

MANAGING KEYDATA CLAIMS

Introduction

In October the Financial Services Compensation Scheme (“**FSCS**”), through its solicitors, Herbert Smith, advised a significant number of IFAs that it would be looking to recover from them sums it had paid by way of compensation to investors who had lost money through investing in products put together by Keydata Investment Services Ltd (“**Keydata**”). At the end of November, proceedings were served on some 470 IFAs alleging negligence, breach of contract / duty and negligent misstatement in respect of the early Keydata products, namely bonds issued by SLS Capital S.A. (“**SLS**”), based in Luxembourg. A significantly larger number of claims are expected in respect of compensation paid out by the FSCS to investors who lost money investing in subsequent bonds marketed by Keydata, issued by Lifemark S.A. (“**Lifemark**”), also based in Luxembourg.

Beale and Company Solicitors LLP is acting for a number of IFAs that are subject to the FSCS claims. **Damian McPhun** (partner specialised in defending claims against IFAs) gives his views on the litigation and the issues facing IFAs regarding Keydata.

Litigation and issues facing IFAs regarding Keydata

The recent action by the FSCS in instructing law firm Herbert Smith to recover sums paid out by the FSCS to investors who had lost money investing in Keydata products has alarmed many. Headlines appear daily in the financial press about IFAs disputing the suggestion that they were negligent and, in some cases, disputing that they were even involved in advising on Keydata products. However, the legal action is not exactly unexpected. The demise of Keydata, which was pushed into administration by the Financial Services Authority (“**FSA**”) on 8 June 2009 (on the basis that it would not be able to meet a tax liability arising out its failure to secure tax-exempt status for certain products marketed as suitable ISA investments) led many IFAs who had recommended Keydata investments to their clients to appreciate that their advice might be called into question and to notify to their professional indemnity insurers circumstances that might give rise to claim. This may have proved a sage thing to do as many insurers over subsequent renewals / placements have sought to exclude from cover any claims arising out of Keydata investments (in much the same way as they have done in relation to Arch Cru investments) and there has been an increase in the application of exclusions for cover in respect of insolvency events.

Given the amounts of compensation paid out by the FSCS already in relation to Keydata (over £250 million) and the uproar which has greeted the huge increase in industry levys as a result, it was always considered very possible that the FSCS would pursue individual IFAs. The FSCS can indemnify investors once a firm is in default (which includes the firm going into administration) – and the FSCS confirmed Keydata’s “default” in November 2009 - if the investors have a claim against the defunct firm. Clearly the FSCS decided that claims against Keydata existed, generally in respect of misleading marketing literature. However, in order to pursue compensation against IFAs (pursuant to an assignment of some or all of the investors’ rights) the FSCS needs to demonstrate some negligence or other breach on the part of the IFA that would entitle the investor (and therefore the FSCS) to claim damages against that IFA.

The FSCS Claim

In short, the (quite generic) basis for the FSCS’s claims against the IFAs is that the IFAs as a whole failed to conduct adequate due diligence in respect of the Keydata products and/or their own clients, so as to ensure that the Keydata investments were suitable for each specific client.

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The FSCS argue that the products were inherently risky (because they effectively gambled on the life expectancy of life policy holders in the US / Canada and the accuracy of actuarial modelling) and included specific factors that increased their risk (such as counterparty risks, exchange rate risks and solvency risks). In the circumstances, it is argued that they were unsuitable investments for a significant number of the IFAs' clients, particularly retail clients. The products were marketed as low risk, but the FSCS (and indeed the FSA) now consider they were anything but and therefore, to the extent that IFAs made statements reflecting what they were told about the products and their being low risk, the FSCS considers that the IFAs were guilty of negligent misstatement.

Issues

There has been much criticism levelled at the FSCS (often from legal firms) that the FSCS did not do its own due diligence in respect of the IFAs it is now pursuing, in terms of reviewing their files. Whilst that may be true, it will not of itself provide a defence to the FSCS's claim. If the Keydata products were in fact not at all low risk and if the IFA failed adequately to ascertain its clients' appetite for risk or did so but invested the client outside their risk profile, there may be an exposure. However, that is 2 fairly significant "ifs". Opinion is divided as to the risk inherent in such products, despite the increasingly bullish comments emanating from the FSA, which has gone from opining in its decision to fine the Norwich & Peterborough Building Society £1.4 million in April 2011 that the products were "*at least as risky as may stocks and shares*" to issuing an (arguably self-serving) statement last week that it wanted to ban retail investment in such "toxic" products (which statement caused a rush last week to redeem investments in the largest Life Settlement Fund (EEA) to the point where trading in the Fund was suspended). Although the FSA is quick to point out it had no responsibility to approve the products, there is certainly anecdotal evidence of it coming into contact with the products on a number of occasions and never did it throw up its hands to exclaim how "toxic" they were. Certainly at the time the Keydata products were introduced to the market, some commentators (including IFAs) warned that they should not be touched with a bargepole. However, others considered them perfectly solid and safe investments (and they were scored as such in industry publications). The fact that some IFAs would not have advised clients to invest in the products does not mean that those that did were automatically negligent.

Ultimately this case will depend on an analysis of the risk inherent in the Keydata products, the extent to which a reasonably competent IFA would have appreciated that, the due diligence steps specific IFAs took (both in respect of the product and their clients), the specific advice they gave to their clients and the risk profiles of those clients. Some of the FSCS allegations may apply to many of the IFAs targeted (whether they will be upheld is another matter), but others will not. One of my clients, for example, which has a very significant exposure, only acted for intermediate / elective professional clients, so a lot of the allegations against it, particularly based on specific provisions in the FSA's Conduct of Business (COB) / Conduct of Business Sourcebook (COBS) Rules simply do not apply.

There may also be causation issues tied up with the very many factors prevalent in the demise of Keydata, including the decision of the FSA in the first place to push Keydata into administration and, at least for far as the bonds issued by SLS are concerned, the well publicised theft of £103 million from the relevant fund by its founder, David Elias. What the FSCS viewed as the cause of the losses for the purposes of paying compensation compared to what they are now saying was the cause will also need to be reviewed. In addition, consideration will need to be given to what losses investors may have suffered in any event, even if they should have been advised to invest in other products and also what recoveries may be made at the end of the day (the future of Keydata and at least the Lifemark bonds remains up in the air).

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At the outset it cannot therefore be said that the FSCS recovery action is doomed to fail, but nor can it be taken as fact that it will succeed, either in whole or in part.

Steps to Take

If you have received letters from Herbert Smith or have been served with the proceedings, it is important that you notify your professional indemnity insurers as soon as possible and send them a copy of what you have received. If you have previously notified your insurers of circumstances that might give rise to a claim in connection with Keydata, you should send them the relevant documents, although the sense may also be to send them to your current insurers (if different) in case there is any question mark over the validity of your notification under that previous policy.

You should also check your policy to see whether it contains any wording either specifically excluding liability in respect of Keydata issues or generally excluding liability for losses arising out of an insolvency or similar.

You may also wish to consider joining with other IFAs in obtaining legal advice. Although there will be many case and IFA specific issues in the litigation, it will be possible to share many of the other legal costs, including investigative costs and, if it comes to it, expert and counsel's costs. My firm has a number of clients doing this but is also working with other law firms representing affected IFAs, with a view to reducing further the costs borne by each specific IFA or its insurers.

For further information contact Damian McPhun on 020 7240 3474. Alternatively email d.mcphun@beale-law.com

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