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Central Bank of Ireland issues Consultation Paper on errors in investment funds

Earlier this week, the Central Bank of Ireland (the "**CBI**") published its Consultation Paper 130 on the regulatory framework that it proposes to establish regarding rules and guidance on the treatment, correction and redress of errors in investment funds ("**CP130**").

Background

In 2014, the International Monetary Fund issued a recommendation to the CBI that it publish rules prescribing how pricing errors should be treated by Irish domiciled funds. Following this, the CBI conducted a thematic review of the fund industry's approach to the treatment of NAV pricing errors which to date has been based on guidance on the treatment and compensation of errors and breaches issued by Irish Funds (the representative body for the funds industry in Ireland). The purpose of introducing a regulatory framework dealing with investment fund errors is to ensure that there is a clarity and consistency of approach in dealing with fund errors and breaches including in relation to reporting.

CP130

CP130 sets down a regulatory framework intended to ensure that where a fund error occurs, that error is identified, assessed and corrected and the relevant fund and/or investor is "Appropriately Rectified", whereby the fund/investor is restored to a position that it/they would have been in had the relevant error or breach not arisen (the "**Framework**"). It is proposed that the Framework will differentiate how an error is "Appropriately Rectified" based on the type of error.

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The Central Bank has indicated that the Framework will comprise of both rules and guidance. If the rules are incorporated into the domestic legislative framework and designated as a "prescribed contravention" then the Central Bank could impose significant fines under its administrative sanctions regime for any breaches of them.

Who is subject to the proposed Framework?

Fund Management Companies

Under CP130, fund management companies are ultimately responsible for ensuring that an error is "Appropriately Rectified". These include:

- Fund Management Companies ("**FMCs**") acting for Irish authorised Undertakings for Collective Investment in Transferable Securities ("**UCITS**") or Alternative Investment Funds ("**AIFs**"); meaning that it is proposed that non-Irish FMCs providing services to Irish domiciled funds will be subject to the Framework; and

- Irish FMCs (which may be acting for non-Irish authorised funds).

Where an Irish FMC manages non-Irish authorised funds, the Framework will apply without prejudice to requirements and guidance in another relevant jurisdiction. With regard to non-Irish FMCs, CP130 does not go in to detail as to how or on what basis the CBI intends to apply the Framework to those entities.

Depositaries

CP130 proposes that the depositary will be required to ensure that the error has been "Appropriately Rectified" by the FMC.

Error Types

Four categories of error are defined under the Framework as follows:

(i) an error in calculation of the Net Asset Value (a "**NAV Error**");

(ii) an error relating to the investments of a fund and non-compliance with the applicable investment restrictions (an "**Investment Breach Error**");

(iii) an error related to the overpayment of a fee (a "**Fee Error**"); and

(iv) errors that do not fall into the above-mentioned three categories (a "**Control Breach Error**").

It is worth bearing in mind that the CBI acknowledges that in the case of a Control Breach Error there may not be a monetary impact on the fund, however, such error may highlight significant issues in the management of the fund.

Identification and treatment of the error

Under CP130, once an error has been identified it must be corrected without delay. The relevant FMC and depositary will also have to assess the materiality of the error as this will inform how the error is to be dealt with. A key proposal under CP130 is the proposed imposition of quantitative and qualitative criteria which must be taken into account when assessing materiality, with the Central Bank intending to issue further guidance on factors that are to be considered when assessing if an error is material. If an error does not meet the quantitative thresholds for materiality, it will still need to be assessed in the context of qualitative factors and may ultimately be deemed material.

Quantitative thresholds

In keeping with the approach adopted by regulators in other jurisdictions, the proposed quantitative thresholds will vary depending on the type of investment fund as follows:

Money market Funds	0.10% of NAV
Other investment funds	0.50% of NAV

Qualitative thresholds

The Central Bank has indicated that qualitative thresholds are likely to include:

(i) the circumstances which resulted in the error (e.g. inadequate controls); or

(ii) the duration of the error.

CP130 provides a non-exhaustive list of factors which include, for example, the assessment of the cumulative impact of an error rather than the impact at a particular valuation point and the circumstances in which the error took place (e.g. series of errors, a recurring error, or an error as a result of certain actions of the FMC). While these are circumstances that would have been taken into consideration by the Central Bank in the event of an error previously, the Framework proposed under CP130 will place them on a more formal footing.

Reporting to the CBI

The CBI acknowledges the merit in maintaining the current dual reporting obligations for both the FMC and the depositary. Under existing legislation, the CBI must be notified by the FMC of any breach of the Irish UCITS Regulations/AIFM Regulations or other relevant Irish legislation, regardless of the materiality of that breach. Under CP130, it is proposed that the CBI must be notified of material errors only.

The FMC will be obliged to (i) report errors to the depositary (thus relying on the depositary to meet the FMC's reporting obligations to the CBI in respect of individual funds), or (ii) report any material error which has not been reported by the depositary to the CBI. Notwithstanding this, both the FMC and the depositary will be required to maintain a written record of all errors that occur. This will be a

new requirement in respect of depositaries for AIFs as this obligation is already in place for depositaries of UCITS funds.

Notification to investors

The CBI is proposing to introduce an obligation on FMCs to notify investors of any error found to be material irrespective of whether redress is required or not. Under the current approach, the Central Bank typically only expects investors to be notified where compensation is being paid but this is a practice that has not been applied consistently.

Redress

As part of the redress considerations in CP130, the CBI is seeking, among other aspects, feedback on (i) whether De Minimis Limits should be applied in respect of payment of redress, (ii) the rationale for a differentiated De Minimis Limit for retail (€50) and institutional (€500) investors, and (iii) what might be an appropriate threshold(s) if De Minimis Limits are to be acceptable.

As part of CP130, the CBI has also set out a list of elements that are proposed to be included in the Framework where the FMC is ensuring payment of redress. These elements include:

(i) in the case of NAV Errors or Control Breach Errors deemed to be material, the payment of redress should be made in all circumstances;

(ii) 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 (regardless of materiality);

(iii) in the case of inadvertent Investment Breach Errors, the payment of redress will generally not be payable unless otherwise determined by the depositary; or

(iv) in the case of Fee Errors, the payment of redress must be made in all circumstances (with the amount of redress reflecting the amount of overpayment).

The CBI has also noted (i) that payment of redress because of an error is without prejudice to the rights of the affected fund and/or investors, and (ii) although errors may arise from the actions of delegates, it is still the responsibility of the FMC to ensure that errors are “Appropriately Rectified”.

Next Steps

The CBI have posed a number of key questions in respect of the Framework proposed under CP103 and requested that stakeholders provide their responses by 9 December, 2019. Responses may be emailed in word format to fundspolicy@centralbank.ie. The CBI’s intention is to publish all written contributions submitted, with a feedback statement to follow along with the finalised requirements of the Framework.

If you have any queries in respect of the issues raised in this article or you require assistance with preparing responses to the CBI as a result of CP130, please do not hesitate to contact us.

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