Split Capital Trusts

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This note outlines the history of what one author described as 'the split capital investment trust crisis'. This crisis saw retail investment opportunities offered by major funds and which had purported to be safe and low risk vehicles for investment, unravel in a spectacular way. Investors saw the value of their funds decline by percentages very many times that of the decline in underlying equity markets. Investigations in the aftermath revealed structural weaknesses in the structures of the funds and accusations of a self-serving financial community.

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A. Split capital trusts

Characteristics of investment trusts

Investment trusts have special characteristics and structures which make them distinct from other investment products which may be used for similar investment objectives. Although described as 'investment trusts' or 'closed end funds', they are structured as companies rather than trusts. This means that they are primarily subject to company law not trust law or financial services regulation (except to the extent that they are recommended by advisers or marketed to investors in which case both the adviser and the process are regulated).

Investors in investment trusts buy shares in the 'company'. The company's business — rather than making something or providing a service — is holding shares in other companies. It receives the dividends on those shares and benefits from any capital growth in its investment portfolio, which it will manage by buying and selling. This provides the company with its income. The combined value of its investments is the basis for the company's own share price, which because the investment trust is listed on a stock market, moves up and down with the market.

They are some special characteristics of investment trusts which flow from this structure. First, their share price is often different from the combined value of their investments. This is known as a **discount** (and occasionally a premium) to net asset value. Discounts go up and down and reflect various considerations, including the fact that investment trust holdings are not always liquid. In other words, it may not be easy to sell the portfolio quickly for its full value in the markets in order to realise its value.[1] The level of discount is always a factor to be taken into account when buying an investment trust share, although how that discount is interpreted will depend on the investor's view of the markets and the likely direction of discounts for that trust and the sector as a whole. A large discount or a volatile discount on a trust's share price will typically invite further investigation by the investor or adviser.

Second, because an 'investor' in an investment trust is actually buying company shares when he invests, trusts can take advantage of the scope which companies have to issue **different classes of share**. They have been doing so for over a century, although the development of more sophisticated investment products, particularly in the field of derivatives, has added greatly to the potential complexity of these arrangements. Typically, where different classes of shares are issued by either a company in general or an investment trust in particular, what differs are the rights of types of shares to receive dividends (perhaps at a specific rate or not at all), and the priority of their claim on the company's profits and assets (i.e. do they have first claim on the profits, or must other types of shares be provided for first). Split-capital trusts are formed specifically to issue several classes of share (or capital):

- Zero-dividend preference shares pay no dividends during their (fixed) lifetime but are repaid at a pre-determined capital value on a set future date (so long as the company

[1] Liquidity has been a factor in the problems faced by some split-capital investment trusts. When they got into financial difficulties, they were unable to sell their investments, particularly if those investments were in other split-capital investment trusts, since investors did not want to buy that type of investment.

has performed well on the stock market). In other words, they are skewed to benefit from capital growth, and are often used to save for specific future expenditure (such as private school fees). Complex derivatives may sometimes be used to engineer the promised capital return.

- Income shares are complementary to capital-weighted shares. They absorb the income provided by the underlying investments' dividends but make no promises on capital return. They will tend to be bought by investors who need a regular stream of income from their investments. They have a lesser claim on the capital than other types of shares when the investment trust is wound up, so the capital returned can decline.

- Capital shares offer neither an income nor a guaranteed capital repayment. They offer high risk, which is balanced by potentially high returns if the portfolio increases significantly in value over its term.

The third characteristic to be aware of is **governance** arrangements. As a company, the investment trust will have a board of directors, including a majority of independent directors (a requirement of the Listing Rules). Those directors are covered by the ordinary fiduciary duties of company directors: they must carry out their duties with the requisite degree of skill and care; they must act in good faith in the interests of the company; they must not act for an improper or collateral purpose, such as against the interests of the company or for personal gain.

In most cases, the key relationship in an investment trust company is with its appointed fund managers. The managers are almost always separate from the company itself but the relationship is very close since the company's only business is its investments. The terms of the relationship are set out in an investment management agreement between the company and the managers. There is scope for considerable inter-dependence and potentially also for conflicts of interest if the directors of the company feel any obligations to the fund manager. Independence is controlled in part by the Listing Rules (which are obligations for companies whose shares are quoted on a stock market).[2] The board of an investment trust is meant to have a majority of directors who are not connected to the fund managers to avoid conflicts of interest arising.

The fourth characteristic is the ability of an investment company to borrow in order to invest. Often called **gearing** or leverage, there is nothing particularly unusual about a company borrowing money if it believes it can put the money to good use (i.e. by increasing value for shareholders through obtaining a better rate of return on the debt than it has to pay the lender in interest). But gearing will always be a factor to take into account when choosing an investment trust since while it increases the potential returns when the markets are good, it may magnify potential losses also. The company will also have to service the debt regularly and in some cases repay the debt if specified circumstances occur. A specific problem was

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[2] The Financial Conduct Authority has responsibility for setting Listing Rules and policing them but it must be stressed that this aspect of the FCA's business is different in kind from its mainstream financial regulation. The FCA's powers over listed companies that are not also authorised to provide investment services are much more limited than its powers over the 'regulated' community.

that zero preference shares issued against assets bought with borrowed funds, ranked behind the banks in terms of prior claims if the investments had to be realised at a loss.

The following table illustrates the growth in splits, and, in particular the growth in the riskier, geared, splits.

Value of Zero Preference Split Shares
£ millions

	Total	Geared	Ungeared	Geared as a % of Total
1993	143.4	38.7	104.7	27%
1994	44.1	36.4	7.7	83%
1995	67.7	9.0	58.7	13%
1996	193.7	90.5	103.2	47%
1997	173.9	5.8	168.1	3%
1998	435.0	219.4	215.6	50%
1999	841.5	658.5	163.0	78%
2000	358.6	331.1	-	92%
2001	883.0	637.6	129.0	72%
2002	236.5	196.3	-	83%
2003	47.4	-	19.1	0%

Source: The split capital investment trust crisis, Andrew Adams p45

Regulatory concerns

The regulator was concerned over split-capital investment trusts for four main reasons:

- Their shares appear to have been marketed as being low-risk when in fact some were very high risks
- Some of these trusts had high levels of gearing which magnified the effect on them of falling share prices
- Some trusts, particularly those with high gearing it seems, have invested very heavily in other split-capital investment trusts. The combined effect was to magnify risks ‘exponentially’
- In some cases, there are mutual cross-holdings in other trusts, and directors who serve on multiple trust boards. This is the so-called magic circle, a term which seems to imply that the market in investment trust shares had been insulated from normal market conditions (even ‘rigged’) to the detriment of investors and the benefit of some investment trust companies and their managers.

The press has written extensively about these issues, particularly since the middle of 2001, and a significant number of investors have suffered from plummeting share prices in the worst-affected trusts.

The former regulator for the retail sector, the Personal Investment Authority, had warned in March 2001 about the need to explain risks when selling split-capital investment trusts and

other products whose performance is backed by derivatives.[3] The previous regulator, the FSA, also gathered a significant amount of information on investment trusts and the way that they have been marketed in an exercise that began in September 2001.

In December 2001, the FSA published a discussion paper which raised various issues about the regulation and structure of split capital investment trusts.[4] In May 2002, it reported back.[5] While it found that many investment trusts were sensible investment choices and the trusts themselves were well run, the FSA was very critical about some of the practices that it found among the highly-geared splits. However, it would be inaccurate and alarmist to paint all investment trusts with the same brush when risk levels vary significantly across the sector, and many trusts are arguably 'safer' than ordinary shares (because they spread risks).

Of an investment trust sector which was worth around £50 billion in March 2002, splits accounted for just £13 billion of these assets. At that date, there were 134 split capital investment trusts, of which 34 had been launched since 1999. The majority of the 134 trusts had cross-holdings of shares in other splits (83 trusts). However, most of the cross-holdings were relatively small (32 had cross-holdings below 20 per cent of their assets, and a further 24 had cross-holdings of between 21 and 40 per cent. Some 16 trusts (£1,000m in assets) had cross-holdings of between 41 and 70 per cent, while 11 (£600m in assets) had cross holdings above 70 per cent.

On the FSA's figures, the majority of the trusts with the highest-levels of cross-holdings also had high borrowings. Thus, of the 11 trusts whose cross-holdings exceeded 70 per cent, 10 had total borrowings of 74 per cent of gross assets. The FSA found that trusts which had cross-holdings have suffered much worse than those without, in the market downturn. Looking at the market in the year to 31 March 2002, the FT-SE 1000 index fell by 16.2 per cent. While a split capital investment trust with no cross-holdings, might have fallen by 39 per cent over that time, those with cross-holdings of less than 20 per cent fell by 82 per cent, and those with cross-holdings over 40 per cent, by some 97 per cent.[6]

B. The crash

The first split to have its shares suspended was those of *Quilter Global Enhanced Income* on 3 April 2002. *Gartmore Monthly Income* began liquidation proceedings in the same month. The unit price of *Aberdeen Progressive Growth Fund* (launched in August 2000 as a low risk trust under the subsequently ironic advertising slogan — "The one year old that lets you sleep at night") fell by 70% in the year to August 2002. All told, between April 2002 and August 2003 the shares of 21 separate funds had been suspended.[7]

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[3] PIA Regulatory Update 85, March 2001

[4] Financial Services Authority, *Split Capital Closed End Funds*, Discussion Paper 10, December 2001

[5] Financial Services Authority, *Split Capital Investment Trusts (Splits)*, Update report on the FSA's inquiry into the Split Capital Investment Trust Market, May 2002

[6] These figures are taken from the May 2002 FSA report. I think they are examples of price movements rather than average moments.

[7] This information is taken from Andrew Adams ed, *The split capital investment trust crisis, chapter 4*

Many investors, and one suspects some professional advisers too, were left wondering what had gone wrong? Part of the answer clearly was the performance of the stock market. Between 1 January 2002 and August 2003, the FTSE 100 fell by 21.5% but the impact on the splits was magnified by the reasons given above.

The fall in capital value meant that there was not enough money to pay dividends on the income shares, nor enough assets to repay the capital on the 'zeros' and other capital shares.

Cross holdings in other trusts meant that what assets they had were increasingly those with identical structures (and problems) as their own. To compound matters the market conditions triggered terms of the bank loans that required the trusts to sell their 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. Of course, the trusts were selling expensively bought shares into a falling market. Where they could not raise sufficient capital to repay their loans liquidation procedures and the order of priority in paying off the debts put the zero preference holders at the end of the queue. Hence, their losses were so large. One investor, who wrote to the Chairman of the Treasury Select Committee, described how his investment of £6,100 had fallen to £25 in less than a year.[8]

C. The Inquest

The FSA found that:

- Risks associated with split capital investment trusts were often not described adequately or explained. In particular, some splits with large borrowings and cross-holdings were described as 'low risk' by product providers when the risk profile is much more complicated.
- Although the tone of the FSA's report is more measured, at a conference, the FSA's managing director referred to 'a contagious cocktail of cross investment and high borrowing'.[9]
- Stock swaps between investment trusts were common.
- In some cases individuals served on multiple boards of split capital trusts: one person is on 15 boards, managed by a number of different firms, while another is on 10 boards which all use the same investment management firm.

In October 2002, the FSA handed over the investigation of allegations of collusive behaviour to its specialist enforcement division[10] at the same time it initiated a review of investment trust rules. In January 2003, the FSA published a consultation document which proposed the following broad changes:

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[8] ibid p129

[9] Financial Services Authority press release, *Split capital problems confined to a minority* says FSA/PN/053/2002, 16 May 2002

[10] See for example, 'Splits inquiry raises payout hopes', *Times*, 12 October 2002; 'Regulator's spotlight falls on Aberdeen', *Daily Telegraph*, 11 October 2002

There are three main areas where the FSA believed new safeguards need to be introduced:

- The nature and content of warnings about the risks to capital;
- A limit on the extent to which investment companies can cross-invest in each other;
- Strengthening the independence of the company from its investment manager and improving the information available to (and powers of) investors.[11]

Of course, it was not helpful to the FSA in its response that, as was described above, although the sellers and the sales process were within its jurisdiction, the trusts themselves, as companies were not. The FSA therefore had to amend the listing rules (of plcs) to achieve their regulatory aims. In October 2003, the FSA published amended rules:

Limit on cross-holdings — Under our new rules listed investment companies may not invest more than 10% of their gross assets in fellow UK listed investment companies unless those companies have a stated policy that allows them to invest no more than 15% of their assets in other UK listed investment companies. This will allow the continued operation of main line funds of funds while curbing the cross-holdings that facilitated a downward spiral in the prices of some investment companies during the bear market;

Risk factors in all listing documents — Listed investment companies will be required to include an explanation in the prospectus of the risk factors specific to the issuer, its industry, its investment policy and securities it proposes to issue;

Increased portfolio disclosure — Listed investment companies must disclose on a monthly basis their holdings in other listed investment companies which do not have a stated policy of investing no more than 15% of their assets in other listed investment companies. They are also required to disclose on a quarterly basis at least the top 10 investments plus other investments greater than 5% in their investment portfolio;

New Conduct of Business risk warnings — There will be a requirement to include risk warnings to investors proposing to invest in listed investment companies that are highly geared or companies who propose to invest in other highly geared investment companies;

Increased board independence — Rules will be introduced defining an independent director as one who is a director of only one other company with the same investment manager. These rules will also limit to one the number of investment manager associates who can be appointed to an investment company's board, subject to annual re-election by shareholders. This will ensure the independence of the investment company's board from the investment manager;

Changes to investment policy — We are introducing changes to require prior shareholder approval of any material change to the stated investment policy of an investment company at any time during its life.[12]

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[11] Financial Services Authority press release, *FSA consults on tough new rules for split caps FSA*/PN/004/2003, 14 January 2003

The consultation process had held out the opportunity for further changes in legislation to cover split capital companies. However, a written statement in November 2005 concluded that, "On balance the Government have concluded that changes to the structure of regulation as it applies to investment trust companies would not result in better regulation".[13]

The final act of regulatory action came with the announcement in May 2007 when the FSA concluded its investigation into the individuals involved in the scandal and published a short press notice:

> The FSA has now resolved and discontinued its investigation in respect of the remaining firms and individuals under investigation:
>
> David Bruce has agreed to resign as CEO of BC Asset Management Limited (BCAM) and to give up his existing controlled functions save for CF27 (investment management). Mr Bruce has also agreed not to perform any significant influence functions until 3 April 2009. The FSA has discontinued its investigation into BCAM.
> Roderick Crawford has agreed not to perform any customer functions until 31 December 2007 and not to perform any significant influence functions until 3 October 2009.
>
> Paul Glover has agreed not to perform any customer functions until 3 October 2007 and not to perform any significant influence functions until 3 October 2008.
>
> Anthony Reid, former CEO of BFS Investments Plc (BFS), has agreed not to perform any controlled functions until 3 October 2009. The FSA has discontinued its investigation into BFS which entered into a creditors voluntary liquidation in February 2006.
>
> The FSA has agreed that it will take no disciplinary action against the above firms and individuals. The FSA has not made any findings of regulatory breach against them and the above firms and individuals have not made any admissions.[14]

This outcome was poorly received in some quarters – 'Split capital shame', 'Just a cop out from the City's chief bobby', just two headlines from press reaction.

D. Compensation

The other side of the FSA's work which was closely followed by investors hit by the collapse of these schemes were the negotiations between the FSA and the fund managers to agree a compensation package. In the absence of compulsory compensation arrangements, the process towards a package was inched forward by lengthy negotiations. The FSA outlined this work in the press release below:

> On 2nd March 2004, the FSA held a private meeting with the chairmen or chief executives of 21 firms that have acted as fund managers or brokers to split capital investment trusts. At the meeting, the regulator shared some of the information that it has gathered during its extensive investigation into the sector and suggested that the firms consider taking part in collective settlement

[12] Adams et al p124
[13] HC Deb 17 November 64WS
[14] FSA Press release 21 May 2007 http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/064.shtml

discussions. These discussions would be aimed at ensuring that firms pay compensation to investors, where appropriate, and that disciplinary action is taken, again where appropriate.

The FSA is determined to take enforcement action where breaches are proven, to do what it can to get adequate compensation for retail customers who have suffered financial loss as a result and to assist in restoring market confidence in the investment trust sector.

Since the meeting on 2nd March, there have been continuing discussions between the regulator and the 21 firms. A number of firms have been provided with outlines of the cases that would be made against them, to assist them in considering their positions, on the basis that this information is treated as confidential.

Firms that have already indicated that they are willing to participate in the mediation process are now engaged in constructive discussions with the FSA about resolution of the issues, including payment of appropriate compensation. The FSA intends to continue with those discussions.

Separately, a group of firms has held preliminary settlement discussions with the FSA. These discussions have been conducted on a confidential and without prejudice basis. While it cannot disclose any details, the FSA has carefully considered what has been said in those discussions and, in particular, the amount of money those firms would be prepared to make available for compensation.

The FSA believes that payment of £350 million as compensation would represent an acceptable amount in the context of these discussions. The amount that those firms have indicated that they would be prepared to make available is so far short of what is necessary that the FSA does not intend to continue with these discussions.

The FSA is continuing with its enforcement investigations against those firms that have refused to take part in the mediation and will begin referring cases to the independent Regulatory Decisions Committee in June. In the meantime, it remains willing to involve these firms in the mediation process should they agree to take part on the basis proposed by the FSA.[15]

Reports of the negotiations appeared regularly in the press. The sum on offer declined over the summer and some of the companies had to leave the group action due to "insufficient resources".

A settlement was finally reached on 24th December 2004: the final sum was £194 million, plus some additional sums paid in by specified trusts such as Aberdeen Asset Management,

[15] Financial Services Authority press release, *Split capital investment trusts update on discussions with firms* FSA/PN/044/2004, 26 May 2004

which pledged £75 million to the overall settlement with another £20 million coming from its insurers.

Announcing the deal the FSA commented:

> The FSA considers that this agreement is in the best interests of investors, for the following reasons:
>
> The complexity caused by several features of this particular investigation, makes the outcome for many investors uncertain (even in the event of successful enforcement actions): the number of firms involved and their differing capacities and involvements; the complexity of the matters under investigation; the fact that investment trusts were not regulated products; and, the fact that the period under investigation straddles the introduction of the Financial Services and Markets Act 2000. This agreement brings certainty for eligible investors in Zeros.
>
> In the event of enforcement proceedings the decision making process could take a number of years. This agreement will ensure that money is quickly available to eligible investors.
>
> It is consistent with the FSA's obligation to use its resources efficiently and effectively.
>
> Investors who are offered the opportunity to obtain a distribution will, of course, have a choice whether to accept it or not. If they accept it will be in full and final settlement of any claims or any remedies they may consider they would otherwise have. If they do not accept the offer, they will remain able to pursue their own claims or remedies.[16]

Even this deal, however, was not the end of all investors' problems. The claim form was heavily criticised as being too long and complex and the deadline for submitting a claim too short. In September 2005 the company administering the compensation package, Fund Distribution Limited (FDL) had to rebut claims that the claims procedure was 'in chaos'.[17] 39,500 investors had claimed compensation. By the end of 2006, investors received between 30% and 50% of their lost investments from the FDL settlement.

Concurrently, the Financial Ombudsman Service (FOS) had also been involved in cases where a split had lost money for investors. In February 2006, the FOS wrote to all outstanding complainants.[18] In its letter, it noted that it had had 5,700 complaints involving 500 firms. Some of these cases were also potentially covered by the FDL settlement, others not, for example those involving companies not party to the FDL settlement. For these investors some good news came following the decision by the Financial Services Compensation Scheme (FCSC) that Exeter Fund managers were in 'default'. Paradoxically 'default' is good in that investors can apply to the FSCS for compensation of up to (then) £48,000 per investor.[19]

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[16] http://www.fsa.gov.uk/pages/Library/Communication/PR/2004/114.shtml

[17] *Payouts over split capital scandal mired in red tape*, The Times, 23 September 2005

[18] FOS complaints letter Retrieved 30 July 2007

[19] Noted Financial Times 5/6 May 2007 and others.