

Central Bank of Ireland CP130

## Treatment, Correction and Redress of Errors in Investment Funds

Authored by Dechert's Financial Services Practice

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Dechert  
LLP



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## Introduction

In September 2019, the Central Bank of Ireland (the **Central Bank**) published CP130, a consultation paper on the proposed regulatory framework (the **Framework**) for the treatment, correction and redress of errors in investment funds (the **Consultation**). It is proposed that the Framework will apply to fund management companies acting for Irish authorised Undertakings for the Collective Investment in Transferable Securities (**UCITS**), Alternative Investment Funds (**AIFs**), Irish domiciled fund management companies acting for non-Irish authorised funds and non-Irish fund management companies acting for Irish authorised funds (each, a **Fund Management Company**).

The deadline for submitting responses to the Consultation is now less than a month away. Dechert is currently finalising its submission to the Central Bank and continues to seek feedback from industry stakeholders for inclusion in its response.

## Background

In 2014, the International Monetary Fund (**IMF**) provided an assessment of the Central Bank's observance of the IOSCO Objectives and Principles of Securities Regulation<sup>1</sup> and found that "*while there is industry guidance, the Central Bank has not issued rules prescribing how pricing errors are to be treated by CIS.*" The IMF recommended that the Central Bank publish rules relating to pricing errors.

The industry guidance referred to by the IMF is the Irish Funds<sup>2</sup> 'Guidance Paper 6 – Investment Restriction Breaches, Pricing Errors, Compensation and Reporting' which is of long standing and which was last updated in March, 2017 (the **IF Guidance**). The IF Guidance set out recommendations in relation to the correction and compensation of investment breaches and pricing errors, and while it was universally applied, there was no formal legal obligation to comply and it was not sanctioned or approved by the Central Bank.

Following the IMF recommendation, the Central Bank carried out a thematic review of the treatment of NAV pricing errors and found that there were inconsistencies in how the IF Guidance was being applied, particularly in relation to reporting of breaches and pricing errors to the Central Bank. The outcome of that review has now resulted in the new Framework

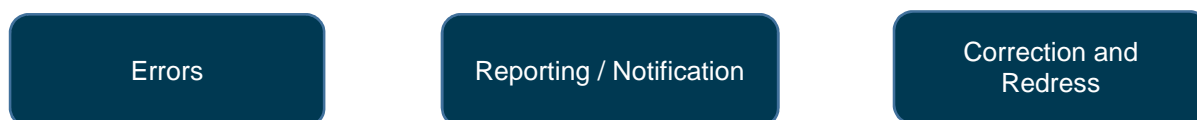
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<sup>1</sup> <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Ireland-Detailed-Assessment-of-Observance-of-IOSCO-Objectives-and-Principles-of-Securities-41581>

<sup>2</sup> Irish Funds is the Irish funds industry representative body.

## The Consultation

The Framework will take the form of rules and guidance and will comprise of the following components:



### 1. Errors

#### *Current Practice*

While the Central Bank requires certain material errors to be reported, it has not published guidance on what constitutes a material error. As a result, the Irish funds industry has had regard to and applied the IF Guidance with regard to materiality, which includes factors to assist stakeholders in subjectively determining materiality, including having regard to the overall control environment in which a fund is managed. The IF Guidance also states that the materiality threshold for errors are those with an error which has a NAV impact of 0.50% or greater.

#### *What's proposed?*

The Consultation imposes an obligation and ultimate responsibility on Fund Management Companies to ensure that errors are “Appropriately Rectified.”<sup>3</sup> It also provides that the fund’s depositary has a role in ensuring rectification. Where an error is identified, it should be corrected without delay.

The concept of Appropriately Rectified will be applied broadly to include reporting of errors, notification to investors and payment of redress obligations.

The Central Bank considers that there are four types of error:

1. NAV error;
2. investment breach error;
3. fee error; and
4. control breach error (i.e. an error which, although it may not have a monetary impact highlights an issue in the management of a fund).

The Framework will be wider in scope than the current IF Guidance which only covers NAV errors and investment breach errors.

In order to ensure an error is Appropriately Rectified, the Fund Management Company should:

1. identify the error and assess it for materiality;
2. correct the error and make any necessary notifications; and
3. ensure appropriate redress.

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<sup>3</sup> ‘Appropriately Rectified’ is defined under CP130 as taking any necessary action to restore the fund / investor to the position that it / they would have been in had the relevant issue not arisen. This includes meeting all reporting and notification obligations and the Payment of Redress as appropriate.

The Consultation provides that redress must be paid in respect of all errors classified as material.<sup>4</sup> One of the key proposals in the Consultation is the introduction of guidance in relation to assessing materiality which will be assessed by way of quantitative and qualitative criteria.

The proposed quantitative thresholds are as follows:

Money Market Funds ( <b>MMFs</b> )	0.10% of NAV
Other Investment Funds	0.50% of NAV

A lower threshold is proposed for MMFs as these funds hold highly liquid instruments such as cash, cash equivalent securities and high credit rating debt-based securities that the Central Bank suggests should be easier to value and subject to lower levels of market volatility. These funds are also subject to the amortised cost method of valuation.

Even where the quantitative materiality thresholds are not met, an error may be deemed to be material based on qualitative materiality factors i.e. any relevant surrounding circumstances. These are likely to include the circumstances that resulted in the error or the duration of the error. The Consultation emphasizes that materiality should be assessed on a case-by-case basis and the Central Bank proposes to issue (a non-exhaustive) guidance on the list of qualitative materiality factors that should be taken into account.

## 2. Central Bank Reporting / Investor Notification

### *Current Practice*

The Central Bank presently imposes a broad reporting obligation on a Fund Management Company<sup>5</sup> for any breach of the Irish UCITS Regulations, Irish AIF Regulations or other Irish legislation.

In contrast, a fund depositary has an obligation to report material breaches of regulatory requirements.<sup>6</sup> UCITS depositaries are also required to report any non-material breach that is not resolved within four weeks of the depositary becoming aware of that breach.<sup>7</sup>

Current industry practice typically treats advertent breaches as material and inadvertent breaches (arising because of market movements or shareholder dealing) as immaterial.

With regard to investor notification, the thematic review indicated that investors were generally notified in relation to errors where:

- (i) the error was material; and
- (ii) the investors were directly affected by the error and due redress.

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<sup>4</sup> In the case of "Fee Errors" (defined as an error related to the overpayment of a fee), the sum of the amount overpaid should be paid to the fund/investor.

<sup>5</sup> Central Bank UCITS Regulations: Regulation 107(2), and AIF Rulebook: Chapter 1, Section 2, Paragraph 5 and Chapter 2, Section 2, paragraph 5.

<sup>6</sup> AIF Rulebook: Chapter 5, Depositary Requirements, iii (Depositary tasks), paragraph 2.

<sup>7</sup> Central Bank UCITS Regulations: Regulation 118(4).

### *What's proposed?*

The Framework proposes to require reporting with regard to material errors only, and the Consultation asks whether a Fund Management Company should have to report:

- errors to the depositary, which would satisfy the Fund Management Company's regulatory reporting obligation; or
- any material errors that have not been reported by the depositary to the Central Bank.

The Fund Management Company and depositary will also be required to maintain a written record of all errors that occur. This imposes a new obligation on depositaries for AIFs, as UCITS depositaries are already subject to this record keeping obligation.<sup>8</sup>

In relation to notification of errors to investors, it is current industry practice to notify shareholders where there has been a material pricing error that directly impacts them and requires redress. A depositary is not required to notify shareholders of an investment breach error in its annual depositary report unless the depositary has sufficient reason to believe the Fund Management Company has not shown adequate control over compliance with investment restrictions.

The Framework proposes to place a new obligation on a Fund Management Company to notify investors of any material error irrespective of whether redress is required or not. This would have a significant impact on a Fund Management Company's reporting obligations, and there is likely to be strong pushback from industry on this specific proposal.

The proposal also clarifies that inadvertent breaches will be subject to the Appropriately Rectified criteria. The Consultation asks whether an advertent or inadvertent breach is well understood.

## **3. Correction and Redress**

### *Current Practice*

The IF Guidance provides details of the circumstances where compensation may be payable for NAV pricing errors and investment breaches. Generally, compensation is payable for (i) material pricing errors only (i.e. those with a NAV impact above 0.50%), and (ii) advertent investment breaches that result in a loss to the fund.

The IF Guidance also provides that it is the responsibility of the Fund Management Company to ensure that any errors are correctly, promptly and appropriately dealt with to the satisfaction of the depositary.

The IF Guidance includes *de minimis* limits with respect to the payment of compensation: €50 for retail investors and €500 for institutional investors.

### *What's proposed?*

The Consultation provides that all errors should be corrected without delay (regardless of materiality) and questions the appropriateness of the *de minimis* limits that the Central Bank views as excessive, particularly for institutional investors. It makes clear that even where an error is caused by a delegate

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<sup>8</sup> Central Bank UCITS Regulations: Regulation 118(5)(a).

of the fund, the Fund Management Company remains ultimately responsible for ensuring it is Appropriately Rectified.

The Consultation also states that redress must be paid in the case of all material errors to ensure that the affected fund/investor is returned to the position that it/they would have been had the error not occurred. Materiality does not apply in the case of fee errors where any overpayment should be repaid.

The Consultation provides (non-exhaustive guidance) on the qualitative materiality factors that need to be considered depending on the circumstances, the nature of the error and case by case assessment. These factors include:

- the financial impact of the error and impact on affected investors should be considered promptly;
- regard should be given to different categories of investors and their tenure;
- ensuring the payment of redress is fair, clear, provided in a timely manner and easily accessible;
- ensuring that the fund does not incur any administrative or other costs arising from the error payment of redress to a fund and/or investors is made in a timely manner without prejudice to the rights of the affected funds and/or investors;
- for material NAV pricing or control breach errors, that redress is paid in all circumstances;
- redress being paid in all circumstances where the error is a result of an advertent investment breach; and
- no redress should be paid for inadvertent investment breaches unless determined by the depositary.

The Framework will also place an absolute obligation on the depositary to ensure that errors are Appropriately Rectified by the Fund Management Company. Currently, the IF Guidance provides that the depositary must use reasonable endeavours to ensure any loss to the fund/investors is made good by the party at fault and the Fund Management Company.

## **Analysis**

While it is a welcome development that the Central Bank is introducing comprehensive guidance in this area, there is likely to be a number of material changes to existing industry practices, and Fund Management Companies should be cognisant of the potential increased responsibilities imposed on them as a result.

## **Next Steps**

The Central Bank is seeking responses to the Consultation by **9 December, 2019**.

Please do not hesitate to get in touch with the Dechert team if you have any queries in relation to this article, or if we can assist you in submitting responses to the Consultation on your behalf.

**This update was authored by:**

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