities, property and a new asset type – structured investments in traded life policies. I note that the adviser wrote that too much of the portfolio was invested in fixed-interest securities and this meant it was "higher/lower risk" than cautious to moderate.

So, it is necessary for me to decide whether the Keydata bond represented a higher risk investment than Mrs A was willing to take. In considering the issue, I have carefully considered the documentation relating to the bond, much as I am sure the IFA did, along with any other information it had access to before making any recommendation.

The underlying fund for the Keydata product consisted of traded life policies which had been grouped together on the basis the stated income stream and capital return of the plan could be generated and the premiums on the policies maintained. The overall returns were dependent on the accuracy of a financial model which was supposed to predict the maturity of these life policies. Also, this arrangement involved and relied on several separate and unrelated businesses all providing different undertakings to ensure the product was monitored and administered correctly and properly.

The product had an international dimension because the different parties involved were based in different countries. For example, the special purpose vehicle was incorporated in Luxembourg and the underlying life policies were bought and sold within the US. This in my view would have further increased the risks with the monitoring and administration of the arrangement. There was the risk the underlying life policies would not mature in line with the model to pay the stated returns and be able to maintain the premiums on the policies. If policies had to be sold to meet any commitments there was a risk this could be at a discount to their purchase value and/or be difficult. Also, all this had to be achieved within a time frame, which in this case was five years, to provide the stated returns to the investor.

This was a fund with a significant overseas component that traded in unusual and opaque investments. There was also a reliance on a limited and specialist model for the valuation of the assets.

The adjudicator explained why he was of the view this particular investment represented a significant risk to Mrs A and in doing so he made reference to the Final Notice and financial penalty imposed by the FSA on Norwich and Peterborough Building Society for its failure to give its customers suitable advice in relation to Keydata products. This Final Notice described the features of the Secure Income Bond in more accessible terms:

"The Keydata Products were based on investments in corporate bonds. On behalf of investors, Keydata purchased bonds which were issued by special purpose vehicles incorporated in Luxembourg. The first Keydata Product offered by N&P was the Secure Income Bond ("SIB") Issue 3, for an investment in a bond issued by SLS Capital SA ("SLS"). N&P offered a further 22 Keydata Products which were investments in bonds issued by Lifemark SA ("Lifemark"). The funds raised through the issue of the bonds (i.e. the amount invested by retail customers in the products through Keydata) were then invested in a portfolio of US life insurance policies and cash. The Keydata product materials stated that the investment mix was intended to be 60% policies/40% cash for the bonds issued by SLS, and 70% policies/30% cash for the bonds issued by Lifemark. SLS and Lifemark each purchased life insurance policies from elderly US citizens, paid the premiums due on those policies, and collected the maturity payment due under the policy when the individual died."

The FSA found that the product material revealed a number of significant distinctive features to the bond, including the following:

- *Although the Keydata Products were intended to return capital in full at the end of the investment period, they offered no capital guarantee, and put all capital invested at potential risk.*

- *The successful performance of the Keydata Products depended on the accuracy of actuarial models used by Keydata. There was a risk that significant technological or pharmaceutical development could impact on the accuracy of the models and when insurance policies were likely to mature.*

- *The bonds had a fixed term of 5 or 7 years. This meant that Keydata undertook to return funds to investors on the date when the bond matured, even if, at that point in time, it had insufficient funds because the insured individuals were living longer than anticipated.*

- *The underlying insurance policy assets were not traded on an exchange in the way that stocks and shares are. The resale market for these assets also created a risk that, if it became necessary to sell an insurance policy to make funds available, this might take longer than anticipated, and might only be possible at a reduced value, reducing the value of the portfolio.*

- *The Keydata Products involved investment in a single specialist asset class (US senior life insurance policies) through a single issuer (at first SLS, then Lifemark). Although a percentage of the investment was to be held in cash, this was not held as a separate* *investment, but was intended to be used to pay the insurance premiums, income payments and operational costs associated with the investment.*

- *The Keydata Products had a significant international dimension: the underlying assets were US life insurance policies, and the issuers of the bonds were based in Luxembourg.*

These concerns were apparent (or should have been) to a financial professional at the time and should have been taken carefully into account in assessing the suitability of the Keydata Secure Income Bond. It is my view this Keydata bond would not have been suitable for all but the most experienced of retail investors and that the risk to the investor's capital was significant. Therefore, it would have been important for potential investors to understand that the fund presented a significant risk to their funds.

If the IFA had carefully considered the product literature (as it should have done) it would have realised that the bond was not suitable for cautious to moderate investors such Mrs A. The significant features of the bond (highlighted by the FSA Final Notice), were features that were or should have been apparent to the IFA in 2006.

I consider that a professional IFA should have appreciated that capital, and a significant proportion of the capital which Mrs A was ultimately prepared to invest, would be placed at significant risk. It is material that Mrs A wanted to produce an income, while taking a cautious to moderate risk. This is hardly surprising given her age and her reliance on this capital to generate an income in her retirement. Having carefully considered the available evidence, I find on balance that the IFA's recommendation to invest in the Keydata bond was entirely at odds with Mrs A's objectives.

Accordingly, I conclude that the recommendation made by the IFA to invest in the bond was not a suitable recommendation for Mrs A. Indeed, the advice demonstrated in my view a complete disregard for Mrs A's particular circumstances and risk profile.

The IFA has pointed out that Keydata was a well respected product provider and had won several industry awards at the time of the advice. However, for the reasons set out I remain of the view the recommended fund would not have been suitable for all but the most experienced retail investor. The adviser should have exercised professional judgement about the inherent nature of the investment and its suitability for their client's specific investment needs and circumstances. Such a recommendation should not have been made on the basis of the reputation up to then of the product provider and any parties that were thought or known to be involved in the overall arrangement.

I realise the Keydata bond represented a different asset type to that which Mrs A had invested in before. Because of this, and the fact the life policies were from the US, it could be said this improved the diversification of the portfolio. But Mrs A was established as having a cautious to moderate attitude to risk. Considering the significant risks inherent in the Keydata investment, it is still my view the product was unsuitable for Mrs A. The fact the product was a new asset type to Mrs A would not in my view justify the recommendation of an unsuitable investment.

I accept that the recommendation report did warn that the return of the capital was not guaranteed and listed numerous scenarios where the capital invested could be at risk and where there were restrictions. Nevertheless, Mrs A received advice from the adviser and was entitled to rely on that advice and it would appear to me that she did. Even if she had read the recommendation report I do not consider that it is fair and reasonable for the IFA to rely on the warnings and descriptions contained. Rather, I am satisfied that it was reasonable for Mrs A to rely on the professional advice provided by the IFA.

It has been argued that Mrs A and her husband were sufficiently experienced and therefore would have understood the risks they were taking with the Keydata product. I appreciate that Mr and Mrs A held other investment funds and therefore would have possessed some knowledge concerning these. However, Mrs A and her husband had sought advice from the IFA because they wanted to draw an income from their investment portfolio in retirement. As I have said before, the role of the adviser was to make suitable recommendations when taking account of their circumstances and risk profile. I am not persuaded the knowledge and experience Mrs A (or her husband) may have gained up to that point would have enabled them to understand the particular risks posed by the Keydata investment. Nor am I persuaded it should absolve the IFA from providing suitable advice.

The IFA has said that not every investment recommended had to reflect the same level of risk for the overall portfolio to meet the cautious to moderate risk profile. I understand this point. However, I am not of the view that the disputed Keydata investment could be considered suitable by virtue of the IFA having stated in the report that some investments could be of a higher level of risk than the client's agreed risk profile. This is especially so if the IFA has not detailed for identification purposes which investments this would apply to.

I realise when describing the features and risks of the bond, the IFA said that it suited Mrs A's five out of ten risk profile when at the start of the report it had described Mrs A as a cautious to moderate investor overall which was four out of ten. However, there was no emphasis within the report on whether the recommended bond was of higher risk than Mrs A's selected risk profile. It is still my view such a fund would not have been suitable for all but the most experienced of retail investors, and certainly not for investors such as Mrs A even if I was persuaded (which I am not) that she was a balanced investor with this part of her capital.

The IFA has suggested that although the structure of the Keydata bond was new to Mrs A the actual fund did not fail for this reason. Rather, it has said Mrs A's losses were caused by the misappropriation by a third party. The misappropriation actually concerned a different Keydata life settlement product than the one being complained of. It involved the bond issued by SLS Capital S.A. In addition, it is not widely held that the taking of the funds from the SLS fund indirectly caused the losses on the Lifemark fund.

It has been said that Mrs A has actually not complained about the suitability of the Keydata product, but instead the amount that was invested. Mr and Mrs A's 2011 letter of complaint to the IFA expressed a concern that 14.1% of their portfolio had been too much to invest in the fund. Additionally, Mrs A's personal exposure to the fund was more at 25.3% and this was not acceptable. It has been mentioned in the letter that they had applied to the FSCS and could only be compensated up to £48,000 so they wanted to be compensated by the IFA for the excess.

Mrs A was permitted to apply to the FSCS for compensation up to a maximum of £48,000. The FSCS has since reassigned her rights to bring the complaint to us to allow her the opportunity to recover the balance of her money which is what she intended when she wrote to the IFA in 2011. If the amount she had invested had been less then it would be likely the loss would have been covered completely by the FSCS and the complaint would not now be with us.

I appreciate Mrs A's complaint, as it has been expressed by her, does not appear to directly concern the suitability of the product in terms of it not matching her objectives or risk profile. I do however have the inquisitorial remit to look beyond what has immediately been complained about. Clearly the complaint relates to the suitability of the advice the IFA gave, and I am satisfied I am able to consider this as a whole and not simply one aspect of the advice.

For the reasons already given, I have already explained why I am of the view Mrs A should not have been in this investment. I am also satisfied that for broadly the same reasons she would not have understood why the product was not suitable in terms of her circumstances and instead preferred to see the large amount that she invested as the cause of the rest of her loss. As such, it is right that the overall suitability of the product is considered by me.

The IFA has suggested that if the complaint is upheld then the redress should only be concerned with any amount invested over 10% of Mr and Mrs A's portfolio. This is because of FSA guidance which it says specified a 10% limit for any investment with a particular structured product provider. This is something I could take into account if I thought the advice in the main was suitable but the amount placed with one provider was too much. Clearly, I have not reached this conclusion so therefore it would be inappropriate to consider such an outcome.

My view in this case has not been reached with hindsight. I have based my findings on the product's suitability for Mrs A based on what the IFA at the time of the advice knew, or could be expected to find out about the investment, and based on reasonable expectations of how the bond would operate.

Having reached this view, I now need to consider what Mrs A would have done "but for" the advice she received.

I have not seen anything which suggests to me (and I find it highly unlikely) that she would have invested in the bond, if it had not been recommended to her. Nor am I persuaded that she would have invested in the bond, if things had happened as they should. The investment was not suitable for her needs and circumstances, and, as stated previously, I do not think she would have invested had she appreciated the risks.

Overall, I consider it most likely that Mrs A would have invested this capital into another investment suitable for a cautious to moderate risk investor. On balance, I consider that a fair benchmark to indicate the investment return on her investment is 1% more than the Bank of England base rate compounded yearly from the date of investment until the date the loss crystallised.

I have also considered what award I should make in respect of interest, given that Mrs A's loss crystallised on 13 November 2009. My normal approach is to award 8% simple per year (before tax) on crystallised losses, unless it is clear that another rate would more accurately reflect the costs to the particular consumer for being out of the money concerned.

The 8% figure is not intended to be an interest rate in the way that a bank deposit account pays interest. Rather it is a rate which I consider to be a fair yardstick for compensating consumers for a wide range of possible losses and lost opportunities they may have incurred. The consumer might, for example, have:

- borrowed money, or continued to borrow money, at credit card or loan rates which they would not have done if the money had been available to them;
- saved or invested the money in some way producing a variety or possible returns;
- spent the money on holidays, home improvements, or any number of goods which might have given them an unquantifiable return;
- or any combination of these things.

The 8% simple interest rate is gross and is subject to tax – and is a rate often (but not always) used by the courts in not dissimilar situations.

I have taken account of the fact that Mrs A had access to a wider portfolio of £491,000 to supplement retirement income. Although the crystallisation of the loss would have given rise to distress and inconvenience, I think that in the shorter term Mrs A would not have had to borrow money or suffered the type of lost opportunities outlined above. As a result, I consider that a rate of 8% would be excessive in this case. I therefore consider that a fair rate of interest is 2.5% simple per year following the crystallisation of the loss in November 2009.

my final decision

For the reasons set out above, my final decision is that I uphold the complaint. I am of the view the Keydata bond should not have been recommended to Mrs A.

My aim is to put Mrs A in the position she would now have been in but for the IFA's poor advice. In deciding how to assess fair compensation I consider it fairest to assume:

- With reasonable advice, Mrs A would have had the original capital intact plus a reasonable rate of return.
- The rate of return on the original capital would have been equivalent to 1% more than Bank of England base rate from time to time compounded yearly.

I award compensation on the following basis:

A= the capital invested in the Keydata bond, less any amounts paid out by way of withdrawals, distributions of capital or before-tax income;

B= a return on the amount from time to time of A, by way of a return of the Bank of England base rate plus 1% per annum, compounded annually from the date of investment until 13 November 2009 (when Keydata defaulted and the loss crystallised) or until the date of the last income payment if later;

C= the residual value of the investment that Mrs A made in the Keydata bond which I asses to be zero for this purpose.

D= A+B-C

To that sum the IFA should add interest from 13 November 2009 or the date of the last income payment if later at the rate of 2.5% a year simple until this award is paid.

If the IFA considers that it is legally obliged to deduct income tax from the interest element of my award (ie the interest added to D), it must send a tax deduction certificate with the payment.

For clarification, A and B above should work as follows. Any sum paid into the investment should be added to the calculation from the point in time when it was actually paid in so it accrues the 'reasonable rate of return' within the calculation from that point on.
Any reduction to the investment (excluding the final encashment payment) should be deducted from the calculation at the point in time when it was actually deducted so it ceases to accrue the 'reasonable rate of return' within the calculation from that point on.

I understand that in some cases, consumers have received income payments after Keydata defaulted. It is only fair that such payments are taken into account in my award and I have allowed for this possibility in the award formula. It should be noted that the income payments do not include any distributions made following the Bondholder Notice dated February 2013 which is discussed further below.

As it is my understanding that on payment of this redress FSCS will require repayment of its compensation to Mrs A, no allowance should be made for any sum received from FSCS in the calculation of the investment loss. However, Mrs A has had use of this money since it was paid in 2011. Accordingly, although the amount D should not be reduced, the sum used to calculate the interest payment should be reduced by the amount she received (I understand this was £48,000) from the FSCS from the date it was received onwards.

In relation to C: I understand that the fund cannot be encashed. For that reason, as set out above, for the purpose of C the investment should be treated as having a nil value. However, that is provided that Mrs A agrees to the IFA taking ownership of the investment if it wishes to. The IFA would then be able to obtain any value of the investment as and when that value can be realised plus any distributions made from it. I would ask Mrs A to note that carefully. She will need to cooperate with the IFA to enable it to make the necessary calculations and in order for it to take ownership of the investment if it wants to.

I am aware that a recent Bondholder Notice dated February 2013 indicates that there may be a further distribution to bondholders. I consider that as part of any arrangement to pay the award and to take ownership of the investment it would be reasonable for the business to make appropriate provision for it to receive any future distribution whenever paid. This would cover a situation where the consumer receives the distribution before the award has been paid and/or before transfer of ownership to the business has been completed. It would also cover a situation where the distribution is incorrectly paid directly to the consumer even though ownership has been transferred.

It is my understanding that HMRC has made certain provisions so that it maybe possible for compensation paid in relation to a Keydata fund that involved an ISA/PEP to be transferred into an ISA wrapper. I am unable to give any more information or advice about this matter.

However, information can be found on the *HMRC.gov.uk website* by entering *ISA reinstatement* in the search box on the home page. I can only suggest that if Mrs A would like to explore this further she contacts HMRC directly or seeks appropriate independent advice.

Doug Mansell
ombudsman