Final decision	
Complainant:	AYZ Association
Firm:	Firm CDE
Complaint Reference:	RV/28
Date:	21 June 2007

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

2. In response to my provisional decision, AYZ said in summary that the firm could and should have performed a standard investment analysis of the relevant zeros on the basis of their detailed prospectuses. This would have established the true risks of the zeros, which were considerably different from those of fixed interest corporate bonds; AYZ listed examples of differences. The firm's risk warning was superficial and inaccurate. And, in the light of its duty to keep the portfolio under review, the firm should have reacted sooner to increased awareness of structural weaknesses in mid-2001 by recommending sale of the zeros while they still had some value.

Complaint

3. The complaint I am asked to resolve is between the AYZ Association, represented by Mr T, and CDE. In December 1998 the firm advised AYZ to buy, among others things, investments in the zero dividend preference shares of two split capital investment trusts: Geared Income Investment Trust and the Leveraged Fund. The firm was providing AYZ with a 'managed advisory' portfolio service.

4. The investments cost around £50,000 and they subsequently failed. AYZ claims that the investments were outside the risk parameters of its moderate risk portfolio, saying that the firm ought to have known about the risks posed by gearing (bank debt) and 'crossholdings' (investments by the splits in other investment trusts) and should have advised it to sell the zeros sooner. It says that it would not have agreed to buy the zeros if the firm had properly described to it the risks and nature of these investments.

5. 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.

6. As I have made clear, I have treated the complaint as being one that AYZ, as a result of the firm's advice, came to hold a portfolio of investments that was unsuitable for it when viewed overall.

Introductory remarks

7. In many ways the dispute between AYZ 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.

8. 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”.

9. 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.

10. 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.

11. 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.

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

13. 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

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

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

14. I have set out the main issues in three 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 AYZ.

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

Summary of findings in this case

15. In the present case the firm supplied AYZ Association (AYZ) with its 'Non-discretionary portfolio supervision' service. This meant that the firm agreed to construct a portfolio for AYZ taking into account its risk profile and investment objectives, and then to monitor the portfolio and give advice if the portfolio required adjustment to keep it in line with that risk profile and those objectives.

16. The portfolio was to be managed on a moderate (or medium) risk basis with an investment objective of seeking a balanced return from income and capital growth. AYZ was prepared to accept a reasonable amount of volatility, say up to 20%.

17. In December 1998 the firm recommended that AYZ buy zeros in two splits, Geared Income Investment Trust and the Leveraged Income Fund, to form part of AYZ's portfolio. The purchases cost AYZ around £50,000.

18. The investments later failed, resulting in a total loss to AYZ. AYZ complained to the firm in late 2004/ early 2005.

19. The investments were in principle suited to a capital growth objective. The firm told AYZ that, while zeros were like fixed interest stocks, they were not guaranteed to pay their target value.

20. Even if the zeros were higher than medium risk investments, they did not form such a large part of AYZ's portfolio, at any point in time, that they unbalanced it, by making it higher than medium risk overall. That being so, the firm was not at fault for recommending the purchase of the zeros or for then not recommending their earlier sale.

21. I therefore find that the firm did not breach its duty to AYZ, and so I have decided not to uphold the complaint.

SECTION 1: The Split Capital Investment Trust sector

22. 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

23. 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.

24. 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.

25. 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.

26. 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.

27. 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.

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

29. “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]

30. 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.

31. 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

32. 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:

33. 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).*
>
> *(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))".

34. 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

35. 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.

36. 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.

37. 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 proposed approach to deciding this case

38. 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

39. 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.

40. 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.

41. 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.

42. 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.

43. 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, AYZ had a 'non-discretionary portfolio supervision' service, and invested in zero dividend preference shares.

44. 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.

45. 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.

46. 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.

47. 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.

48. The question I need to resolve is whether or not a particular sale of a particular product 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. However, what I must decide is whether the risk profile that the firm attributed to the investment properly reflected the risk factors that ought fairly to have been known to the firm at the relevant time.

49. 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.

50. 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.

51. 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.

52. 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.

53. 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 to date.

54. 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

55. 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.

56. 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.

57. 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

58. 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.

59. 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

60. 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.

61. 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.

62. 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 proposed approach

63. Overall, in deciding my proposed 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

64. 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.

65. 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.

66. 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.

67. 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

68. 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.

69. 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.

70. 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.

71. 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.

72. 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.

73. 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.

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

75. So at what point was the background such that the 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.

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

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

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 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

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

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.

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.

[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.

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 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.

So gearing through bank borrowing needs to be taken account of as a risk factor. However, I consider that for this 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

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

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'. Ordinary 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.

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.

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

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 the firm 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 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.

(d) 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 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

[9] For example, via its solicitors

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: AYZ's complaint against Firm CDE

Complaint

Mr T is bringing the complaint on behalf of the AYZ Association. The complaint is that the firm mis-sold AYZ zero dividend preference shares in Geared Income Investment Trust and Leveraged Income Fund ('the investments') because they were far outside the parameters of its moderate risk portfolio. Mr T also said that the firm failed to communicate the risks involved in the investments at the time of advice and subsequently failed to provide any assessment about the investments until January 2002.

I have considered:

i. whether the firm owed AYZ certain responsibilities
ii. what was the nature of those responsibilities?
iii. did the firm fail somehow in carrying out those responsibilities?

Circumstances

In December 1996, AYZ opened an investment account with the firm. The service required was the 'Non-Discretionary portfolio supervision service'.

As per the Client Agreement, the account was to be managed on a moderate risk basis with an investment objective of seeking a balanced return from income and capital growth. AYZ was prepared to accept a reasonable amount of volatility, say up to 20%.

In December 1998 the firm advised the purchase of four zero dividend preference shares including the investments. The total cost of the purchase was around £100,000 and the investments (i.e. the zeros in Geared Income and Leverage Income) cost £50,650.

There does not appear to be any specific further advice concerning the investments until January 2002 when the adviser referred to the problems in the splits sector which affected the performance of the zeros in the portfolio and stated that the situation was being monitored closely. This was followed by a letter in May 2002 which essentially said that most of the zeros that had run into difficulties had done so primarily because of their underlying portfolios having large exposure to geared income shares of other splits. The adviser stated that the firm was taken unawares about the extent of 'cross holdings' within different split capital investment trusts and by the time this came to light the poor liquidity in the market meant that it was very difficult to sell the investments. In August 2002 the investments were suspended from trading.

AYZ complained to the firm about the investments in its letters dated 16 December 2004 and 21 January 2005 and the firm responded on 24 December 2004 and 22 February 2005, rejecting the complaint.

The Financial Ombudsman Service adjudicator did not uphold the complaint for the reasons set out in his letter of 17 January 2006.

The complainant's submissions

Mr T rejected the adjudicator's conclusions in his letter dated 10 February 2006. He said that the risks involved in the investments were high owing to the strategy of gearing the returns through bank borrowings and investing in income shares of other split capital investment trusts. He said that this should have been apparent to the firm from the information contained in the prospectuses, especially as the firm underwrote the Leveraged Income Fund issue.

Mr T said that the firm was in breach of the FSA's Conduct of Business Rules as the firm recommended the investments despite the underlying risks clearly apparent from the prospectuses, which the firm had in its possession but did not show to AYZ.

Mr T said that subsequent to the initial advice the firm had an ongoing responsibility to ensure the suitability of the investments, yet the firm failed to do so especially in 2000 / 2001 when there was considerable market commentary drawing attention to the risks of gearing and holdings in other split capital investment trusts.

Mr T did not accept the adjudicator's view that the portfolio overall was suitable for a moderate risk profile. He said that AYZ accepted the recommendation on the understanding that the investments were suitable alternatives to fixed interest stocks and it was most unlikely that AYZ would have found the balance of the risk in the portfolio acceptable if the risks had been correctly explained. He said that to have 8% of a moderate portfolio invested in shares of this nature was unacceptable.

I have referred earlier in this decision to AYZ's further submissions in response to my provisional decision dated 1 February 2007.

Findings

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

I note that the portfolio was to be managed on a 'Non-Discretionary portfolio supervision' basis. This meant that the firm had a responsibility to monitor the continued suitability of the portfolio and advise AYZ of any changes required to ensure that the portfolio remained in line with the agreed objectives and risk profile. The decision to implement the changes, however, rested with AYZ.

The complainant says that the investments were advised as suitable alternatives to fixed interest stocks and if AYZ had been aware of the risks involved in the securities it was unlikely that it would have found the balance of the risk in the portfolio acceptable.

I note that the investments were recommended as 'fixed interest' investments. However, the adviser in his letter of 11 December 1998 also stated that the zero dividend preference shares formed part of the share capital of split capital investment trusts and that their repayment values were not guaranteed and were conditional upon the assets of the trusts being sufficient to repay the zero dividend shareholders. Therefore, I consider that AYZ was on notice that the zeros were to some extent different from typical fixed interest securities.

Further, according to the Private Client Agreement Letter, a moderate risk portfolio would principally include sovereign debt securities, bonds with high credit ratings, most types of investments in the leading 350 UK companies, Unit Trusts, Investment Trusts and a modest percentage directly in smaller companies. The investments were shares in two investment trusts. So under the mandate, the firm was entitled to invest in investment trusts as part of a moderate risk portfolio.

The investments were purchased with an objective to provide a capital return. This is in line with the agreed investment objective of a 'balanced return'.

The Client Agreement Letter also stated that in achieving the investment objectives the firm would seek to establish a portfolio that would meet the requirements "*by overall spread and balance as a whole and not by trying to do so through each individual holding on a 'stand alone' basis*".

Therefore, before the complaint could be upheld, I would have to be satisfied that the mix of investments in the portfolio made it unsuitable overall in that the level of risk carried by the portfolio as a whole or the features of the investments within it fell outside the agreed risk profile and objectives of the portfolio.

As the firm provided a 'managed' service, it had a continuing responsibility to monitor the portfolio and advise AYZ of any changes required to keep the overall portfolio in line with the agreed investment objective and risk profile.

Bearing this in mind, I have looked at the composition of the portfolio periodically from the time the investments in question were made to the time they failed.

Breakdown of portfolio as at 31 December 1998 (immediately after advice)

Holding	**% of the Portfolio**
Cash and Gilts	17%
Invesco Recovery and Monthly High Income Zeros	8%
Leveraged Income and Geared Income Investment Trust zeros	8%
Equities / Collective investments	67%
	100%

The investments constituted about 8% of the portfolio at the time. Even if the investments were higher than moderate risk at the time, this was adequately balanced by the Gilts and lower risk zeros within the portfolio. The remaining investments were predominantly in blue chip equities and collective investments and were overall suited to a moderate risk portfolio.

Breakdown of portfolio as at 31 March 1999

Holding	**% of the Portfolio**
Gilts and Cash	16%
Invesco Recovery and Monthly High Income Zeros	8%
Leveraged Income and Geared Income Investment Trust zeros	8%
Equities / Collective investments	68%
	100%

Breakdown of portfolio as at 31 March 2000

Holding	**% of the Portfolio**
Gilts and Cash *	8%
Invesco Recovery and Monthly High Income Zeros	5%
Leveraged Income and Geared Income Investment Trust zeros	5%
Equities / Collective investments	79%
Venture Capital Trusts	3%
	100%

* includes a negligible percentage of other fixed interest securities

Breakdown of portfolio as at 31 March 2001

Holding	**% of the Portfolio**
Gilts and Cash	11%
Invesco Recovery and Monthly High Income Zeros	6%
Leveraged Income and Geared Income Investment Trust zeros	6%
Equities / Collective investments	75%
Venture Capital Trusts	2%
	100%

Breakdown of portfolio as at 31 March 2002

Holding	**% of the Portfolio**
Gilts and Cash	12%
Invesco Recovery and Monthly High Income Zeros	6%
Leveraged Income and Geared Income Investment Trust zeros	0.3%
Equities / Collective investments	79.7%
Venture Capital Trusts	2%
	100%

Again, as at these dates I consider that there was an adequate level of lower risk securities that counterbalanced the level of holdings in the two investments. The rest of the portfolio continued to remain invested predominantly in blue chip equities and collective investments and suited a moderate risk portfolio overall.

In summary, my findings are that the investments were within the firm's definition of investments for a moderate risk portfolio, that the inclusion of the investments – even if they were higher than medium risk – did not unbalance the portfolio, and that the portfolio remained a moderate risk portfolio overall.

Mr T has said that the firm did not communicate the risks involved in the investments either at the time of initial advice or later. I note that the adviser in his letter of 11 December 1998 did warn that the repayment values from the zeros were not guaranteed and were conditional upon the assets of the trusts being sufficient to repay the zero dividend shareholders. As regards Mr T's comment that the firm underwrote the Leveraged Income Fund issue, they were not underwriters to the issue and had only agreed to subscribe to a small percentage of zero dividend preference shares in the Fund.

Nevertheless, as pointed out by the adjudicator, the focus of our enquiry is whether the firm breached its duty in relation to the advice it gave on the portfolio. The firm will only have breached that duty, and therefore there will only have been a recoverable loss, if it can be shown that the firm gave advice which resulted in AYZ holding a portfolio that was unsuitable, overall, for the moderate risk profile. In my view, this has not been demonstrated, so my decision is that it is fair and reasonable not to uphold the complaint.

Roger Yeomans
Ombudsman