

note for intermediary firms on complaints involving ‘zeros’

The Financial Ombudsman Service has received a surge of complaints involving split capital investment trusts (splits). Handling these cases has presented challenges for us and for the firms complained about. This note is intended to clear up some misapprehensions that have arisen about our process and approach.

It focuses on cases brought against intermediary firms – such as stockbrokers and independent financial advisers – in relation to zero dividend preference shares (zeros) acquired on the basis that they were low risk.

Many of the points, but not all, are also applicable to cases brought against intermediary firms in respect of: zeros acquired on the basis of some other risk level; other classes of splits shares; and holdings in unit trusts and investment trusts that invested in splits.

The note describes relevant aspects of our casework process and of our current approach to cases about zeros. But it is not a definitive description of our casework process. And it is not the last word on our approach, which continues to evolve in the light of the information received in individual cases.

from the beginning

Our customer contact division looks after the initial processing of complaints. This includes checking whether the financial firm has issued a final response, or whether eight weeks have gone by since the complaint was made to the firm, and obtaining a completed complaint form. Then the case is passed to our casework division, at which point a letter is sent to the firm asking for a copy of its file.

If the firm recognises that it has a number of cases where the circumstances are similar, so that the outcome is very likely to turn on exactly the same factors, it would be helpful if the firm were to identify the cases concerned. This will give us an opportunity of considering whether to identify a lead case.

lead cases

We decide each case on the basis of its own circumstances. But, if we receive lots of cases where the circumstances are very similar, we may choose one or more apparently typical cases as ‘lead cases’. Focusing initially on these lead cases can help to save duplicated effort for all concerned.

Once a lead case has been decided by an ombudsman, we can deal with all the other follow-on cases in the same group. We do not apply the lead case decision without giving an opportunity to comment on whether it applies to the particular facts and circumstances of the follow-on cases.

We contact whichever party (firm or customer) would lose if we followed the lead-case decision in the particular follow-on case, and ask them to tell us how the circumstances of the particular case differ from the lead case (if at all).

In the light of what they say, we can decide whether the outcome of the particular follow-on case should follow the lead case – or whether there are circumstances that require separate investigation. So, each individual case still ends up being decided on the basis of its own circumstances.

consideration by an adjudicator

Otherwise, each case is allocated to one of the adjudicators in our casework division. The adjudicator considers it in the light of any relevant information, including the papers we have received from the complainant and the firm. If the case appears to be within our jurisdiction, but unsuitable for mediation, the adjudicator considers whether it is possible to express a view on the merits.

This may be possible on the basis of the information already available, or the adjudicator may first need to seek further information from one party or both parties. Broadly, the relevant information is likely to be of three types:

- information specific to the case
- information relating to splits and zeros in general
- information specific to the particular zero

information specific to the case

This includes:

- the date(s) on which the firm provided a service to the customer
- the nature of the service that the firm provided
- what ‘know your customer’ information the firm should have obtained for that kind of service
- what ‘know your customer’ information the firm actually obtained
- the customer’s own individual circumstances and attitude to risk
- any formal agreement between the firm and the customer
- any record of the information that the firm considered in relation to the particular zero
- any record of the firm’s reasons for any advice it gave or the action it took.

The service may have been:

- a one-off service, such as investment advice on one date
- a repeat service, such as investment advice followed by periodic reviews
- a continuing service, such as discretionary portfolio management over a period.

information relating to splits and zeros *in general*

We appreciate that intermediary firms may well have taken account of research data available from specialist sources, comments by regulatory bodies and trade bodies. We also appreciate that intermediary firms may well have taken account of positive information about splits and zeros in the specialist and general press.

But, over time, the specialist and general press included an accumulation of negative comment – such as that contained in the publications quoted in the annex to this note. This shows that – in addition to positive information – there was negative information in the public domain, at particular dates. This included comments about the risk levels potentially

associated with zeros – and about the risk factors that might need to be considered in assessing the suitability of a particular zero as an investment.

There are few things in life that do not have any detractors. So an isolated negative voice may be treated with caution. But there comes a point when the number of voices, and the content of what they are saying, builds up to a stage where they should not be ignored – and where they put firms on notice that an appropriate degree of caution is required.

The adjudicator will not normally rely on this published information in establishing the risk level associated with a particular zero.

But the adjudicator will normally rely on these publications in establishing the extent to which the firm should have been on notice of the existence of these risk factors on the date(s) it provided its service. This is relevant in establishing what information the firm should have considered at the relevant time about the particular zero.

information specific to the *particular zero*

In order to ensure consistency between different cases involving the same zero, the information specific to particular zeros is assessed centrally by specialist adjudicators.

The totality of this information includes (so far as they were accessible to intermediaries):

- the material available to intermediaries from the sponsor of the splits company
- details of the portfolio
- asset cover and hurdle rate
- borrowing (sometimes called gearing or financial gearing)
- holdings in other investment trust companies (in some circumstances called crossholdings).

The adjudicator dealing with a particular case draws on this centralised assessment, in order to reach a view on the apparent risk level of the particular zero and its suitability for the complainant – in the light of the types of information that the adjudicator considers the intermediary firm should have considered on the date(s) when the service was provided.

As explained below, this does not mean the adjudicator will expect the intermediary firm to have looked at all of these items of information in every case. It is important not to judge what the firm should have done on the basis of hindsight. Instead, the adjudicator will take into account when the service was provided before considering what the intermediary firm should have looked at.

what the firm should have looked at

A few firms that acted as intermediaries were also closely involved with the launch or management of particular splits companies, other splits-related investments or generic portfolios of splits. These firms may have had ready access to some information that was not subject to the constraints of client confidentiality and any ‘Chinese wall’ – but which was not readily available to intermediary firms in general. So consideration of how far these firms were in a position to assess risk factors relating to a particular zero or zeros in general calls for special treatment.

But, for the majority of intermediary firms, the adjudicator is likely to conclude that the firm’s service was provided in one of three periods (or, for a continuing or repeat service, over more than one of these periods):

- early period
- middle period
- late period.

As our approach continues to evolve in the light of the information received in individual cases, we regret that we are not in a position to publish start and end dates for these periods.

early period

During this period, the adjudicator is likely to conclude that it was not unreasonable for the intermediary firm to assume that any zero was low risk, unless (exceptionally) the contrary was apparent from the material available to intermediaries from the sponsor of the splits company at that time – for example, where it was obvious that the particular zero was issued by a splits company that invested solely in unlisted equities.

middle period

During this period, the adjudicator is likely to conclude that – because of the accumulated information that had been published about the risk levels potentially associated with zeros, and about the risk factors that a firm might need to take into account in assessing the suitability of a particular zero as an investment – the intermediary firm should have considered not only the material available to intermediaries from the sponsor of the splits company at that time but also (as a minimum) the asset cover and the hurdle rate.

So it will be particularly relevant for the adjudicator to consider whether, if the firm had considered these factors, it should have been apparent at the time that there was an insufficient safety margin in the asset cover and hurdle rate to be consistent with the appropriate risk level.

late period

During this period, the adjudicator is likely to conclude that – because of the accumulated further information published about the risk levels potentially associated with zeros, and about the risk factors that a firm might need to take into account in assessing the suitability of a particular zero as an investment – the intermediary firm should have considered not only the material available to intermediaries from the sponsor of the splits company at that time, the asset cover and the hurdle rate, but also (as a minimum) the extent of any borrowing and holdings in other investment trust companies.

So it will be particularly relevant for the adjudicator to consider whether, if the firm had considered these factors, it should have been apparent at the material time that there was an insufficient safety margin in the asset cover and hurdle rate or there was a too significant level of borrowing and/or holdings in other investment trust companies.

borrowings

As mentioned above, the adjudicator is likely to conclude that – in the late period – firms should have considered borrowings by the splits company. As firms will appreciate:

- Structural gearing is inherent in the nature of a splits company. But some splits companies also have borrowing (or financial gearing) in the hope of producing increased returns. Borrowing is not inherent in the nature of a splits company, but a splits company is not subject to the same limits on borrowing as apply (for example) to unit trusts.

- When times are good and returns are higher than interest rates, borrowing can enable a splits company to produce an increased return. But, so far as borrowing aims to increase a splits company's return more than required to meet the target value for its zeros, it is the other classes of shares (not the zeros) that benefit.
- Borrowing does not only increase 'good' effects. When returns are lower than interest rates it also increases 'bad' effects. A shortfall between investment return and interest on borrowing may force a splits company to make a forced sale of some of its underlying assets – unless it increases the amount of future interest by borrowing even more ('borrowing from Peter to pay Paul').
- Any borrowing is likely to include terms (imposed by the lender) about liquidity, requiring that borrowing should not exceed some specified percentage of the value of the splits company's assets. Any shortfall in investment return, or reduction in the value of underlying assets, may force a splits company to make a forced sale of some of the underlying assets in order to maintain the required liquidity.
- Insofar as borrowing affects investment return and/or requires a splits company to make a forced sale of assets, it is the other shares (rather than the zeros) that will suffer first. But, if the negative effects are sufficiently large, they will then eat into the asset cover and the value of the zeros.

holdings in other investment trust companies

As mentioned above, the adjudicator is likely to conclude that – in the late period – firms should have considered the implications of the splits company's holding shares in other investment trust companies (splits companies and ordinary investment trust companies).

In some circumstances this is referred to as crossholding, which leads some firms to argue that the issue arises only where splits company A has shares in splits company B and splits company B has shares in splits company A.

If (perhaps to avoid a breach of its banking covenants) one of the companies is forced to sell assets, this may trigger a downward spiral. The effect does not necessarily diminish with each step, because the market price of shares in an investment trust company is not linked directly to the value of the underlying assets, and is affected by supply and demand.

But the issue arises even without there being reciprocal holdings between two or more splits companies.

- The true value of the asset cover for the zeros in a splits company can be affected, not only by borrowings incurred by that splits company, but also by borrowings incurred by investment trust companies in which it invests. So the overall amount of any borrowing can be magnified.
- The true value of the assets depends on the underlying equities and stocks. But, if there are intervening layers of investment trust companies, this can make it difficult to consider whether the underlying equities and stocks are diversified and avoid risky sectors.
- If splits company C buys shares in investment trust company D, whose shares are trading at a premium to the value of the underlying assets, splits company C's asset cover is based partly on investment trust company D's share price rather than the value of its underlying assets.
- And if investment trust company D's underlying assets include shares in investment trust company E, whose shares are trading at a premium to the value of the underlying assets,

the value of investment trust company D's assets is based on investment trust company E's share price rather than the value of its underlying assets, with knock-on effect on splits company C.

market values

Sometimes firms say that the market did not value zeros with extensive bank borrowings and/or holdings in other investment trusts differently from other zeros – and that this demonstrates that bank borrowings and investments in other investment trusts do not affect the risk profile of the zero.

But market prices are not necessarily a good indicator of risk profile. They reflect not only the anticipated risk but also the anticipated reward. Market prices are largely set by and for market professionals – who are well able to assess the trade-off between risk and reward.

portfolio management cases

Where the adjudicator considers the firm should have recognised that the zero was not low risk – taking into account the issues that should have been considered during the relevant period – there is a further stage to be considered in those cases where the firm was involved in the ongoing management of a portfolio that included the zero and other investments.

In such cases, the adjudicator usually needs to go on to consider the parameters set by the portfolio management agreement, including the objectives and any definitions of risk. For example, a medium-risk portfolio might properly contain a balance of investments ranging from low to high risk.

Even if the zero is not low risk, it may not have adversely affected the overall balance of the portfolio – perhaps because the zero formed a very low proportion and/or was counter-balanced by the risk level of other investments in the portfolio.

As with other portfolio management complaints, the adjudicator first considers liability and then (if appropriate) how redress should be calculated.

adjudicator's view

In the light of all the information, the adjudicator issues a view letter. This represents the adjudicator's view of the conclusions an ombudsman would be likely to reach. The adjudicator then sends the view letter to the party that looks like losing at this stage, to give that party an opportunity of defending its position. The view letter is not usually copied to the other party at this stage.

In some cases, the party that looks like losing will be the complainant. In other cases it will be the intermediary firm. In less complex cases, a view that is adverse to the firm will go on to deal with redress. In more complex cases, it will just deal with the merits – leaving redress to be dealt with separately.

Ordinarily, where the adjudicator considers that the complaint should be upheld, any redress will seek to put the complainant in the position he/she should have been in. Often this will involve comparing the result of the unsuitable investment with some proxy for the result of an alternative, suitable investment.

There may be cases where – even if the zero was not correctly classified within the portfolio – the complainant is no worse off, nor better off. If so, the adjudicator will not need to

consider suitability – because we only award compensation for loss where there is both liability *and* loss.

In some cases, it may not be apparent to the adjudicator that there was no loss, and the adjudicator's view may deal with liability. If the firm considers that there was no loss for which compensation could be awarded, the firm should explain this in responding to the adjudicator's view.

responding to an adjudicator's view

What follows focuses on those cases where it is the intermediary firm that looks like losing. At this stage, the intermediary firm should consider the following issues:

- First, the firm should consider whether the adjudicator is in possession of all the relevant facts and documents about what happened. If the firm wishes to bring out additional relevant information or supply additional relevant documents, this is its opportunity to do so. Where appropriate, the firm will need to account for why something was not mentioned in its final response letter or supplied when the ombudsman service requested a copy of the firm's file.
- Second, the firm should note what information about the zero the firm should have considered – according to the adjudicator – at the material time. If the firm did not consider that information at the material time, and still considers it was right not to do so, it should explain why it believes the information was not relevant. And, where appropriate, the firm should explain what alternative information it did consider at the material time.
- The adjudicator's view can only reflect an assessment of the particular zero that is based on published information – including marketing material, and prospectuses as updated by subsequent reports and accounts – plus any additional research data amongst the information that the firm has already supplied. If the firm says its service was based on other research data, it should produce it – and account for why it was not produced when the ombudsman service asked for a copy of the firm's file.
- Third, the firm should note the adjudicator's reasons for considering that – on the basis of the information available to the intermediary firm at the material time – the firm should have known that the particular zero was in fact not low risk, or was otherwise unsuitable for the complainant (or the complainant's portfolio). This is the firm's opportunity to advance reasons why it believed that the zero was actually low risk and/or suitable.
- In portfolio management cases, the firm should also consider the effect on the balance of the overall portfolio of the adjudicator's conclusions about the apparent risk level of the zero. If the firm disagrees with the adjudicator's view that the overall balance of the portfolio was taken outside the agreed parameters, it should explain why it considers that to be the case.
- In some portfolio management cases, it may be material to consider whether the firm should have sold or advised the complainant to sell. No firm can be expected to predict the future. What the firm needs to show (with reasons) is that the view it took was a reasonable one at the time. If the splits company had breached its banking covenants, the firm should show why it expected the share price to improve.
- If the firm considered that sale was appropriate, but there were no buyers, it should demonstrate that with evidence from the material time. It should also show what other steps it took to keep the overall balance of the portfolio within the required parameters – or, if that was not possible, what it told the complainant at the time.

- Fourth, the firm should consider the details of any redress (such as compensation) that the adjudicator has recommended. Whatever the position on liability, if the firm disagrees with the suggested redress it should explain what alternative it considers appropriate, and why.

Unfortunately, a few firms become swayed by emotion and lose sight of the fact that the adjudicator is seeking to consider impartially a dispute that has arisen between the complainant and the firm. The adjudicator is not a party to the dispute, and should not be upbraided or subjected to cross-examination.

It is for the firm to defend its position with evidence and arguments – and to supply information and evidence to demonstrate why it considers that the adjudicator's view does not accurately reflect the position, based on the information available at the material time.

in the light of the firm's response

Following the firm's response, it may be necessary or appropriate for the adjudicator to seek further information or comment from the complainant. The adjudicator will then reconsider the case.

- The adjudicator may consider that relevant new issues have been raised, which require further investigation. If so, the adjudicator will pursue that investigation.
- The adjudicator may consider that, in the light of the additional information and comments supplied, the ombudsman would be likely to come to a conclusion different from that set out in the adjudicator's view. If so, the adjudicator will issue a revised view to the party that looks like losing – or an adjudication, which is a more formal document that (unlike a view) is sent to both parties at the same time.
- The adjudicator may consider that – after taking into account any further information and comments – the conclusions in his/her view (or, where appropriate, any subsequent view or adjudication) are still correct. If so, the adjudicator will copy the view letter to the other side and refer the case to an ombudsman. The ombudsman will consider all of the information and comments from the outset. In some cases there may be a hearing or an ombudsman's provisional decision. Most cases will proceed straight to an ombudsman's final decision.