

Cases involving 'splits' and 'zeros'

This guide provides updated information about the Financial Ombudsman Service's work on cases relating to split capital investment trusts

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- what split capital investment trusts are
- different types of 'splits' shares
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Please note:

- the issues involved in 'splits' cases are wide-ranging and complex
- this summary does not cover all the details
- nothing in this summary prejudices what we may decide in any individual case

If you need this information in a different format (for example – large print, Braille, audiotape etc) or in a different language, please let us know

What are 'splits' and 'zeros'?

'Splits' are a special type of investment trust company. 'Zeros' are a special type of 'splits' share.

What is an 'investment trust company'?

It is a company listed on the stock exchange. Its business is to invest in other companies. Buying shares in an investment trust company is a way of investing in a spread of other companies. There have been investment trust companies for more than 100 years.

What is special about a 'split capital' investment trust company?

A 'splits' company is an investment trust company that has different types of share, giving different rights to the shareholders. There have been 'splits' companies for more than 100 years; though 'zero' shares first appeared in 1987.

What different types of share are there?

That depends on the set-up of the particular 'splits' company. Most of the complaints we have received relate either to zero dividend preference shares ('zeros') or to income shares – though 'splits' companies usually have capital, or ordinary, shares as well.

What are 'zero dividend preference shares'?

'Zero dividend' means they produce no income. 'Preference' means they come before any other shares when the company's capital is shared out. They are intended to pay out a specified amount of capital at a specified date, provided the company has enough assets.

What are 'income shares'?

As their name indicates, they produce income. Some are entitled to a share of any capital that is left over when all the 'zeros' have been paid out. Others are not entitled to any of the capital.

But I didn't invest in a 'splits' company!

Some of the cases we are dealing with concern people who bought 'splits' shares directly. But some concern people who bought an investment that put its money wholly or mainly in 'splits', and whose value is affected by the value of the 'splits' it invested in.

How could I have invested indirectly in 'splits'?

Various investments could have been based wholly or mainly on 'splits' – for example, units in a unit trust, shares in an open-ended investment company (OEIC), shares in an 'ordinary' investment trust company, a personal equity plan (PEP) or an individual savings account (ISA).

What has happened to 'splits' and 'zeros'?

Some 'splits' companies are in financial difficulties. In the worst cases, share dealings have been suspended or liquidators appointed.

Are there problems with all 'splits' companies?

Because the stock market generally has fallen, many shares and investments have reduced in value. But not all 'splits' companies are in financial difficulties. The main problems relate to a limited number of them.

What has gone wrong with some 'splits' companies?

Their assets have fallen in value drastically, and by much more than the stock market generally. So there is not enough money to pay dividends on the income shares, there may not be enough assets to repay the capital on the 'zeros' and other capital shares are likely to get nothing.

Why did it happen?

They have all been affected by the fall in the stock market. But some have suffered from the effect of borrowing, cross-holdings in other 'splits' companies or both of these.

Why did they borrow?

A 'splits' company invests in other companies' shares. If it borrows, it can buy more shares. If those shares produce income (and/or growth in value) greater than the interest on the borrowing, the 'splits' company produces more for its income shareholders (and/or its 'zero' and other capital shareholders).

How can that cause a problem?

If those shares produce income that is less than the interest on the borrowing – or if the value of the shares falls, as many shares have done – the 'splits' company loses money for its shareholders. And the terms of the borrowing may require it to sell shares.

Why would the terms of the borrowing require it to sell shares?

The terms of the loan may say, for example, that the loan must not exceed half the value of the 'splits' company's assets. If the 'splits' company loses money, the value of its assets may reduce to a point where it has to repay some of the borrowing – by selling shares it has invested in.

Does that mean a 'splits' company shouldn't borrow?

It is all a question of what is prudent in the circumstances, taking a realistic view of the benefits and the level of risk the shareholders were led to expect. And, if a 'splits' company does borrow, not borrowing too much in relation to its assets and its ability to repay.

Why would any company take such a risk?

Many house buyers do something very similar. They take out a mortgage to buy a house more expensive than they could buy for cash, expecting the increase in value will outstrip the cost of the loan. But it can go wrong if house prices fall.

What about cross-holdings?

Some 'splits' companies invested in one another's shares. As with borrowing, this might increase the benefits if everything is going well – but it might increase the dangers if things go badly and 'splits' companies start to bring each other down.

What or who is to blame?

That depends on whom you listen to. Some financial firms blame an 'unprecedented' fall in the stock market. Many investors say that fall merely exposed problems that already existed.

What do some financial firms say?

They say: They sold the shares in good faith. No 'splits' company had failed in the past. No 'splits' company had failed to pay out its 'zeros' in full. Present problems arise from a stock-market fall greater, and longer, than could reasonably have been predicted.

But didn't the House of Commons Treasury Committee criticise 'splits'?

The Committee's conclusions included: Many of the 'splits' companies launched in the late 1990s were structured in such a way that, in adverse market conditions, the 'zeros' were not low risk. Even those who designed them did not fully understand how they would react in falling markets.

Where does the Financial Services Authority come in?

The financial regulator, the Financial Services Authority (FSA), does not have power to regulate 'splits' companies. But it does regulate the financial firms that advised people to buy 'splits' shares, as well as the financial firms that manage investments for 'splits' companies.

What did the FSA say?

It said that some 'splits' companies had problems, from borrowings and/or cross-holdings, which were there already – but became apparent when the stock market fell.

What is the FSA doing?

It has announced that it is investigating the 'splits' marketing material produced by some financial firms, to see if it explained the risks appropriately – and it is investigating whether there was any collusion among a 'magic circle' of some firms.

Where is the FSA up to with its investigations?

The FSA is acting in the role of 'policeman'. It has to follow stringent procedural rules, and it cannot tell the Financial Ombudsman Service precisely what it is doing and what it might or might not have discovered.

When will we know the results of the FSA's investigations?

It could all take a long time. We are currently proceeding on the basis that we will need to decide most 'splits' cases before the FSA's investigations are completed – though some 'splits' cases may turn on general issues, where fairness may require us to await interim developments.

What if the FSA's investigation turns up evidence?

We might reopen a case where there is fresh evidence about the firm complained against. But, for example, proof of secret wrongdoing by a 'splits' manager would not justify reopening a case against an independent financial adviser who could not have been expected to know about it.

Can the FSA make a financial firm pay compensation?

The FSA does not deal with individual cases. That is the Financial Ombudsman Service's role. But, if the FSA's investigation proves general wrongdoing by a particular financial firm, the FSA may be able to make the firm sort out the problems it caused.

What cases can the ombudsman consider?

Unlike the courts, there are limits on the financial firms we cover and on who can bring cases to us.

What is the Financial Ombudsman Service?

We were established by law, as an alternative to the civil courts, to resolve individual financial services complaints. We do not control the extent of our jurisdiction – including the firms and customers we cover. We have no power to make rules for financial firms. That is for Parliament and the FSA.

What financial firms does the ombudsman cover?

Broadly, the Financial Ombudsman Service has jurisdiction to deal with complaints against financial firms that are now regulated by the FSA – including financial firms that advised people to buy ‘splits’ shares.

Who can bring a ‘splits’ complaint against a particular firm to the ombudsman?

We can consider complaints where the complainant was a customer of the particular firm complained against. The complainant might be a customer as a result of the firm advising on the purchase of ‘splits’ shares, arranging the purchase or selling them the ‘splits’ shares.

Who else can bring a ‘splits’ complaint to the ombudsman?

We can also consider complaints where the complainant held units in a unit trust, or shares in an open-ended investment company (OEIC), that was managed by the particular financial firm complained against.

Can the ombudsman consider a complaint against a ‘splits’ company?

As previously explained, the ‘splits’ companies themselves are not regulated by the FSA. So the Financial Ombudsman Service has no jurisdiction to deal with complaints against these companies.

Can the ombudsman consider complaints against a ‘splits’ manager?

We have no power to consider complaints about what a financial firm did in its capacity as manager of the investments in a ‘splits’ company – because the ‘splits’ manager’s customer was the ‘splits’ company, not its shareholders.

Who can deal with a claim against a ‘splits’ company or ‘splits’ manager?

Only the courts have power to deal with claims against the ‘splits’ company, or claims about what a financial firm did as manager of the investments in a ‘splits’ company. The ombudsman has no power to give legal advice about the prospects of such claims.

Can the ombudsman consider complaints about a ‘splits’ company’s prospectus?

The prospectus was issued, under stock exchange rules, when the ‘splits’ shares were launched. We do not have power to consider complaints about it.

Can the ombudsman consider complaints about ‘splits’ marketing material?

It depends on the relationship between the complainant and the firm that issued the marketing material. We can only deal with such complaints if the complainant was, or became, the firm’s customer – or if the customer bought units in a unit trust, or shares in an open-ended investment company (OEIC), managed by the firm.

When can the ombudsman award compensation?

Where the complainant and the financial firm are covered by our jurisdiction, we can award compensation of up to £100,000 – if the financial firm was to blame.

When will the ombudsman hold the financial firm liable?

Broadly, the ombudsman will hold the financial firm liable if it advised a customer to buy 'splits' shares when they were 'unsuitable' for the customer – or if the financial firm misled a customer into buying 'splits' shares through it or from it.

What about holdings in unit trusts or open-ended investment companies (OEICs)?

Broadly, the ombudsman will hold the financial firm that managed the unit trust or OEIC liable if it bought 'splits' shares for the unit trust or OEIC inappropriately – or if the financial firm misled a customer into buying a holding in the unit trust or OEIC.

Why might 'splits' shares have been 'unsuitable' for a customer?

In considering suitability, we have to consider the investor's circumstances, the purpose of the investment and the appropriate balance between the return the investor needed and the risk the investor could afford to take.

Didn't the Treasury Committee say that some 'splits' shares were too risky?

The Committee took evidence from only three financial firms – one of the institutions that launched a large number of 'splits' companies, and two brokers. It dealt with general issues and did not make specific judgements about individual 'splits' companies.

Doesn't the drastic fall in value prove that 'splits' shares were too risky?

Any investment can go down as well as up. Many types of investment went down as the stock market fell. We must avoid judging with the benefit of hindsight. What matters is what the financial firm complained against knew, or should have known, about the risk of the particular 'splits' company at the time.

Why are 'splits' cases particularly complex?

'Splits' companies are structured in a complicated way. And we have received cases concerning many different ones, involving a multiplicity of financial firms.

How many 'splits' companies is the ombudsman looking at?

We have cases concerning 'splits' companies launched by 29 different financial institutions. Most of these organisations sponsored a number of individual 'splits' companies – 11 of them in one case. We have to look at each of the many 'splits' companies separately.

Aren't all 'splits' companies roughly the same?

Only some 'splits' companies are in financial difficulties. The share structure varies from one to another. Whether there are borrowings and/or cross-holdings (and the extent of these) varies from one to another – and also over time. So we have to look at each 'split', and each period, individually.

How many 'splits' cases has the ombudsman received?

We have received more than 3,600 such cases so far. These involve a large number of different 'splits' companies, relating to different periods. They also involve claims against almost 500 different financial firms.

Why are so many financial firms involved?

Some complainants bought 'splits' shares, as single holdings or part of a portfolio. Some acquired an indirect interest in 'splits' through a unit trust, an open-ended investment company (OEIC), an 'ordinary' investment trust company, a personal equity plan (PEP) or an individual savings account (ISA).

What roles did the firms play?

Some advised. Some arranged. Some managed – a portfolio, a unit trust, an OEIC, a PEP or an ISA. One transaction could involve, for example, firm A advising the purchase of an ISA managed by firm B and invested in a unit trust managed by firm C that invested in 'splits' managed by firms D, E and F.

What rules did the firms have to follow?

FSA regulation of investment firms only started on 1 December 2001. Before that, different types of firm were regulated (under differing rulebooks) by IMRO (the Investment Management Regulatory Organisation), PIA (the Personal Investment Authority) and SFA (the Securities and Futures Authority).

Does that affect the Financial Ombudsman Service's powers?

We are required to take into account parts of the differing rulebooks of the previous complaints schemes: the Office of the Investment Ombudsman (for IMRO firms); the PIA Ombudsman Bureau (for PIA firms); and the SFA Complaints Bureau and Consumer Arbitration Scheme (for SFA firms).

Has the ombudsman got enough people for this complex work?

We have more than 600 staff dealing with all types of financial services cases. So we have the people we need to handle large numbers of cases about a particular topic. But there is a limited supply of people who have the specialist technical knowledge needed for some aspects of 'splits' cases and who are independent.

How does the ombudsman deal with ‘splits’ cases?

Because of the number of cases involving ‘splits’, and the complexity of some of the issues involved, we need to adapt our normal procedures to the circumstances.

How does the Financial Ombudsman Service usually proceed?

Usually, one of our adjudicators investigates all relevant aspects of a case and then issues an initial decision. If either side disagrees with the initial decision, an ombudsman reviews the case and issues a final decision – which is the end of our process.

What if the Financial Ombudsman Service receives lots of similar cases?

If we receive lots of cases about the same financial product, we may choose one or more apparently typical cases as ‘lead cases’ – as we have done with ‘splits’ cases. Focusing initially on these ‘lead cases’ can help to save duplicated effort for all concerned.

How are the current lead cases going?

Some financial firms are disputing liability very strongly, and supporting their stance with extensive evidence. For example, the pile of papers in one case is more than 8 inches high – plus extensive background material and computer spreadsheets.

What about other evidence?

Financial firms have easier access to relevant information than complainants do. To ensure we are fair to both sides, it is essential that we have ample time for investigation. And some types of ‘splits’ cases may turn on general issues, where fairness might require us to await information that will only become available as the FSA’s investigations progress.

How long will the lead cases take?

Realistically, it is likely to be months yet before we can say when some lead cases will reach a final conclusion. And after that, in view of the amounts at stake, we cannot discount the possibility that a losing party will judicially review our final decision in the High Court – causing further delay.

What happens when the ‘lead cases’ have been decided?

Once the ‘lead cases’ have been decided, we can deal with all the linked ‘follow-on’ cases – the cases where we believe the circumstances are similar. We copy, or summarise, the lead-case decision to the parties in the ‘follow-on’ cases – and ask them how (if at all) their circumstances materially differ.

What happens then?

In the light of what the parties 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 a different outcome.

Do all the ‘splits’ cases have to wait?

We are continuing to identify cases that turn *wholly* on issues specific to that particular case, and so do not need to await the decision of a lead case. When we identify such cases, we will contact the parties with a view to progressing the cases to decision.

What about the remaining cases?

Cases that turn *partly* on issues specific to the particular ‘split’ will have to await the relevant lead case. In the meantime, we might be able to start deciding any case-specific issues in the individual cases. Such a two-stage approach could save time later once the lead case is decided.

What about 'splits' holders who are suffering hardship?

The AITC Foundation has been set up to provide financial help to people who are in severe financial hardship as a result of losing money in 'splits'.

Who set up this hardship fund?

The Association of Investment Trust Companies (AITC), which is an investment industry body, set up the AITC Foundation. Neither the Financial Ombudsman Service nor the FSA has any involvement in how it operates.

Who can apply to the AITC Foundation?

Applications can be made by people who are suffering severe financial hardship because they (or a deceased person on whom they were dependent) lost money in 'zeros' or income shares in a 'splits' company or certain other investment companies.

What does 'severe financial hardship' mean?

Applicants' savings and net investments must not exceed £16,000 (excluding the value of their main home). The Foundation will consider whether applicants have immediate and severe financial needs that they cannot meet because of the loss.

In what sorts of circumstances might the Foundation help?

These could include help with: pressing needs as a result of illness or unemployment; the threat of losing a home through mortgage or rent arrears; nursing home fees or mobility aids; school fees at critical stages of education, for example coming up to GCSE or 'A' levels.

How much can be applied for?

The Foundation will decide how much help it is prepared to give, depending on the individual circumstances. But the maximum amount that can be awarded is £10,000.

Where can I get more information and an application form?

The AITC Foundation is at Durrant House, 8-13 Chiswell Street, London, EC1Y 4YY. Its website is at www.aitc.co.uk/aitcfoundation, and its e-mail address is foundation@aitc.co.uk. Its phone number is 020 7282 5571.