

Financial Services Authority

# Split Capital Investment Trusts (Splits)

Update report on FSA's enquiry  
into the Split Capital Investment  
Trust Market

May 2002



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**It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.**

# 1 Introduction

- 1.1 In December 2001, we published Discussion Paper 10 (DP10) on Split Capital Investment Trusts (Splits). Then, in February 2002 we announced that we were making enquiries into various aspects of the Splits market, including visits to a number of fund managers, brokers, banks and Independent Financial Advisers. In this paper we provide feedback on the responses to DP10, a status report on the analytical and investigative work we have undertaken to date and an indication of the work we plan for the future. We appreciate that investors in Splits will be concerned about their investment and whether there is any action they should consider taking. On 9 April we posted a consumer information bulletin on our website ([www.fsa.gov.uk](http://www.fsa.gov.uk)) and we have recently updated this bulletin, particularly in respect of actions investors should take if they believe they have a case for compensation. This bulletin is attached as Annex B.

# 2 Background

## **The Investment Trust Sector**

- 2.1 Since it was first launched in the 19<sup>th</sup> century, the Investment Trust Sector has provided an efficient means for retail investors to build a diversified equity portfolio. The sector has grown from a market capitalisation of £5.78 billion in 1980 to £49.5 billion at the end of March 2002. Like other listed companies, Investment Trusts issue shares that are publicly traded on the London Stock Exchange (LSE). At 31 March 2002 there were 395 listed Investment Trusts on the LSE. Investment Trusts generally trade at a discount to their underlying asset value and the markets in them are not always liquid.
- 2.2 Investment Trusts that issue various classes of shares carrying different rights, risks and rewards, are known as Splits. Shares in Splits were first launched over 100 years ago, but there has been an acceleration in the number of new issues during the past 3 years. Currently, there are 134 Splits in issue, having a combined market capitalisation of £13.2 billion at 31 March 2002. Between 1990 and 1999, 55 Splits were launched on the LSE and between 1999 and 2001, 34 were launched.
- 2.3 The three main types of share issued by Splits are: Zero Dividend Preference Shares (Zeros), Income Shares and Capital Shares. Zeros do not pay dividends but have a predetermined value that is paid to shareholders on a set date in the future as long as the Split has enough net assets. Zeros are a relatively new feature of Splits, having been introduced in 1987. Income shares pay dividends, but the repayment of capital ranks after zeros have been paid out. Capital shares do not pay dividends and do not have a predetermined value, but take any assets remaining at maturity, after zeros and income shares have been paid out.
- 2.4 The different classes of Splits have been marketed to investors on the basis of how the managers and advisers have assessed their particular risk and reward characteristics. Zeros have been looked at alongside other investments that offer a predetermined value at a future date and have been marketed as a

means of saving for known outgoings, such as school fees. Income shares have been compared to other income generating products, such as deposit accounts and bonds, and have been marketed as a means of generating a regular source of income. Capital shares have been marketed to investors with an appetite for higher levels of risk.

- 2.5 The recent problems in the Splits sector have been widely covered in the media. We discuss these problems below. It is, however, important to recognise that the investment trust sector as a whole does not pose particular risks or problems at the present time. It is still an efficient investment vehicle for retail investors who wish to gain equity market exposure and who understand and accept the associated risks. Values of many Splits have fallen during the past two years due to the decline in underlying stock markets, rather than any unusual or inappropriate investing or financing arrangements.

### Recent problems in the Splits sector

- 2.6 As the table below illustrates, a number of Splits have invested a portion of their portfolio in the shares of other Splits. Some have also borrowed funds from banks to leverage (or, to put it another way, to gear) the fund so that investors' exposure is magnified in both falling and rising markets.

	31 March 2002	
	Number	Market capitalisation (£ million)
Splits in issue	<u>134</u>	<u>13,200</u>
Splits with no cross holdings	51	6,300
Splits with cross holdings	83	6,900
% of portfolio held in other Splits	32	3,200
under 20%	24	2,100
21-40%	16	1,000
41-70%	11	600
over 70%		
	<u>83</u>	<u>6,900</u>

- 2.7 16 Splits have cross holdings in other Splits of between 41% and 70% of their portfolio. Of these, 15 have total borrowings of 54% of their gross assets. 11 Splits have cross holdings in other Splits of over 70% of their portfolio. Of these, 10 have total borrowings of 74% of gross assets. So, many of these Splits have both high gearing and high cross holdings, which in some cases are holdings in Splits which have these same characteristics. This exposes

investors to exponential risk as the gearing effect is multiplied. The impact of this is that interest charges, which are based on borrowings, and management charges, which are based on the level of gross assets, are substantially greater than would otherwise be the case, the effect of falling stock markets is magnified and the ability to unwind positions is hampered by poor liquidity.

These factors combine to reduce significantly the size of the fund, causing a dramatic fall in the price of some Splits over the last 3 years, as illustrated below:

### Market changes during period 31 March 1999 to 31 March 2002

FTSE 100	- 16.2%
FTSE All-Share	- 11.7%
Examples of share price movements of Splits	
- No cross holdings	-39.1%
- Cross holdings of :	
under 20%	-82.21%
21-40%	-88.23%
41-70%	-97.85%
over 70%	-97.97%

- 2.8 During 2001, a number of Splits announced that they had breached their banking covenants. Since the beginning of 2002, a number of Splits have made announcements to the LSE about their financial position. At the time of writing these announcements have fallen into the following categories:

Announcement	Number of Splits
Dividend suspensions	11
Dividend cuts	7
Restructurings and placings	5
Debt repayment	12
Conversion of bank debt and new money injected by manager	1
Insolvency	1

- 2.9 When a new Split is launched, it is required to publish a prospectus in line with the UK Listing Authority's Rules. The disclosures in the prospectus should include details of the investment policy of the Split, which would be expected to include whether it could invest in the shares of other Splits (and if so to what extent) and also whether it could raise borrowings from banks. If the investor is buying directly through the LSE, this information is central to their evaluation of investment risk. It is also essential for firms who market, distribute or advise on the purchase of Splits, as they are required to identify and communicate clearly the material risks the investor will face. Failure to do so is a breach of FSA Conduct of Business rules.

- 2.10 It is the manager's responsibility to operate the fund in line with the investment mandate set by the Split's Board of Directors, which must itself be consistent with the policies in the prospectus. Failure by managers to operate the fund within this mandate would be a breach of the FSA Principles for Businesses and, potentially, would be actionable by the Board of the Split.
- 2.11 If a material change in investment or borrowing strategy is proposed by the manager and accepted by the Splits' Board, the Board is required under the Listing rules to get the approval of shareholders, before implementing any such change. Failure to do so would be a breach of the Listing rules. If they get such shareholder approval, marketing information and advice given to clients will need to reflect any changes in the risk profile of the trust. Failure to do so would be a breach of FSA Conduct of Business rules.
- 2.12 The factors above are relevant to firms that may be subject to enforcement action by the FSA, if breaches of rules are identified. Furthermore, firms may be liable to pay compensation to investors if they have not been treated fairly.

# 3 FSA enquiries

3.1 Since February 2002, we have visited 20 authorised firms to collect, analyse and evaluate data and information on their activities in the Splits market and we have a further 14 visits planned. On completion of our visits we will have covered the following types of firm:

Type of Firm	Number Visited
Fund Managers	4
Stockbrokers	7
Sponsors	1
Independent Financial Advisers (IFAs)	20
Banks	2

3.2 In addition to firm visits, we have also performed desk- based analyses, including:

- reviewing the prospectuses of a sample of Splits;
- analysing the gearing and cross holdings of all Splits;
- reviewing the websites of the Splits most at risk (40 in total, having the highest levels of cross holdings and borrowings);
- reviewing the websites of other Split information providers;
- obtaining and reviewing the Split activity of 60 IFAs;
- collecting and analysing market transactions for 4 firms, covering 20 Splits;
- collecting and analysing market data on stock swaps for 18 firms, covering 80 Splits;
- monitoring Stock Exchange announcements via UK-Wire Alerts for the Splits most at risk;

- requesting and reading minutes of the boards of several Splits;
  - analysing directorships among the 40 Splits most at risk, to identify individuals holding multiple board positions;
  - meeting Association of Investment Trust Companies (AITC) and several other trade associations; and
  - meeting the Treasury Select Committee, Lord Newby, HM Treasury, DTI, FSA Consumer Panel and The Financial Ombudsman Service.
- 3.3 The above number of firms visited are from a total population of 34 fund managers who manage Splits and funds invested in Splits (our visits focussed on the larger managers in this sector), and from a large population (over 4,000) of IFAs and stockbrokers.
- 3.4 The following is a summary of the main findings from our work to date, together with our comments:

## **Marketing material and advice**

### **Findings**

- 3.5 Splits, including those with cross-holdings and substantial borrowings, have habitually been described as “low risk” in product providers’ marketing materials, with zeros sometimes compared to building society accounts, National Savings and gilts. Splits have also been described as “safe as houses”, or having “more safety features than a Volvo” and it has also been said that they “tend to come into their own when stockmarkets are flat or falling”. Such statements were made both in documents that promoted direct investments in Splits and in documentation that promoted investment via packaged products such as ISAs and Investment Trust Savings Schemes.
- 3.6 In some cases the “low risk” statements or indicators were in documents given to financial advisers by the product providers. These included those advisers based within professional firms of solicitors and accountants, some of whom have relied on these documents when giving advice to their clients, without undertaking any independent analysis of the product.

### **Comment**

- 3.7 Our inquiries reveal that in many cases marketing material given to investors and advisers has not adequately disclosed or explained the risks of investing in certain Splits. These inquiries also raise a concern that advisers have not always given their clients a detailed explanation of the risks. This suggests that some consumers who have made investments in Splits on the basis of disclosures by product providers have inadvertently acquired an unsuitable

product due to inadequate risk disclosures. Other consumers may have acquired unsuitable investments based on advice.

## **Management of Splits**

### **Findings**

- 3.8 ‘Stock swaps’ have been commonplace among certain Splits that have cross holdings in their portfolio. These are transactions where a management firm have exchanged shares from one Split portfolio for shares in another Split, which may or may not be managed by the same firm. In some instances, these have been done to support an in-house or external share issue or a restructuring of the Split.

### **Comment**

- 3.9 Managers must make investment decisions that are consistent with the investment mandate and the investment policy stated in the prospectus. Investment decisions must be made for the benefit of shareholders in the investing Split, not for the benefit of either the investee Split or the management firm. Where such investments are funded by the sale of more liquid assets or by “stock swaps”, the benefits of the investment decision to each class of current shareholder become more difficult to establish.

## **Governance of Splits**

### **Findings**

- 3.10 We have identified instances of individuals holding directorships in a number of Splits:
- Sixteen people are on the board of more than one Split.
  - One individual is on the board of 15 different Splits, managed by a number of different firms.
  - One person sits on the board of ten Splits managed by a number of different firms.
  - One individual sits on ten Split boards that share the same investment management firm.
  - One individual is on eight Split boards that share the same investment management firm.

## **Comment**

- 3.11 As public companies, Splits have boards of directors who are responsible for the actions of the company. There are rules covering the boards in the Listing rules, and other requirements in the Companies Act. Like all Investment Trusts, a Split is required to have a majority of independent directors who are not also directors of, or employees of, or professional advisers to, the investment managers or any other company in the same group as the investment managers. These ‘independent’ directors are intended to ensure that the board as a whole acts, and continues to act, independently of the investment manager.
- 3.12 Those who hold a number of directorships and those who may be connected to the management company of at least some of the Splits concerned, do not usually form part of the independent majority. They are usually appointed because they are investment professionals and will be influential on the boards. Where stock is being swapped between Splits, and individuals sit on the board of two or more of the Splits involved, it must be difficult for those concerned to manage conflicts of interest. We are aware of situations where stock swaps have been made between Splits, where there are some common directors.

# 4 The powers of the FSA

- 4.1 Our powers in relation to Investment Trusts, including Splits, are not the same as for other types of investment funds. Although Splits are investment companies, they are not regulated as Collective Investment Schemes (as are for example authorised unit trust schemes). They are public companies whose shares are listed and traded on exchanges. The directors of a Split may carry out the investment management of the company without needing our permission or authorisation. Alternatively, and more usually, the directors may appoint a separate investment management company to manage the trust's funds. Such a company would need our authorisation and would have to comply with applicable standards, which include operating within the context of the particular investment mandate set by the directors of the Investment Trust.
- 4.2 Financial advisers who recommend and promote the sale of Investment Trust shares are required to be authorised by us. In their dealings with customers they must comply with rules which are designed to ensure that investors receive information which is clear and not misleading and they must only recommend investments that are suitable for the customer's circumstances.
- 4.3 Any financial promotions for Splits would also need to be in line with the financial promotions rules, in particular the requirement to be clear, fair and not misleading.
- 4.4 All regulated firms, including financial advisers and product providers, are also required to comply with the FSA's Principles for Businesses, which are a general statement of the fundamental obligations of firms under the regulatory system. In taking our work on Splits forward, we will need to have particular regard to the following principles:
- Principle 1: integrity
  - Principle 2: skill, care and diligence
  - Principle 5: market conduct

- Principle 6: customers' interests
- Principle 7: communications with clients
- Principle 9: customers: relationships of trust

4.5 These Principles mean that we have a range of different responsibilities and powers. Investment Trust companies are subject to the rules which govern the admission of shares to listing. The company and its directors have responsibility for the adequacy and accuracy of the prospectus. Then, separately, investment managers and financial advisers promoting investment trust shares are required to comply with applicable Conduct of Business rules. So, in respect of the current problems for some investors in the Splits market (caused by misleading descriptions of the risks in the marketing or advising process, and/or collusive behaviour among some managers giving rise to high cross holdings), we have adequate powers under Financial Services and Markets Act (FSMA). In relation to activities before N2 (30 November 2001), pre-existing powers allow us to proceed with enforcement action and to require firms to compensate investors, when such action is justified.

# 5 Next steps

5.1 We now plan to take the following steps:

## **Dealing with past problems**

- investigate the activities of those producing and distributing marketing material, where we are starting enforcement proceedings;
- investigate specific cases relating to alleged collusive behaviour within or between managers of Splits, which may result in enforcement proceedings; and
- investigate possible mis-selling by advisors which may also result in enforcement proceedings;

## **Reviewing the regime**

- liaise with the Financial Ombudsman Service to determine whether there are wider implications for treating customers fairly, arising from the complaints they have received;
- write to Derek Higgs, who is leading an independent review on the role and effectiveness on non executive directors, on our findings concerning the Directors of Splits;
- consider whether the investigations referred to above suggest that changes are required to the FSA Handbook; and
- consider in our fundamental review of the Listing rules if any tightening is required in the definition of “independent”, for the purposes of establishing a majority of independent directors of Investment Trust Companies;

## **Reviewing disclosure**

- liaise with the AITC to monitor the effectiveness of its proposal for all Splits to disclose their portfolios and borrowings to the AITC, frequently and regularly. Consider amendments to Listing rules, if the industry does not adopt this initiative; and
- continue to update our consumer website with information that will be helpful to investors in the Split sector.

# 6 Feedback on responses to Discussion Paper 10 (DP10)

## Summary

- 6.1 DP10 asked for views on whether changes could be made to improve standards in the Splits market, either by the industry or to our regime. We received 37 responses to the questions we asked in DP10. We have included a list of the respondents who were willing to be identified in Annex A. We received comments of a more general kind from other parties, but these are not included in the feedback below.
- 6.2 The overall response to DP10 was one of broad support for the AITC's proposals on disclosure. There is a general consensus that the entire portfolio should be disclosed regularly, along with a detailed explanation of the underlying risk of the portfolio. There are differing views on the frequency of disclosure. However, the majority of respondents stated that it should be between once a month and every quarter. It was also stated that we should consider full disclosure of hurdle rates, level of gearing and fees. The majority of respondents were of the opinion that the Listing rules should not be amended and that the appropriate level of disclosure should be left to market forces, with guidance from the AITC, with the AITC acting as the central reference point for information.
- 6.3 Respondents did not favour regulation of governance arrangements or a code of conduct for directors of Splits. Before any changes to governance are considered, it was argued that we should look at any proposals that were forthcoming from the Modern Company Law review being undertaken by the DTI. Some respondents showed concern over the independence of directors but commented that the mechanisms to challenge any conflicts of interest were already in place.
- 6.4 There was a general consensus that there was no requirement for further guidance to be given to those giving advice on Splits and that greater disclosure on the holdings and the underlying risk would be enough. Some

suggested, however, that we needed to extend our work on promoting consumer understanding.

## Detailed feedback

6.5 This section sets out our feedback and commentary on the responses to DP10.

Q1: The AITC proposal (on disclosure) could be a step forward towards enabling market forces to improve confidence in the sector, in preference to or ahead of direct regulatory action. We would welcome your views on the role greater disclosure should play in the Splits sector. In particular, would it be appropriate to amend the Listing rules?

**Summary of responses:** Thirty-five out of thirty-seven respondents were in favour of greater disclosure of information by Splits. Monthly disclosure received backing from five respondents as did quarterly disclosure, with a further six respondents wanting the level to be decided by market forces. Eleven out of the sixteen in this group of respondents were investment companies. Nineteen respondents expressed no view on the frequency of disclosure. The desired level and scope of disclosure varied a great deal and so the main areas of concern have been broken down and analysed below.

### Disclosure of Investment Portfolio

6.6 Although there is a difference of opinion on how often, to what extent and where a Split should disclose its portfolio, the general consensus is that full disclosure would be the most appropriate way forward. The AITC proposal of disclosing holdings over 0.5 per cent of assets seems to some respondents to be a rather arbitrary figure. A Split with one holding above the 0.5 per cent threshold would have to publish its holding whilst another with a large number of holdings slightly below this threshold would not have to disclose the holdings. Although recent press coverage has highlighted the limited nature of the problems being suffered by the sector, it was felt that greater disclosure should apply to all types of Investment Trusts.

6.7 The preferred disclosure period ranged widely, from daily reporting to once a year in the annual report and accounts and/or prospectus. It is clear that almost everyone is in favour of publishing full details of the Splits investments in the annual report, with the favoured frequency of additional disclosure being between once a month and once a quarter. The argument against more frequent disclosure centred on the consequences of making more information available in the public domain. If the breakdown of the whole portfolio were to be published more frequently it would allow, in certain circumstances, market makers to move prices against the fund to the detriment of shareholders.

- 6.8 Respondents were almost unanimous on where the information should be published. Individual Splits should publish data on their own funds on individual web sites with the AITC being the favoured site to list the details of all Splits. Indeed, the AITC have proposed this solution and are willing to publish data for members and non-members alike. A very small minority believed that we should list the information on our web-site, possibly amongst the comparative tables.

### **Disclosure of investment risks**

- 6.9 In addition to the actual composition of the portfolio, a small number of respondents felt that the distribution of risk across the portfolio should also be disclosed. Funds should highlight any specific or systemic risks within the portfolio, particularly those that could not be controlled by the sale of securities (such as illiquid stocks and bank lending). Funds should also provide quantitative risk measurements for each asset class, especially sensitivity to change in market prices, the volatility of the underlying portfolio and gross revenue earned per asset class.

### **Listing Rules**

**Summary of responses:** Eighteen respondents, including all four trade bodies and ten investment companies, were against the idea of amending the Listing rules. Fifteen respondents, including all the investment trusts and seven investment companies, were in favour of amending the Listing rules, whilst the remainder made no comment.

- 6.10 The majority of respondents did not think that changing the Listing rules was necessary to make the sector more transparent and so more attractive to potential investors. They believe that any amendments would not allow flexibility to alter the frequency and content of Splits disclosure and believe that market forces, together with AITC recommendations and other regulations, should dictate the appropriate level. Despite the controversy and high profile nature of the problems suffered by the sector, the overall feeling was that it would be wrong to differentiate Splits from other public companies by changing the Listing rules that apply to them.
- 6.11 A few respondents believed that the present framework, which is largely voluntary, is not sufficient to ensure full compliance and that amendments to the Listing rules for disclosure would be necessary. However, if a consistent period and level of disclosure was agreed throughout the industry, it seems that this group would not be averse to leaving the Listing rules unchanged. That is, provided that all the sector participants strictly adhered to the new proposals.

## Other issues

- 6.12 There were a number of other issues raised by a few respondents. Again, these were mostly to do with the disclosure of specific information. The allegations of collusion amongst Splits managers, with cross-holdings in each other's Splits, was one of the major concerns. The possibility of systemic collapse caused by these cross-holdings was highlighted by a number of respondents. The fact that it would be difficult to prove the existence of collusion or malpractice was also mentioned. Despite these concerns, respondents did not want to encourage any limitations on the level of cross-holdings. They simply requested more disclosure of cross-holdings and other highly-g geared investments so that it is clear that these funds are higher risk than Splits that have either no cross-holdings or holdings in other Splits that are not reciprocated.
- 6.13 Gearing, hurdle rates and fees were also mentioned briefly. It was noted that, although there was some concern over the high gearing of some Splits, high gearing in itself was not necessarily a bad thing. In fact, in a bull market, high gearing could provide more benefit to shareholders than funds with a lower level of gearing. The calculation of hurdle rates was another concern, with calls for an industry standard for the calculation of these rates to be put in place to allow like-for-like comparison between different Splits. Clearer explanations of hurdle rates and the risks, particularly how the underlying portfolio must perform to provide investors with the returns they are expecting, were requested. Lastly, there was a brief mention of the desire for a clear breakdown of the fee structure and how it applies to different classes of shareholders.

**Our response:** we generally encourage greater disclosure as it promotes transparency within the financial markets. Full portfolio disclosure would aid transparency and help to highlight the level and type of risk being taken by investors. The current Listing rules require a level of disclosure far lower than a firm's full portfolio. We are currently undertaking a major review of the Listing rules (to take into account, amongst other matters, the proposed Prospectus Directive from Europe). The issues particular to Splits, and the effects of voluntary disclosure, will be considered within this review and, in the light of industry responses to the AITC's encouragement of voluntary disclosure – a proposal to which we have given our support.

Q2: We would welcome your views on governance of Splits, and in particular the FSA's role, if any, in such governance issues.

- 6.14 Director independence and competence, regulation and the introduction of a code of conduct were the main issues that emerged from replies.

## Director Independence and Competence

**Summary of responses:** fourteen respondents had no concerns about director independence; ten of these were investment companies. Eight respondents, including three individuals and five investment companies, did have concerns. The remaining fifteen responses, including all IFAs and three of the trade bodies, made no comment on director independence or competence.

- 6.15 There were mixed views on the independence of investment trust directors. Most respondents were satisfied that directors of investment trusts were independent of the fund managers. There were also a large number of comments pointing out that if a director was not acting independently on behalf of shareholders, he should not be a director. They add that if there are any problems with a director, there are already procedures in place for dealing with them. Institutional shareholders are now increasingly willing to make appropriate representations to have grievances heard and acted upon; however, private customers generally do not have the same standing.
- 6.16 The remainder of respondents were concerned that there is not enough distance between the board and the managers. This stemmed from the view that, when a management company decides to create a new trust, it has a view on the non-executive directors it would like to see elected. These directors are contacted by the management and invited to serve on the board. If they accept, then their name appears in the prospectus and the shareholders simply ratify the manager's selection. Although these directors are independent, they have, in effect, been chosen by the managers rather than been elected by the shareholders.
- 6.17 This concern is exacerbated when a director sits on the board of several trusts within the same management company or group. With several directors' fees being paid from the same management team, there is a concern that the director may inadvertently be acting in the interest of the group, rather than in the interest of shareholders. The complexity of Splits can give rise to conflicts of interest in the decision making process, particularly with regard to different classes of shareholders. So it may be prudent for boards to put decisions in the public domain, rather than require the public to assume that the Directors have acted independently behind closed doors. The point was made that, whilst directors should be allowed to sit on boards of different Splits managed by different firms, if they disclose this fact, they should not be allowed to sit on several boards of Splits within the same group.
- 6.18 There were more general concerns about the level of technical competence required by directors on the board of a Split. There was general agreement that for a board to act effectively it needs to ensure that all the risks being run by the Split are recognised, acknowledged, understood and managed. With each Split facing a unique and complex set of risks it was felt that some

directors, although well meaning, may lack expertise to evaluate properly the effects on shareholders of the course of action that managers and advisors recommend to them. It was felt that further guidance might be the way to this problem.

### More Regulation?

**Summary of responses:** twenty respondents, including seventeen investment companies and one investment trust, did not want any further regulation. Fifteen respondents made no comment on the need for further regulation.

- 6.19 Somewhat unsurprisingly, respondents were almost unanimous in their belief that there is no need for further regulation on governance. Following the introduction of various governance codes (Cadbury, Greenbury, Hampel) alongside the Companies Act 1985 and AITC guidance for directors, it was felt that more regulation would be unnecessary and of no further benefit to the sector. With the Modern Company Law review being conducted by the DTI it would also be inappropriate to introduce any new regulations before the conclusions of the review were announced.

### Code of conduct

**Summary of responses:** ten respondents, mainly IFAs, individuals and trade bodies, called for a code of conduct to be introduced. Only six respondents did not want a new code of conduct and the remaining twenty-one respondents, including fifteen investment companies, made no comment.

- 6.20 Despite the request for no further regulation there was rather less resistance to the idea of a code of conduct. Just under half the respondents were either keen on such a code being introduced or were not adverse to the idea. A code is seen as more practical and flexible than any strict regulations that could be introduced. It is seen as a way of setting out directors' responsibilities to different classes of shareholder and appears to present a possible solution to the issue of director independence. Conversely, the rest of the respondents felt that a code of conduct would be totally unnecessary, given the amount of existing regulations and governance codes.

**Our response:** we have limited authority in relation to directors of listed companies that are not also regulated firms. We would not object to a voluntary code of conduct being adopted by directors of Splits. Such a code and/or other requirements would have to be discussed with other relevant parties, for example the DTI, and, so far as non executive directors are concerned, would have to be drafted in the light of findings of Derek Higgs' independent review on the role and effectiveness on non executive directors. We propose to discuss the issues with Mr Higgs.

Q3: We would welcome your views on whether those giving advice on Splits might require more guidance from us.

**Summary of responses:** Sixteen respondents, including eleven investment companies, three individuals, a trade body but only one IFA, wanted more guidance for those people marketing Splits. Ten respondents, including three trade bodies, did not think more guidance was necessary. The remaining eleven responses did not mention the marketing of Splits at all.

- 6.21 The question of whether we should issue more guidance on Splits seems to have divided respondents into two camps; one group asking for further guidance and the other believing current regulations are adequate. Both camps agree that Splits are complex instruments. They state that advisors should need to demonstrate a good understanding of the complexities, particularly the risks, hurdle rates and how they can work to the advantage of clients, before they begin to advise investors on these investments. It was even suggested that only individuals or firms authorised to advise on and deal in derivatives should be allowed to market these funds.
- 6.22 The first group, believing that further guidance is needed, argue that more detailed and clearer guidance, in combination with relevant training, will be enough to give advisors the appropriate level of understanding to enable them to advise clients wishing to invest in Splits. Despite requests for more guidance, only a small group of respondents gave any indication as to what form this additional guidance should take. From this small group the need for further guidance on hurdle rates and the risks involved with each class of share were of prime concern.
- 6.23 The second group, believing there is already enough guidance, felt that more detailed disclosure within the Split prospectus, coupled with relevant training, would give advisors adequate understanding of the product to minimise the risk of mis-selling. They believe that the AITC and other groups already provide enough information on Splits and any regulatory guidance would not necessarily add value to the current information.
- 6.24 Although it is believed that greater disclosure and training, with or without additional guidance, will improve confidence in the sector, a key theme running through the responses was the need for more consumer education on the sector. Respondents suggested that we would be the most obvious entity to provide this consumer education.

**Our response:** Splits were marketed as “low risk” investment products in the recent past. It is clear that the risks relating to these products were not always fully understood or explained to potential investors even after the specific guidance on Splits was issued by the Personal Investment Authority.<sup>1</sup> As mentioned above, we are continuing our examination of the routes by which private investors have acquired shares in Splits and also of sources of information on which their decisions were based. We will consider whether our further investigations suggest that changes are required to the FSA Handbook.

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1 PIA Regulatory Update 85, March 2001.

# List of non-confidential Respondents to DP10

Aberdeen Asset Management Plc  
Alfred Simmons Investment Consultants  
Asher Reed & Company  
Association of Investment Trust Companies  
BFS Investments Plc  
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The Association of Private Client Investment Managers and Stockbrokers  
(APCIMS)

The United Kingdom Shareholders Association

University of Edinburgh – Centre for Financial Markets Research

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# Consumer information bulletin

## What are they?

Splits are investment companies and most are listed on the London Stock Exchange; there are around 120 Splits. If you have invested in a Split, you have bought shares in a company. You may have invested in Splits either by buying shares direct, or indirectly as part of an ISA or Unit Trust.

## What type of shares do Splits offer?

There are three main types of share. These are:

- **Zero dividend preference shares (Zeros)**

A zero has a predetermined set value which is not guaranteed. Shareholders will get this on a set date in the future, as long as the Split has enough money. In other words, the repayment is fixed if stock market performance has been good enough.

- **Income Shares**

Income shares pay dividends. That is, they pay an income if stock market performance is good enough but do not offer the predetermined return at the end of the investment.

- **Capital Shares**

Capital shares do not pay an income or have a predetermined value. Their value will depend on how much money there is after Zeros and Income shareholders are paid.

Research shows that some splits have high levels of investment in other, similar trusts and high borrowing. One investment, Zero Dividend Preference

Shares, is described as relatively low risk. This has been seen as being suitable for consumers who want to save for known commitments, such as school fees.

## **Does the FSA regulate Splits?**

Where Splits are held within an ISA or Unit Trust, or where an IFA gave advice, FSA rules apply. In March 2001 we reminded advisers to give clear risk warnings about investing in Splits. Firms which give you advice on whether to buy Splits are required to comply with FSA's rules on suitability. The FSA's advertising rules will also apply to a sales brochure.

However, the FSA does not regulate Splits in the same way as it does unit trusts. In the case of a unit trust, the manager must follow detailed rules on how funds are invested.

As most Splits are companies listed on the London Stock Exchange the Listing Rules apply to them. These govern how shares are offered for sale, and the way the company makes information available. This is the same set of rules that govern other shares you might buy.

Since 30 November 2001, we have new powers to deal with market abuse, which means that we can publicly censure or impose an unlimited fine on anyone, whether they are authorised or not, who commits market abuse such as buying shares in a company in advance with inside knowledge about, say, a forthcoming takeover, or creating false or misleading impressions, or purposely talking up (or down) the price of shares to a distorted level.

## **Why are Splits in the news lately?**

You may be concerned at the recent announcements by some trusts about their financial position. Some Splits have high levels of investment in other, similar trusts and high borrowing. It is these points, especially when both are true, that have caused some Splits to become financially weak as the stock market has fallen.

Some other Splits are showing a lower value than, say, a year ago. But this could be because of falling shares prices rather than anything specific to Splits.

## **Some frequently asked questions and answers about your Splits investment**

***I am concerned by recent newspaper comments about Splits. Are they all in difficulty?***

No. The current difficulties only affect some Splits where they have borrowed a lot, or invested a lot of money in other Splits. Many Splits are still confident they will meet their investment objectives and provide the expected returns.

***Where can I find out more about my investment?***

There are various ways. You can access the website of most Splits by pressing your web browsers search button and typing in 'Split Capital Investment Trusts'. You will find some independent websites that show how most Splits are doing, and often a site specifically for your own Split. Or, The Association of Investment Trust Companies has a website at [www.aitc.co.uk](http://www.aitc.co.uk) that contains details of some Splits.

***You can contact the person who advised you to invest.***

If you have invested directly, the most recent statement sent to shareholders should include an analysis at the last financial year-end of your Split's investments and borrowing.

Newspapers are often a good source of information and recently there have been many articles about how Splits are performing.

***I have read about gearing and cross holdings. What do they mean?***

Gearing is when a split borrows money from a bank to invest. When the stock market does well, the investments bought by the money borrowed are worth enough to repay the bank and leave some extra money for the shareholders. But if the money invested does not do well, the money borrowed must be repaid from the Split's other money. This includes the money that would otherwise repay the shareholders.

Cross holdings are where one Split invests in another Split.

A recent FSA review found that Splits with a high investment in other Splits tend also to have high borrowing.

***What is a restructuring?***

Some Splits have broken the agreement with their bank about the value of their investments compared with the money they have borrowed. So, the Split needs to raise more money. A restructuring is an issue of new shares to raise this extra money.

However, some Splits have found it difficult to do this at the moment because of current stock market conditions.

### ***Where do I stand?***

If there has been regulatory misconduct, whether in relation to the marketing or the management of the trusts, there may be remedies for consumers who have experienced losses as a result. If appropriate, we can take action against those concerned. From the information available to us, there can be no blanket presumption that investor losses in splits have arisen from misconduct. The most significant factor has been the fall in equity prices - exacerbated by the effect of gearing and in some instances by a degree of cross holding in other trusts.

Investors who think that they may have been mis-advised or mis-informed about their investment should review carefully the advice and literature they received when they bought their shares. Investors are unlikely to have grounds for complaint if the nature and degree of the possible risks associated with the investment trust were adequately explained, either verbally or in writing.

### ***What should I do?***

We cannot advise investment trust investors on whether their best interests would lie in holding on to trust shares in the expectation of a market improvement. Investors who are facing difficulty and who are unsure about what to do should consider taking advice from a financial adviser.

Losses suffered by investors, which are caused by a fall in equity markets, will not be recoverable as compensation. That is, unless it could be shown that such losses were caused by a breach of a legal obligation owed to the investor.

The adequacy of any advice which investors may have received from financial advisers will also be relevant although any mis-descriptions in the prospectus or listing documents would primarily be the responsibility of the split and its directors.

Investors who consider they may have a complaint against a regulated firm should pursue the matter with the firm concerned first. If dissatisfied with a response, the complaint can be referred to the Financial Ombudsman Service at South Quay Plaza, 183 Marsh Wall, London E14 9SR.

### **How to make a complaint**

#### ***What happens if a Split goes bust? Am I protected?***

If the Split has borrowed any money, the bank will be the first in the queue to get its money back. People who have Zeros are normally next in line. Income shareholders come next and then Capital shareholders. The Financial Services Compensation Scheme does not cover the failure of a Split.

***I have heard the FSA is examining Splits. Is there any news?***

Following a discussion paper issued in December 2001, we have been looking at allegations of mis-selling and collusive behaviour among Splits. This work is still going on but we will be putting another report on our website very soon.

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