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CP130: TREATMENT, CORRECTION AND REDRESS OF ERRORS

On 9th September 2019, the Central Bank of Ireland ("CBI") published a consultation paper, CP130, regarding the treatment, correction and redress of errors in investment funds. This follows the CBI's 2015 thematic review of the industry's approach to the treatment of Net Asset Value ("NAV") pricing errors. The thematic review was triggered by a recommendation from the International Monetary Fund ("IMF") to produce a regulatory framework covering fund errors, during its assessment of Ireland compliance with IOSCO Objectives and Principles of Securities Regulation.

During the CBI's thematic review, the Irish Fund's Guidance Paper 6 was covered, although the paper had not been sanctioned or approved by the CBI.

The CBI is seeking responses from stakeholders, to the key questions contained in CP130 and invites any general observations noted regarding the matters contained within, by 9th December 2019.

CP130 is available here from the CBI's website.

To whom will the proposed regulatory framework apply?

The CBI has proposed that the Fund Management Company is ultimately responsible for ensuring an error is "Appropriately Rectified", meaning that the fund/investor is returned to the position it would have been in had the error not occurred. The term "Appropriately Rectified" includes the completion of all correction, reporting, notification obligations and the payment of compensation, or redress if applicable.

In addition, it is noted that the Depositary has a role to ensure that the error has been appropriately rectified by the Fund Management Company.

Therefore, the proposed regulatory framework by CP130 will apply to Fund Management Companies acting on for Irish authorised UCITS and AIFs, and to Irish Fund Management Companies which may be acting for non-Irish authorised funds. The framework will set out responsibilities and reporting obligations for both Fund Management Companies and depositaries.

What constitutes an "Error" within CP130?

It is proposed that that the following steps should be taken when assessing an error:

(i) Identification and classification of the type of error
(ii) Correction of the error in a timely manner
(iii) Payment of redress (or compensation) to the fund and/or investor(s)

The CBI has proposed that there are four different types of errors:

1. **NAV Error** – an error in the calculation of the NAV

2. **Investment Breach Error** – an error resulting from the non-compliance of a fund with the applicable investment restrictions

3. **Fee Error** – an error caused by an overpayment of a fee

4. **Control Breach Error** – an error which does not fall into the categories outlined in 1-3 above eg: payment of redemption proceeds to an incorrect investor but subsequently returned in a short timeframe.

How does CP130 propose errors should be corrected?

As per the Irish Fund's Guidance Paper 6, to correct an error, the fund/investor must be straight away brought back to the position it would have been in had the error not occurred.

CP130 proposes that regardless of materiality, the Fund Management Company must ensure that an error is rectified without delay and the depositary must ensure this takes place. Materiality must be assessed as this affects the treatment of the error, the notification obligations and the payment of redress.

Materiality

CP130 proposes that, if an error is deemed material, then redress must be paid to return the fund/investor to the position it should have been in had the error not occurred. There is one exception to this rule within CP130 which relates to fee errors, in which case materiality is irrelevant and full redress must be paid to the fund and/or investor(s).

Quantitative Materiality Threshold & Qualitative Materiality Factors

In order to assess the materiality of an error, CP130 proposes that the error must firstly be assessed to deem if it is above or below the Quantitative Materiality Threshold ("QMT"). The proposed QMT is as per the Irish Fund's Guidance Paper 6 level:

- Money Market Funds: 10bps (as per Money Market Funds Regulations)
- Other Funds: 50 bps

Regardless of the quantitative materiality of an error, the error must also be assessed in the context of Qualitative Materiality Factors ("QMF's"). Examples of QMF's which may deem a quantitative immaterial error, to be material, include:

(i) An error caused by inadequate controls, examples of which include:
   - A subscription/redemption not processed for the correct investor may indicate issues with control environment;
   - Series of similar errors; or
   - An error caused by an action of the Fund Management Company;

(ii) Duration of the error:
   - Materiality may be below QMT on an individual valuation point but on an aggregate or cumulative basis, over the full duration of the error, it may exceed the QMT.

CP130 has proposed that an error's materiality must be assessed on a case-by-case basis and must take the best interests of the investor(s) into account.

How should the payment of redress be managed?

CP130 proposes that once it is determined that an error is deemed material, either by breaching the QMT or due to QMF's, redress must be paid to return the fund and/or investor(s) to the position it/they would have been in had the error not occurred.

Regardless of the party which has been deemed responsible for the error and from whom the redress payment has been sought, the Fund Management Company remains responsible for ensuring that the error is appropriately rectified, and the depositary is responsible for ensuring that this is the case.

De Minimis Limits

Irish Funds Guidance Paper 6 and industry practice, provide for de minimis limits, below which compensation or redress is not currently paid:

- €50 per retail investor
- €500 per institutional investor

CP130 proposes that although the concept of de minimis limits has merits, the current limits are excessive and the CBI is therefore seeking feedback from the industry on:

(i) whether such limits should be applied;
(ii) a rationale for a differentiated approach for retail investors versus institutional investors; and
(iii) an appropriate de minimis limit threshold with rationale.

Advertent and Inadvertent Investment Restriction Breaches

As outlined above, CP130 also covers errors caused as a result of non-compliance with investment restrictions, an "Investment Breach Error", both advertent and inadvertent. The CP130 proposals are in line with current market practice and Irish Funds Guidance Paper 6.

In relation to advertent breaches, the proposal is to pay redress in all cases, regardless of materiality.

With regards to inadvertent breaches, no redress payment is proposed, regardless of materiality, unless the depositary deems it appropriate.

What reporting obligations proposals have been made by CP130?

Currently the Fund Management Company and the depositary are required to report all material errors to the CBI. In addition, the depositary is required to report all errors that are not resolved within 4 weeks and to maintain a written record of all errors.

In relation to the reporting to the CBI of errors, CP130 proposes the following:

- Reporting of material errors only, to the CBI by both the Fund Management Company and the depositary, which qualify as “material” under the definition given by CP130

- Depositary to complete filing for both itself and the Fund Management Company providing the Fund Management Company notifies the depositary of all errors
  OR
  The Fund Management Company to report material errors to the CBI that have not been reported by the depositary to the CBI

- Both the Fund Management Company and the depositary are to maintain a written record of all errors.

On the back of inconsistencies identified by the CBI during the thematic review conducted in 2015, the CBI proposes the introduction of obligations on the Fund Management Company to notify investors of any material error, regardless of redress. Feedback has been sought on whether there is merit in informing investors where redress is required but is not paid as it falls below the de minimis level.