

Central Bank to Introduce Rules for Dealing with Fund Errors

What has been published by the Central Bank?

On 9 September 2019, the Central Bank of Ireland (**Central Bank**) published a consultation seeking feedback on a proposed set of rules covering the 'treatment, correction and redress of errors in investment funds'.

The consultation, which is open until 9 December 2019, poses a series of questions to industry on a proposed approach to the development of a regulatory framework in this area. Following this consultation, the Central Bank proposes a further consultation on the draft requirements and guidance which it will prepare, taking account of the outcome of the current process.

Industry, therefore, has an early opportunity to put forward its views ahead of the Central Bank commencing to draft the rules.

What is the impact of this publication by the Central Bank?

Currently, there is no formal Irish regulatory regime for the treatment of errors in investment funds. This consultation, therefore, represents the first step by the Central Bank in the establishment of a set of rules and requirements to govern how funds and their management companies should address fund errors.

The Irish industry body, Irish Funds, has a long-standing guidance paper (**Guidance Paper 6**), revised on several occasions, which addresses 'Investment Restriction Breaches, Pricing Errors, Compensation & Reporting'. In the absence of a regulatory regime, these guidelines are regularly deferred to by industry participants when addressing the matter of investment fund errors.

From an industry participant perspective, it is, therefore, welcome that the Central Bank's consultation paper acknowledges the existence of the industry guidelines and, in certain respects, proposes carrying over principles within the guidelines in its development of rules in this area. The consultation paper, however, covers a broader range of topics than those in Irish Funds' Guidance Paper 6 (see 'subject matter' below).

Analysis of Proposed Regulatory Rules

The following table considers the proposals from the Central Bank in its consultation paper and crucially, from an impact perspective, whether and how such proposals diverge from current practice under the industry guidelines.

	CENTRAL BANK PROPOSED RULE	CURRENT INDUSTRY GUIDELINE	DO PROPOSED CENTRAL BANK RULES DIVERGE FROM INDUSTRY GUIDANCE?
Scope	Scope is determined by reference to manager status and includes all UCITS managers, AIFMs, fund management companies (subject to local rules in respect of non-Irish funds under management) (FMCs) and depositaries.	Scope is determined by reference to fund type and includes all UCITS, AIFs and non-UCITS	Yes. The scope of the Central Bank's proposed rules is broader as it includes non-Irish funds managed by Irish FMCs (without prejudice to requirements and guidance in another relevant jurisdiction).
Subject Matter	NAV errors, investment errors, overpayment of fees and any other error not captured under one of these headings.	NAV errors and fund investment breach errors.	Yes. The subject matter of the Central Bank's proposed rules is broader as it covers the additional errors of overpayment of fees and any other errors (referred to as 'Control Breach Errors') not captured under one of these headings.
Materiality Threshold for Errors	<p><i>Quantitative Materiality Thresholds:</i> MMFs 0.10% of NAV Other investment funds 0.50% of NAV.</p> <p><i>Qualitative Materiality Factors:</i> Where an error is deemed not to meet or exceed the materiality threshold, the error may nevertheless be deemed to be material taking into account any relevant surrounding circumstances. Such qualitative factors are likely to include (i) the circumstances which resulted in the error (for example, inadequate controls) or (ii) the duration of the error.</p>	An error which has a NAV impact of 0.50% or greater.	Yes. The Central Bank's proposed rules for the calculation of the 'materiality threshold' for errors are more detailed as they provide for both a quantitative and qualitative measurement. The quantitative measurement also differs from current industry guidelines as it includes a lower measure for MMFs of 0.10% of NAV.
Compensation Requirement for Errors	In respect of material errors unless the error is a fee error, in which case a sum at least equal to the sum of the overpayment should be repaid to the fund and, where applicable, to investors.	In respect of material errors only.	Technically no divergence as industry guidelines do not cover fee errors. However, the Central Bank's definition of 'material' would lead to divergence from industry guidelines.

	CENTRAL BANK PROPOSED RULE	CURRENT INDUSTRY GUIDELINE	DO PROPOSED CENTRAL BANK RULES DIVERGE FROM INDUSTRY GUIDANCE?
Compensation Requirement for Inadvertent Investment Breach Error	In the case of an inadvertent investment breach error (either material and non-material), it would appear appropriate that redress should generally not be payable except where otherwise deemed appropriate by the depositary.	Compensation is not normally required in respect of an inadvertent investment breach error.	No material divergence.
Compensation Arrangements	The Central Bank proposes to introduce guidance and rules in relation to how redress arrangements should operate where errors occur. The guidance will include principles prescribing how such redress arrangements should generally operate.	Should a pricing error continue over a period of time, compensation will normally be required only on the dates where the pricing error is material. Appendix 2 outlines the various compensation arrangements that should be considered in the event of a material pricing error.	Potential divergence depending on the outcome of the Central Bank's consultation.
De-Minimus Levels (DML) for Compensation	The Central Bank considers that DMLs may have some merit to avoid a situation where an investor would receive a redress payment but due to the costs involved would not accrue any net benefit. However, the current industry DMLs (see column to the right) appear excessive, particularly for institutional investors. The Central Bank is therefore seeking feedback on (i) whether DMLs should be applied, (ii) the rationale for a differentiated approach for retail and institutional investors and (iii) what might be an appropriate threshold(s) if DMLs are to be applicable.	In circumstances where a material pricing error has occurred, it is permissible to apply a DML. For example, the DML may require the individual compensation amount payable per shareholder/unitholder to exceed a certain value, prior to becoming payable to the shareholder. It is industry standard to apply a DML per shareholder at €50 for retail investors and €500 for institutional investors, provided a material pricing error has occurred. It is recommended that approval from the FMC is obtained prior to the application of a DML.	Potential divergence depending on the outcome of the Central Bank's consultation.

	CENTRAL BANK PROPOSED RULE	CURRENT INDUSTRY GUIDELINE	DO PROPOSED CENTRAL BANK RULES DIVERGE FROM INDUSTRY GUIDANCE?
Pricing Errors & 'Best Available Information' Exemption	N/A	Where a NAV is dependent upon an estimate or exercise of judgement, if judgment is exercised in a manner that is consistent with the valuation policy and procedures of the fund and the FMC has taken the due care and skill that a diligent FMC would reasonably be expected to take in the circumstances, a subsequent difference upon receipt of additional information in the future would not be considered a NAV pricing error.	Yes. The Central Bank's proposed rules do not include this exemption and provide for the payment of redress for all material NAV errors.
Recording of Errors	The FMC and depositary will be required to maintain a written record of all errors that occur.	The FMC shall ensure all material pricing errors are recorded, and the administrator shall maintain a pricing error log to record all errors (material and non-material).	No material divergence proposed by Central Bank.
Regulatory Reporting of Material Errors to the Central Bank	Existing dual reporting obligations to be maintained. However, it is proposed to amend the obligations imposed on the FMC to consist of one of the following: <ul style="list-style-type: none"> • Imposing an obligation on a FMC to report errors to the depositary, which in turn would fulfil the regulatory reporting obligation as required; or • Imposing an obligation on a FMC to report any material errors which have not been reported by the depositary to the Central Bank. 	Dual regulatory reporting obligations of FMC and depositary noted.	Limited divergence proposed to the FMC's regulatory reporting obligation.
Regulatory Reporting of Non-Material Errors to the Central Bank	Taking account of experience and feedback from the functioning of the current reporting regime, the Central Bank proposes requiring reporting with respect to material errors only.	The FMC may agree with each depositary whether reporting of non-material pricing errors is required on an ad-hoc or periodic basis.	No divergence. Central Bank proposes aligning new rules with current industry guidelines.

	CENTRAL BANK PROPOSED RULE	CURRENT INDUSTRY GUIDELINE	DO PROPOSED CENTRAL BANK RULES DIVERGE FROM INDUSTRY GUIDANCE?
Responsibility for Rectifying Errors	The FMC is ultimately responsible for ensuring that the error is 'appropriately rectified' i.e. it ensures (i) identification and classification of the error (including assessing materiality), (ii) correction of the error (including compliance with any reporting and notification obligations) and (iii) redress of the error (including the payment of redress to the fund and / or investors).	It is the responsibility of the FMC to ensure that any errors are correctly, promptly and appropriately dealt with to the satisfaction of the Depositary	No divergence.
Depositary Oversight of Error Rectification	The depositary must ensure that the error has been appropriately rectified by the FMC.	The depositary shall use reasonable endeavours to ensure any loss to the fund/investors is made good by the party at fault and/the FMC.	Yes. The Central Bank's proposal includes the introduction of a new rule which would oblige depositaries to ensure rectification of the error.
Investor Notification of Errors	The Central Bank considers that there is merit in introducing an obligation on FMCs to notify investors of any error found to be material irrespective of whether redress is required or not. Feedback is sought in the Central Bank's consultation paper.	Where the investment breach error is rectified to the satisfaction of the depositary, the depositary is not required to make reference to the investment breach error in the annual depositary report to shareholders unless the depositary has sufficient reason to believe the FMC has not demonstrated adequate control over the compliance with investment restrictions.	Potential divergence depending on the outcome of the Central Bank's consultation.

Next steps

The Central Bank's consultation on the 'Treatment, Correction and Redress of Investment Fund Errors' is open until 9 December 2019. Once the consultation is closed, the Central Bank will publish all contributions submitted along with a feedback statement.

ESMA asks if funds should be excluded from market abuse regime

What has been published by ESMA?

On 3 October 2019, ESMA published a consultation seeking feedback on its review of the Market Abuse Regulation (MAR). MAR is the key piece of legislation in the package of measures which make up the EU market abuse regime. The regime targets increased transparency and market integrity through the detection, sanctioning and deterring of insider dealing, market manipulation and unlawful disclosure of inside information.

Why are funds impacted by ESMA's consultation?

Investment funds admitted to trading on a regulated market in the EU (or trading on trading venue) are within the scope of MAR. In March of this year, ESMA clarified that all such funds, irrespective of legal structure (i.e. corporate and those without legal personality) are 'issuers' and thus in-scope of MAR.

How might funds be impacted by ESMA's consultation?

Section 10 of the consultation "focusses on the different impacts derived from considering collective investment undertakings within the scope of MAR" and analyses "whether there is [a] genuine need for MAR to be amended to explicitly include or exclude these entities". Stakeholders are requested to provide feedback on whether they "consider that [investment funds] admitted to trading or trading on a trading venue should be differentiated with respect to other issuers." The consultation is therefore an opportunity for industry participants to feedback generally on whether MAR should or should not apply to investment funds. As discussed below, the consultation also addresses specific aspects of MAR and its application to in-scope funds.

Notification of transactions by persons discharging managerial responsibilities (PDMRs)

MAR contains requirements in respect of PDMRs of in-scope funds which include an obligation on the PDMRs to notify all (subject to applicable thresholds) personal transactions related to shares in the fund, to the fund and the competent authority. In its consultation, ESMA considers the appropriateness of this obligation and, as a preliminary view, suggests there are grounds for MAR to explicitly apply PDMR obligations to funds as well as their management companies. In assessing who should come within the definition of a PDMR, ESMA considers that externally managed corporate funds should have two categories of PDMRs; (i) members of the administrative, management or supervisory body of the fund, and (ii) 'relevant persons' from the management company (or from service providers acting for the fund in question). In respect of non-corporate funds, ESMA considers that such funds should be subject to the PDMR requirements under MAR and the consequential obligations should apply to the category (ii) PDMRs above.

Obligation to draw up insider lists

ESMA's preliminary view, as expressed in the consultation, is that the MAR obligation to draw up a list of all persons who have access to inside information should be applied to funds and asks for stakeholder feedback on this view. Notably, ESMA elected to outline its interpretation of this obligation as it has "detected that currently some issuers include in their insider lists persons who [] could have accessed that information even if they never did that in practice". According to ESMA, "insider lists should only include persons who effectively accessed a piece of inside information, and not those who could have done that." ESMA notes the option under the Market Abuse regime to have a 'permanent insider section' of the insider list which includes those who "have access at all times to all inside information". ESMA, however, notes that this is supplemental to the insider list, which should be an event-based list including those who actually accessed the inside information. ESMA seeks feedback on the application of this interpretation of the insider list obligation. Feedback is also sought on a proposed amendment to this obligation which would allow funds to include one contact person per external provider with each such provider including in their own insiders list the persons accessing that piece of insider information.

Next steps

The consultation is open until 29 November 2019. ESMA will use the feedback it receives to provide a report for the Commission in Q1 2020, which will be used in the preparation of any legislation deemed appropriate.

CP86/Fund Management Company Effectiveness thematic review

On 7 October 2019, during a speech delivered at an Asset/Wealth Management INED event, the Central Bank's Director of Asset Management and Investment Banking provided managers of Irish funds with updates on several "hot topics - from a regulatory perspective".

CP 86/ Fund Management Company Effectiveness thematic review

In August 2019, the Central Bank issued a questionnaire to fund management companies on the implementation of the Fund Management Companies Guidance. This represented the "first phase of the review" of over "300 in scope firms". The Central Bank has now completed its analysis of the responses received and "progressed to the desk-based review phase". It is expected that "a series of onsite inspections will commence in November 2019 which will continue into Q1 2020." While the Central Bank expects to complete "this body of work" in the first half of next year, "the thematic review still has a distance to travel" and "further consultations in terms of the domestic regulatory framework", "the issuance of an industry letter outlining good or poor practices identified" and "firm specific Risk Mitigation Programmes should we identify critical risks that require mitigation action" may all still issue as part of this thematic review.

In addressing motivating factors for the review, the Director highlighted the necessity "to show that any delegation, including the delegation to an investment manager, can be carried out in such a way that the management company is able to robustly oversee the activities of the delegate and challenge if any deviation from the requirements emerge. If a funds domicile cannot do that, then it will not be successful in convincing European peers that the funds can operate effectively, to a high standard, on a cross-border basis."

Regulatory follow-up to recent thematic work

In addition to the above, several other key items of interest to fund management companies and their boards were addressed, including:

1. *Cybersecurity risk*: the Central Bank recently completed a thematic inspection of four firms, with varying business models, on cybersecurity risk which has resulted in the issuance of risk mitigation programmes to each firm. An industry letter will be issuing "in due course", the contents of which will require to be considered by all in the context of their "own cybersecurity risk management practices to establish whether any of the findings identified also exist within their firm and, where necessary, take steps to remediate any issues or weaknesses."
2. *Compliance, risk and internal audit services*: earlier this year, the Central Bank carried out a thematic review to evaluate the approaches in use regarding compliance, risk and internal audit services, which form part of two of the three lines of defence. According to the Director, "one of the key findings from this body of work is that boards and senior management are not spending enough time reviewing the control frameworks in place." Again, "an industry letter will be issued in coming months and similar to the cyber security letter, [the Central Bank] would encourage all firms to consider what actions need to be taken, if any, in light of the issues raised therein."
3. *Liquidity management*: the importance placed by the Central Bank on the matters raised in its recent letter to external fund management companies and internally managed funds on liquidity management were emphasised.
4. *Outsourcing*: while not directly in-scope, the relevance for fund management companies of the principles of the EBA's guidelines on outsourcing which came into effect last week was highlighted, "In particular, the guidelines clarify that the management body of each institution remains responsible for that institution and its activities at all times."