

Errors in Investment Funds: The Central Bank of Ireland consults on regulatory framework

The Central Bank of Ireland (CBI) issued a consultation paper about the treatment, correction and redress of fund errors. The consultation closes on 9 December 2019

- To date, treatment of investment restriction breaches, pricing errors, compensation and reporting has been governed by industry guidance and market practice - the CBI proposals differ on some points from the current guidance and practice
- The CBI considers that the fund management company (UCITS management company, AIFM or self-managed entity) is ultimately responsible for ensuring that the error is rectified and that the depositary has a role in ensuring that this happens
- The CBI's proposed guiding principle is that where an error occurs, the fund and/or the investor should be 'appropriately rectified'
- Four error types are categorised
- A quantitative materiality threshold of 0.5% of NAV is proposed, except for money market funds, where 0.10% is proposed
- Qualitative materiality factors will need to be assessed in addition to quantitative thresholds
- The proposed regulatory framework deals with regulatory reporting of errors to the CBI and expectations for investor notification
- The CBI is interested in views on de minimus limits of €50 per retail investor and €500 per institutional investor
- The regulatory framework is proposed to apply to fund management companies acting for Irish UCITS or AIFs and for non-Irish authorised funds, SMICs and internally managed AIFs (FMCs). We give some thought in this briefing about the position of an Irish UCITS or AIF managed by a non-Irish fund manager

FMC and depositary obligations

The CBI proposes that, in the event of an error, the FMC should

- i. identify and classify the error, including an assessment of materiality
- ii. correct the error, including compliance with any reporting and notification obligations
- iii. redress the error, including payment of redress to the fund and/or investors

This requirement will be put on a statutory footing by amending Irish legislation for UCITS and AIFs.

This will be a change from current market practice and guidance which does not place statutory liability on FMCs in the event of a fund error.

It is proposed the depositary will be required to ensure that the error has been appropriately rectified by the FMC.

If an error has arisen from the action of a delegate of the FMC, the CBI considers it still the responsibility of the FMC to ensure errors are appropriately rectified and the responsibility of the depositary to ensure this is the case. A FMC may seek compensation from a particular delegate.

Regulatory reporting requirements for FMCs and depositaries will be changed to cater for the new framework. FMCs and depositaries will be required to keep a record of all errors. This will be a new requirement for AIF depositaries.

Classification of some events may need careful consideration and the effect of the error may also need to be assessed to assist with classification. One example of this, not dealt with in the CP, is payment of an incorrect dividend amount.

Appropriate rectification

The CBI considers that a fund or investor has been appropriately rectified where the fund/investor is restored to the position that they would have been in if the issue giving rise to the error had not arisen.

The CBI proposes that appropriate rectification will include:

- Reporting of errors
- Notification to investors
- Payment of redress

An externally managed Irish UCITS or AIF with a non-Irish management company will need to consider whether and how it should comply with the proposed CBI guidance. Taking an example of a Luxembourg management company managing an Irish UCITS, the board of the Irish UCITS may decide to bring the CBI regulatory framework to the attention of the Luxembourg management company requesting that the management company assess any fund errors arising through a filter of the CBI framework. This may involve a gap analysis between the equivalent Luxembourg rules and the CBI framework.

Classification of errors

FMCs will be required to classify errors as part of the correction process. A control breach is not an error explicitly set out in current industry guidance. An example of a control breach is given by the CBI where a redemption payment is paid to the wrong investor account but returned in a short time. This may not have a monetary effect on the fund, or may only have a very short term effect as it is capable of being reversed. However the CBI considers that this demonstrates significant issues in the management of the fund and should be classified as an error.

Depending on the type of error, different steps may be taken to appropriately rectify it.

Suggested fund error types

- NAV Error
- Investment Breach Error
- Fee error
- Control breach error

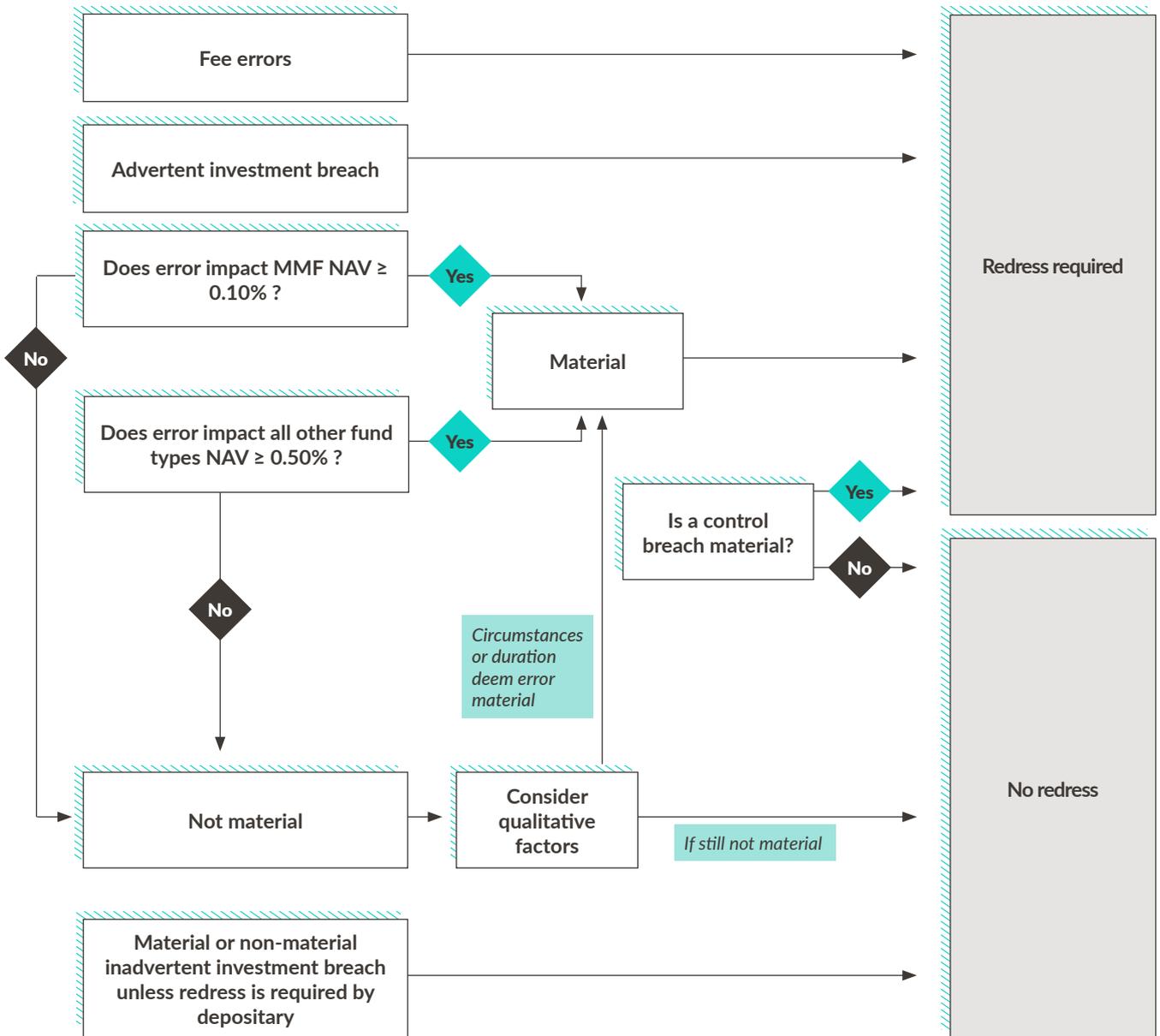
Materiality

The CBI proposes that the FMC and depositary should assess the materiality of the error once it has been identified. Materiality will affect treatment of the error in terms of reporting, notification and redress. If an error is deemed to be below the quantitative materiality threshold, it must be assessed for qualitative factors such as failings in governance giving rise to the error or the length of time the error lasted. This assessment can result in an error being categorised as material even where it is below the quantitative limits. Where an error occurs which exceeds the pre-determined threshold, it should automatically be considered material.

Investment breach errors

In the case of an inadvertent investment breach the process above does not apply. No redress of an inadvertent investment breach will be required unless otherwise determined by the depositary.

It appears that the CBI intends no materiality threshold will apply for advertent investment breaches. FMCs should note this position. The CP states “In the case of Investment Breach Errors, the Payment of Redress should be made in all circumstances where the error is as a result of an advertent breach”. This can be contrasted with the immediately preceding statement that “In the case of NAV Errors or Control Breach Errors deemed to be material, the Payment of Redress should be made in all circumstances”. The opening remarks in the CP are inconsistent with this position. Redress of Fee Errors is stated to be the “one exception” to the rule that where an error is considered material, redress should be paid in all circumstances. Below is an illustration of the CBI proposals of how materiality would affect redress.



Materiality thresholds

The CBI does not ask in the CP if stakeholders agree with the separate threshold of 0.10% for money market funds and, based on the rationale given for this proposal, we could assume that this threshold is not up for debate. The CBI does ask if lower thresholds should be considered and other fund types should have a different threshold. It would seem that a 0.50% threshold, which is applied in current market practice, should

work for all other fund types. It may be worth considering if real estate funds and ETFs should have a different threshold.

Regulatory Reporting

The CBI currently imposes a general obligation on the FMC and depositary to report breaches. The CBI proposes to require reporting of material breaches only. The CBI feels it can adopt this approach as its proposed framework defines what is a material error.

The CBI further proposes to maintain dual reporting but amend reporting obligations to one of the following

- FMC reports material errors to the depositary who in turn would report to the CBI
- FMC reports material errors to the CBI which have not already been reported by the depositary to the CBI

The CBI invites responses on the preferred option. It also asks if alternatives to dual reporting should be considered and whether a time period for notification should be specified.

Investor notification

The CBI is proposing to require notification to investors of any material error even where it has been established that redress is not required.

The proposal is a material change from current industry practice. The current practice, although there are differences in approach, is to notify where the impact on NAV from the error is greater than 0.50% and compensation is calculated to be due.

Redress

Redress is considered by the CBI as a critical component of an effective response to a fund error. The concept of redress is linked to the materiality points illustrated above. The CBI acknowledges that the payment of redress by a FMC is without prejudice to the rights of the affected fund and / or investors. This means that they may have an additional and separate right of action against the FMC, but this has always been the case and the CBI proposals do not affect this.

The CBI asks whether de minimus limits are useful. It is current industry practice not to pay out compensation below €50 for retail investors and €500 for institutional investors. The CBI comments that it can see the usefulness of de minimus limits where the compensation due to an investor is small and the cost of payment wipes out or is more than the redress benefit. It adds that it regards the current industry practice limits as excessive, particularly in the case of institutional investors.

Correction of errors

Once an error has been identified, the CBI suggests that the FMC must correct it without delay. The CBI also uses the phrase “as quickly as possible”. Current industry guidance places responsibility on the FMC to ensure that any errors are correctly, promptly and appropriately dealt with to the satisfaction of the depositary. The CBI gives a specific example that in the case of a NAV error, it should be corrected in the next valuation following discovery of the error. This could be challenging depending on the frequency of fund dealing as it may take time to calculate the impact of the error.

Conclusion

Now is the time to carefully analyse the CBI’s proposals in the CP. It would appear that the CBI has already given a good deal of consideration to the issues around fund errors. This could indicate that the future regulatory requirements, when they are finalised, will be very close to the text in the CP except possibly in the cases where the CBI has specifically addressed questions to stakeholders. There is an opportunity before 9 December 2019 to suggest refinements or propose changes, which should be supported with well-constructed reasoning. Responses to the consultation questions and other feedback can be sent directly to the CBI.

A&L Goodbody will be preparing a response to the CP. The response will address, amongst other things, the proposal that there will be no materiality threshold for advertent investment breaches.

If you would like to include your feedback in the A&L Goodbody response or would like further information on the information contained in this briefing, you can contact a member of the [A&L Goodbody Asset Management & Investment Funds team](#).

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